CHAPTER-1
INTRODUCTION

1.1 History of Micro-finance – Global Context

The concept of micro-finance is not new. It is an old wine in a new bottle. It is a successful model which is prepared gradually over a period of time. It is an outcome of a trial and error approach adopted and nurtured hundreds years ago. Formal credit and savings institutions for the poor who were traditionally neglected by commercial banks have around for decades. Savings and credit groups that operated for centuries include “Susus” of Ghana, “Chit-funds” in India, “Tnadas” in Mexico, “Arisan” in Indonesia, “Cheetu” in Sri Lanka, “Tontines” in West Africa and “Pasanku” in Bolivia.

To analyze and understand macro-effects of today’s commercialized micro-finance business, it becomes important to analyze its origin. Microfinance is a journey. It is a success story of hundreds of years. It is believed that micro finance originated in Bangladesh some forty years ago. However, it has its roots way back in 1800s. One of the earlier and longer lived micro-credit organizations providing small loans to rural poor with no collateral was the Irish Loan Fund System, initiated in the early 1700s by the author and journalist Jonathan Swift. Swift’s idea began slowly but by the 1840s had become a widespread institution of about 300 funds all over the world.

An economical historian at Yale named Timothy Guinnane has been doing some research on Fedrick Wilhelm Raiffeisen’s village bank movement in Germany which started in 1864 and by the year 1901 the bank reached 2 million rural farmers (Seibel H. 2003). The concept of credit union was developed by Fedrick Wilhelm Raiffeisen and his supporters. The basic aim of this union was to reduce the dependence of rural population on moneylenders. This resulted into a widespread co operative movement expanding its reach in Europe, North America and eventually in developed countries. However, this movement was successful in rural areas of Germany; the urban area was headed by Schule-Delizsch who established urban savings and credit cooperatives, now called volksbanken (peoples’ banks).

In Indonesia, the Indonesian people’s Credit Banks (BPR) or the Bank Perkreditan Rakyat opened in 1895. The BPR became the largest microfinance system in Indonesia with close to 9,000 units (Tim H. 2008).

In Latin America, several rural finance institutions were established with the objective of mobilizing financial resources and reducing the burden of local money lenders and land lords.
However, they didn’t succeed in their mission and closed down. Most of these institutions were owned by government agencies and private banks.

In 1974, Professor Muhammad Yunus visited the poverty struck village of Jobra, Bangladesh and lent twenty seven dollars to forty two basket weavers. With the sponsorship of Central Bank of the country and support of nationalized commercial banks, the project was extended to Tangil District (a district of Dhaka) in 1997. In October 1983, the Grameen project was transformed into an independent bank by government legislation. In Bangladesh today, Grameen has 1084 branches, with 12,500 staff serving 2.1 million borrowers in 37,000 villages (Grameen Bank 2011).

The Grameen Bank and Professor Muhammad Yunus were awarded the Nobel Prize in 2006 for this successful model of providing finance to poor people.

1.2 History of Microfinance: Indian Context

If microfinance be defined generically as small transactions (loans or savings), then, it dates back to more than thousand years and spread through trading relations over the wider region. However, if used in the more contemporary sense, like has been used since the mid ‘70s, then it is about twenty years old in India.

1.2.1 Evolution of Microfinance (Traditional Approach)

The origins of indigenous microfinance in India predate those reported above in Ireland and Germany, covering three major types of financial sources: money lenders, chit funds or rotating savings and credit associations (ROSCAs), and merchant bankers. Moneylenders are oldest of the three strands, with a variegated and checkered history.

Indian Society: Earliest Times to 800 A.D. (Moneylenders & Gahapati)

The Indian society had different class of people who were used to deal with lands and working as landlord. They used to get cultivate their land by peasants or slaves. They were major source of finance to rural ordinary people. However, this class had not been the same throughout the history but had different names, structures and system of work with a definite time period.

Money lenders constitute major source of informal credit in rural India and oldest form of financial services. Moneylenders provide small loans from their own resources to the village people. Money lending is referred to as an “art” in the Vedic era during the period 2000-1400 B.C. In the Rig Veda, there is a reference to ‘rina’ and in the Satapatha Brahmana, a usurer is referred to as Kusidan.
The archaeological and literary sources provide evidences of emergence of a distinct group called Gahapati (big individual landlords) who got their land cultivated by slaves (Dasa), hired labourers (Karmakara) and Shudras during 6th and 4th Century B.C. The use of dependent labour was indicative of the emergence of a deprived class whose labour was being used to produce surplus food (Basant et al., 2003). The product of land would not go to Sudra or Dasa but to the master i.e. Gahapati. The society during this time was also having a distinct group called ‘Setthi’ meaning a ‘person having the best’. It shows that people who dealt with money matters had acquired considerable prestige and power. It was from the class of rich landowners that section of rich traders evolved. Their profession as bankers flourished with the invention of coined money (Basant et al., 2003). During this time period, the society was characterized by the lowest caste known as Shudras as mentioned earlier. The Pali literature frequently mentions dasas (slaves) and Karmakara (wage labourers). The term Dalidda is used for denoting extremely poor people who did not have anything to eat and no covering for their back.

The references to kings in the sixth century B.C on the other hand indicate his rule over a territory with a regular taxation system and army. There are references to Krasaka i.e. peasants who paid taxes to the king. The distinction was made between Raja and Praja. An official called Bhagadugha collected bhaga i.e. share of the agricultural produce. Survey of agricultural land was done by an official called Rajjugahaka.

