CHAPTER - 1

Introduction
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Chapter 1 is presented in two parts: Part A and Part B. Part A constitutes an overview of the microfinance scenario which includes - Introduction, meaning and definition of microfinance, terminology, key principles of microfinance, Global microfinance scenario, microfinance in Asia, microfinance models and players, microfinance in India and objectives of microfinance. Part B describes emerging issues and challenges in microfinance.

Part A: Microfinance Scenario

Background of the Study

Provision of credit to the poor has been a key concern of policy makers in India since Independence. Rural development and poverty reduction form the core of socio economic development programmes in our country. There have been several poverty alleviation initiatives made by the government of India which include the Integrated Rural Development Programme (IRDP) in 1980 which envisaged self employment among the poor through loans provided by banks for the purchase of productive assets along with subsidies provided by the government. As the goal of poverty reduction through increased growth did not achieve desired results due to the modest growth rate of our economy, the need to develop a people centric programme of development was thought to be imperative. A series of research studies conducted by National Bank for Agriculture and Rural Development (NABARD) in the early eighties showed that despite a wide network of rural bank branches and implementation of a variety of poverty alleviation programmes, a large number of poor people continued to be outside the fold of the formal banking system as the existing banking policies, systems and procedures, deposit and loan products were perhaps not suited to meet the immediate needs of the poor.

Thus, began a search for alternative policies, systems and procedures, savings and loan products, other complementary services and new delivery mechanism which will fulfill
the requirements of the poor. The need to improve access of the poor to the banking network in the country was thought to be of utmost importance. NABARD’s vision of a participatory approach to development, with focus on social mobilisation and recognition of the the potential of women in thrift and management, lead to the development of the self help group bank linkage model in our country. The strategy involved forming small cohesive participative groups of the poor, encouraging them to pool their thrift regularly and use these pooled resources to make small interest bearing loans to their members. This marked the beginning of the microfinance movement in our country and this microfinance movement has developed into an organised means of dealing with poverty reduction as the strength of a group is greater than the total strength of individual members. Microfinance is the provision of loans and other financial services to the poor. The microfinance movement has evolved due to the efforts of committed individuals and financial agencies to promote self employment and contribute to poverty alleviation and provision of social security. Access to financial services can be an important tool for preventing people from falling into - or moving out of - poverty. Research shows that poverty is aggravated with restricted access to finance. All economic agents, low-income households and micro-entrepreneurs can benefit from credit, savings, and insurance services. These services can help them take advantage of business opportunities, increase their earning potential, build assets, and reduce vulnerability to external shocks. Without access to finance from professional service providers, low-income and disadvantaged groups have to rely on informal sources of funding such as family, friends, or money lenders and may become targets of predatory schemes. Financial exclusion and restricted access to financial services thus reduces the potential welfare of individuals and the productivity of enterprises in an economy (World Bank, 2004a). Microcredit, or microfinance, is banking the unbankables, bringing credit, savings and other essential financial services within the reach of millions of people who are too poor to be served by regular banks, in most cases because they are unable to offer sufficient collateral. In general, banks are for people with money, not for people without.” (Gert van Maanen, 2004).
Microcredit is based on the premise that the poor have skills which remain unutilized or underutilized. It is definitely not the lack of skills which make poor people poor, charity is not the answer to poverty. It only helps poverty to continue. It creates dependency and takes away the individual’s initiative to break through the wall of poverty. Unleashing of energy and creativity in each human being is the answer to poverty.” (Muhammad Yunus, 2003).

Microcredit belongs to the group of financial service innovations under the term of microfinance, other services according to microfinance is micro savings, money transfer vehicles and micro insurance. Microcredit is an innovation for the developing countries. Micro credit is a service for poor people that are unemployed, entrepreneurs or farmers who are not bankable. The reason why they are not bankable is the lack of collateral, steady employment, income and a verifiable credit history, because of this reasons they can’t even meet the minimal qualifications for an ordinary credit. By helping people with micro credits it gives them more available choices and opportunities with a reduced risk. It has successfully enabled poor people to start their own business generating or sustain an income and often begin to build up wealth and exit poverty. Microfinance plays an important role in fighting the multi-dimensional aspects of poverty. Microfinance increases household income, which leads to attendant benefits such as increased food security, the building of assets, and an increased likelihood of educating one’s children. Microfinance is also a means for self-empowerment. It enables the poor to make changes when they increase income, become business owners and reduce their vulnerability to external shocks like illness, weather and more.

Micro credit has widely been directed by the non-profit sector while commercial lenders require more conventional forms of collateral before making loans to microfinance institutions. But now it is successfully growing bigger and getting more credibility in the traditional finance world. Due to that the traditional banking industries have begun to realize that these borrowers fit more correctly in a category called pre bankable. The industry has realized that those who lack access to traditional formal financial institutions actually require and desire a variety of financial products. Nowadays the mainstream finance industry is counting the micro credit projects as a
source of growth. Before almost everyone were neglecting the success of micro credit in the beginning of the 1970s when pilot projects such as ACCION were released until the United Nations declared 2005 the International Year of Micro credit.

