Chapter-3

Microfinance in India - A Macro Analysis

CHAPTER 3

MICROFINANCE IN INDIA- A MACRO ANALYSIS

This chapter comprised of two parts: The first part gives an overview of the formal financial system and also discusses the deficiencies in the formal finance while the second part shed light on the microfinance sector in India.

3.1 Formal Financial Sector in India

While the provision of financial services in India can be traced to the era of Kautilya in the fourth century BC, the age of organized sector finance in India is generally acknowledged to have started with the Cooperative Credit Societies Act of 1904 (World Bank, 2006). The Cooperative Credit Societies were based on the models of the German cooperative movement, in particular the Raiffeisen[1]. The objective of the Act was to facilitate promotion of cooperative societies, for the promotion of thrift and self-help among agriculturists, artisans and persons of limited means. This Act is a true precursor to modern microfinance in the country.

The true expansion of financial services in India started with the Nationalization of all banks in the country during the late 1960s. This was reinforced with the establishment of Regional Rural Banks (RRBs) in 1976, and henceforth directed credit became the mantra of the Indian financial sector. In the meantime, the cooperative sector infrastructure had developed through the creation of an apex banking structure at the District and State levels to ensure the smooth flow of capital in the cooperative system. Yet, the entire network of Primary Cooperatives in the country and the RRBs, established to meet the needs of the rural sector in general and the poor in particular, has not proved to be successful. The cooperatives suffered from mismanagement, leadership by the privileged and corruption, and were gradually smothered by state patronage and protection, in many cases including management by ill-motivated government-appointed persons. Meanwhile, saddled with the burden of directed credit and a restrictive interest rate regime the financial position of the RRBs deteriorated (Karmakar, 2008).

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1 The Raiffeisen credit cooperatives started in Germany by Friedrich Wilhelm Raiffeisen, in 1847, were famously meant to "control the use made of money for economic improvements, and to improve the moral and physical values of people and also, their will to act by themselves"

For many years bankers and senior government officers in India described the Government of India's main poverty alleviation program- the Integrated Rural Development Program (IRDP) - as the world's largest microfinance program[2]. The objective of IRDP is to enable identified rural poor families to cross the poverty line by providing productive assets. The assets which could be in primary, secondary or tertiary sectors are provided through financial assistance in the form of subsidies by the government and the term credit advanced by financial institutions. The program is implemented in all the blocks in the country as a centrally sponsored scheme funded on 50:50 basis by the Centre and State. Started in the early 1980s, the IRDP, involved the commercial banks in giving loans of less than US$330 to poor people and, over twenty years, this resulted in financial assistance of around $5,600 million to roughly 55 million families[3].

The main problem with IRDP was its design which incorporated a substantial element of subsidy amounting to 25-50 per cent of each family's proposed investment cost in an income generating activity, prompting extensive misappropriation and mis-utilization of funds (Dreze 1990; Copestake 1996 & Shankar 1991). This situation led bankers to regard the IRDP loan as a politically motivated handout and they largely failed to follow up on repayments due from borrowers. The net result was that the estimates of the repayment rates in the IRDP ranged from 25-33 per cent. Not surprisingly, the two decades of IRDP experience in the 1980s and 1990s affected the credibility of micro-borrowers in the view of bankers and ultimately hindered the access of low income clients to banking services (World Bank, 1998)[4].

Home to 1.13 billion people as of 2008, India constitutes approximately one sixth of the world's total population. It is the world's largest democracy and a key emerging market alongside China and Brazil. India is amongst the world's largest economies. All economic indicators viz. GDP growth rate, export growth, foreign

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2 The Integrated Rural Development Programme (IRDP) is a rural development program of the Government of India launched in Financial Year 1978 and extended throughout India by 1980. It is a self-employment program intended to raise the income-generation capacity of target groups among the poor.