In the Mahajanapadas the basic unit of settlement was the Gama (which in Prakrit and Pali languages is the equivalent of Sanskrit Grama) meaning a village. There are references to land ownership and tenancy rights of varied kinds. Kassaka and ksetrika denoted the common peasants who were generally of the Sudra Jati.

The Indian society during Maurayan period (during the second half of the first millennium B.C) also experienced the existence of gahapatis and grambhojakas. These groups are said to have employed hired labourers on land indicating their capacity do so as a land owning gentry. Megasthenes in his account of the Indian society and its division into seven classes mentions the farmers as second class, next only to the philosophers, who are mentioned as the first class and followed by the soldiers who are mentioned as the third class (Sen et al, 2003). The sources of Gupta period (during 4th to 6th Century A.D) also suggest the existence of a class of people who enjoyed superior rights over land and by belonging to higher varnas had high income and social status. These people were differently known as Gramikas, Kutumbis and Mahattaras (Chattopadhyaya et al., 2003). Moreover, merchants were important
communities during this period. Nagarasresthi and Sarthavaha (who were representatives of merchants) were associated with the administration of the district in north Bengal. The ordinary cultivators, known by various terms such as Krishibala, Karshaka or Kinsas who had low economic and social status. These cultivators were found to be exploited by the masters. However, domestic female slaves were also exploited, and a text like the Kamasutra, which was probably written in Gupta period, tells us how much hardship they had to go through at the hands of their masters (Chattopadhyaya et al., 2003).

Indian Society: From 8th to Mid-18th Century (Samantas, Sarafs & Baniya)

The early medieval period in Indian history marks the growth of cultivation and organization of land restrictions through land grants (Brahmadeya). These grants began around the beginning of Christian era and covered practically the entire sub-continent by the end of twelfth century (Champak L. and Jain V. K. 2003). Grants of cultivable land to Brahmans and registration of gifts of land on copper plates are recommended by all the Smritis and Puranas of the post-Gupta centuries. The Indian Feudalistic society was characterized by existence of forced labour. There are more than hundred references to forced labour in the Chola inscriptions. There was a practice of giving land along with human resources like peasants, craftsmen and artisans (Champak L. and Jain V. K. 2003). The peasantry was under heavy burden of taxation and indebtedness. It was because of economic coercion and exploitation of peasants, the concept of brahmahatya (killing of Brahmana) emerged during this period of time.

During eighth century, the role of merchants in the society was considerably eroded which again came back into prominence during tenth century. Money-lending became the major activities of merchants during this time. There emerged a separate group of merchants, called nikshepa-vanika in western India, who specialized in banking or money-lending. The Lekhapaddhati, a text from Gujarat, refers to a merchant’s son who claimed his share in the ancestral property to start the business of money-lending. Medhatithi, a legal commentator, speaks of the association or corporation of moneylenders.

During the twelfth century a new hierarchical system of samantas emerged in northern and eastern India. A text on the twelfth century classifies various vassals in the descending order on the basis of the number of villages owned by them: Mahamadaleshvara (1,00,000 villages), madalika (50,000 villages), mahasamanta (20,000 villages), samanta, laghusamanta and caturamshika (10,000; 5,000 and 1000 villages respectively) (Kumar M. and Shrimali K.M. 2003). The major functions of samantas included regular payment of
tributes, compliance with imperial orders and administering justice, military obligations etc. However, there is little evidence on the relationship of samantas and peasants or cultivators. The Ghorian invasion during 1192-1206 resulted into the formation of Delhi Sultanate in India. It had not only changed the political structure but also brought economic changes in Indian society. Delhi sultanate was characterized by various types of merchants like karwanis or nayaks and Multanis (Moosvi S. 2003). Out of these communities Multanis and Sahas were engaged in usury and commerce (sud or sauda). These merchants were in a position to give loans to nobles. Another class of Delhi Sultanate was that of dallals (brokers). They worked as a link between buyer and the seller and took commission from both the parties. However, Sarafs were, yet, a distinct group of mercantile which was involved in issue of bills of exchange (hundi) or letter of credit, thereby acting as bankers.

India from 16th to the beginning of 18th Century was under rule of Mughals. During Mughals’ rule the Vaisyas and other caste also got involved in commercial activities. The emergence of Baniyas (one of Vaisya sub caste) as the leading merchant is recorded from various European Travelers’ contemporary like Linschoten, 1583-89 and Tavenier 1656-67 (Khan A. R. 2003). The word Baniya is derived from Sanskrit word vanik meaning merchants who were found in North India and Deccan. They belonged to the Hindu and Jain (mainly in Gujarat and Rajasthan) communities. Their counterparts were the Khatris in Punjab and Kornatis in Golkunda. Many of the Baniyas carried surnames pointing to the place of origin e.g. Agarwals came from Agroha (Haryana), Oswals from Osi in Marwar. Traders from Marwar were known as Marwaris. The council of these merchants was known as mahajan. These Baniyas worked as moneylenders who were accompanied by another category of personnel called Sarafs. Sarafs performed three distinct functions: (i) as money-changers; (ii) as bankers and (iii) as traders of gold, silver and jewellery.

Banking and insurance activities gained momentum during Mughals rule. The deposit rate available for Agra, for 1645 and Surat for 1630 were around nine and half per cent par annum (Khan A. R. 2003). The rate of interest on loan depended mainly on individual’s need. Tapan Roy Chaudhary shows that the peasants took loans at a high rate of 150 per cent per annum in Bengal in the eighteenth century (Khan A. R. 2003).