Most of the micro credit institutions and agencies all over the world focus on women in developing countries. Observations and experience shows that women are a small credit risk, repaying their loans and tend more often to benefit the whole family. In another aspect it is also seen as a method giving the women more status in a socioeconomic way and changing the current conservative relationship between gender and class when women are able to provide income to the household. Women are in most cases responsible for children, and in poor conditions it results in physical and social underdevelopment of their children. A recent World Bank report confirms that societies that discriminate on the basis of gender pay the cost of greater poverty, slower economic growth, weaker governance, and a lower living standard for all people. At a macro level, it is because 70% of the world’s poor are women. Women have a higher unemployment rate than men in virtually every country and make up the majority of the informal sector of most economies. They constitute the bulk of those who need microfinance services.

Thus, it can be said that there is no universal definition of microfinance. It varies by country and can take different forms depending on a particular economy’s level and structure of development. Broad regional variations can be observed in loan sizes, types of services, target clientele, outreach, and delivery methodologies. However, in general terms, microfinance caters to the poor and underserved segments of the population by providing “small-scale financial services . . . to people who farm or herd; operate small or microenterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools, and to other individuals and local groups in developing economies, in both rural and urban areas” (World Bank and Open Society Institute 2003).

In India, the most authoritative definition is provided by the Reserve Bank of India: “Microfinance is defined as the provision of a broad range of financial services such as deposits, loans, money transfers, and insurance to small enterprises and households.”
The main objective of microfinance is often regarded as poverty alleviation but financial inclusion subsumes this objective as long as reaching the poor (or maximizing the depth of outreach) is given equal attention in product design, delivery systems and monitoring.

The key principles of microfinance outlined by Consultative Group to Assist the poor (CGAP) and endorsed by the G8 at Sea Island Summit 2004 are listed below.

**Key Principles of Microfinance**

1. **The poor need a variety of financial services, not just loans.** Just like everyone else, poor people need a wide range of financial services that are convenient, flexible, and reasonably priced. Depending on their circumstances, poor people need not only credit, but also savings, cash transfers, and insurance.

2. **Microfinance is a powerful instrument against poverty.** Access to sustainable financial services enables the poor to increase incomes, build assets, and reduce their vulnerability to external shocks. Microfinance allows poor households to move from everyday survival to planning for the future, investing in better nutrition, improved living conditions, and children’s health and education.

3. **Microfinance means building financial systems that serve the poor.** Poor people constitute the vast majority of the population in most developing countries. Yet, an overwhelming number of the poor continue to lack access to basic financial services. In many countries, microfinance continues to be seen as a marginal sector and primarily a development concern for donors, governments, and socially-responsible investors. In order to achieve its full potential of reaching a large number of the poor, microfinance should become an integral part of the financial sector.

4. **Financial sustainability is necessary to reach significant numbers of poor people.** Most poor people are not able to access financial services because of the lack of strong retail financial intermediaries. Building financially sustainable
institutions is not an end in itself. It is the only way to reach significant scale and impact far beyond what donor agencies can fund. Sustainability is the ability of a microfinance provider to cover all of its costs. It allows the continued operation of the microfinance provider and the ongoing provision of financial services to the poor. Achieving financial sustainability means reducing transaction costs, offering better products and services that meet client needs, and finding new ways to reach the unbanked poor.

5. Microfinance is about building permanent local financial institutions. Building financial systems for the poor means building sound domestic financial intermediaries that can provide financial services to poor people on a permanent basis. Such institutions should be able to mobilize and recycle domestic savings, extend credit, and provide a range of services. Dependence on funding from donors and governments - including government-financed development banks - will gradually diminish as local financial institutions and private capital markets mature.

6. Microcredit is not always the answer. Microcredit is not appropriate for everyone or every situation. The destitute and hungry who have no income or means of repayment need other forms of support before they can make use of loans. In many cases, small grants, infrastructure improvements, employment and training programs, and other non-financial services may be more appropriate tools for poverty alleviation. Wherever possible, such non-financial services should be coupled with building savings.

7. Interest rate ceilings can damage poor people’s access to financial services. It costs much more to make many small loans than a few large loans. Unless microlenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs, and their growth and sustainability will be limited by the scarce and uncertain supply of subsidized funding. When governments regulate interest rates, they usually set them at levels too low to permit sustainable microcredit. At the same time, microlenders should not pass on operational inefficiencies to clients in the form of prices (interest rates and other fees) that are
far higher than they need to be.

8. The government’s role is as an enabler, not as a direct provider of financial services. National governments play an important role in setting a supportive policy environment that stimulates the development of financial services while protecting poor people’s savings. The key things that a government can do for microfinance are to maintain macroeconomic stability, avoid interest-rate caps, and refrain from distorting the market with unsustainable subsidized, high-delinquency loan programs. Governments can also support financial services for the poor by improving the business environment for entrepreneurs, clamping down on corruption, and improving access to markets and infrastructure. In special situations, government funding for sound and independent microfinance institutions may be warranted when other funds are lacking.

9. Donor subsidies should complement, not compete with private sector capital. Donors should use appropriate grant, loan, and equity instruments on a temporary basis to build the institutional capacity of financial providers, develop supporting infrastructure (like rating agencies, credit bureaus, audit capacity, etc.), and support experimental services and products. In some cases, longer-term donor subsidies may be required to reach sparsely populated and otherwise difficult-to-reach populations. To be effective, donor funding must seek to integrate financial services for the poor into local financial markets; apply specialist expertise to the design and implementation of projects; require that financial institutions and other partners meet minimum performance standards as a condition for continued support; and plan for exit from the outset.

