CHAPTER 2

Microfinance an Overview

2.1 Microfinance
2.2 Microfinance Institution (MFI)
2.3 Approaches of Microfinance
2.4 Microfinance Delivery Models
2.5 Cost and Revenue Components of MFI’s
   2.5.1 Cost Components
   2.5.2 Revenue Components
2.6 Microfinance in India
   2.6.1 Microfinance Development Phases
   2.6.2 Microfinance Crisis in India
   2.6.3 Legal Structure of MFIs in India
2.7 Microfinance in Gujarat

References
Chapter 2 Microfinance an Overview

The current chapter highlights macroeconomic problem, poverty. Review of literature on microfinance, various aspects of microfinance, microfinance institutions and its different forms, microfinance delivery models, cost - revenue components, statutory provisions related to microfinance and status of microfinance in India and Gujarat have been studied in detail.

2.1 Microfinance

Poverty is the root cause of macroeconomic problem of underdeveloped or developing countries like India. Poverty can be eliminated by monetarily endowing the poor. Imparting education on vocational and financial skills and providing financial support through financial inclusion are two main aspects of financial empowerment. Microfinance is the main tool for financial support and financial inclusion of such poor people.

In general sense microfinance is providing small and marginal loans (micro credit) to poor people, who usually fall under unorganised sector for financing their income generating activity.

According to Otero, “Microfinance is the provision of financial services to low-income poor and very poor self-employed people” (Otero, 1999). The same is defined by International Labour Organization (ILO), “Microfinance is an economic development approach that involves providing financial services through institutions to low income clients”\(^{13}\). According to Asian Development Bank microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, remittance (i.e. money transfer) and insurance to poor and low-income households and their microenterprises (Asian Development Bank, 2000).

According to Pashankar, Microfinance refers to small savings, credit and insurance services extended to socially and economically disadvantaged segments of society (Pashankar, 2003). Further OECD indicates that, Microfinance refers to loans, savings, insurance, transfer services and other financial products targeted at low-income client (OECD, 2006).

Wrenn states that microfinance involves the provision of financial services such as savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector. According to him though, the terms

\(^{13}\text{http://www.adb.org/sites/default/files/institutional-document/32094/financepolicy.pdf}\)
microcredit and microfinance are often used interchangeably, but there is difference between them (Wrenn, 2007).

The above definition highlights mainly two aspects, one type of financial services and the receiver of such financial services. However it do not clarify the objective of microfinance services. However below given definitions clarify the objective of microfinance,

According to the report submitted to Reserve Bank of India, to study Issues and Concerns in the MFI Sector under the chairmanship of Y.H.Malegam, “Microfinance is an economic development tool whose objective is to assist the poor to work their way out of poverty. It covers a range of services which include, in addition to the provision of credit, many other services such as savings, insurance, money transfers, counselling, etc.”

According to The National Microfinance Taskforce, 1999 constituted by NABARD under the Chairmanship of Shri Y C Nanda defined microfinance as “provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards” (NABARD, 1999).

The above definition not only include the types of financial services and the receiver of such financial services but also include the objective of poverty eradication and mend their standard of living. The various functions and objectives of microfinance can be summarised as follows:

a. Microfinance addresses macroeconomic problem of poverty by enabling the poor to work their way out of poverty.

b. Microfinance provides credit facility at reasonable rates to poor or low-income groups, who are not covered by formal organized sector.

c. The loan size of such credits are of small amounts.

d. Normally such loans are provided without collateral security and easily accessible by poor.

e. Normally purposes of such loans are for financing their income generating activities.

f. The time duration of such loans is short.

g. Normally such loans are provided under group lending model, SHG enable to control transaction costs.

h. Most of the microfinance institutions provide loans to the women that, enables women’s empowerment and enhancing their status within their families, the community and society at large.

i. The chances of loan loss (bad debts) is less than the traditional commercial loans.

j. Many microfinance institutions accept Deposits that promote savings among the poor and it reduces cost of financing.

k. It provides insurance facility to the poor for financial security against health and life risk, it also helps institute in generating additional income.

l. Microfinance institutions also provide other social, financial and educational services.

Dalawai considers microcredit and microfinance as two different service products of microfinance, according to him Microfinance refers to collection of banking practices built around providing small loans (typically without collateral) and accepting tiny savings deposits (Dalawai, 2014)

The literature reviewed on microfinance depict that, microfinance involves provisions of various financial services such as microcredit, savings, payment, insurance, pensions etc. to the poor or low income group for their income generating activity and financial sustainability. Microfinance institutions educate to help them for their income generating activity. It also provides services to address various social and economic problems.
2.2 **Microfinance Institution (MFI)**

Microfinance is a tool for poverty eradication and Development for any underdeveloped or developing country. According to Otero, the intersection between microfinance and development occurs at the institutional level that deliver financial services to the poor. They are distribution channels for deploying services that respond to the material capital needs of poor (Otero, 1999).