**Indian Society: From Mid-18th Century to 19th Century (Chit Funds or ROSCA)**

After the decline Mughal Empire from 1739, there were regional powers that established. However, very soon India became a colony for British Rulers. The next 200 years of time period was waiting for India for exploitation. By the late of 18th century the exploitability of
peasantry was significantly increased due to increase in population, taxation and prices of food grains. The Indian Peasantry was under pressure of Britishers and local privileged class which include state ministers, deshmukhs, military officers with saranjam, financiers and traders. During this time, evidences of loans in cash and kind, among different personnel involved in landholding, peasants, agricultural labourers, craftsmen and soldiers were found in Maharashtra (Ghosh P, 2003). The Zamindars were used charge more from the peasants than they had to pay to the state. Most of the time the peasants had to borrow money from money lenders. The money lenders charged exorbitant rate of interest of for the money they lend to peasants.

Chit funds or ROSCAs, are widespread institutions of ancient origin in India, under which, a number of people, usually under an organizer, join together to regularly (e.g. daily, weekly, monthly) contribute equal amounts of money (or kind) allocated to on member at a time; a cycle ends when each participant had his turn. As chit funds grew in size and volume and the risk of fraudulent pyramid schemes increased, there has been a tendency of regulating the chits. Starting with the Travancore Chit Act of 1945 followed by other state-level laws, they were increasingly included in the formal financial sector. Chit funds attained such importance that in 1982, after ten years of deliberations, a federal Chit Funds Act was passed, providing legal status to chits as non-banking financial intermediaries.

Merchant banking i.e., financial intermediation comprising lending, deposit taking and other financial services – evolved in India during the first millennium B.C. and was widespread in India and beyond as early as the third century B.C.

1.2.2 Evolution of Microfinance (Contemporary Approach)

Phase 1: The Cooperative Movement (1900 – 1960):

In early 20th Century, the availability of credit in India, more particularly in rural areas was non-existent. There was no organized institutional credit for agriculture and related activities. People had to resort to moneylenders who charged higher rate of interest for financing agricultural requirements. It was the year 1892 when Government of Madras presidency felt inspired by the German Raiffeisen movement of savings and credit cooperatives and recommended, just three years after, the passing of German Co-operative Act in 1889, to replicate the approach in India. In 1901, the Government of India accepted proposal and in 1904, the first legislation on cooperatives was passed. In 1912, Government of India enacted a comprehensive Cooperative Societies Act. In 1914, the Maclagen committee suggested a three tier structure for cooperative baking i.e. Primary Agricultural Cooperative Societies
(PACS) at grass root level, Central Cooperative Banks (CCB) at the district level and State Cooperative Banks (SCB) at the state or apex level. The objective of this structure was to assist ordinary village people and reduce their dependency on money lenders by serving them on “no profit, no loss” basis. Under the Government of India Act of 1919, authority over cooperatives was transferred to the provinces, which were authorized to enact their own cooperative laws. Over a period of time, state governments were authorized to regulate matters relating to appointment of chief executives, suspension of elected board of directors, issuing of directives and supervision. The cooperative banks had been criticized for state and political interference. Absence of a single authority, irregularity in financial services and mismanagement had led to several scams also.

**Phase 2: Subsidized Social Banking (1960s – 1990):**

With failure of cooperatives, Government focused on measures such as nationalization of Banks, expansion of rural branch networks, establishment of Regional Rural Banks (RRBs) and the setting up of apex institutions such as the National Bank for Agriculture and Rural Development (NABARD) and the Small Scale Industries Development Bank of India (SIDBI), including initiation of a government sponsored Integrated Rural Development Programme (IRDP). While these steps led to reaching a large population, the period was characterized by large-scale misuse of credit, creating a negative perception about the credibility of micro borrowers among bankers, thus further hindering access to banking services for the low-income people.

**Phase 3: SHG-Bank Linkage Programme (1990 – 2000):**

The failure of subsidized social banking triggered a paradigm shift in delivery of rural credit with NABARD initiating the Self Help Group (SHG) Bank Linkage Programme (SBLP), aiming to link informal women's groups to formal banks. The program helped increase banking system outreach to otherwise unreached people and initiate a change in the bank’s outlook towards low-income families from ‘beneficiaries’ to ‘customers’. This period was thus marked by the extension of credit at market rates.

The model generated a lot of interest among newly emerging Microfinance Institutions (MFIs), largely of non-profit origin, to collaborate with NABARD under this program. The macroeconomic crisis in the early 1990s that led to introduction of the Economic Reforms of 1991 resulted in greater autonomy to the financial sector. This also led to emergence of new generation private sector banks that would become important players in the microfinance sector a decade later.
Phase 4: Commercialization of Microfinance (2000 Onwards):

After 2000, there was a paradigm shift in Indian microfinance industry. The growth and sustainability issues have forced non-for-profit institutions to transform into for-profit. According to Vikram Akula, chairman of SKS microfinance, “NGOs were facing the problems of three C’s; i.e. the lack of capital, the lack of capacity and the high cost of doing microfinance.” Most of the NGOs started transformation process and became profit motivated enterprises. Thus, the micro-finance industry enters into the commercialization phase where existing players started profit making and new ones entered into the industry.

1.3 Indian Microfinance Industry

Micro-finance in India has gone through three distinct phases in the past High Growth and Commercialization (till 2009), Crisis and Volatility (2010-12) and Consolidation (2012-14).

1.3.1 First Phase: High Growth & Commercialization (2000-2009)

During First Phase, the Indian microfinance industry was expanding by leaps and bounds. It was growing at a rate of more than 50% per annum – even higher than mobile phone industry. According to Intellecap Report (2007), the compounded average growth rate in industry found to be 79.9% from 2003 to 2007. According to Ghate P. (State of Sector Report, 2006), the industry was dominated by two models SHG Bank Linkage Programme (SBLP) programme started by NABARD and Microfinance Institutions (MFI) model. Further, the larger of the main two models, the SBLP covered about 14 million poor households in March 2006; the MFI model served 7.3 million households, of which 3.2 million were poor.

