CHAPTER - 4

MICROFINANCE AND CREDIT LENDING MODELS

Microfinance institutions are the oldest financial institutions in the world, but with time they have adapted to the changes, and have started using various credit lending models. Microfinance services are provided with different methods in India. A total of 14 models are existing in India. They include associations, bank guarantees, community banking, cooperatives, credit unions, Grameen, group, individual, intermediaries, NGOs, peer pressure, ROSCAs, small business, and village banking models. In reality, the models are loosely related with each other, and most good and sustainable microfinance institutions have features of two or more models in their activities. The Microfinance lending models vary in their legal forms, in the channels and methods of delivery, in their governance structure, in their approach to sustainability and also in their approach to microfinance where their funds are sourced from, and how the money is governed.  

The basic methodology being used in commercial microfinance in India was innovated by Grameen Bank and later improvised by several players. This methodology involved the following elements:

1. Identify the potential customer.

2. Organize the potential customers into groups, so that they could address the issue of information asymmetry and lack of collaterals by transferring what could be an individual liability into a group liability and hold the group morally responsible for repayment – through a process of public oath.

3. Have standardized products, standardized operating systems and enforce discipline; ensure that the exceptions were dealt with severely.

Different institutions in formal and informal sector have successfully tried out these models. Though these models have their own model specific strengths and weaknesses, they have demonstrated to provide financial services to the unorganized sector with effective outreach. Majority of the microfinance institutions offer and provide credit on a solidarity-group lending basis without collateral. There is also a range of other methodologies that MFIs follow. Some MFIs start with one methodology and later on move or diversify to another methodology so that they do not exclude certain socio-economic categories of clients. So it becomes important to have a basic understanding of methodologies and activity of Credit Lending Models.

The scholar has made an attempt to go through and study different Micro-Finance and credit lending models which are being used and working in socio-economic development of rural sector in India.

ASSOCIATION OR GROUP MODEL

An association is formed by the poor in the target community to offer microfinance services (micro savings, microcredit, micro-insurance, etc.) to themselves. Associations or groups can be composed of youth, or women; they can form around political/religious/cultural issues; can create support structures for microenterprises and other work-based issues. It gathers capital and intermediates between banks, MFIs and its members. Example: Self Help Groups. In some countries, an 'association' can be a legal body that has certain advantages such as collection of fees, insurance, tax breaks and other protective measures.
Group method primarily involves a group of individuals, which becomes the basic unit of operation for the MFIs. As MFIs have to provide collateral free loans, group methodologies help in creating social collateral (peer pressure) that can effectively substitute physical collateral. Group becomes a basic unit with which MFIs deal. The group approach delegates the entire financial process to the group rather than to the financial institutions. All financial activities like savings, getting loans, repayment of loans and record keeping are managed at the group level.

In this method, 10-20 members are organized to form a group. These group members make regular savings of fixed amount in a common fund. The amount and frequency of savings is mutually decided by the group members. After the successful working of such a group for some months the group is linked to a financial institution for getting credit. The financial institutions issue loan in the name of group and whole group is considered responsible for repayment. The amount of loan depends upon the total accumulated amount of saving of the group. The group itself selects its members before acquiring a loan. Loans are granted to selected member(s) of the group first and then to the rest of the members. Most MFIs require a percentage of the loan that is supposed to be saved in advance, which points out the ability to make regular payments and serve as collateral. Group members themselves decide about the criteria of dividing the loan among the group members. With this loan the whole group may jointly start a micro-enterprise or the members may start their individual businesses. An individual may also use his loan for consumptive purpose or meeting other priority needs.

Group members are jointly accountable for the repayment of each other’s loans and usually meet weekly to collect repayments. To ensure repayment, peer pressure and joint liability works very well. The entire group will be disqualified and
will not be eligible for further loans, even if one member of the group becomes a defaulter. The creditworthiness of the borrower is therefore determined by the members rather than by the MFI. These type of group based credit delivery methods help to empower the group members because they remain involved in various group activities. They visit the bank, market and hold group meetings which help them to increase self-confidence.

In India, the group based credit delivery method known as SHG-BLP is a predominant method of providing microfinance. Programme Hubungan Bank Danksm (PHBK) project in Indonesia and the Chikola groups of K-REP in Kenya are also using such group based credit delivery models. The Group Model's basic philosophy lies in the fact that shortcomings and weaknesses at the individual level are overcome by the collective responsibility and security afforded by the formation of a group of such individuals. The collective coming together of individual members is used for a number of purposes: educating and awareness building, collective bargaining power, peer pressure etc. A few advantages of group model’s methodology are being given here as follows.

**ADVANTAGES OF GROUP METHODOLOGY**

**a)** The self-selection process of forming a group doubles as a screening device due to the fact that individuals are more likely to select credit worthy peers that can repay the loan. As Dean Karlan argues, this process allows an MFI to overcome inherent information asymmetries by taking advantage of social ties and peer pressure.