The person, generally poor or person of low income group, who requires micro credit, saving and other financial services is considered as microfinance client. In broad terms MFI is an institute that offers financial services to microfinance clients.

According to OECD, Microfinance Institution is an organisation which provides microfinance facility to the poor mostly for their livelihood. It includes a broad range of financial sector organisations such as banks, non-bank financial institutions, financial co-operatives and credit unions, finance companies and NGOs specialising in serving people who lack access to traditional financial services (OECD, 2006).

As per Geetika, access to financial services has been recognized as a human right. A large number of the poor continue to remain outside the fold of the formal and organised banking system. Exploitation by informal credit system and failure of formal market and the government in providing credit access to the poor gave birth to Microfinance institutions. Microfinance institution refers to a wide range of organizations dedicated to providing these services and includes NGOs, credit unions, co-operatives, private commercial banks, NBFCs and parts of State-owned banks.(Geetika, 2015).

**Role of Microfinance Institutions**

According to Robinson, the role of microfinance institutions is to ensure that the poor also have access to finance for productive purposes which is summarised as follows:

- Improve financial security
- Facilitate growth of enterprises
- Allow storage of excess liquidity for future use
- Improve the livelihoods of low income earners and those of their dependents

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• Help people of low income reduce risk, improve management, and realize high return on investments.

• Social change through empowering women and changing gender relations in the community and households (Robinson, 2001).
2.3 Approaches of Microfinance

Microfinance institutions act as a social intervention or a poverty alleviation tool. Though most microfinance institutions are not financially viable, they always face a dilemma between achieving commercial viability and serving the poor. The concept of microfinance has been influenced by two major schools; the Welfarist school and Institutional school, which is also known as Social approach and Commercial Approach of microfinance (Robinson, 2001).

Social Approach

Welfarist school of thoughts give more emphasis on Social Approach. Various not for profit organisation, government institutions and institutions depend on donation and subsidies providing microfinance services at low rate to the poor are covered under this category. Welfarist focuses on immediate improvement of the economic safety for the poor. They focus on providing financial services to the poorest of the poor at subsidised rate of interest. The MFIs that fall under this approach are heavily reliant on the government subsidies and grants as well as donor subsidies. Saving mobilisation is not a part of the lending process in this approach. Though they understand that the long term sustainability of MFI is very important, however, they do not agree that avoiding donor subsidies completely will be required to achieve that state (Robinson, 2001).

Welfarists tend to emphasize poverty alleviation, place relatively greater weight on depth of outreach relative to breadth of outreach, and gauge institutional success more so according to social metrics (Brau & Woller, 2004).

According to Charikinya, Margaret, Gombarume, & Njanike; social intermediation helps in poverty reduction because it develops the economy, empower individuals, building democratic peoples’ organizations and changing wider systems within the society (Charikinya, Margaret, Gombarume, & Njanike, 2011).

Commercial Approach

Institutional school focuses on developing a financially sustainable institution that is expected to serve the poor. The basic foundation of such an approach is to provide financial services to poor at an affordable cost. Numerous large-scale, profit seeking microfinance organisations come under this approach that provides high quality financial services to the poor. According
to Institutionalise, a significant impact on poverty can be achieved only if MFIs are financially self-sufficient and independent from any subsidised funding from donor or government (Robinson, 2001).

The demand for microfinance is much greater than supplied by subsidised microfinance institutions, because of limited availability of subsided fund and intuitional malpractice. The only way to close the absurd gap between demand and supply in microfinance is for microfinance institutions to mobilize savings, to raise capital commercially, and to service clients through extensive branch networks. Institutional self-sufficiency is the only possible means to meet widespread client demand for convenient, appropriate financial services. Building sustainable institutions allows donors to maximize the outreach of their scarce funds. Financially self-sufficient institutions finance their microloan portfolios commercially, enabling them to multiply outreach by leveraging additional capital (Robinson, 2001).

Until the 1990s, microfinance was mainly seen as an impact-driven development programme based on the support of governments and private donors. MFIs typically charge below-market interest rates and did not necessarily operate on a self-sufficient basis. A number of failures among heavily subsidised state-owned development banks finally led to the conviction that MFIs should become commercially-oriented and seek operational self-sufficiency16 (Deutsche Bank, 2012).