10. The lack of institutional and human capacity is the key constraint. Microfinance is a specialized field that combines banking with social goals, and capacity needs to be built at all levels, from financial institutions through the regulatory and supervisory bodies and information systems, to government development entities and donor agencies. Most investments in the sector, both public and private, should focus on this capacity building.
11. **The importance of financial and outreach transparency.** Accurate, standardized, and comparable information on the financial and social performance of financial institutions providing services to the poor is imperative. Bank supervisors and regulators, donors, investors, and more importantly, the poor who are clients of microfinance need this information to adequately assess risk and returns.

The concept of Microfinance has been influenced by two schools of thought namely the institutionalist and the welfarist. While the institutionalist school focuses on the development of a financially sustainable institution to serve the poor, the welfarist school focuses on the immediate improvement of economic safety for the poor. Though the objectives of the two approaches are different, the common objective is to improve the economic and socio-economic impact of microfinance in a way that leads to financial sufficiency. The Microfinance sector today is faced with the challenge of providing financial access to the poor while covering operational costs while designing their product services and delivery method to improve impact. The sector strives to achieve objectives in six dimensions:

**Table 1: Six Degrees of Outreach of Microfinance**

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Breadth:</td>
<td>Serve as many people as possible</td>
</tr>
<tr>
<td>Depth:</td>
<td>Serve people who are underserved by financial institutions</td>
</tr>
<tr>
<td>Length:</td>
<td>Generate enough revenue to cover costs, provide adequate returns to investors to maintain their support</td>
</tr>
<tr>
<td>Cost:</td>
<td>Control costs, maximize efficiency and productivity to keep interest rates as low as possible.</td>
</tr>
<tr>
<td>Worth:</td>
<td>Keep clients satisfied so that they continue to choose the Microfinance Institution over competitors</td>
</tr>
<tr>
<td>Scope:</td>
<td>Understand client needs for financial services and offer a product menu to address those needs</td>
</tr>
</tbody>
</table>

*Source: Mark Schreiner, 2002*

The success of the Microfinance sector today depends on available partnerships, legal and regulatory environment, internal capacity and the future plans. The strategic
direction of any player is driven by the relationship between its vision, mission, values, and objectives. The effectiveness of the strategic direction can be enhanced by ensuring clarity in its mission, vision and value. This can be developed through a participatory process that involves key stakeholders. Schreiner (2002) notes that the social benefits of microfinance will depend on all six dimensions. The best way to maximize all six dimensions of outreach is through better performance.

**Global Microfinance Scenario**

At a time when the world’s richest countries are sinking into debt and middle-class consumers everywhere are defaulting on their loans, lending money to the world’s poor hardly seems wise. Yet, the practice of providing small sums to low-income entrepreneurs - known as microfinance - has never been more popular, or more important. Microfinance has existed in many forms for decades, but has only recently garnered global attention as a commercially viable activity that can offer real opportunities for micro-entrepreneurs. This is in large part due to the efforts of Mohammed Yunus, who founded Grameen Bank in 1983 and was awarded the Nobel Prize in 2006 for his efforts to increase financial access for the world’s poor.

From 2004 to 2008 microfinance enjoyed unprecedented growth in emerging markets. According to data from the Microfinance Information Exchange (MIX), the sector expanded at historic rates, with average annual asset growth of 39%, accumulating total assets of over US$60 billion by December 2008. The number of active borrowers remained higher in South Asia when compared to the other regions in the world. In 2009, Europe and Central Asia recorded a decline in the number of depositors while Central Asia had the lowest growth rate in terms of Gross Loan Portfolio. Yet the development and regulation of microfinance as a stand-alone sector, as well as the business environments in which it operates, vary greatly from country to country. The Microfinance Information Exchange (MIX) is the leading provider of business information and data services for the microfinance industry. Dedicated to strengthening the microfinance sector by promoting transparency, MIX provides detailed performance and financial information on microfinance institutions, investors, networks, and service providers associated with the industry.
As global economic growth slowed in 2008, microfinance institutions around the globe began to feel the impact in their own portfolios and performance. The sustained expansion in borrowers served in the first part of the decade ceded to slower growth and rising operating costs by 2008. The MIX global data was the first set to capture the impact of the crisis and economic slowdown on the operational and financial performance of Microfinance Institutions. Together, in 2011 2000 benchmarked Microfinance Institutions served 55 million borrowers with 32 billion USD in loans, and collected 22 billion USD in deposits. (MIX Market data 2011)