During this period, there was paradigm shift in objective of micro-finance community from reducing inequality and inducing social change to self-sustainability and profitability. Earlier micro-finance was considered as developmental activity and later on it converted into a promising business opportunity. The birth of second generation MFIs (after 2000) promoted the idea of commercialization in micro-finance by addressing issues of sustainability. Soon, new MFIs started doing business of microfinance attracted by high demand, soft regulation, high repayment rates from clients (almost near to 99 percent) and easy availability of funds. Old players especially NGOs started transforming into NBFCs so as to scale up their operations and ensure sustainability. The top 10 microfinance institutions, during this phase, include SKS microfinance, Cashpoor MC, Sarvodaya Nano Finance, ESAF, Spandna, AWS, CReSA, KBSLAB, GK and ABCRDM (Microfinance Information Exchange Report – 2008).
Suppliers of funds like private sector banks, venture capitalists and financial institutions provided huge amount of funds as earning profit was ensured. It resulted into high competition, multiple borrowings by clients and mission drift. The level of commercialization and competition can be analyzed from the opinion of Mr. Vikram Akula, Founder and Chairperson of SKS Microfinance made at the time of announcement of its IPO: Grameen Bank reaches 7 million clients … it took Professor Yunus 35 years to do that … Can you imagine how many generations it will take to reach 150 million poor households? ... We have to scale more rapidly, and only commercial capital will meet our huge funding requirements. The only way to get that is to be ... extremely profitable’ (Nath S. 2010).

1.3.2 Second Phase: Crisis & Volatility (2010-12)
The academicians and practitioners started worrying about micro-finance industry the way it has undergone through changes. Prof. Muhammad Yunus, noble laureate and father of microfinance movement, warned at the time of announcement of IPO of SKS Microfinance saying that ‘If you build it up that there's a lot of money to make, you can get a subprime kind of thing, but this time it's the really poor people who will be in trouble’. Similarly, Sriram M. S. (2010a) said that ‘The poor are smart, sometimes smarter than the people who are lending to them….. If the MFI gives the sense to the borrower that it is unscrupulous, the borrower will take the MFI for a ride sooner or later! The day they reach a tipping point where they think enough is enough, they will default’. This statement soon became reality for microfinance industry.

The crisis started from Andhra Pradesh, the mother land of Indian Micro-finance, on October 15, 2010, when state government passed an ordinance prohibiting MFIs from collecting weekly repayments and reaching out to borrowers at their doorsteps, apart from making government approval mandatory for every second loan to a borrower. This was followed by a spate of suicides by poor borrowers allegedly owing to coercive recovery practices by MFIs. The ordinance was built on four premises: MFIs charge usurious interest rates; if clients fail to pay on time, MFIs use coercive methods to collect the interest; these practices are forcing poor to commit suicide and MFIs make huge profits and have no social mission to help the poor (Intellecap White Paper, 2010). The state accounted for a third of the 30,000 crore Indian microfinance sector. Sukumar (2011) observed that Andhra Pradesh (AP) today has over 9.2 million defaulters listed on the credit bureaus of this country. All the MFIs have uploaded their credit history to three credit bureaus - Cibil, Equifax and High Mark. It is a harsh reality and is painful that AP has the distinction of highest rural defaulters on the credit
The history of credit bureaus. The Second Phase of crisis and volatility was the outcome of commercialization, profit motives of MFIs, soft regulation and lending practices and finally excess growth and priority norms (Rajdev A. and Pathan R. 2013).

1.3.3 Third Phase: Consolidation (2012-14)

In third phase, microfinance industry witnessed good growth after the AP crisis. According to CARE report (2014), loan portfolio grew at 63% Y-O-Y in FY 2013 as compared to 9% fall in FY 2012. During FY 2013, total outstanding loan portfolio of the MFIs covered in the study increased to ₹12,289 crore in FY 2013 from ₹8,384 crore in FY 2012. After AP crisis, to overcome regulatory uncertainty Government of India initiated microfinance bill. Introduction of margin cap and interest rate cap in May 2011 by RBI lead to lowering of interest rates being charged to the borrowers. The decrease in interest rates (portfolio yield) coupled with lower disbursements due to funding constraints resulted in lower growth in total income in FY12. However, the margin caps were also removed by RBI later on so as to stabilize industry.

1.4 SWOT Analysis of Micro-Finance Industry in India

1.4.1 Strengths

1.4.1.1 Consistent Impressive Growth

India is the largest micro-finance market in the world, with the annual growth rate of over 50 percent. After two decades of its emergence, micro-finance industry has matured from a developmental activity to commercial opportunity. According to Intellcap Report (2007) of 60 Indian MFIs, the micro-finance industry has recorded impressive CAGR of 71 per cent, 79 per cent and 76 per cent in its client base, portfolio size and assets, respectively (Intellcap Report, Undated). The size of portfolio of Indian MFIs has increase from 42 million to 769 million during the period of 2003-07.

1.4.1.2 Financial Inclusion

Because of lack of collateral and proper documentation, poor families in India remain financially excluded. The small and marginal farmers, agricultural laborers, artisans and the members of the scheduled tribes are the worst victims of financial exclusions. According to C. Rangrajan Committee (2008) on financial inclusion, 73% of Indian households are not indebted to formal financial institutions. Microfinance Institutions provide various financial services like savings, loans, insurance, credit, payments etc to those poorest families that are
not financially included. Thus, microfinance services can create capital at the bottom of the pyramid.

