Chapter-9  SUGGESTIONS

We have created a slavery-free world, a small pox-free world, an apartheid-free world. Creating a poverty-free world would be greater than all these accomplishments. This would be a world that we could all be proud to live in.

Mohammad Yunus: Founder of Grameen Bank.

9.1 Observations:

Despite the remarkable impacts of Micro finance and its contribution to the economy of some developing countries, the dominant mono-product culture of short term loans backed by compulsory savings mean that Micro Finance is not contributing as much as it might. In addition to a clear need for product diversification (but not proliferation) to offer Micro Finance Clients a wider range of services, there is a clear need for Microfinance Institutions to look carefully at how to optimize their delivery and communication systems. Microfinance continues to struggle to maximize the cost effectiveness and client responsiveness of delivery systems and this will be one of the industry’s key challenges for the next decade. In addition, Microfinance Institutions continually struggle to communicate effectively with their clients and markets thus losing opportunities to retain and serve existing clients as well as attract new ones. Selling products and, in increasingly competitive environments, branding is also essential both for the sustainability of Microfinance Institutions, as well as empowering poor people to access the financial services of their choice.
But the diverse range of core functions affected by a market led approach present a significant problem for Microfinance Institutions and indeed corporation operating in almost every industry worldwide. A market led approach, by definition, affects almost every aspect of the business, and thus the Marketing Director needs to be a master of networking, alliance building and collaborative working within the organisation.

- Microfinance is useful to combat against poverty.
- Access to financial services is crucial in reducing the Poor’s vulnerability versus income and expenditure shack.
- In order to succeed, the focus must be one of building sustainable Microfinance institutions and not of running a project.
- Permanency, scale and long term commitment are key characteristics of successful Microfinance.
- Financial sustainability for the Microfinance Institutes must be a goal.
- Retail capacity is today the single most important constraint when it comes to increased outreach this does not mean that there is a need for more institutions but rather that the institutions should either be professionalized to be able to scale up their activities of leave the Microfinance field.
- Microfinance requires specialization, unprofessional projects risk destroying the markets for the professional ones and thereby threatening the chances of a long term access to financial services for the poor.
- Because of risk and cost involved, the poorest clients can not always be reached with Microfinance, but can and should be reached by providing safe saving services.
Establishing strategic alliances between Microfinance Institutes and other organisations provide additional services, such as education and information, has a great potential.

The major constraints identified in the research that seem to be facing microfinance in India are greater and more diverse sources of funding, a meaningful set of poverty impact indicators in order to make meaningful statements about social impact, and lack of an enabling policy environment for microfinance. In terms of an enabling policy environment, the main thing that Microfinance Institutions can do is to work together with regulators to ensure that there is an understanding about the needs and challenges of Microfinance Institutions.

Microfinance Institutions in India, including those mentioned in this study, have formed an association and self regulatory body, Sa-Dhan, which provides a platform for communicating ideas jointly to the Reserve Bank of India and other authorities. The more that the government and central bank understand the nature of the business and what constrains growth, the better they will be able to strike the balance between enabling growth and protecting the poor. This might be done by setting a minimum standard of regulation for Microfinance Institutions but refraining from restrictive and inflexible regulation such as interest rate caps or prohibitive restrictions on foreign investment. Positive regulation such as liquidity requirements and capital requirements can sometimes ensure that Microfinance Institutions are not taking on risk so as to jeopardize continuing operations. Some minimum regulation creates a sense of
accountability for Microfinance Institutions, placing them on a common platform and creating incentive to better manage risk. This can make a big difference to the quality of the services offered the poor and thus, the potential microfinance as a field has for really improving the lives of the poor.

To address the issue of need for a differential regulatory framework, there is need to answers to the following questions and concerns facing MFIs in the Country:

(i) Is non-existence of a separate differential regulatory framework a critical bottleneck hindering the growth of the sector?

(ii) Will MFIs be sustainable in medium term? If so, will they continue to focus on the poor?

(iii) Is access to public / member deposit the key issue for their sustainability?