**Fig 1: Global Distribution of Microfinance Institutions**

*Source: MIX Market 2010*
Table 2: Global Microfinance Scenario

<table>
<thead>
<tr>
<th>Region</th>
<th>Africa</th>
<th>East Asia And The Pacific</th>
<th>Eastern Europe And Central Asia</th>
<th>South Asia</th>
<th>Middle East And North Africa</th>
<th>Latin America And The Caribbean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total No of Microfinance Institutions</td>
<td>508</td>
<td>289</td>
<td>419</td>
<td>368</td>
<td>76</td>
<td>478</td>
</tr>
<tr>
<td>Gross Loan Portfolio USD, 2010</td>
<td>4.6 Billion</td>
<td>21.2 Billion</td>
<td>8.2 Billion</td>
<td>9.0 Billion</td>
<td>1.2 Billion</td>
<td>22.9 Billion</td>
</tr>
<tr>
<td>Number of active borrowers 2010</td>
<td>4.5 Million</td>
<td>15.8 Million</td>
<td>2.8 Million</td>
<td>58.6 Million</td>
<td>2.2 Million</td>
<td>15.0 Million</td>
</tr>
<tr>
<td>Average loan balance per borrower USD, 2010</td>
<td>371.9</td>
<td>304.9</td>
<td>1682.6</td>
<td>144</td>
<td>610.8</td>
<td>1031.6</td>
</tr>
<tr>
<td>Deposits USD, 2010</td>
<td>4.7 Billion</td>
<td>3.3 Billion</td>
<td>6.0 Billion</td>
<td>3.3 Billion</td>
<td>122.0 Million</td>
<td>15.3 Billion</td>
</tr>
<tr>
<td>Assets USD, 2010</td>
<td>6.7 Billion</td>
<td>8.4 Billion</td>
<td>11.9 Billion</td>
<td>11.4 Billion</td>
<td>1.6 Billion</td>
<td>29.2 Billion</td>
</tr>
<tr>
<td>Number of depositors 2010</td>
<td>16.6 Million</td>
<td>5.8 Million</td>
<td>2.8 Million</td>
<td>26.4 Million</td>
<td>89552</td>
<td>15.4 Million</td>
</tr>
</tbody>
</table>

Source: Mix market data 2011

**Microfinance in Asia**

Microfinance in Asia remained profitable overall in 2008, although operating expenses reflected higher costs of personnel and financing in some sectors. Decreasing operating expenses will require innovation from Microfinance Institutions in order to result in lower costs to clients. The microfinance industry in Asia is one of the largest in the world with a huge number of microfinance service providers characterized by a strong
focus on social mission. The unmet demand for microfinance is still growing. Asia has some of the largest Microfinance institutions including BRI Indonesia and ASA Bangladesh. They cater to different market segments. Historically, the microfinance sector in most countries has been resilient to external financial crises. In Asia, the microfinance sector in most countries has largely been funded by international donors, government development funds and individual deposit mobilisation, with India and to a certain extent the Philippines, being the exceptions. Hence the effect of the global liquidity contraction on the cost and availability of funding to Microfinance Institutions is yet to be determined and will depend on the funding structure of the institution. In countries where domestic commercial banks have begun lending to Microfinance Institutions, money flow has become tighter and slower and has more conditions attached.
Historically, the microfinance sector in most countries has been resilient to external financial crises. The microfinance sector has emerged as an effective strategy in addressing poverty and empowering the poor. The capacity, quality and range of microfinance institutions and the infrastructure that supports them varies widely within countries and from country to country. Financially sustainable, commercially viable microfinance Institutions co-exist alongside donor subsidised entities and basic community revolving funds. In every country, a few large institutions account for the
bulk of outreach, with Bangladesh being the most prominent example, with Grameen, BRAC, ASA and Proshika accounting for 86% of the microfinance market. The market in India, Indonesia and the Philippines is more vibrant, where banks and non-bank financial institutions are gaining greater importance. In Nepal, Sri Lanka and Vietnam, there continues to be significant government involvement in service delivery, with micro credit used at a policy level. In India, Bangladesh, Indonesia and the Philippines there was strong growth of the microfinance industry, in terms of outreach and operational and financial sustainability and efficiency, is gradually leading to the commercialization of the Microfinance Institutions. The pressure to maximise returns by the new private equity, commercial and social investors is likely to result in the scaling-up of operations, the dampening of downward pressure on interest rates, and the increase in loan sizes. The desire to reach a massive scale may augur well for financial inclusion, but can threaten the quality of growth. In addition, increases in interest rates and loan size would result in limiting the access to microfinance.

Technological innovation in microfinance can promote reaching the unbanked. Most countries in Asia are operating in challenging and non conducive regulatory framework on availability of financial services increases poor people’s dependence on local sources of capital at exorbitant rates. However, the global financial crisis did not deter the microfinance sector in Asia from attracting investment from global players. Most countries are looking at better use of technology for financial inclusion as it will enable reduction in transaction costs. A major bottleneck faced by microfinance providers in Asia is the lack of financial resources which is a major constraint in their ability to invest in developing systems and human resources to manage the unprecedented growth in client numbers.

In Asia, the sheer numbers pose a challenge. The phenomenal growth in outreach of 58.6 million still leaves many, in countries like Bangladesh, India, Pakistan and the Philippines the industry faces two dilemmas, the first being sustainability versus expansion in client base, and second being small versus larger loan sizes. To work towards sustainability, Microfinance Institutions need to professionalise and upgrade staff skills (especially in finance), increase the use of technology, streamline operations with management information systems and achieve cost efficiency. Microfinance
Institutions would have to expand horizontally to service an expanded client base, as well as implementing the vertical professionalisation of all functions within the institution. Sustainability, as well as interest caps (especially in India) on small loans, has prompted Microfinance Institutions to provide larger loans and hence all together forgo the target population of the very poor. In such instances ‘mission drift’ becomes a default option, leaving the Microfinance Institution little room to maneuver.

**Microfinance Models and Players**

Microfinance services are provided through a variety of delivery methodologies ranging from the very popular Self Help Group methodology to Grameen joint liability groups and the individual banking arrangements of the savings and credit cooperative societies.

**Bank –Self Help Group Linkage**

Micro financing through Self Help Groups is a reliable mechanism as the beneficiary group members are encouraged to make voluntary savings on a regular basis. They use the savings to make interest-bearing loans to their members. The process of saving, lending and recovering it back imbibes the essentials of financial intermediation including prioritization of needs and thus builds financial discipline.