According to the research document on Microfinance evolution of Deutsche Bank, “From a development policy perspective, it was argued that commercialisation of the microfinance business would be conducive to social objectives. Since commercially operating MFIs would make use of existing funds more efficiently and have a strong incentive to grow, they would also be better able to close the perceived gap between supply and demand in microfinance…..

More recently, commercialisation in combination with excessive profit-orientation has often been cited as the main cause for the problems in microfinance. Excessive profit-orientation is made responsible for driving interest rates up, transferring wealth from the poor to MFI managers and owners, as well as for an increasing share of over indebted borrowers among MFI clients” (Deutsche Bank, 2012).

The above literature give insight about the two approaches of microfinance institutions. The initial objective of microfinance is based on social approach. Sustainability of microfinance

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institution and to meet growing and unfulfilled demand for microfinance are the major limitations of social approach. This give birth to institutional approach, which has self-sustainability and profitability as a primary objective over social. Excess commercialisation and profit-orientation leads to economical imbalance and financial like Andhra Pradesh witnessed in 2010.
2.4 Microfinance Delivery Models

Microfinance delivery models are the methods by which microfinance credit is provided. Microfinance institutions around the world follow different methodologies for providing microcredit to the poor and low-income groups. Following are the some famous models of MFIs,

1. Grameen Bank Model

Grameen Bank model found by Professor Muhammad Yunus 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 is the key factor in ensuring 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 (Sinha, 2003). Under this model women were initially given equal access to the schemes, and proved to be not only reliable borrowers but also astute entrepreneurs as well.

2. Self-help Group (SHG) Bank Linkage Programme

The SHG is the dominant microfinance methodology in India. According to Geetika, “The SHG model, in the form of the SHG-Bank linkage program (SBLP) was initiated in the early 1990s by the National Bank for Agriculture and Rural Development (NABARD). SHG linkage is based on the principle of `savings first’. These savings are not only a way of creating group solidarity and testing people’s willingness regularly to keep some cash aside, they also create a loan fund from which the group can borrow”17 (Geetika, 2015). According to Sinha, “The operations of 15-25 member SHGs are based on the principle of revolving the members’ own savings. External financial assistance by MFIs or banks augments the resources available to the group-operated revolving fund. Savings thus precede borrowing by the members. In many SHG programmes, the volume of individual borrowing is determined either by the volume of member savings or the savings of the group as a whole. Some NGOs operate microfinance programmes by organising federations.

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of SHGs to act as the MFI which obtains external loan funds in bulk to be channelled to the members via the SHGs” (Sinha, 2003).

3. Federated Self Help Group Model:

Federations of SHGs bring together several SHGs. Federations having member strength between 1000 to 3000 are generally registered under the Societies Registration Act. It has three-tier structure where the SHG is the basic unit; the cluster is the intermediate unit and an apex body. The executive body at the apex level consists of 9 to 15 members. Federation fulfil the function of an agent and manager of external credit funds. The Federation of SHGs assists the SHGs in recovering difficult loans and strengthening weak SHGs. Thus the Federation helps all the weak SHGs in carrying out their savings and credit functions smoothly. In India SHGs include those promoted by the Dhan Foundation, PRADAN, Chaitanya and SEWA are famous in India (Guha, 2004).

4. Joint Liability Groups or Individual Liability

The Joint Liability Group method was made famous by Grameen Bank in Bangladesh and has been replicated by MFIs across the world. According to Geetika, “Under the JLG model, MFIs organize members into groups with the understanding that even though members will be given individual loans, the group as a whole will be liable for repayment. As in the case of SHGs, social pressure ensures that repayment levels remains over 98 percent in India. The size of the group is much smaller than an SHG with each group comprising of 5 women. Certain microfinance institutions also lend to individuals with individual liability. In order to qualify for a bigger individual loan, members must have demonstrated good credit history over one to two years. The advantage of the JLG model over the SHG model lies in the former’s ability to scale. It is highly replicable and allows MFIs to rapidly expand their client base and become more profitable. In fact 30 percent of the 70 million microfinance clients in India are members of the top 10 MFIs. Critics of the MFI/JLG model argue that high growth rate experienced by MFIs in India has translated into a mission drift with the focus shifting from client satisfaction to profit making” (Geetika, 2015).

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5. **Bank Partnership Model:**

According to Y.S.P. Thorat, “This model is an innovative way of financing MFIs. The bank is the lender and the MFI acts as an agent for handling items of work relating to credit monitoring, supervision and recovery. In other words, the MFI acts as an agent and takes care of all relationships with the client, from first contact to final repayment. The model has the potential to significantly increase the amount of funding that MFIs can leverage on a relatively small equity base. A sub-variation of this model is where the MFI, as an NBFC, holds the individual loans on its books for a while before securitizing them and selling them to the bank. Such refinancing through securitization enables the MFI enlarged funding access. If the MFI fulfils the “true sale” criteria, the exposure of the bank is treated as being to the individual borrower and the prudential exposure norms do not then inhibit such funding of MFIs by commercial banks through the securitization structure” (Thorat, 2005).