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Furthermore, the group acts as a sort of social collateral in the absence of actual physical collateral that is often required when anyone takes out a loan.¹

b) The groups take part in peer monitoring, which means that the social connections facilitate the monitoring process. This has two distinct benefits. The first benefit is that the group acts as a pressure mechanism to ensure that individuals do not default. The social pressure exerted by the group can force individuals to repay in order to avoid severe repercussions. Karlan suggests that these repercussions could be economic and result in reduced trading partners for one’s business, social and lead to loss of friends, or psychological and damage one’s self esteem. Regardless of the type of repercussion, the group effectively acts as an enforcement mechanism, which studies suggest is a powerful tool in ensuring repayment rates at low costs to the MFI. This highlights the second benefit of group monitoring. This benefit is in terms of costs. Monitoring by the group decreases transaction costs because microfinance officers (MFO) do not constantly have to keep tabs on each client. As Karlan elucidates, “Group loans help formal lenders overcome the prohibitively high fixed costs of delivering small loans.”

c) MFIs actually deliver the financial service at the client’s location which could be a village in rural areas or a colony/slum in urban area. Having a group, helps the MFIs in getting all clients at one spot rather than visiting each individual’s house. Also in the absence of a group, if a client refuses to pay there is no forum where such a case can be discussed or there is no method through which the MFI can exert pressure on the client. This helps the MFI in increasing the efficiency of

staff and controlling the cost. Group methodology creates a forum where individuals come and discuss, can provide opinion, and exert social pressure.

d) Group methodology is also important because in case of larger loan defaults a financial institution can take recourse or legal action but in small loans legal recourse is not an economically sound option, as the cost of recovery through that method can be higher than the amount to be recovered itself. Moreover, the clients that the MFIs are dealing with are generally poor and may face genuine problems at times. Rather than taking an aggressive/legal approach, it is always better to have more constructive and collective approach, which is provided by the Groups.

Finally, both group monitoring and group meetings for distributing loans and collecting repayments offer a structure that decreases costs while sustaining high repayment rates. One of the main drivers of the group model is the exceptionally high repayment rate that has become the trademark of the Group Based Loan (GBL) system.

PITFALLS OF GROUP METHODOLOGY

Group loans do not come without drawbacks. Beyond the stated benefits, there are also several challenges that these loans present.

(a) On one hand, the group formation guides to lower transaction costs for the MFIs, but on the other hand, hostility among group members can lead to “voluntary dropouts”, this process leads to social costs. These social costs can be a negative restraint to group borrowing and joint liability approaches, and include coercive peer pressure, loss of faith and the likelihood that the poorest and most vulnerable will remain excluded or further stigmatized.
(b) Due to group liability, “bad clients can ‘free ride’ off of good clients causing default rates to rise”. , there might be social costs leading to tensions within the group and tensions outside the group. For example, tensions may arise if someone cannot repay, a member misses a meeting, or a member acts as a free rider within the group. These group tensions may lead to less incentive for the entire group to continue taking loans, and may result in the group disbanding. Furthermore, if the group sees someone constantly defaulting, they may start defaulting as well if they know the group may not last.

(c) It could be argued that problem of adverse selection remains, since bad risk borrowers will be more attracted to group loans than good risk candidates, since more risk will ultimately fall to those good risk candidates.

(d) Since lending demands may change over time, tension can grow in the group, as those demanding smaller loans will not want to act as collateral on a peer’s larger loan. This heterogeneity of borrowers is restrictive as it prevents those individuals doing well from doing even better, therefore stagnating as opposed to encouraging growth.

(e) Another challenge with group loans remains the inflexibility of the products. As individuals mature within the group, the demand often shifts for new products that MFIs cannot provide. For example, if a client starts a business and it begins to flourish, then the need for larger loans might arise. However, these programs inadvertently place limits on wealthier borrowers. In sum, the rigidity of the program due to the risk aversion of other clients in the group makes it difficult for growing entrepreneurs to gain the additional funds that they need to continue to expand. As a result, MFIs are not keeping up with the growing demand for new products by their clients.
COMMUNITY BANKING MODEL

Community Banking model essentially treats the whole community as one unit, and establishes semi-formal or formal institutions through which microfinance is dispensed. Such institutions are usually formed by extensive help from NGOs and other organizations, who also train the community members in various financial activities of the community bank, closely related to the village banking model. These institutions may have savings components and other income-generating projects included in their structure. In many cases, community banks are also part of larger community development programmes which use finance as an inducement for action. Village banks are community-based credit and savings associations. They typically consist of 25 to 50 low-income individuals who are seeking to improve their lives through self-employment activities.