1.4.1.3 Capacity Building of the borrower

Microfinance creates access to productive capital which together with two other forms of capital Viz. human capital and social capital enables people improves their living conditions. The loans that are given by micro-finance institutions go along way in generating income and employment opportunities for its members as well as for non members. The trickle down effect is observed both within and outside the family of the borrower. The benefits actually trickle down to the other members of the borrower’s family. Simultaneously, the program helps in indirectly generating employment opportunities for its non-members as well. BASIX, for example, has proved this through its unique approach to micro-finance that money can work wonders for both the provider and the beneficiary. It has enabled people in 20,000 villages to have deep freezers to store milk. About 1,000 veterinarians and agricultural scientists are available in these villages to advise on loan options.

1.4.2 Weaknesses

1.4.2.1 Multiple Borrowings & Evergreening

There is ample evidence of multiple borrowing by poor clients among various sources of informal and semi-formal borrowers ranging from chit funds, moneylenders and private financiers to SHGs and MFIs (Srinivasan R. and Kamath R. 2009). A borrower who has taken MFI loan for productive purpose would still resort to family and friends for an emergency or might go to pawn-broker or money lender. Moreover, increasing competition among the MFIs has resulted in “overlapping” – multiple microfinance membership at the level of households.

1.4.2.2 High Interest Rates

The effective interest rate charged by micro-finance institutions to their clients has varied between 24% and 40% per annum (Bindu A. and Mor N. 2010). Given that default rates on microfinance loans are extremely low; these rates seem “usurious”. MFIs justify them citing high operating costs involved in serving remote areas with small loans. This rate is even higher than that of banks and other non-banking financial companies. In this situation, the key question to ask is whether a poor borrower is better off after he has access to microfinance, even when small loans he gets are more expensive than bank credit. Farmers borrow money at usurious interest rates and commit suicide once they realize they can’t pay back.
1.4.2.3 Lack of Regulation
The 22,500 crore micro-finance industry in India is facing heat due to lack of proper regulation. It is characterized by high leverage, practices of over lending and forceful recoveries. The sector, as of now, is working with a plurality in regulatory mechanism – RBI, and Central and State Governments of India. Though MFIs organized under the NBFC structure are governed by RBI regulations, there is no specific regulators for Micro-Finance Institutions (MFIs) constituted as Section 25 companies, trusts and societies. The Microfinance Development Bill 2007, which proposes to make NABARD a regulator for such MFIs, has still not seen the light of the day.

1.4.3 Opportunities
1.4.3.1 Going beyond Micro-credit
The micro-finance industry in India, is dominated by a techno-managerial perspective, with a large number of technical manuals and courses on how to achieve outreach. During the expansion phase of microfinance industry, the main objective has been lost. According to Prof. M.S. Sriram, micro-finance institutions need to prioritize the development objective. Going beyond micro-credit has usually been framed in terms of including micro-financial services other than credit for micro-enterprise: savings, consumption loans and insurance in particular.

1.4.3.2 M-Banking to transform microfinance industry
There is growing need of Mobile banking in the financial market of India. It can be an effective tool in making financial inclusion a success story. With mobile phone usage expanding drastically in the country, banks, cellular phone service providers and other intermediaries are entering into alliances, offering less affluent customers – including those not having access to bank accounts and credit cards – hassle free access to funds. The Reserve Bank of India (RBI), the country’s central bank, is finalizing the guidelines for mobile payment services. Banks and MFIs are confident that once M-banking is introduced, it will gain rapid following especially in the unorganized sector.

1.4.4 Threats
1.4.4.1 Andhra Pradesh Government’s Ordinance
Microfinance industry in India is facing severe problems due to legal interference by state governments. The Andhra Pradesh government, a state which is hub of micro-finance services, has passed the ordinance to regulate Micro-finance Institutions. The ordinance imposes, serious administrative costs on Micro-finance Institutions that has potential to kill
them. According to this new ordinance, MFIs have to register with district authorities in that state. They also will have to disclose the rate of interest they charge to authorities and their system of operating and recovery of the money. In addition to their regulation can be cancelled at any time if there are complaints against their working.

1.4.4.2 Credit Crunch

Banks are used to finance micro-finance institutions to meet their priority sector lending targets. Public and private sector banks account for 78.5 per cent of MFI’s total borrowings of ₹17,096 crore. In addition, MFIs manage loan portfolio of ₹4,200 crore on behalf of banks. Now, the situation is turning up after passing of the AP resolution. Banks are planning to stop lending to Micro-finance Institutions (MFSIs) because of increase in default risk in Andhra Pradesh.

1.4.4.3 High Leverage

The major problem being faced by Indian MFIs is that they are not allowed to take deposits, for lack of investment grade credit rating. However, in the rush to grow at all costs, they are increasingly leveraging balance sheets. They are borrowing from domestic and international markets to cater to the needs of the target group, which they describe as sub-prime market. At the end of March 2009, the debt-equity ratio of the level of 122.3 in the Indian micro-finance industry is reported (Goel M. and Somedo, 2009). Against that the level of debt-equity ratio in Africa, Afghanistan, Bangladesh, Nepal, Pakistan and Sri Lanka was 4.2, 3, (1.5), 12.3, (19.7) and 4.2 respectively.