6. **Banking Correspondents:**

According to Thorat, “The proposal of “banking correspondents” could take this model a step further extending it to savings. It would allow MFIs to collect savings deposits from the poor on behalf of the bank. It would use the ability of the MFI to get close to poor clients while relying on the financial strength of the bank to safeguard the deposits. Currently, RBI regulations do not allow banks to employ agents for liability - i.e. deposit-products. This regulation evolved at a time when there were genuine fears that fly-by-night agents purporting to act on behalf of banks in whom the people have confidence could mobilize savings of gullible public and then vanish with them. It remains to be seen whether the mechanics of such relationships can be worked out in a way that minimizes the risk of misuse” (Thorat, 2005).
2.5 Cost and Revenue Components of MFI’s

In long term, operationally and financially sustainable microfinance institute can provide microfinance services to the poor and low income groups. A firm is said to be operationally sustainable when it is able to cover all its operating and financial cost from its operating revenue. Therefore it is essential to understand the cost and revenue components of microfinance institutions.

2.5.1 Cost Components

The costs incurred by microfinance institutions is made up of three main components Financial Costs, Operating Expenses and Risk Cost. However there is one more cost component that Microfinance institute should consider is capitalisation as cost. The details about these cost are as follows,

1. Financial Cost / Cost of Fund

Financial cost means cost of raising funds to carry on business activity. There are many ways of raising funds for any institution. Microfinance institution have four main sources to fund their business activities. These are Deposits funding, Debt Funding, Equity funding and donations and subsidies.

a. Deposits Funding: Banks and co-operative banks, can accept deposits. Further those Non-Banking Financial institutions (NBFCs) registered with the Reserve Bank that hold a deposit accepting Certificate of Registration can accept deposits. Further Cooperative Credit Societies can accept deposits from their members but not from the general public. It is not legally permissible for other entities to accept public deposits (RBI, 2013). Microfinance institutions in form of bank or registered under Co-operative bank and NBFC having licence of accepting deposits from general public. Whereas microfinance institutions registered under co-operative society act can accept deposits from their members. Microfinance institutes other than these are prevented from accepting the deposits. The rate of interest on deposits are much lesser then the other source debt financing. Further such microfinance institutions are able to take advantage of their outreach to mobilize savings and thus reduce its cost.
b. **Debt funding (Institutional Loans):** There are two kinds of institutional loans one is loans from government agency or nodal agency like NABARD, SIDBI or MUDRA BANK were specially created to refinance and to promote microfinance. The second is from the banks and financial institutions. The rate of interest charged by the former is lesser than the later. However, these rate are higher than the rate of interest payable on deposits.

c. **Equity Funding:** Microfinance institutions registered under the Companies act, NBFC-MFIs Bank or Co-operative bank may get finance by way of issuing financial securities as promoters/member’s capital (or equity/quasi equity). The institute does not have any fix liability towards such fund as rate of dividend payable on such equity capital is not fixed. Equity other than ‘grants’ is, obviously, the cheapest of all funds as there is no interest liability and payment of dividend is to be made only when profits have been earned\(^\text{20}\) (Planning Commission, 2007). However expected return on equity funding is highest among all the sources.

d. **Donation Subsidy:** Government frequently issues grant and subsidry to microfinance institutions, generally not for profit motive, to fulfil social objects. Similarly MFIs regularly received grants from international and national level which is null financial cost to such MFIs. There is no cost associated to such fund. However it is hard to get finance from such source and there is a limitation sustainability if financed from such source. Institute must consider notional cost equivalent to cost of debt fund so as to arrive at realistic situation of an institution.

The financial cost to the MFI will be the weighted average of all the different kinds of funds (Planning Commission, 2007). At the initial stage of life cycle microfinance institutions has to rely on debt funding. The legal status of a microfinance institution plays a major role for getting right source of fund. Deposits are the cheapest source of finance. As the cost of fund is less microfinance intuitions enjoy higher spread between rate lending and rate of borrowings.

\(^{20}\)planningcommission.nic.in/aboutus/committee/.../wg11_micro.doc
2. Operating Cost

The operational cost of servicing micro-finance/micro-credit institutions is much higher than the operational cost of traditional banking transactions. The critical costs involved in operations of any formal banking sector are: staff salaries, traveling expenses, commissions not classified under financial costs, expenses involved in promotion of groups, staff welfare expenses, amortization and depreciation, rent charges paid for hired buildings and other overheads. Collection charges form the highest contributor towards direct transaction cost. Some of the main elements of operational costs are Salary structure, conveyance costs and number of groups per field worker (Planning Commission, 2007).