Community-based organizations (CBO) differ from solidarity group in that they assume eventual graduation of their borrowers from the lending institutions. Therefore, the primary function of CBOs is to develop internal financial management capacity of the group in order to create a mini-bank, independent of the lending institution, owned and managed entirely by the poor. The subcategories of the CBOs are community managed loan funds (CMLF) and village savings and loan associations (VSLA). The former is more widely known as a village banking model and it was developed by John Hatch of FINCA. The main distinctions between CMFLs and VSLAs are the following:

1. CMLFs receive initial external funding (in the form of a loan or grant). There are two main approaches to community-managed loan funds-Village Banking and
Revolving Loan Funds. In addition to the external funding, CMLFs have internal fund (money invested by the members of the fund).

2. VSLAs generate all funds internally (through member savings or retained interest) and receive no external funding. VSLAs can receive technical assistance from NGOs and some equity funding only.

THE REASONS WHY COMMUNITY BANKING MAKES SENSE OF POPULARITY

1) **It is “micro” enterprise with “macro” impact.** One out of five people struggle to live on less than Rs.50 a day. But a loan of Rs.5,000 can make the difference between abject poverty and survival. Creating a successful small business generates on-going income for food and shelter for the family and funds for children to attend school.

2) **It helps people help themselves.** Loans to start or expand small businesses help the poor raise their standard of living under their own management and initiative. Credit to the poor provides a hand-up, not a handout – helping to restore hope and protecting dignity while improving well-being.

3) **Members bank on each other.** Community banks borrow a lump sum during fixed cycles and distribute smaller increments to each bank member. The guarantee on the loan is the high degree of peer pressure among members to assure that all pay back on time. In the case that one member defaults, the others members must cover the deficit to ensure access to another loan cycle.

4) **Small loans are direct deposits against hunger.** When mothers earn, whole family gets benefits. This increased capacity to buy more food improves the family’s diet, making them less vulnerable to disease and death.
5) **It breaks the cycle of poverty.** In developing countries more than half of the population survives by working in small-scale businesses or microenterprises. Access to credit enables the poor to transform their own communities. And because the model is replicable and the money is recycled, community banks can cost-effectively reach far greater numbers of people than traditional aid programs.

6) **It doesn’t create dependency.** Bank members don’t need to receive loans for a lifetime. Many “graduate” after a few years with healthy businesses that rely on their own profits for continued growth.

7) **Members learn while they earn.** Bank members learn skills that improve their businesses and personal lives. They elect officers, keep records, budget their incomes and savings, and share marketing strategies. Some groups add health education to their weekly meetings.

8) **It provides a safe way to save.** Commercial banks require such high minimum deposits that the very poor are locked out. When banked collectively, precious savings are protected from theft, exploitation and natural disasters. Savings plans in community banks often give people the opportunity to save for the first time in their lives.

9) **It builds more than small businesses.** By providing mutual support and encouraging individual empowerment, community banks build stronger families and strengthen civil society. Members often use their new skills to build up community organizations and their churches.

10) **It pays for itself.** Community bank programs have the potential and goal of becoming self-sustaining. The interest charged on loans helps finance program
operations and provides continued capital to make loans available to new communities.

MODEL SUPPORTING OUR COMMUNITIES

The Royal Bank of Scotland (RBS) Foundation India is the platform that houses all our Community Investment initiatives, seamlessly integrating legacy of economic inclusion with new opportunities whilst maintaining strategic alignment with the RBS group's overall approach to supporting our communities. RBS’ Microcredit Business, Microfinance Technical Assistance and Livelihood Support Programmes nurture and support small enterprises and the poorest communities across the country. In 2009, RBS widened scope of activities to offer the RBS Global Employee and Community Engagement schemes to its employees in India.¹

So Community Banking Model can successfully work in India, if borrowers (community) would have involved properly, Andhra Pradesh (A.P.) crisis might be avoided in the history of microfinance in India.²

Microcredit Business: Our Microcredit Business aligns the financial strength of the bank with the distribution network of Micro Finance Institutions (MFIs). Launched in India in September 2003, we were the ‘first international bank’ to offer microfinance.

Microfinance Technical Assistance: In response to the skewed distribution of microfinance in the country, in 2006 RBS launched the Microfinance Technical Assistance programme, focused on building robust and creditworthy MFIs in the underserved regions of the country. Along with CORDAID (an international Dutch NGO) and Micro Save (an international consultancy), RBS provides 12-18 months of hand holding support to nascent MFIs across the country. Its programme works with

¹RBS Foundation India Supporting Enterprise Report, 2009.
²Success stands by Community based Microfinance, 2010: inbaraj_20042002@yahoo.ca.
36 MFIs, across 13 states of India, impacting the lives of more than 100,000 poor families

**Livelihood Support:** Recognizing that credit is a necessary, but not sufficient condition for poverty alleviation, in 2007 RBS fortified microfinance services with a third level of engagement - Livelihood Support. RBS presently have 15 projects across 11 states, each one helping build the credit inclusiveness of more than 63,000 poor women by strengthening their income generating abilities through trainings that help them better manage their productive assets and get better prices for their produce.