(iv) Can MFIs finance loans for income generation at interest rates, which are sustainable by the rural poor?

(v) Is it possible to evolve commonly agreed standards for MFI sector covering performance, accounting and governance issues, which can open up possibilities of self-regulation?

(vi) Has the sector reached a critical mass where regulation becomes important?
It is observed that while a few of the MFIs have reached significant scales of outreach, the MFI sector as a whole is still in evolving phase as is reflected in wide debates ranging around (i) desirability of NGOs taking up financial intermediation, (ii) unproven financial and organizational sustainability of the model, (iii) high transaction costs leading to higher rates of interest being charged to the poor clients, (iv) absence of commonly agreed performance, accounting and governance standards, (v) heavy expectations of low cost funds, including equity and the start up costs, etc.

The current debate on development of a regulatory system for the MFIs focuses on three stages. Stage one: - to make the MFIs appreciate the need for certain common performance standards, stage two: - making it mandatory for the MFIs to get registered with identified or designated institutions and stage three: - to encourage development of network of MFIs which could function as quasi Self-Regulatory Organizations (SROs) at a later date or identifying a suitable organization to handle the regulatory arrangements. The Committee recommended that while the MFIs may continue to work as wholesalers of micro credit by entering into tie-ups with banks and apex development institutions, more experimentation have to be done to satisfy about the sustainability of the MFI model. Such experimentation needs to be encouraged in areas where banks are still not meeting adequate credit demand of the rural poor.

NABARD's support is being provided to various forms of microfinance institutions covering MFIs, second tier mF lending institutions, Grameen bank replicators, NGO-MFIs, SHG Federations etc. NABARD provides loan funds in the form of Revolving Fund Assistance (RFA) to NGO-MFIs on a
very selective basis. The RFA is generally provided for a period of 5 to 6 years and is necessarily to be used for on lending to MF clients (SHGs or individuals). In addition, the agencies are also sanctioned, on a case-to-case basis, *grant* assistance for partly meeting the salary of field level staff, infrastructure development and operational deficits during the initial years.

NABARD also provides technical support in the form of capacity building of staff of MFIs and also bankers in appraisal of MFIs for providing wholesale resource support. Since 2002, training programmes on "Appraisal of MFIs" are being conducted through Bankers Institute of Rural Development (BIRD), Lucknow. These training programmes are intended to equip the stakeholders to appreciate the nuances in financing NGO-MFIs and also enhance the flow of loanable funds from mainstream financial Institutions like banks. Specially designed capacity building programmes are also being organized for Chief Executives & other staff of NGOs on promotion as well as managing of self help groups on a regular basis through our regional offices, in association with reputed resource NGOs & training establishments.

Realizing the importance of MFIs in the delivery of financial services to the poor and their potential for expansion of services in remote and lesser-banked areas, NABARD has been extending technical and fund support to this sector. Some of the concerns that necessitated NABARD to commence were;

1) The need to provide timely credit to the poor in under-banked regions and

ii) To further improve the outreach of rural credit delivery system through alternate credit delivery mechanisms.
9.2 Policy Suggestions

For better mechanism following policy suggestions are made.

(A) Market-Based Interest Rates

Market-Based Interest Rates will induce Flows of Funds to Poor Areas With large numbers of clients spread over extensive areas, small loan sizes, and high transaction costs and risks, rural financial institutions can survive only with an adequate interest spread. Liberalization of interest rates on loans is one prerequisite for the sustainability of rural financial institutions and for the flow of funds to rural areas. My survey shows that when rural households have to choose between high interest rates and accessibility of loans, they prefer the latter. However, liberalizing interest rates for loans may be used by RCCs to transfer their low efficiency to farmers given their monopoly status in the current rural financial market. In addition, liberalizing interest rates for deposits may also cause fierce competition among financial institutions if those with high risks increase their rates to hide operational losses. Nevertheless, liberalizing interest rates is the only way to go in the future, and it has to be done in parallel with opening markets. Without adequate interest rates, suppliers will not enter the market. Only when interest rates are sufficient to cover costs and risks, competition among market players may be able to drive the rates down. Bolivia is a good example. When interest rates were first liberalized, the rates climbed rapidly but were then were pushed down to a reasonable level by microfinance market competition. This is called the competitive equilibrium of interest rates, but it cannot be achieved in the PRC where there are many counties with one RCC as the only financial institution.
(B) Introduce New Types of Financial Institutions and Explore New Forms of Financial Organizations