Large number of micro credit results into large number of transactions and further requires more manpower. Therefore, salaries account for the major cost of these institutions. The sustainability of microfinance thus depends greatly on staff efficiency in terms of number of clients a staff member is able to deal with. The larger institutions are able to service more borrowers per staff member as some economies of scale take effect. With increase in the size of loan portfolio the operating expense ratio (OER) starts declining (Planning Commission, 2007).

Salaries to staff can be reduced by allotting part of the operations to external parties or intermediaries like ‘Customer Service Agents’, who are paid commission based on the amount of savings mobilized, loans disbursed and its repayment rate. Many MFIs extends credit to these intermediaries, who would in turn lend to their customers. This increases outreach, with lower transaction costs. Operating costs can also be reduced with the use of information technology like computerization or use of credit cards and smart cards to reduce cost of operations (Vijay Mahajan, 1999).

Operating expenses are the most important cost component of MFIs. Institutional efficiency is generally measured by dividing operating expenses by the size of the loan portfolio. An MFI is usually regarded as having become more efficient when it lowers this indicator\(^\text{21}\) (CGAP, 2009).

\(^\text{21}\) https://www.cgap.org/blog/what-drives-mfi-efficiency
3. Risk Cost

Generally the poor have no or limited assets to pledge as collateral security against their loan, therefore the formal banking sector is always cautious while disbursing loan to them. (Planning Commission, 2007).

There are issues of moral hazard leads to wilful default. It is important to establish screening mechanisms, for acquiring relevant information about potential borrowers. Commercial intermediaries or customer service agents have a lot of informal information about potential borrowers, which is factored in while making the first loan decision. Subsequent loans are based on the borrower’s repayment history. It is also necessary to establish incentives for staff and borrowers that increase repayment (Vijay Mahajan, 1999).

According to Planning commission, “Bank – SHG linkage where the group guarantees the loan on behalf of the individual loanee. A majority of MFI’s follow a similar strategy of first organizing and then lending through SHGs. Those MFI’s that follow the Grameen Bank model of direct lending to people, give loans to individuals through ‘joint liability groups,’ especially in urban areas where there could be chances of a loanee changing his/her residence (90% of MFI loanees and SHG members are women) or migrate to some other place; but, the same cannot happen in the case of all persons constituting the ‘joint liability group’. The repayments on the ground have been as high as 90-95 per cent and the chances of ‘wilful default’ have been greatly reduced” (Planning Commission, 2007).

According to Planning commission, “Group Guarantee, however, is not good enough in the case of non-wilful default arising from illness (or death) or similar conditions beyond the control of the borrowers. Risk of this kind needs to be addressed in a different manner…. management risk arising from the illness of the loanee, business risk due to crop failure and market risk arising from lack of demand have been identified as the more important areas of concern vis-à-vis micro –finance. It is now a general practise amongst the banks and the MFI’s lending to the poor to insist on the life and non-life insurance, which is available at a cost (at a premium)” (Planning Commission, 2007).
4. **Capitalization as Cost**

According to Planning commission, “A minimum capitalization is considered necessary for building the equity base through retained earnings. This strengthens the capacity of these institutions for both leveraging higher borrowings from lenders / banks as well as to attract more equity due to the ability to pay higher dividends to the shareholders” (Planning Commission, 2007).
2.5.2 Revenue Components

Revenue components of microfinance institutions is categorized in four parts; Interest on Advances, Commission as Business Correspondence, Bank Charges, and Other Income.

1. Interest on Advances

Interest on advances is a lending rate or price charged by the microfinance institutions on micro credit to the poor. While designing the microfinance blueprint it is essential to set the interest rates and service charges. The short and long term goals and success of the MFI can to a major extent be defined by Effective pricing of financial services offered by it (MFI) (Mel’nikov, Bryzgalova, & Ogoro, 2004). An equilibrium needs to be established to link the affordability of MFI clients and earnings of the microfinance organization, so that it is able to cover all of its costs. Commonly it is supposed that demand for financial services among poor borrowers is highly inelastic—that is, a relatively large increase in interest rates tends to cause a relatively small reduction in quantity of loans demanded. This price inelasticity for micro loans has been known and stated by many in this industry. This leads us to one of the golden rules of microfinance: access is more important to small borrowers than costs. So interest rates are far above commercial banks rates. However, to achieve the desired object of social welfare an MFI must corroborate that its operations are efficiently managed so that it does not have to put on undue pressure on its clients by levying high interest rates and fees on borrowings, in order to cover its operational cost and cost of financing (Ledgerwood, 2000).