**Employee Engagement:** RBS committed to enhance employee engagement by involving its employees in Community Investment initiatives. The RBS group's Community Investment programmes such as Community Cash back, Give As You Earn, and our global employee recognition scheme, Community Stars, emphasize the joy of sharing, giving, teamwork, appreciation and collaboration. In addition to these, foundation also offers a range of volunteering opportunities to suit individual employee interests and passion.

**CO-OPERATIVE MODEL**

Cooperatives are very much like 'associations and Community Banks' except that their ownership structure does not include the poor. A co-operative is an autonomous association of persons belonging to the same local or professional community united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise. Some cooperatives include member-financing and savings activities in their mandate. Members participate in all the major decisions and democratically elect officers from among themselves to monitor the administration of the co-operative.
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 mobilize savings from members.

The leading organization that has been successful in using the cooperative form in rural micro finance in India has been the Cooperative Development Forum (CDF), Hyderabad, which has relied upon a ‘credit union’ involving the saving first strategy. It has built up a network of Women Thrift Groups (WTGs) and Men Thrift Groups (MTGs). They are registered under Mutually Aided Cooperated Society Act (MACs) and mobilize savings resources from the members and access outside-supplementary resources from the individual system. The WTG or MTG are divided into small groups (10 to 15 members) to facilitate better monitoring of thrift and repayment of loans. CDF encouraged members to identify more strongly with their WTG/MTG rather than with the groups, as WTG/MTG are the primary legal entities and viable units of operation.

**ADVANTAGES OF THE MODEL**

(a) Most of the WTG/MTGs decided to register themselves under the New Generation Cooperative Act, which allows for greater flexibility and autonomy in operations. A set of geographically continuous cooperatives forms an association of WTG/MTG.

(b) The Associations provides training, management of the loan insurance fund and inter-lending. It also plays a support role by helping the member cooperative in handling accounting, auditing and other administrative matters.
(c) Cooperatives can access various types of savings from its members besides providing credit like other MFOs. It can also easily get its stakeholders in the governance structure by the use of democratic processes.

(d) Cooperatives can grow organically by setting up federations as and when they have a need to wield clout and negotiate on matters of policy.

**CONTRIBUTION OF COOPERATIVE MODELS FOR ECONOMIC DEVELOPMENT**

Cooperatives reach significantly more individuals and families in the microfinance sector than other financial institutions. They have helped to improve access to finance for all. Financial cooperatives contribute to social development and improved living conditions in communities. They constantly innovate. They can fully assume their role in redefining the global financial sector if their importance and specific nature is recognized. They contribute to socio-economic development by:

(a) Creating sustainable local prosperity;

(b) Making it possible for all individuals to become self-sufficient;

(c) Helping to safeguard against excesses, risks and overly aggressive practices;

(d) Making members more resilient to external shocks;

(e) Participating in the creation of quality jobs;

(f) Being major drivers of economic growth;

(g) Encouraging innovation and sustainable development.

(h) Potential to scale-up their coverage of poor.

(i) Bringing good dividends in terms of increased lending and assured recovery.
PITFALLS OF THE MODEL

(a) The macro level studies indicate that the cooperatives at large have not been able to fully tap the potential of SBLP for reviving their business position. The general skewed spread of SBLP has also affected the linkage by cooperatives. The late reach of SBLP to cooperatives coupled with lack of legal clarity on the position of SHGs, and poor governance and business abilities of cooperatives have come in the way of widespread adoption of SBLP by cooperatives.

(b) Lack of appreciation of the potential involved under SBLP and inadequate professional and other abilities to pursue a programme of SBLP type are some of the constraints faced by the cooperatives. Simultaneously, the apparent delay both in promoting SBLP among the cooperatives and in creating a suitable legal environment has also made cooperatives to be lax in taking the needed initiatives.

(c) Cooperatives also experience problems in accessing mainstream finance, because of their poor image. No single cooperative has reached up to the level of activity to become eligible to be incorporated in the formal system of microfinance.

(d) Again, the greatest challenge on the governance front is the fact that so many cooperatives are not part of an organized network, but function as standalone organizations. Their area of operations is demarcated; this weakens their capacity for good governance. Strengthening the board of directors and educating members about the importance of proper governance is also imperative. And finally, governments need to get involved by creating a proper regulatory framework for cooperatives, applying the norms and being able to close down those cooperatives that are not bona fide.
THE GRAMEEN MODEL

Grameen model is based on the concept of joint liability. It is the brainchild of Prof Muhammad Yunus, founder of Grameen Bank in Bangladesh. Grameen model is the most accepted and prevalent micro-finance delivery model in the world today. Many MFIs have accepted the model as it has high focus on standardization and discipline. It has been highly successful in its banking service to the poor as well as in its poverty alleviation programmes.