The major advantage of the Self Help Group model is the empowerment and participation it has engendered in millions of rural women, most of whom are below the poverty line. It also has the advantage that it can spread much faster, taking advantage of India’s huge network of bank branches and the potential of Primary Agricultural Cooperative Societies (PACS’s). Three distinct Bank-Self Help Group linkage models are currently in existence.
Table 4: Models of Micro credit and the Role of Banks

<table>
<thead>
<tr>
<th>Models of Micro-credit</th>
<th>Role of banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model 1</td>
<td>Banks take up the work of forming and nurturing the groups, opening their saving accounts and providing them bank loans.</td>
</tr>
<tr>
<td>Model 2</td>
<td>Self Help Groups are formed by NGO’s and formal agencies but are directly financed by banks.</td>
</tr>
<tr>
<td>Model 3</td>
<td>Self Help Groups are financed by banks using NGO’s and other agencies as financial Intermediaries.</td>
</tr>
</tbody>
</table>

Fig 2: SHG Bank Linkage Model

Bank – Microfinance Institution Linkage

The emerging role of Microfinance Institutions as institutions other than banks engaged in providing financial services to the poor is being recognized and the banking sector has been extending loans to the Microfinance Institutions for on lending to the Self Help Groups.

The more recent model adopted by Indian microfinance is that of the Joint Liability Group (JLG), which is an adaptation from the Grameen model. It is emerging as an alternative to the home grown Self Help Group model. The JLG is not linked with a bank but is intermediated by the loan officer of a Microfinance Institution who is responsible for formation and management of the group. Unlike the Self Help Group model wherein the loan is given to the group and the bank does not track individuals credit history, in the Grameen-inspired JLG model the loan is given to the individual (usually by the Microfinance Institution), backed by the group guarantee. This enables creation of an individual credit history.

Individual Banking Programmes (IBPs)

IBPs entail the provision by Microfinance Institutions of financial services to individual clients by organizing them into joint liability groups, credit and savings cooperatives or even Self Help Groups. The model is increasingly popular for microfinance particularly through cooperatives. In the case of cooperatives, all borrowers are members of the organisation either directly or indirectly by being members of primary cooperatives or associations which are members of the apex society. Creditworthiness and loan security are a function of cooperative membership within which member savings and peer pressure are assumed to be a key factor. Though the magnitude and timing of savings and loans are largely unrelated, a special effort is made to mobilise savings from members. There are now a large number of mutually aided cooperative societies which provide credit to the poor.

Grameen Model

This model was initially promoted by the well known Grameen Bank of Bangladesh. These undertake individual lending but all borrowers are members of 5-member joint
liability groups which, in turn, get together with 7-10 other such groups from the same village or neighbourhood to form a centre. Within each group and centre peer pressure ensures prompt repayment. Each borrower’s creditworthiness is determined by the overall creditworthiness of the group. Savings are a compulsory component of the loan repayment schedule but do not determine the magnitude or timing of the loan.

**Table 5: Characteristics of Microfinance Delivery Models**

<table>
<thead>
<tr>
<th>Financial Service</th>
<th>Characteristic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>Loan amount</td>
<td>Determined by the longevity of the client’s association with the MFI. Not often directly related to the credit needs of the borrower.</td>
</tr>
<tr>
<td></td>
<td>Loan term</td>
<td>Usually 12 months, occasionally less, sometimes greater</td>
</tr>
<tr>
<td></td>
<td>Repayment instalments</td>
<td>Monthly or weekly – usually fixed, equal amounts</td>
</tr>
<tr>
<td></td>
<td>Interest charges</td>
<td>Range: 24-36%, usually levied as a flat charge, partly to simplify calculations for both the MFI and the client. Some MFIs charge lower rates but suffer from poor sustainability as a result.</td>
</tr>
<tr>
<td></td>
<td>Collateral</td>
<td>No physical collateral but often linked to some compulsory savings component which acts as financial collateral. Reinforced by joint liability (Grameen) with other clients or peer pressure arising from membership of a community group revolving its own as well as borrowed funds (SHGs, cooperatives). Some MFIs also create reserve funds to cover the risk of default.</td>
</tr>
<tr>
<td>Savings</td>
<td>Amount deposited</td>
<td>Grameen: Compulsory – usually a fixed proportion of the repayment instalment SHG: Compulsory – fixed amounts per (weekly or monthly) meeting to be deposited as part of the group fund; occasionally also voluntary Some MFIs now offer long term fixed deposits.</td>
</tr>
<tr>
<td></td>
<td>Withdrawals</td>
<td>Compulsory savings cannot be withdrawn except when the client leaves the group. Voluntary savings often require some notice of withdrawal.</td>
</tr>
<tr>
<td></td>
<td>Interest paid</td>
<td>Most programmes pay 4.6% interest (not consistent)</td>
</tr>
<tr>
<td>Insurance</td>
<td>Life</td>
<td>Some MFIs are starting to offer life insurance covering client loan repayments plus a small payment to the family in case of the death of the client. A reserve fund is created for the purpose or insurance is bought from the organised sector on behalf of the client.</td>
</tr>
<tr>
<td></td>
<td>Animal</td>
<td>Usually linked with a formal insurance company which obtains bulk business from the MFI while the latter provides the service of premium collection; assists in the verification of claims</td>
</tr>
</tbody>
</table>

*Source: Microfinance: An introduction N.Srinivasan and M.S. Sriram IIMB Management Review, June 2003*
Microfinance Credit delivery Models are often characterized by the

- Attendance of regular weekly fortnightly or monthly group meetings by their clients
- Training of clients in usage of loan or participation in discussions socially relevant issues such as discrimination, gender awareness, health, sanitation and education
- Contribution of fixed amounts, termed ‘savings’, to a fund managed either by the group or by the Microfinance Institution with direct access of the member limited or even barred
- Repayment of fixed amounts as installments on any loan she obtains from the Microfinance Institution or from the group.