Interest rates for the microfinance products should be fixed so as to maintain high standards of financial performance, and to set standards in poverty impact and social welfare. It should balance social objective by fixing affordable rate to the poor so as to increase the outreach and commercial objectives of financial sustainability, rate at which institute can cover its all cost including capitalization need.

There are various regulations related to pricing of micro loans. According to the provisions laid down by the Reserve Bank of India for NBFC-MIF, interest rate of micro loans should be the lower of maximum rate of interest cap and operating cost of fund plus specified rate of interest. Further, pricing of micro credit is restricted on refinance provided by the MUDRA Bank.
2. **Commission as Business Correspondence**

Many microfinance institutions act as a business correspondence agent or intermediary of Bank or other financial institutions for microcredit. Microfinance institutions get commissions from such financial services.

3. **Bank Charges**

Banks provide various financial facilities like remittance etc. microfinance institution get commission on providing such financial services.

4. **Other Income.**

Other income include all other income received by the microfinance institution. It include income like profit on sale of assets, interest received on investments etc.
2.6 Microfinance in India

There are many factors which have contributed towards the evolution of MFI industry in India. Those which need special mention here include the revolution of microfinance providers, the substantial supply gap for basic financial services, and the expanding forms of funding sources available in the market and its compatibility with the MFI industry and the use of technology in various MFI operations.

2.6.1 Microfinance Development Phases

The formal industry has developed, there has been a shift from specialized NGOs to an increasing number of regulated and licensed MFIs which stress that sustainability and impact go hand in hand (Tripathi, 2014). Providing micro financial services to the low income people in India is not a recent concept it was in vogue even in pre-independence era, though it officially gained momentum only after 1970s. Since pre independence era local money lenders or ‘Sahukars’, also known as informal sector provide financial credit to the poor or low income group at very high rate. These proved to be exploitation of such weaker section. The development of microfinance institutions in India can be divided into following four phases.

**Phase 1 (1960-1990):**

In the 1960’s, the cooperative segment controlled the credit delivery system in rural India. The period between 1960 and 1990, referred to as the “social banking” phase. This phase includes nationalization of private commercial banks, expansion of rural branch networks, extension of subsidized credit, establishment of regional rural banks (RRBs) and the establishment of regional rural banks and the establishment of apex institutions such as national bank for agriculture and rural development (NABARD) and small scale industries development board of India (SIDBI) (Tripathi, 2014). In 1974, SEWA Cooperative Bank was established by Mrs. Ela Bhatt to help low income women escape this trap and reduce their dependence on moneylenders much like Grameen Bank in Bangladesh. The success of SEWA laid a foundation for emergence of various microfinance institutions. During the first phase various formal microfinance institutions mainly not for profit organisations have established (Rao & Ramesh, 2014).
Phase 2 (1990-2000):

After 1990, India witnesses the second phase “financial system approach ” of credit delivery. In this phase NABARD initiated the self-help group (SHG)-bank linkage program which links informal women’s groups to formal banks. The NGOs were requested to work with the poor. This concept held great appeal for NGOs working with poor and encouraging many of them to team up with NABARD in their programmes (Tripathi, 2014).

Phase 3 (2000-2010):

The third phase of Indian microfinance is said to have begun from the year 2000, there were further changes in policies, operating formals, and stakeholder orientations in the financial services space. This phase emphasizes on “inclusive growth and financial inclusion”. During this phase many NGO-MFI converted into regulated legal formats such as Non-banking finance companies (NBFCs). To extend their rural reach the commercial banks embraced innovative ways of partnering with NGO-MFI and other rural organizations (Tripathi, 2014). However the Krishna crisis of 2005 in Andhra Pradesh affected the growth of microfinance institutions marginally.

Phase 4 (2010 onwards):

So far the fourth phase has witnessed many ups and down in microfinance industry. It started with a crisis, popularly known as Andhra Crisis, which created panic among microfinance institutions. According to Geetanjali Minhas, “in 2010, the Andhra Pradesh government passed an ordinance to regulate microfinance institutions and that had a huge impact in the country. Post-October 2010 was a difficult phase for the industry when funding completely dried up as banks and investors slammed their brakes. Best institutions were struggling. But right from November-December 2010, the RBI and the finance ministry got into the act. With regulatory attention from the government and the RBI and policy developments have had a very positive effect; like the drafting of a revised microfinance bill which was put in public domain in July 2011. In December 2011, the RBI came out with a detailed set of directions for Non-Banking Financial Companies (NBFCs) and microfinance institutions (MFIs) and created a special category of Non-Banking Financial Companies known as ‘NBFC-MFIs’. This meant that regulations, rules and guidelines designed to deal with this class of
organisations could be gradually developed, formed and released – which is what is happening now\footnote{http://www.governancenow.com/views/interview/industry-eagerly-awaiting-passage-microfinance-bill} (Minhas, 2013). Government has drafted The Micro Finance Institutions (Development and Regulation) Bill, 2012. It is estimated that the growth of Indian microfinance sector will be nearly ten times by 2011 (Tripathi, 2014).