THE OBJECTIVES OF THE GRAMEEN BANK MODEL

(i) To extend banking facilities to poor men and women (ii) Eliminate the exploitation of the poor by moneylenders (iii) Create opportunities for self-employment for the vast multitude of unemployed in rural area (iv) Bring the disadvantaged, mostly women from the poorest households, within the fold of an organizational format which they could understand and manage by themselves (v) Reverse the age-old vicious circle of ‘low income, low saving and low investment’ into a virtuous circle of ‘low income, injection of credit, investment, more income, more savings, more investment, more income’. 1

FEATURES

‘Grameen credit’ according to Muhammad Yunus, is based on the premise that the poor have skills which remain unutilised or under-utilised. ‘Grameen credit’ promotes credit as a human right and is targeted at the poor, particularly poor women. The most distinctive feature is that it is not based on any collateral, or legally enforceable contracts, but on trust. It provides service at the doorstep of the poor based on the principle that the bank should go to the people. Another unique feature

of ‘Grameen credit’ is that it gives high priority to building social capital through the formation of groups and centers, develops leadership qualities and undertakes a process of discussion among borrowers. It lays special emphasis on protection of the environment and children's education, and provides scholarships and student loans for higher education. For the formation of human capital it attempts to increase people’s access to technology, like mobile phones and solar power.

**WORKING OF GRAMEEN MODEL**

**Operating Unit:** A bank unit is set up with a Field Manager and a number of bank workers, covering an area of about 15 to 22 villages. The manager and workers start by visiting villages to familiarise themselves with the local milieu in which they will be operating and identify prospective clientele, as well as explain the purpose, functions, and mode of operation of the bank to the local population. Grameen model, as mentioned, is a joint liability group model. Here five-member groups are formed and eight such groups form a Center. Hence, in a full-capacity Center there are 40 members (8 x 5). However, over the years people have experimented with Centers of different sizes and now there are variations of 5-8 groups within a Center. Center is the operational unit for the MFI, which means that MFI deals with a Center as a whole.

**Eligibility for Loan:** In the first stage, out of Group of five prospective borrowers; only two of them are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to rules of the bank. Only if the first two borrowers repay the principal plus interest over a period of fifty weeks, other members of the group become eligible themselves for a loan.
**Group Meetings:** Meetings also take place only at the Central level and individual groups do not meet. Group meetings take place only in front of the Field staff of the MFI. The model suggests weekly meeting for frequent interaction with the clients to reduce credit risk. These groups of five meet together weekly, with seven other groups, so that bank staff meets with forty clients at a time. The meetings are conducted for carrying out the financial transactions only. The meetings are conducted systematically in a short-time and other social issues are not discussed.

**Terms and Conditions of Loan:** Flat interest is charged again for making the system standardized. In flat rate system installment size of repayment remains small for all weeks and hence is convenient and easier to explain. Also, it is easy to break the loan installment into the principal and interest component. The group leader collects the loan repayments and savings prior to the meeting and hands it over to the Centre leader who gives it to the field worker during the meeting. This collected amount is deposited in the branch on the same day. No new loan is issued from this collected amount. It discourages all possible leakages in monetary transactions.

**Joint Liability:** The Group and Center are Joint liability Groups, which means that all members are jointly responsible (‘liable’) for the repayment. MFI recovers full money from Center, if any member has defaulted: the group members have to pool in money to repay to the MFI. If Group members are unable to do it, Center as whole has to contribute and share the responsibility. According to the rules, if one member ever defaults, all in the group are denied subsequent loans. Because of these restrictions, there is substantial group pressure to keep individual records clear. In this sense, collective responsibility of Group/Peer pressure replaces the collateral.

Responsibility for the loans of all the group members is crucial, because it is the group - not the bank - that initially evaluates loan proposals. Defaulters spoil
things for everybody else, so group members choose their partners wisely. If all five repay their loans promptly, each is guaranteed access to credit for the rest of the life - or as long as she elects to remain a customer. The most significant aspect of the Grameen Bank Model has been its high loan recovery rate (98% and above).

Grameen model is being followed by India by Association for Sarva Seva Farms (ASSEFA), Activities for Social Alternatives (ASA), SHARE Microfinance. Lt CASHPOR Financial and Technical Services Ltd have adopted this methodology with little variations.

**INTERMEDIARY MODEL**

Access to microfinance has improved lives up to some extent, the estimated impact appear to be quite small and heterogeneous. This is because of the restrictions mandated by microfinance institutions. A better model of microfinance should be designed that will be more flexible system of microfinance that targets smallholder agriculture, without requiring collateral and without endangering financial sustainability. Ideally it should allow individual liability loans, drop savings requirements, have less rigid repayment schedules (so that recipients can invest in high return projects with longer gestation period like agriculture) and reduce/eliminate costly meetings with MFI officials. Is it possible to do all of these and still ensure high repayment rates? Designing such a model that functions is not easy because crucial issues like borrower selection and repayment incentives have to be addressed.