1.5 Regulatory Framework

Microfinance industry in India is made up of non-for profit companies, for profit companies (NBFCs), Local Area Banks, Public societies and trust, Cooperatives and banks. This variety of institutional framework not only brings diversity but also complexity for a common regulatory framework. When Gesellschaft für Technische Zusammenarbeit (GTZ) commissioned study on legal frameworks for micro-finance, it was decided that India doesn’t easily fit into the format chosen for the study, and that it would be worth studying the case in more depth (Staschen S. 2003). Reserve Bank of India from late 1990s, has taken several measures for the orderly development of microfinance sector in the country. In 1998, to set up a policy framework, NABARD, set up a task force on Supportive Policy and Regulatory Framework for microfinance. The task force comprised senior officials from GOI, RBI, NABARD, banks
and chief executives of prominent NGOs implementing various microfinance models in the country. The task force emphasized to ensure the basic tenets of SHGs and that should not lost in pursuit of targets. It also recognized the mechanism of self-regulation for NGO-MFIs and the need for encouraging promotion of SROs. It recommended that major functions of SROs would be:

- Overseeing functioning of MFIs as base-level regulators
- Undertaking registration
- Evolving proper systems for microfinance of accounts and reporting
- Setting performance standards
- Conducting inspections
- Undertaking training
- Representing MFIs in various forays.

In April 1999 the word microcredit was used for the first time in the credit policy, months after the task force, was set up, but ahead of its report, i.e. October, 1999 (Sriram M. S. 2011b). For the first time, a definition of microfinance was agreed upon. Microfinance was defined as:

“Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards”. (Staschen S. 2003)

RBI in 1996 issued instructions to the bank to treat SHG bank linkage model as a part of their mainstream lending. According to the circular, lending to SHG or to NGOs for onlending to SHG is taken as part of their direct lending. In April 1999, RBI set up Micro-credit special cell for promoting SHG bank linkage programme.

In January 2000, RBI announced that NBFC undertaking the business of micro-finance and registered under section 25 of the Companies Act would no longer be subject to strict regulation and prudential requirements of other NBFCs (Sinha S. 2000).

A detailed notification of February 2000, made six significant points (Sriram M. S. 2011b):

- No interest cap on loans to MFIs and their loans to clients.
- Freedom to banks to formulate their own model/conduit/intermediary for extending microcredit.
- No criteria for selecting MFIs.
- Banks to formulate their own lending norms.
• Banks to formulate a simple system, minimum procedures and documentation for augmenting flow of credit by removing all operational irritants.
• Banks to include microcredit at the branch, district and state credit plans with quarterly progress to be reported to RBI.

A high level meeting on Micro-finance was held under the chairmanship of deputy governor Shri Vepa Kamesam on August 6, 2003 which recommended the following issues:

• Banks may be encouraged to allocate part of their development funds towards group formation expenditure.
• Interest rates on small loans from commercial banks to individuals may be de-regulated.
• Acceptability of service area norms for micro/rural banking may be revisited in view of banks’ increasing interest in micro finance.
• Banking and other financial services may be offered through emerging low-cost rural networks like e-governance projects and information kiosks.

The microfinance industry in India entered in crisis like situation in October, 2010 when the government of Andhra Pradesh passed the ordinance to regulate micro-finance institutions. The excessive interest rates and increase in number of suicides of poor people forced government to prevent microfinance institutions in recoveries. According to a report from Legatum Ventures, because of this legislation, the MFIs that have disbursed ₹ 5,000 crore ($1.13 billion) to borrowers in first half of FY 2011, now would be able to disburse only ₹ 8.5 crore ($1.9 million) in second half of FY 2011. The RBI constituted a sub-committee, as its meeting held on October, 2010, under the chairmanship of Shri Yezdi Malegam (known as Malegam Committee) to study issues and concerns in the microfinance sector.

The Malegam committee has submitted its report in January 2011 which recommended following issues:

• **A Separate Category of NBFC–MFI**
  To promote microfinance growth, a separate category of NBFC-MFI would be created which is defined as, “A company (other than a company licensed under Section 25 of the Companies Act, 1956) which provides financial services pre-dominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more
frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf”.

- **Eligibility of Borrower**
  The Malegam committee has identified the level of income of poor beneficiary who is eligible for getting a loan from NBFC-MFI. According to the committee, the loan would be given to the borrower whose annual income (household income) does not exceed ₹ 50,000. However, the issue is that if a household crosses the limit of ₹ 50,000 then it would have to be excluded from availability of further microfinance services.

  Moreover, a person who needs microfinance loan must be a member of a JLG and further he/she cannot be a member of more than one SHG/JLG.

- **Size of the Loan and its Use**
  According to the committee, a borrower can take a loan of maximum amount of ₹ 25,000. It is also recommended that the aggregate value of all outstanding loans of an individual borrower should not exceed the amount of ₹ 25,000 so as to prevent over borrowing. Out of the total amount of loan, a borrower must use 75% amount for productive purposes so that poor families can increase their level of income. The tenure of such loan does not exceed 12 months in case of loan amount of ₹ 15,000 and 24 months in case of a loan amount of ₹ 25,000. However, borrower can decide the frequency of repayment for the loan.

- **Pricing of Interest and Transparency**
  To prevent the exploitation of borrowers and safeguard their interests, committee has recommended margin cap system (which provides a cap on the difference between the amount charged to the borrower and the cost of funds to the MFI). According to this system, there would be a margin cap of 10% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of ₹100 crores and a margin cap of 12% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding ₹100 crores. There should also be a cap of 24% on individual loans.

  To bring uniformity in interest charges and thereby transparency, malegam committee also recommended following issues:
There should be only three components in the pricing of the loan, namely (i) a processing fee, not exceeding 1% of the gross loan amount (ii) the interest charge and (iii) the insurance premium.