Preconditions for successful RCC reform include opening rural financial markets, introducing various types of financial institutions, and establishing a competitive environment. In addition to formal financial institutions, regulated and commercially oriented microfinance institutions (engaging in lending only and initially prohibited from taking deposits), village-based cooperative associations, privately owned banks, and informal finance providers should all be considered. Options for organizing RCCs should not be restricted to the types stipulated in Documents. The keys to their success are their fitness in local markets and ability to create financial innovations.

In rural areas in Gujarat with difficult transportation conditions, the management costs of the provincial RCCU, the supervisory costs of the Bank Supervision Bureau, and the operational costs of the county RCCU are high. Community-based financial institutions with good governance structures will help serve the local economy. Therefore, each area should be allowed to develop new forms of financial institutions and let the markets decide the winners. In the near term, several potential directions in promoting competition in rural financial markets include RCC reform, pilot tests of regulated microfinance and cooperative finance in real sense, and legalization of informal finance. In the early stages, provincial pilot programs for regulated microfinance agencies that do not accept deposits can be considered. These institutions can initially use their own funds and those donated by international organizations. At a later stage, funds from wholesale institutions (e.g., postal savings) can be a major revenue source.
These institutions can avoid possible moral hazard problems from taking public deposits without prudential financial supervision. This is different from institutions accepting deposits that are backed by implicit state guarantees against loan losses which can lead to moral hazard problems. The development of regulated microfinance institutions can not only introduce competition in the rural financial market, it can also play an important role in legalizing informal finance.

(C) Implement Market-Based Rural Credit Cooperative Pilot Programs
Based on the theory of financial hierarchy, different financial institutions have their advantages and disadvantages, and the market should select the survivors. In the PRC, cooperative finance is not cooperative finance in a real sense as it has to address policy issues. In fact, neither cooperative nor commercial finance can be sustained with government intervention. The government should not preempt any form of financial institution; the market and investors should have the final say. To achieve this, policymakers should answer the following questions. Is it possible to allow some RCCs to stay out of a county RCCU? Is it possible to allow two RCCUs in one county? Is it possible to allow some county RCCUs to stay out of a provincial RCCU? Establishing cross-regional RCCs should be allowed. Interventions in RCC operations mostly come from local governments, especially county and town governments. Establishing cross-regional RCCs would avoid the current overlapping of administrative and business regions. That is, one RCC could cover several towns, and if needed, an RCCU could cover a number of counties. The number of towns and counties covered by each local RCC or RCCU may not be large, but should not be fewer than
three. Using the game theory, it is highly possible for two county and town governments to collaborate in rent-seeking from RCCs, but the possibilities for collaboration are much lower if three or more than three towns and counties are involved. This is in line with the PBC strategy of establishing cross-province regional centers to prevent local government interference. Profitable RCCs should be allowed to choose to join an RCCU or to stay outside at their own discretion. Under the present pilot program, RCCs have no choice but to join the RCCU system which will prevent any external competition. This has essentially led to monopolies, the natural enemy of innovation. If profitable RCCs are allowed to join RCCUs or to stay outside, a competitive environment will be created. This will also resolve the problem of exit mechanisms and subject RCCs to market discipline.

(D) Create an Enabling Environment for the Sustainable Development of Rural Credit Cooperatives:

Most areas in Gujarat are inhabited by minorities and are underdeveloped. Although reforms and policies of the central government that support them have helped to innovate systems, transform mechanisms, and enhance support for agriculture, RCCs in the province still face a set of particular difficulties due to weak agriculture infrastructure, a large poverty-stricken population, and a high incidence of poverty. These difficulties include heavy historical burdens and the lack of an exit mechanism.