The clients are provided loans of small amounts which include loans for consumption and of late include an insurance component for the client.

**Microfinance in India**

Since Independence, the Government of India and the Reserve Bank of India (RBI) have made concerted efforts to provide the poor with access to credit. Recognizing the potential of microfinance to positively influence the development of the poor, the Reserve Bank, NABARD and SIDBI have taken several initiatives over the years to give a further fillip to the microfinance movement in India.

The micro credit programme formally heralded in 1992 with a modest pilot project of linking around 500 self help groups (SHG) has made rapid strides. NABARD which has spearheaded the microfinance programme in India is playing a major role in the provision of ensuring access to banking services to all by the year 2011. The Self Help Group-bank linkage programme (SBLP) initiated by NABARD has grown rapidly and the savings component, in particular has been a success with an increasing number of groups having reached loan absorption limit.

Following the RBI guidelines issued vide its circular dated 18 February, 2000 to all scheduled commercial banks including RRBs, Microfinance Institutions are availing bulk loans from banks for on lending to Self Help Groups and other small borrowers. Besides, development financial institutions such as National Bank for Agriculture and Rural Development (NABARD) and Small Industries Development of India (SIDBI)
and many microfinance promotion organizations have started providing bulk loans to Microfinance institutions. As a result Microfinance Institutions have started playing the role of intermediaries between development financial institutions and poor individual retail borrowers living in rural and urban areas. In another model of credit delivery NABARD provides refinance to commercial bank which provide loans to Self Help Groups in order to facilitate relationship between banks and poor borrowers.

For the year 2010-11, 22 Public Sector Commercial Banks, 15 private sector Commercial Banks, 2 foreign Commercial Banks, 10 Regional Rural Banks (RRBs) had reportedly financed Microfinance Institutions for on-lending. The Self Help Group-Bank Linkage Programme is considered as an important tool for inclusive growth and delivering financial services to poor households. The following is the geographical distribution of the Self Help Group-Bank Linkage Programme in India for the year ended March 2010-11.

The outreach of microfinance services has substantially increased in India in recent years. This has been due partly to the phenomenal growth of the Self Help Group-Bank Linkage Programme and the growth of Microfinance Institution – Non-Bank financial institutions which offer small value financial services to low income families. India has the fastest growing microfinance sector in the world. It presents the single largest Microfinance market in the world with over 600 million people living below USD1.50 a day while the combined Microfinance Institution and Self Help Group market serves only an estimated 67 million borrowers (Srinivasan, 2009). India’s unmet demand for microfinance is still the highest in the world.

Regionally, microfinance is concentrated in South India, where in Microfinance Institutions had most of their outreach and loan volumes in Andhra Pradesh, Tamil Nadu and Karnataka (52 % of clients and 59 % of outstanding loans). There are six major states and all the north-eastern states in which Microfinance Institutions have very few clients, constituting less than 1% of total clients.

Key reasons for the higher microfinance outreach in South India include

- The origination of the bank Self Help Group linkage program in Karnataka largely through the initiatives of the non-government organization (NGO) MYRADA and
the consequent greater participation of Karnataka-based banks, such as the Syndicate Bank and Canara Bank in the programme;

- Better governance that has enabled the development of a larger number of good quality NGOs that, in turn, have spawned Microfinance Institutions; more vibrant local economies in the southern states compared to the less developed states in the north and east; and

- Higher literacy and participation rates of women in the local economy making them more suitable clients for Microfinance Institutions.

Fig 3: Geographical spread of Self Help Group –Bank linkage Programme as on 31.3.2011

Source: NABARD report on status of microfinance 2010-11

The credit delivery model of banks providing funds to microfinance institutions has also been fairly successful in India.
The Microfinance Institutions in India are characterized by diverse institutional and legal forms namely

1. NGO Microfinance Institutions – Registered under Societies Registration Act, 1860 and / or Indian Trust Act, 1880
2. Cooperative Microfinance Institutions – Registered under State Cooperative Societies Act or Mutually Aided Cooperative Societies Act (MACS) or Multi-State Coop. Societies Act, 2002
3. NBFC Microfinance Institutions under Section 25 of Companies Act, 1956 (Not for profit)
4. NBFC Microfinance Institutions incorporated under Companies Act, 1956 & registered with RBI

Indian microfinance has reached out to 3.17 crore clients with loan outstanding of ₹13730.62 Crores for the year ending March, 2011. During the year 2010-11, the microfinance through Microfinance Institution channel grew by 18.75% in 2011 in terms of client outreach and 13.5% in terms of credit portfolio. Microfinance Institutions collectively disbursed ₹33730 crores as loans to clients during 2010-11.