Only the actual cost of insurance should be recovered and no administrative charges should be levied.

Every MFI should provide to the borrower a loan card which (i) shows the effective rate of interest (ii) the other terms and conditions attached to the loan (iii) information which adequately identifies the borrower and (iv) acknowledgements by the MFI of payments of installments received and the final discharge. The Card should show this information in the local language understood by the borrower.

The effective rate of interest charged by the MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.

There should be adequate regulations regarding the manner in which insurance premium is computed and collected and policy proceeds disposed off.

There should not be any recovery of security deposit. Security deposits already collected should be returned.

There should be a standard form of loan agreement.

- **Corporate Size and Solvency**
  It was recommended that all NBFC-MFIs should have a minimum net worth of ₹15 crores. To maintain solvency, an MFI should be required to maintain at all times an aggregate provision for loan losses which shall be the higher of:

  - 1% of the outstanding loan portfolio or
  - 50% of the aggregate loan installments which are overdue for more than 90 days and less than 180 days and 100% of the aggregate loan installments which are overdue for 180 days or more.

- **Coercive Methods of Recovery**
  It was because of coercive methods of recoveries that most of the poor people started committing suicides in Andhra Pradesh. To prevent MFIs from using coercive practices in collecting payments, malegam committee made several recommendations which are as under:
The responsibility to ensure that coercive methods of recovery are not used should rest with the MFIs and they and their managements should be subject to severe penalties if such methods are used.

The regulator should monitor whether MFIs have a proper Code of Conduct and proper systems for recruitment, training and supervision of field staff to ensure the prevention of coercive methods of recovery.

Field staff should not be allowed to make recovery at the place of residence or work of the borrower and all recoveries should only be made at the Group level at a central place to be designated.

MFIs should consider the experience of banks that faced similar problems in relation to retail loans in the past and profit by that experience.

Each MFI must establish a proper Grievance Redressal Procedure. The institution of independent Ombudsmen should be examined and based on such examination, an appropriate mechanism may be recommended by RBI to lead banks.

**Coercive Methods of Recovery**

For the overall compliance, malegam committee has suggested following measures:

- The primary responsibility for ensuring compliance with the regulations should rest with the MFI itself and it and its management must be penalized in the event of non-compliance.
- Industry associations must ensure compliance through the implementation of the Code of Conduct with penalties for non-compliance.
- Banks also must play a part in compliance by surveillance of MFIs through their branches.
- The Reserve Bank should have the responsibility for off-site and on-site supervision of MFIs but the on-site supervision may be confined to the larger MFIs and be restricted to the functioning of the organizational arrangements and systems with some supervision of branches. It should also include supervision of the industry associations in so far as their compliance mechanism is concerned. Reserve Bank should also explore the use of outside agencies for inspection.
- The Reserve Bank should have the power to remove from office the CEO and / or a director in the event of persistent violation of the regulations quite apart
from the power to deregister an MFI and prevent it from operating in the microfinance sector.

- The Reserve Bank should considerably enhance its existing supervisory organization dealing with NBFC-MFIs.

1.6 Gujarat Economy – An overview

The state took its name from the Gujara, the land of Gujjars, who ruled the area during 700’s and 800’s, the first settlers in the state of Gujarat who happened to be ethnic group of India, Pakistan and Afghanistan. After independence, in 1948, a Mahagujarat conference took place to integrate the entire Gujarati speaking population under one administrative body and on May 1, 1960, the Bombay state split into the states of Maharashtra and Gujarat. The term ‘Mahagujarat’ encompassed the whole Guajarati speaking area including Gujarat, Saurashtra and Katchh.

1.6.1 Demography

The population of Gujarat is 6.04 crore which has increased by 19.17% from 2001 to 2011 (Census 2011). The population density was merely 46 in 1901 which increased 105 in 1960 and finally in 2011, it has crossed the figure of 300. The percentage of urban population was 22.33 during 1901. Because of development and urbanization it has increased to 37.36 during 2001(Census 2011). In 1901, there were 954 females per 1000 males, while it was 972 at national level. At present, the sex ratio is 918 which show that there is a need to increase the awareness about girl child.

1.6.2 Industrial Growth

Gujarat is considered as industrial hub of India. The prosperity of Gujarat belongs to the development of industries since its birth time. Gujarati people are known for their entrepreneurship in business ventures. With increase in level of economic development of Gujarat, the contribution from agriculture sector has drastically reduced. According to the report of **State Domestic Product, Gujarat State (2009-10)**, it is found that contribution from primary sector in domestic production was 41.8% in 1960-61 and it has come down to 18.2% in 2009-10. On the other side, contribution from secondary sector has increased from 29% in 1980-81 to 36.9% in 2009-10. Whereas, the share of tertiary sector in economy was 32.5% in 1960-61 which remained stable in 1980-81 at 32.3% and thereafter gained a steep rise and registered a share of 48.6% in 2013-14 (see Table 1.1).
### Table 1.1

**Contribution of Various Sectors in GDP of Gujarat**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Primary</td>
<td>19.5</td>
<td>18.2</td>
<td>19.2</td>
<td>22.1</td>
<td>14.2</td>
<td>12.9</td>
<td>14.9</td>
</tr>
<tr>
<td>1.1</td>
<td>Agriculture</td>
<td>13.2</td>
<td>13.8</td>
<td>15.4</td>
<td>18.6</td>
<td>10.2</td>
<td>9.6</td>
<td>11.7</td>
</tr>
<tr>
<td>2</td>
<td>Secondary</td>
<td>36.5</td>
<td>36.9</td>
<td>36.4</td>
<td>34.2</td>
<td>38.6</td>
<td>38.4</td>
<td>36.6</td>
</tr>
<tr>
<td>2.1</td>
<td>Manufacturing</td>
<td>27.3</td>
<td>26.4</td>
<td>25.8</td>
<td>23.8</td>
<td>27.4</td>
<td>26.5</td>
<td>24.6</td>
</tr>
<tr>
<td>3</td>
<td>Tertiary</td>
<td>44.0</td>
<td>44.9</td>
<td>44.4</td>
<td>43.8</td>
<td>47.2</td>
<td>48.7</td>
<td>48.6</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>


### 1.6.3 Agriculture

Agriculture forms a major part of the state’s economy. It not only provides food grains to the people but also provides raw-material for agro based industries. Unfavorable climatic conditions and soil factors in some areas are major concerns for better yield.