However, the provincial government cannot solve the fundamental problems faced by RCCs. It is worth noting that RCCs in the western region differ from their eastern counterparts in business size, NPL size, operating environment, and sustainability. Although the policy on the pilot programs is
set according to the level of local economic development and to the geographical and social environment, the actual result of implementation shows that those RCCs in the western region in need of support have not benefited much. In addition, except for those not-so-significant preferential taxation treatments and “policy fund selections”, other support policies are uniform. In the long run, the resolution of issues of RCCs in Gujarat depends on the development of the local economy and the deepening of reform efforts, especially transforming operating mechanisms and improving RCC institutional capacity. Nevertheless, in the short term, it is necessary for the central government to introduce further supporting policies and measures. These can include, among others, prolonging the exemption period for corporate income tax in the western region, removing business taxes, and establishing an RCC development fund in the western region to build an electronic network, purchase an armored car, and train employees. Other elements of an enabling environment include the development of agriculture insurance and futures market for agricultural products, promotion of financial innovation of rural financial institutions, and provision of substitutes for collateral and guarantee for rural households and SMEs.

(E) **Role of the Government:**

The central government should increase inputs into infrastructure in poverty-stricken areas including transportation, communication, water conservation, education, and health care. A social security system in rural areas should also be created to enable RCCs to conduct commercial operations. Presently, many RCC loans have been used for public aid and as public finance funds. A healthy public finance system in rural areas is the basis for a sound rural
financial system and a prerequisite for preventing local government intervention in the operations of rural financial institutions. The provincial government should regulate the behavior of local governments. Regulations are also needed to punish debt evasion and to establish standards for creditworthiness for households, villages, and townships in order to create an enabling credit environment. Only with a good credit environment can more external funds be attracted. In addition, the government should change the use of poverty alleviation funds for interest-subsidized loans to a risk-sharing fund to mitigate some financial risks of RCCs or to distribute subsidies directly to households. This will leverage fiscal funds and strengthen awareness of finance and risks in rural households. Many rural households regard interest subsidized poverty loans as aid that does not need to be repaid. This has distorted market order. Financial awareness can only be strengthened when the poverty alleviation loan is renamed, when there are no preferential interest rates, and when risk premiums are decided by creditworthiness. Meanwhile, rural households will acquire risk awareness when families with high credit rating can borrow at low interest rates while families with poor ratings will have to pay more and will have little bargaining power. This does not mean that subsidies will be completely abolished; instead, direct fiscal subsidies can be provided to destitute rural households. The only difference is that support is provided by the government through fiscal aids rather than by financial institutions through loans. The establishment of a risk-sharing fund can also help to maintain order in financial markets. With such a fund, loans from financial institutions can carry only market-based interest rates. This will prevent potentially destructive competition among financial institutions that use
interest-subsidized funds to invest in commercial projects thus creating an unequal playing field. Some ABC branches in certain areas have used poverty alleviation loans\textsuperscript{16} to compete with other commercial banks on small hydropower and express road projects, thus distorting the markets. In the future, interest subsidized loans should be stopped, and loans should carry only normal interest rates aligned with risk and creditworthiness. The government will provide direct support to destitute households. These measures will effectively keep the financial markets in order. Moreover, preferential tax treatment can also reduce operation cost of financial institutions, and encourage them to set up more outlets in poor areas.