In 2014 Indian Government has announced Micro Unit Development and Refinance Agency (MUDRA) known as MUDRA bank. The aim of MUDRA bank is to provide refinance for microenterprise at subsidised rate and financial literacy to the poor and low income group. It is expected that, these will help in development of microfinance industry in India.

### 2.6.2 Microfinance Crisis in India

The role of Andhra Pradesh is always been in the centre stage of Indian Microfinance industry. According to the research document on Microfinance evolution of Deutsche Bank, “The Indian state of Andhra Pradesh is one of the most saturated and competitive microfinance markets worldwide, with private MFIs and state-subsidised schemes competing against each other. The private MFIs are growing faster and operating more aggressively than the state-owned schemes, achieving a repayment rate of almost 100% for a long time”\footnote{https://www.db.com/en/docs/Microfinance-in-evolution.pdf} (Deutsche Bank, 2012). However, Andhra Parades was the epic centre for the two major financial crisis in the microfinance industry that India has witnessed.

#### Krishna Crisis 2005

The first episode, called the Krishna crisis, took place in 2005 in the Krishna district in Andhra Pradesh. The allegations of bad practice were levelled against the microfinance institutions (Sane & Thomas, 2011). The local politicians miscommunicated to the MFI clients, that they would not have to repay their existing loan dues and thus many MFIs collapsed due to the same (Legatum Ventures, 2011). During this period the concept of NBFC-MFI was still in its budding stage but in Andhra Pradesh it was in an uprising position. According to Shylendra, 2006, as quoted by Sane & Thomas, “District authorities closed down 50 branches of two major MFIs following accusations that they were charging spurious interest rates and indulging in forced loan practices. The state
government and the micro-finance sector negotiated a set of terms under which MFIs could get back on track with the micro-lending business in the state. Once the negotiations were over, however, anecdote suggests that business growth took precedence over fulfilling the terms under which the MFIs were allowed to continue their business, and the MFIs took no further action to adhere to the terms” (Sane & Thomas, 2011).

**Andhra Crisis 2010**

The second episode called Andhra crisis, arises in October, 2010. In 2010, Andhra crisis created panic among MFIs. The issue of financial sustainability deepened during this period. During this time too, there were similar allegations against MFIs (as during 2006) of having for poor credit interfaces with the micro-borrower. This prompted the AP government to propose an ordinance, which was passed as law within two months. The Andhra Pradesh Government ordinance of October 15, 2010 was built on the basis of four premises:

a) MFIs charge spurious interest rates;

b) If clients fail to pay on time, MFIs use strong-arm techniques to collect dues;

c) The above steps are driving the poor towards suicidal tendencies;

d) MFIs are profit oriented and none of its objectives are directed towards helping the poor²⁴ (Intellecap, 2010).

When comparing the 2005 crisis period with 2010, we see systemic outcomes of events. The ordinance passed by the AP government has effectively stopped collections on old loans and prohibited any new micro-lending business in the state of Andhra Pradesh. The intervention of the government through the ordinance encouraged default from the borrowers. As quoted by Sane & Thomas, “For some of the MFIs (including the large NBFC-MFIs that had a strong presence in the state), there was a significant increase in the default probabilities in their portfolio, with the rise in defaults being largely restricted to AP. What was unexpected was the reaction of the banking sector in completely cutting of liquidity to the MFIs across the country. This was irrespective of

whether the MFI portfolio had any AP credit-exposure, or whether there were any observed changes in the credit quality of the non-AP exposure. This full-blown liquidity crisis for the MFIs has had far more damaging effects than the AP intervention itself (Sane & Thomas, 2011).

As part of the response to prevent several MFIs shutting down from the lack of liquidity, as well as an effort to prevent other state governments from taking the same steps as AP, the crisis demand for intervention towards standardization of regulations in the microfinance sector. The RBI has constituted a committee to recommend regulatory reforms and practices for the NBFC-MFIs and to get them implemented for the microfinance sector as a whole (Sane & Thomas, 2011).

The ordinance passed by the AP government has effectively stopped collections on old loans and prohibited any new micro-lending business in the state of Andhra Pradesh (Sane & Thomas, 2011).