One possible solution is to draw upon one of the key premises of microfinance: harness of local information and social capital. If there are third parties within the local community with information concerning creditworthiness of borrowers and with some ability to impose sanctions on non-performers. These third
parties could be appointed as loan intermediaries. On this basis we can say that
Intermediary model of credit lending position is a 'go-between' organization between
the lenders and borrowers. The intermediary plays a critical role of generating credit
awareness and education among the borrowers (including, in some cases, starting
savings programmes. These activities are geared towards raising the 'credit
worthiness' of the borrowers to a level sufficient enough to make them attractive to
the lenders. The links developed by the intermediaries could cover funding,
programme links, training and education, and research. Such activities can take place
at various levels from international and national to regional, local and individual
level.\(^1\) Intermediaries could be individual lenders, NGOs, microenterprise/
microcredit programmes, and commercial banks (for government financed
programmes). Lenders could be government agencies, commercial banks,
international donors, etc. Most models mentioned here invariably have some form of
organizational or operational intermediary - dealing directly with microcredit, or non-
financial services.

For recommendations, agents receive incentives in monetary as well as non-
monetary basis. The agents receive commissions based on loan repayments. Second,
there is a system of deposits and bonuses aimed at ensuring that the agent
recommends good borrowers. Finally agents (in conversations during field visits)
noted that they expected to increase their visibility within the village community and
hence experience an increase in their long term reputation within the community and
a boost to their ego.

From a policy perspective this approach resembles the recent policy
recommendation by the Reserve Bank of India to set up a network of banking

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correspondents (BCs) and banking facilitators (BFs) in order to expand financial services to rural areas, remote locations and uncovered households. The agents in our framework could be viewed as BFs.

**ADVANTAGES OF MODEL**

(a) The loans involve several dynamic features to encourage borrower repayment incentives: future eligibility for loans is linked to repayment of current loans, and loan sizes grow progressively with successful repayment. Safe borrowers would make a positive contribution to social surplus.

(b) The loans are designed to finance cultivation and marketing of agriculture produce. Borrowers can repay in the form of producer’s cold store receipts at harvest time, so they do not have to sell the crop at that time in order to repay the loans.

(c) An insurance aspect is included in the loan: repayment obligations are reduced following adverse village level covariate shocks to crop yields or revenues (which are verified by post-harvest surveys).

(d) Intermediated loans experience higher take up (controlling for landholding) as these clients do not have to bear the burden of making up for the repayment burdens of their group members if the latter default. Nor do they have to incur the costs of attending group meetings, achieving savings targets, or all the problems of free-riding and social tensions.

(e) Some additional features reduce transactions costs for borrowers: loans are made directly by the MFI, with MFI officials visiting each borrower in their homes. Borrowers do not have to open bank accounts, with all transactions taking place at
their door-step. There are no savings requirements or mandated meetings with agents or MFI officials.

(f) The administrative costs of lenders are substantially lower owing to the elimination of these requirements, since MFIs do not have to hire officials who conduct weekly meetings and collect savings deposits from borrowers.

PITFALLS OF THE MODEL

(a) The success of this program will crucially depend on the agent recommending good clients. So the obvious question is: what are the agent's incentives to recommend good clients. Therefore handsome share of commission has to be given to agents.

(b) With the higher provision of incentives for intermediaries, cost of borrower will rise, which will further deteriorate the situation.

(c) Agents can refer clients, pursue the client’s proposal and facilitate the MFIs to carry out its transactions; however the final decision on whether to actually provide the loan to the recommended household rests with the actual lender.

(d) Finally agents might be politically motivated and might view this as an extension of the government anti-poverty programs and use this to increase the political dominance of the party in power within the village.

The agents appointed as intermediaries do seem to have been incentivized by the commissions to select safe types from among their clientele or those that they have better information about (through past interactions and/or caste religion networks) and the evidence does not suggest collusive behavior. Nevertheless what should really matter is the impact of these loans on agricultural operations, and on the
incomes earned by the borrowers. For that we need to wait for the experiment to run its full course.

**INDIVIDUAL BANKING MODEL**

In the past decade, many MFIs have begun to recognize that the traditional group based lending (GBL) model is too restrictive and not universally applicable. As a result, many institutions have started to shift towards various alternative models including group based loans with individual liabilities where repayment is still weekly during a group meeting, or by simply shifting to a model that extends an individual liability loan. The shift towards individual loans has been remarkable over the past few years. As Dean Karlan and Jonathan Zinman said “recent estimates suggest that about one-half of microfinance institutions are individual liability lenders.” Therefore, it is not accurate to denote that microfinance is solely based on a group lending methodology. The individual model is, in many cases, a part of a larger ‘credit plus’ programme, where other socio-economic services such as skill development, education, and other outreach services are provided. This is a straightforward credit lending model where micro loans are given directly to the borrower. It does not include the formation of groups, or generating peer pressures to ensure repayment.¹

**WORKING OF MODEL**

In Individual lending method, MFIs provide loans to an individual based on his/her own personal creditworthiness. Individual lending is more prevalent with clients who generally need bigger size loans and have the capacity to produce guarantee and generate enough comfort to the MFI. MFIs generally base their decision on personal knowledge of the client, his/her reputation among peers and