(F) Promulgate a Community Re-Investment Law and Establish a Mechanism to Reduce the Outflow of Postal Savings:

Rural areas suffer from large outflows of funds. Many state-owned financial institutions take deposits but make few loans in these areas, and postal savings has extracted large amounts of funds from rural areas by re-depositing them in PBC. Such outflows over a long period of time will inevitably hamper the growth of the rural economy. The PRC should learn from international experience to promulgate laws and regulations on community reinvestment. The community re-investment law in the United States requires financial institutions to meet credit demands of their communities if operations are based on sound and prudential criteria, though no compulsory ratio is specified. In comparison, Thailand requires all financial institutions to lend 20\% of all deposits to the agricultural sector. More research is warranted on which model the PRC community re-investment law should adopt, and more time is needed to formulate
regulations or directives. Nevertheless, pumping postal savings back into rural areas and increasing rural financial inputs through ADBC can be implemented in the near future. In the PRC, one third of postal savings comes from rural areas, one third from counties and towns, and the remainder from cities. Without opening rural financial markets, keeping postal savings where they originate will only strengthen the monopoly status of RCCs and will present a significant moral dilemma. In addition, in the absence of a deposit insurance system, the inflow of postal savings to rural areas through RCCs still presents an asymmetric risk, i.e., the borrower is the provincial RCCU but the actual user is the county RCCU. Therefore, liberalization of rural financial markets has to be integrated into the determination of a potential market-based mechanism to induce additional postal savings back to rural areas. Also, the internal control mechanism of ADBC should be improved, and its operational transparency should be enhanced. With this, the operational scope of ADBC can be expanded according to its capability.

(G) Separate Regulation from Management and Implement Minimum Regulatory Requirements:
The current financial supervision system in the PRC is an integral part of the traditional government administration system; administrative intervention or micro-management is the main means of supervision. Financial supervisors lift market entry criteria for financial institutions especially for private financial institutions through administrative approvals. They direct the lending of financial institutions under the name of supervision. They set the goal of supervision as reducing NPLs, not as safeguarding the soundness of
the financial system. To encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations. The requirement is that each insured depository institution’s record in helping meet the credit needs of its entire community be evaluated periodically. That record is taken into account in considering an institution’s application for deposit facilities, including mergers and acquisitions. Most depository institutions have at least one officer responsible for implementing and meeting the regulatory requirements. PBC reduced the interest rate for new redeposit from postal savings to the level of interest rate of reserves of financial institutions and allowed postal savings to use the new deposits at their discretion. Prior to the date, the interest rate for re-deposits from postal savings was 4.13%. They apply uniform supervisory standards for all financial institutions. These practices, combined with limited supervisory capacity, have limited the diversification of financial institutions. Therefore, the success of RCC pilot programs also depends on the reform of supervision. First, a firewall between supervision and micromanagement should be built. Such a firewall can prevent moral hazards in RCC operations as well as excessive supervision. Second, minimum regulatory requirements should be implemented. A rigid supervisory legal framework may suffocate financial innovations; this is particularly true in transitional economies. The main objective of supervisory authorities is to prevent financial risks while avoiding rigidity in supervision. Minimum regulatory requirements can ensure basic financial safety while leaving room for financial innovation.
(H) Enhancing Regulatory Mechanisms and Establishing a Deposit Insurance System:

Supervision of RCCs is relatively difficult because RCCs are normally in scattered geographical locations, which make collecting information more expensive. To ensure efficient supervision, it is imperative to strengthen the governance structures of rural financial institutions and to improve their operational transparency. An efficient supervisory mechanism should be a positive incentive mechanism at the heart of which is prompt corrective actions. Under such a system, the supervisor should take actions such as restricting the business scope and dividend distribution of a financial institution whose capital adequacy ratio, leverage ratio, and/or other performance indicators are beyond certain initial thresholds. These actions may prevent managers from taking more operational risks or other actions that endanger the interests of the shareholders. If performance indicators reach the second threshold, the regulator may request acquisition or merger of the financial institution to maximize its value and protect the interest of shareholders. If performance keeps on deteriorating, the regulator should take actions to close the institution when its assets are still at least equivalent to its liabilities. In the PRC, it is also necessary to establish a timely and effective exit mechanism under which small and medium-sized depositors can be properly protected and compensated in case of failure. Therefore, a deposit insurance system should be established as soon as possible. While opening rural financial markets, the regulator should take corrective measures to strengthen regulation in accordance with the development of rural financial institutions. Meanwhile, a deposit insurance system should be established to ensure the effective operation of the rural financial markets.
(I) Establish an Evaluation System for Rural Credit Cooperative Pilot Programs:
The results of any reforms will vary in different regions and external environments; this is particularly true of financial sector reform. An evaluation system can be used to alleviate risks in reform, to summarize experience, and to improve reforms in the future. The evaluation system for RCC reform should cover, among others, the following three aspects: (i) the post-reform sustainability of RCCs; (ii) the compatibility between the post-reform rural financial system and the local economy; and (iii) the post-reform capacity for financial innovation. Only with such an evaluation system will PBC notes with futures options be valuable.