The various crops grown in the state include groundnut, cotton, tobacco (second highest production in the country), istabgul, cumin sugarcane, juwar, bajra, rice, wheat, pulses tur and gram. The farmers of Gujarat have started producing bananas and mangoes in the state.

Animal husbandry and dairying have played a vital role in the rural economy of Gujarat. Dairy farming, primarily concerned with milk production, functions on a co-operative basis and has more than a million members. Gujarat is the largest producer of milk in India.

### 1.6.4 Gujarat: Socio-Economic Profile

Gujarat is considered as one of the fastest growing states of India. In terms of per capita income, Gujarat is on 6th position after Delhi, Goa, Punjab, Hariana and Maharashtra. It has become investment hub for domestic and multinational companies. However, irrespective of higher industrial growth in Gujarat, it has failed to achieve the same level of growth in social sector. As Menon S. V. (2009) reports the high growth rate and industrial development in Gujarat is not reflected in its social and human development indicators in which the state lags behind other states. Table No. 1.2 shows an analysis of summary of various studies highlighting that the state has failed in social and human development and gained in terms of industrial growth and prosperity skewed in favor of rich class.
<table>
<thead>
<tr>
<th></th>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Gujarat records a per capita income of ₹89,668 (as of 2011-12), well above the national average level of ₹61,564 for the same year, indicative that benefits of growth are reaching at the individual level (CARE Report, 2013)</td>
<td>Gujarat is a paradigmatic example of ‘decent work’ where it is found that economic growth has been accompanied by much lower (negative or zero) growth rate of employment (Bagchi et al. 2005).</td>
</tr>
<tr>
<td>2</td>
<td>Shah, as cited Menon S. V. (2009), using NSS data found that incidence of urban poverty in Gujarat has declined from 30.66% in 1993-94 to 15.59% in 1999-2000.</td>
<td>The Official Poverty Line (OPL) underestimates poverty in a state. Nutrition poverty levels in Gujarat are higher than all-India levels; it was found that using calorie-based poverty line urban poverty in Gujarat has increased from 50% in 1993-94 to 54% in 1999-2000 (Dixit A. 2011).</td>
</tr>
<tr>
<td>3</td>
<td>Gujarat ranks 4th in per capita income, having a per-capita GDP 2.47 times India’s average (Menon S. V. 2009).</td>
<td>In terms of Life Expectancy at Birth (LEB) and Infant Mortality Rate (IMR) Gujarat ranks low i.e. 9th and 6th respectively (Menon S. V. 2009).</td>
</tr>
<tr>
<td>4</td>
<td>Gujarat has attracted Foreign Direct Investment of worth ₹1,82,998 crores in the last five years, which is the highest among all states in the country (Menon S. V. 2009)</td>
<td>The state is facing problem of high incidence of casual employment, while employment growth is higher in sectors that have low productivity and low wages, and there is a high incidence of poverty among the workers employed in them (Kundu A. 2000).</td>
</tr>
</tbody>
</table>

Dholakiya R. and Iyangar S. (2000) have pointed out two important weaknesses of Gujarat:
- Gujarat is found to have lower exposure in higher education which is reflected in lack of development of knowledge and skill based industries in Gujarat. Moreover, Gujarat is found to have low penetration in central government services.
- Gujarat, compared to other states invests fewer amounts of resources for the development of its citizens.
References


Champak L. and Jain V. K. (2003). Early Medieval Economy: 8th to 13th Century, Block 1, Indira Gandhi National Open University, School of Social Sciences, 5-49.

Chattopadhyaya B. D, ChandraBhupesh and JhaVishwa (2003). Indian Polity: B.C 300 to 800 A.D, Block 8, Indira Gandhi National Open University, School of Social Sciences, 19-22.


Nath S. (2010). The year that was: VikramAkula's Moment of Reckoning, Forbes India, retrieved from http://forbesindia.com/article/special/the-year-that-was-vikram-akulas-moment-of-reckoning/13452/1


Sriram M. S. (2010a). What isWrong with Indian Microfinance, Forbes India, retrieved from http://www.mssriram.in/sites/mssriram.in/files/Forbes%20IndiaWhat%20is20WrongWith_0.pdf


Websites
http://censusindia.gov.in/2011-common
http://indiamicrofinance.com/capital-square-advisors-malegam-committee-report.html
http://www.grameen-info.org/index.php?
http://www.icra.in
http://www.intellecap.net
http://www.microfinancefocus.com/content/ifmr-capital%E2%80%99s-view-malegam-committee-report
http://www.microfinancefocus.com/content/life-sustaining-support-malegam-committee-%E2%80%93-will-it-ensure-longevity
http://www.microfinanceregulationcenter.org
http://www.sa-dhan.net/Adls/D11/RegSupr/SummaryandRecommendTaskforce.htm