¹Dean Karlan and Jonathan Zinman, (The Economic Growth Center, Yale University, Working Paper, 976, 2010), P. 2.
society, client’s income sources and business position. MFIs also ask for individual
guarantors or take post-dated cheques from clients. Individual guarantors come from
friends or relatives well known to the borrower and who are ready to take liability of
repaying the loan, should the borrower fail to do so. If the loan is significantly larger,
then MFIs may also take some collateral security. In this model, the financial
institutions have to make frequent and close contact with individual clients to provide
credit products customised to the specific needs of the individual. It is most successful
for larger, urban-based, production-oriented businesses. The formal financial
institutions like Commercial Banks, Regional Rural Banks and Co-operative Banks
adopt predominantly individual banking based model for lending to unorganised
sector comprising both farm and non farm sector.

ADVANTAGES OF MODEL

There are many reasons why individual loans are better in some instances than
group loans.

(a) Specifically, these loans may attract new clients who did not participate
previously in microfinance programs because the group atmosphere did not suit
their needs. In turn, this allows an MFI to increase its reach.

(b) Individual loans also permit MFIs to tailor the loan specifically for its clients’
needs. This is especially attractive for agricultural financing, which needs more
flexibility in its repayment cycles.

(c) Individual loans also give a client more privacy. By taking away the group
atmosphere, individuals do not have to disclose their financials to anyone other
than the MFI. If there was a potential for social tension in a group atmosphere,
individual loans can eliminate this risk as friends and family members no longer have to vouch or cover loans for another person.

(d) Finally, individual loans give MFI an opportunity to monitor the uses of the loan more closely to ensure that it is going to the assumed purpose. This means that MFOs must become more actively engaged with individual clients, which could potentially increase the costs of servicing these loans. Therefore, it is perhaps important to understand what roles existing structures or informal lenders can play in facilitating agent based monitoring practices.

**PITFALLS OF MODEL**

Individual lending also comes with some reservations.

(a) Few MFIs provide individual loans to low-income people because poorer clients are considered higher risk clients due to their lack of collateral, plus the labor-intensive nature of the credits and hence the lack of profitability of small-credits.

(b) Group peer pressure is absent and therefore programme management, client appraisal poses specific challenges. Here clients have to be monitored and deeper field research is necessary in order to choose the right clientele, especially because these people have no tangible collateral or credit history and in most cases are illiterate. Sources of information for the field officer are the family, friends and leaders of the community.

(c) With this model, the loan is given directly to the borrower and it is his/her sole duty to pay back the full amount plus interest rates without financial support from a group in case he/she defaults.

(d) Technical assistance as well as payment schedules and business management training is generally provided by the MFI for recovery of loans. More monitoring
might lead to increased costs of servicing a loan, as mentioned previously. Screening potential clients might end up being costly as well.

This model is followed by many financial institutions like the Association for the Development of Micro-Enterprises (ADEMI) in Dominican Republic, BASIC BANK (Bangladesh), Bank Rakyat Indonesia (BRI) in Indonesia, Senegal Egypt, Self-Employment Women’s Association in India, etc. However, BRI does request collateral and a loan co-signer, while ADEMI and BASIC BANK will take the best collateral it can be the Socio-Economic and Gender Analysis (SEAGA) Programme, FAO).

OTHER MODELS

(i) MIXED / MULTIPLE MODELS

Some MFIs started with the Grameen model but converted to the SHG model at a later stage. However they did not completely do away with Grameen type lending and smaller groups. They are a mix of SHG and Grameen model. Many MFIs have adopted multiple models for the provision of micro finance. It was seen that NGO-based MFIs are using mostly the SHG model and the NBFI-based MFIs are mostly using the JLG model for the disbursement of micro finance. But in the recent past, it was noticed that certain MFIs are using multiple models like SHG, JLG, Mutual Aided Cooperatives etc. even in the same operational area and same category of product. ADHIKAR Micro Fin, a Orissa-based NGO-MFI, provided microfinance products and services through various models like JLG Model, Cooperative Model, Remittance Model and Banking Correspondence Model. The main difference between these programs is rather marginal. The SHGs model is widely used in India.

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According to the SHGs and Grameen models offer economies of transaction cost to MFIs, but at the cost of members time because the unit of dealing is “group” rather than individual. In contrast, MFIs offering individual loans incur higher transaction costs for serving their borrowers.

(ii) BUSINESS FACILITATOR/ BUSINESS CORRESPONDENT MODEL

In 2006, RBI permitted banks to appoint business facilitators and business correspondents (BC). While the former can merely promote the business of the bank; the latter can take on a larger scope of activities, such as disbursal of small value credits, collection of small value deposits, sale of micro insurance, pension and other third party products as well as receipt and delivery of small value remittances and other payment instruments.