9.3 Future of Microfinance:
Access to large-scale international assistance has helped a large number of microfinance NGOs to grow. Sustainability of most of these NGOs will be at stake due to decline in international aid, intense competition for resources, lack of professionalism and requisite competence. The coming years will look more to the quality of services and products the MFIs provide to the borrowers, or they will be out of service. It is likely that there will be merger of smaller microfinance NGOs with the bigger ones as it is happening in the case of many banks and financial institutions in different parts of the world.

Not only mandatory deposits or time deposits, but many other kinds of savings services including insurance will be developed. The package of financial services will have to be bigger than what is in place. For example,
the microfinance institutions may develop social sector loans such as loan for education of children. The microfinance sector will also develop loan products and technical services for small and medium scale entrepreneurs. Such support can foster job creation for the poor in the rural sector.

MFIs will have to develop much more professionalism. They should be for-profit commercial organisations. Some of the NGOs will be coverted to such type of organisations and provide wider variety of financial services on commercial principles.

Consultancy services are part of the modern concept of business management, development of new commercial products and streamlining the financial services. Bangladesh has practically no capacity now to provide consultancy services. With experiences and competence gained, Bangladesh can produce a large number of experts to offer technical assistance to other countries.

The microfinance NGOs are now a turning point. One of the critical challenges facing the NGOs is meeting the growing demand of capital fund vis-a-vis the declining trend of international aid. The existence of many microfinance NGOs will be at stake unless they can generate adequate resources internally. One encouraging feature however, is that the NGOs are now active in finding out alternative sources of fund. Some of the big actors have diversified savings products, introduced cost-sharing devices for services and other strategies. This is a good sign, but not enough to deal with the complexities involved.
Microfinance has largely been used as a tool for alleviating poverty. The programmes have shown that targets for poverty alleviation are both achievable and attainable. The task however, is still unfinished. Microfinance will thus have to play a bigger role in Bangladesh.

Larger coverage of the ultra poor in the microfinance net is essential, but difficult. The lesson learnt is that the ultra poor can not be attracted to credit unless an appropriate development package is designed and introduced. BRAC’s IGVGD Programme which has covered more than one million ultra poor women provides an illustration.

Small farmers can be among the potential users of microfinance. They have been identified as “tomorrow’s poor”. The small farmers are quite large in number and a very productive force in our agriculture. Microfinance linked with modern technology can improve their productivity as well as economic solvency.

There is yet another group who needs particular attention of the microfinance operators. They are the ‘poverty graduates’, who are members of NGO microfinance programmes and have crossed the poverty line. They are capable to handle larger enterprises. For this, they need larger amount of loans. BRAC has introduced a special programme, viz., Micro Enterprise Lending and Assistance (MELA), to meet specific needs of this emerging group.
Wider adoption of technology should be a major focus of future microfinance operators. Modern production technology and enterprise development can increase productivity and ensure better returns out of the credit investment. Technology development is costly, but it will ensure sustainability of microfinance programmes.

The incidence of membership overlaps and intense competition for resources among the NGOs are creating unhealthy atmosphere. It is also affecting the credit disciplines. NGOs have to consider this issue more seriously. The NGO should be more alert towards transparency in operations and governance.

Continuing search for customer-friendly products, innovations, and cost-effective operational strategies must be ongoing for greater impact and sustainability of microfinance programmes.