Table 6: Progress under Bank-Microfinance Institution Linkage Model

<table>
<thead>
<tr>
<th>Particulars</th>
<th>2008-09</th>
<th>2009-10</th>
<th>2010-11</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of MFIs</td>
<td>Amount</td>
<td>No. of MFIs</td>
</tr>
<tr>
<td>Loans disbursed by banks to MFIs</td>
<td>581</td>
<td>(12.2 %)</td>
<td>691</td>
</tr>
<tr>
<td>Loans outstanding against MFIs as on 31 March</td>
<td>1915</td>
<td>(72.7 %)</td>
<td>1513</td>
</tr>
<tr>
<td>Loan Outstanding as % of fresh loans</td>
<td>329.6</td>
<td>134.2</td>
<td>219.0</td>
</tr>
</tbody>
</table>

Source: NABARD report on status of microfinance 2010-11

The outreach of microfinance services has substantially increased in India in recent years partly because of the phenomenal growth of the Self Help Group-bank linkage
programme and on account of the substantial growth of Microfinance Institution – non-  
bank financial institutions offering small value financial services to low income  
families. India has the fastest growing microfinance sector in the world. It presents the  
single largest Microfinance market in the world with over 600 million people living  
below USD 1.50 a day while the combined Microfinance Institution and Self Help  
Group market serves only an estimated 67 million borrowers (Srinivasan, 2009). India’s  
unmet demand for microfinance is still highest in the world.

**Objectives of Microfinance**

The objective of microfinance is to provide financial services to those who have  
incomes which are small and unstable. Their credit needs are often small and arise  
suddenly. Most of their credit needs are for consumption and the formal banking  
system is unable to cater to their requirement without a demand for collateral.  
Microfinance is able to reach the poor as it is able to provide them with financial  
services at a scale appropriate to them.

Micro-Credit to the poor often works on the assumption that availability of finance will  
enable them to come out of the vicious circle of poverty. However, when micro credit  
results in bringing about the habit of savings for future needs, it will augur a sense of  
social and economic security in the borrowers. Micro- credit as a tool for development  
can be successful when it is able to combine the advantages of access to credit and  
financial sustainability.

Micro-credit has emerged as an important tool for development and poverty alleviation  
as it promises delivery of higher incomes and growth in assets for the poor by  
promoting micro enterprises. This promise can become a reality if the poor develop the  
potential to make use of market opportunities in running their micro-enterprises which  
will help them to increase the control they exercise over their economic environment.  
Ownership of assets can reduce risk arising due to rising expenditure on consumption  
and fluctuation in incomes of the borrowers. Micro-credit providers can bring about a  
change in the lives of borrowers when they focus on poverty alleviation by including  
livelihood promotion, women empowerment, development of people’s organizations  
and conducive institutional environment as their core values.
Mahajan and Ramola (1996) proposed a matrix to explain the interplay between access and sustainability of the micro credit industry. While the formal financial sector may achieve financial sustainability, it may not have outreach to poor clients (quadrant 2 in fig. 4). Nongovernmental organizations have impressive outreach but are often unsustainable (quadrant 4 in fig. 4). Good micro-credit practice needs to combine both outreach and sustainability (quadrant 1 in fig. 4). Providers of Micro-credit work towards achieving this position.

**Fig 4: Combining Outreach and Sustainability (Source: Mahajan and Ramola 1996)**

<table>
<thead>
<tr>
<th>High sustainability</th>
<th>Low sustainability</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Sustainable financial services reach target clients</td>
<td>4. Highly subsidized financial services reach target clients</td>
</tr>
<tr>
<td>2. Sustainable financial services with low access by target clients</td>
<td>3. Highly subsidized financial services with low access by target clients</td>
</tr>
</tbody>
</table>

**Low sustainability**

Microfinance is viewed as a poverty alleviation tool and attempts have been made by countries to examine the social and economic impact of microfinance. In countries such as Nepal, Bangladesh, India, Vietnam, China and Philippines, where impact studies were carried out, Microfinance can be considered to be a value addition to the total economy as it resulted in the following benefits to its clients:

- better food security and nutrition,
- better housing and health,
- better school enrolments for children,
- women’s empowerment and mobility,
- higher average household income and/or a
• more secure and consistent cash flow over the year,
• higher levels of literacy,
• building of human capital and assets and
• community participation, self-employment and employment of family member,
• Employment creation- employment of non family labour.
• Facilitate financial inclusion and promote inclusive growth.

Micro-enterprises that are promoted by individuals often face difficulties due to their inability to spread the risk of borrowings. On the other hand, collective ownership of micro-enterprises mitigates the borrowing risk as it gets distributed over the members of the group. This lead to the emergence and popularity of Self help groups in our country.

**Part-B: Emerging Issues and Challenges in Microfinance**

Over the past decade, the microfinance sector in India has grown in size, prominence, stature, and visibility through the increasing participation of international and domestic banks, private equity investors, donors, and the private sector. Their key objective is to provide small-ticket financing on a sustainable basis while enhancing the economic status of less-advantaged sections of society. Development institutions, such as NABARD and SIDBI, have also played an important role in paving the way for funding and institutional strengthening of Indian Microfinance Institutions. The Indian microfinance model falls in between state involvement and private commercial initiatives is a program in India started by the National Bank of Agriculture and Rural Development (NABARD), under which a number of private banks in India have become involved in microfinance. ICICI Bank in particular has experimented with some innovative approaches to microfinance involvement under the NABARD program. These trends place microfinance in India squarely within the conventional financial sector and raise important issues of governance and regulation in connection with the new institutions.
Institutional structures and governance practices among Indian Microfinance Institutions are quite varied and differ significantly from mainstream financial intermediaries because many of them are incorporated under a wide range of legal structures. And a lack of clarity in regulations and low transparency compound the problem. Moreover, many Microfinance Institutions, particularly those that have evolved from non-governmental organizations (NGOs) into "NGO-Microfinance Institutions," are still struggling to strike the right balance between their social and business goals, two seemingly conflicting objectives.