BUSINESS FACILITATOR (BF) MODEL

As per RBI guidelines, banks are encouraged to use intermediaries, such as NGOs, Farmers' Clubs, cooperatives, community based organisations, IT enabled rural outlets of corporate entities, post offices, insurance agents, well-functioning Panchayats, Village Knowledge Centres, Agri Clinics/Agri Business Centres, Krishi Vigyan Kendras and KVIC/KVIB units, as Business Facilitator (BF) for providing facilitation services, viz. identification of borrowers and fitment of activities; collection and preliminary processing of loan applications including verification of primary information/data; creating awareness about savings and other products and education and advice on managing money and debt counseling; processing and submission of applications to banks; promotion and nurturing SHGs/ JLGs; post sanction monitoring; monitoring and handholding of SHGs/JLGs/Credit Groups/others; and follow-up for recovery.
BUSINESS CORRESPONDENT (BC) MODEL

It has been widely recognised that it is not feasible to have physical banking facility in every habitation. Hence, the financial inclusion strategy largely focuses on the use of information and communication technology (ICT) to expand access to banking facilities through Business Correspondent (BC), who carries a hand-held device which is networked to the bank’s systems. RBI issued guidelines in January 2006 for the engagement of BCs by banks for providing banking and financial services in addition to the traditional ‘brick and mortar’ model. Under the BC Model, banks have been permitted to use the services of various entities like NGOs/SHGs, Farmers Clubs (FC), PACS, Microfinance Institutions (MFIs) and other Civil Society Organisations (CSOs), companies registered under Section 25 of the Companies Act, 1956, ‘for profit’ companies, retired Government/bank employees/teachers, ex-servicemen, individual owners of kirana/medical/Fair Price shops, agents of small savings schemes of GOI/Insurance companies, individuals who own petrol pumps, and Post Offices to act as BCs.¹

PITFALLS OF THE BC MODEL

(a) The eligibility criteria excluded a number of large MFIs in the country. While most other kinds of MFIs are eligible to function as BCs, NBFCs not registered as not-for-profit companies were excluded through subsequent notification. The reasons for this exclusion are reported to be the possible use of the model to bypass time consuming requirements to obtain branch licenses and possible exploitation of customers due to excessive commercialization.² Some MFIs who are group entities registered as trusts and societies have made use of these

¹RBI CIRCULAR: http://rbidocs.rbi.org.in/rdocs/Notification/PDFs/68417.pdf
structures to become BCs. It is also possible that the potential costs of record keeping and coordination with the concerned bank are likely to far outweigh the advantages of offering the additional services to customers.

(b) BCs are not permitted to charge fees from the clients as banks are expected to remunerate them. In the case of loans, this results in effective capping of the overall interest rate that the borrowers could be charged as banks are not permitted to charge interest rates above their benchmark prime lending rate for loans which are lower in amount than Rs. 200,000. This caps the interest rate of all microfinance loans as these loans by definition are lower than Rs.50,000.

(c) In a later notification, RBI stipulated that every BC should be attached to a particular bank branch (called the base branch) and the distance between the place of business of a BC and that of the branch should not exceed 15 km in rural, semi-urban and urban areas and 5 km in metropolitan areas. This restriction also reduced the attractiveness of the scheme.

**MAINSTREAMING BC MODEL**

The BC model has the potential to speed up the process of financial inclusion in India and bring the vast majority of population within the banking fold. An RBI Working Group (RBI, 2009)\(^1\) recognised the fact that the process of financial inclusion involves the three critical aspects of (a) access to banking markets, (b) access to credit markets and (c) financial education. The BC model should, therefore, encompass each of the above three aspects in order to be able to address the issue of financial inclusion in a holistic manner. Banks need to appreciate the benefits arising out of adopting the ‘branchless’ BC model and implement the same with missionary

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zeal so as to achieve the ultimate goal of financial inclusion. There is a need to mainstream the BC Model by banks, by utilising the services of SHGs, NGOs, Farmers Clubs, Post Offices, PACS, retired school teachers, and other suitable persons and agencies. There are 1,39,182 Post Offices in rural India, and they are in closest proximity (2 km on an average) to rural clients compared to branches of commercial banks, RRBs and cooperatives (5 km on an average). Thus Post Offices functioning as BCs, could lead to a massive expansion in the outreach of banks.¹

**WAY FORWARD**

In the last but not the least, the scholar suggests that market driven business model shall pave way for a legitimate and more sustainable model with social objectives. The current commercial-only-model should move towards that model which balances growth with equity by putting the poor at prime position. Today’s business model should transform its goal to social equity instead of profit. The formal sector is looking proactively as to how the MFIs could take the new business model so as to make them more resilient to the undesirable practices and thus make them compliant to the conditions of Malegam and at the same time be responsible by demonstrating governance, management and operational practices inclined towards well-being of clients.

The MFIs in India can play a major role in these efforts after their suggested restructuring on the proposed PPP model and financial support to them through collective actions of the central and state governments along with commercials banks in India. A client centered business model is the need of the hour lest microfinance faces the danger of heading for its death knell.

¹Priyadarshee, A. (2010). Institute for Development Policy and Management, University of Manchester, UK.