In 2009 alone, the ten leading MFIs of Andhra Pradesh doubled their client base. According to the Case study in research document on Microfinance evolution of Deutsche Bank, “Over time, the focus of MFIs had shifted largely from a social mission to an aggressive commercialisation approach. Incentives for MFI staff were set accordingly: People from the top management to the loan officers were strongly incentivised to achieve fast growth and raise profits. Being able to attract sufficient funding from domestic and foreign sources, MFIs could fully concentrate on the expansion of their lending business. While MFIs were rather successful in expanding their loan books, the average debt outstanding per household soon was more than eight times higher than the national average, with 84% of households taking out more than two loans and the median household four. At that time, the market share of SKS in Andhra Pradesh was larger than that of the largest commercial bank. However, the fast expansion of the market could no longer be sustained. At the height of the boom, following the IPO of SKS in August 2010, the government reacted to mounting criticism of the sector. It published a list of 123 victims of private MFIs and investigated 76 cases where loan officers were blamed to have driven over indebted borrowers to suicide. The boom finally came to a halt by the end of November 2010, when the government imposed strict regulation on privately operated MFIs, leading to a temporary freeze of the market” (Deutsche Bank, 2012).
Various state governments and Government of India since then have taken many steps through legislations and RBI intervention to protect the interest of all stakeholders of microfinance industry.

2.6.3 Legal Structure of MFIs in India

According to Sa-Dhan25, mentioned various legal forms under which a microfinance institutions in India can be registered. It includes; Societies Registration Act- 1860, Indian Trusts Act- 1882, Section 25 of the Companies Act- 1956, Non-Banking Finance Companies (NBFCs), Nidhi Companies, Banking Regulation Act as applicable to Cooperatives, State Acts on Mutually Aided Cooperative Societies and Producer Companies Act (Proposed) (Sa-Dhan, 2006).

According to Microfinance Institutions (Development and Regulation) Bill, 2012, “micro finance institution means, -

a) a society registered under the Societies Registration Act, 1860; or
b) a company registered under section 3 of the Companies Act, 1956; or
c) a trust established under any law for the time being in force; or
d) a body corporate; or
e) any other organisation, as may be specified by the Reserve Bank,

the object of which is to provide micro finance services in such manner as may be specified by regulations but does not include—

(i) a banking company, the State Bank of India including its subsidiary banks, a scheduled bank, a co-operative bank, Export and Import Bank, Reconstruction Bank, National Housing Bank, National Bank, a Regional Rural Bank and Small Industries Development Bank;
(ii) a co-operative society engaged primarily in agricultural operations or industrial activity or purchase or sale of any goods;

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25 Sa-Dhan – the Association of community development finance Institutions, founded as the Association of Community Development Finance Institutions with a mission to build the field of community development finance in India to help its member and associate institutions to better serve low-income households, particularly women, in both rural and urban India, in their quest for establishing stable livelihoods and improving quality of life. It has 220 members including 169 MFIs, represent over 80% of client outreach and portfolio outstanding of India’s "MF sector"
(iii) any individual carrying on the activity of money-lending and registered as a moneylender under the provision of any State law which regulates such activities” (MFI Bill, 2012).

Out of the mentioned various legal structure; Societies Registration Act- 1860, Indian Trusts Act- 1882, Section 8 companies of Companies Act-2013 (Section 25 of the Companies Act-1956), Non-Banking Finance Companies – Microfinance Institutions (NBFC-MFIs) registered under Reserve Bank of India, and Co-operative Bank as per the Banking Regulation Act are the most popular form of legal structure under which microfinance institutions are registered.

These are, NBFC-MFI, Co-operative society, Co-operative Bank, Trust and limited liability Company under Section 2526.

26 Section 25 company is company registered under Company Act 1956, which is now termed as Section 8 Company under Company Act 2013.
2.7 Microfinance in Gujarat

Gujarat has the first formal bank, SEWA Cooperative Bank established in 1974 in India. As per the information mentioned in the web map of www.sa-dhan.net in 2011, as on 31st March 2011, the total number of institutions purely involved in microfinance activities are fifteen out of which nine MFIs have their headquarters in Gujarat. The total number of microfinance institutions were increased to eighteen, however microfinance institutions having their headquarters in Gujarat is reduced to five\textsuperscript{27} (Sa-Dhan, Sa-dhan Web Map, 2014). This is due to financial inefficiency and new government policy some of them have either closed down or are converted into or acquired by other institutions. Currently there are four NBFC-MFIs; two NGOs, one registered under trust and another under section 25, and one cooperative Bank; and few Credit co-operative societies are catering microfinance services.

\textsuperscript{27}http://www.sa-dhan.net/files/Sa-dhan-indian-map.htm
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2-28