Double counting of clients, multiple loans accounts of individuals clients inflating the overall number of clients, counting of accounts rather than clients and reckoning of non-borrowing clients in the absence of full information are some of the concerns raised by skeptics on the data reported. These numbers are more indicative of the growing trends and also indicate a significant need for sprucing up the Management Information Systems of Banks and integrating them with the databases of Microfinance Institutions and Self Help Groups. This can considerably reduce ambiguity and provide more accurate estimates of the state of the sector.

Governance-related issues constitute the biggest challenge to the sustainability of India's Microfinance sector. The most progressive Microfinance Institutions, and a few newly established players with strong private investor support and sound governance practices, are setting industry standards and benchmarks. But they're still the minority. CRISIL reports that the majority of Microfinance Institutions need to reorient and strengthen their governance architecture-from legal structures, to board composition, to internal controls - if they are to survive and continue to grow.

The microfinance sector has continued to grow rapidly and with it the need for better regulation. The proposed Microfinance Bill has been pending in Parliament since 2007, although it is expected to pass in 2010. However, the bill does not cover non-bank financial companies (NBFCs) and microfinance institutions (Microfinance Institutions) registered as not-for-profit companies, thereby ignoring over 80% of the microfinance sector.

The Reserve Bank of India (RBI, the central bank) regulates two types of institutions that engage in microfinance activities: banks and NBFCs. There are also Self Help
Groups (SHGs) that operate as informal credit and savings groupings of 5-30 poor individuals. Under the proposed bill, the National Bank for Agriculture and Rural Development (NABARD) would be responsible for regulating, registering and overseeing the microfinance activity of Self Help Groups and NGO-Microfinance Institutions. A real possibility is a regime with two regulators — RBI for NBFCs and banks and NABARD for Self Help Groups and NGO-Microfinance Institutions. Although they are the largest, Microfinance Institutions, NBFCs are not allowed to accept fixed term deposits without special approval, which requires an investment grade rating from a credit rating agency. Both regulatory approval and credit ratings have become increasingly difficult, if not impossible, to obtain. NGO-Microfinance Institutions are currently prohibited from accepting deposits; however, the Micro Financial Sector Bill pending in parliament since 2007 could open up deposit-taking restrictions on NGO-Microfinance Institutions.

Some of the challenges faced by the sector include:

- Organizational capacity of Microfinance Institutions, outside of the few large and successful ones is lacking
- Limited existence and institutional capacity of institutions – networks, credit bureau, financial and social rating agencies, training and business development services
- Limited product range, current clientele needs – micro insurance, remittances and savings
- New products frontiers (agriculture and agri-based industries, housing, SME – historically credit for petty trade)
- Access to technology
- Mission drift
- Policy lending as against market discipline
- Legal and regulatory framework

Source: Microfinance in Asia, trends challenges and opportunities, 2009: Jamie Bedson

The greatest opportunity for the sector is the attention it has received in the last five years, and the general acknowledgement that microfinance is an effective poverty
alleviation tool. Governments, Microfinance Institutions, the development community and private investors are all focused on creating a supportive policy environment, developing the financial infrastructure and viable institutions and supporting pro-poor product innovations to ensure permanent access to financial services for the majority, as compared to the exclusivity of financial systems in the developed world.

The Opportunities faced by the Microfinance Sector include the following

- Work towards bringing about regulatory reform
- Improving access to commercial funding – banks, private investors
- Number of successful Microfinance Institutions graduating to join the leaders
- Expanding outreach with the down-scaling of commercial banks.
- Savings / deposit mobilisation as a sustainable source of funding
- Development of new Products with the use of technology. Build Partnerships across sectors

Some positive developments that look encouraging to the microfinance sector are:

- Under two separate circulars issued in 2009, domestic banks are required to lend 10% of their adjusted net bank credit to weaker players, such as Self Help Groups, or to Microfinance Institutions that lend to Self Help Groups.
- A Microfinance credit information Bureau is being created; that will pool borrowers’ details from 34 participating NBFC-Microfinance Institutions that are part of the Microfinance Institutions Network (Microfinance Institution, a regulatory organization). Moreover, existing credit bureaus are actively involved in a collective effort to standardise data collection from Microfinance Institutions, as well as to settle on a common data format.
- The central bank has allowed 29 banks to operate mobile-based payment services. Some pilots have involved Microfinance Institutions, but there has been no widespread roll-out of the service.
- As of 1st July 2010, RBI lifted interest rate restrictions on small loans provided by commercial banks in an effort to increase the level of competition in the microfinance sector. Previously, interest rates for all loans under ₹200,000 (around
USD 4,300) from commercial banks had to be set at a level equal to or below the bank’s benchmark Prime Lending Rate.

Microfinance sector is at a stage where it has to prove that it can create value to its clients by providing appropriate financial services. Growth and sustainability over a long period of time will depend not just on the numbers of clients and volume of business, but the quality of service and relevance of the services to the lenders. The goal of responsible finance can be achieved through coordinated efforts of investors, government and the regulator.