3 The Scheme is merged with another Scheme named swarnjayanti gram swarozgar yojana (SGSY) since 01.04.1999.

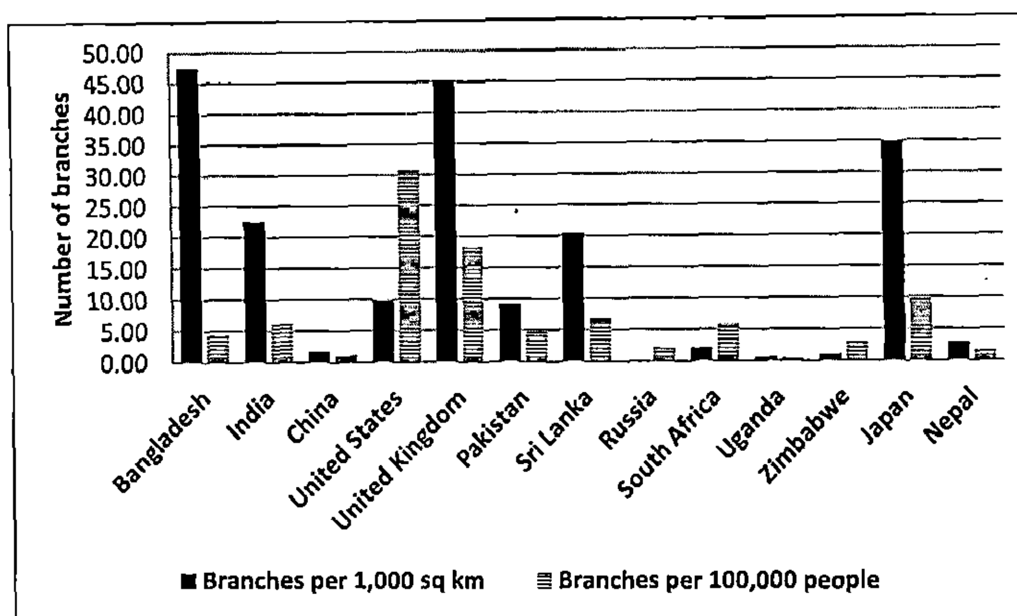
4 A World Bank study (1998) reported few loan recipient acquiring and retaining productive assets and a high percentage of IRDP loan underwriting consumption in case of marriage, sickness and other expenditure.

exchange reserves, FDI inflows, etc. have shown rising trends during recent years. Although wealth is increasing for the nation but it is not accruing to all citizens.

According to RBI over 40 per cent of India's poor do not even have bank accounts. The National Sample Survey 59th round (2003) estimates revealed a disappointing fact that of the total cultivator households only 27 per cent have received credit from formal sources and 22 per cent from informal sources. The remaining 51 per cent mostly marginal farmers have virtually no access to credit. According to the new estimates of the World Bank in 2005 around 26 per cent of the world population was living in poverty. The new estimates are based on a new poverty line of $1.25 per day in 2005 Purchasing power parity. Estimates have shown that the share of India increases from 22 per cent in 1990 to 30 per cent in 2005. Deepening the financial system and widening its reach is crucial for both accelerating growth and for equitable distribution, given the present stage of development of our country (Swain, 2008).

Poverty is one of the most important challenges confronting successive governments in independent India. Lots of efforts have been devoted for the elimination of rural poverty. Various anti-poverty programmes have been prepared and implemented for the removal of rural poverty, but all these efforts by the government resulted only in partial success. Various social, cultural and institutional factors are responsible for the vicious circle of poverty which grips the rural masses. Inadequate access to financial services is one of the most important factors behind rural poverty. The role of finance to tackle poverty has been recognized by the government in the early period of independence, which prompted the Government to take a series of steps for making banking system more suitable for rural financing. Despite vast banking network in the country, a sizable section of the population remains outside the domain of the formal banking system. A recent World Bank-NCAER survey on rural finance indicates that 70 per cent of the rural poor do not have a bank account and 87 per cent have no access to credit from the formal sources. It is widely recognized that access to financial services can play a critical role in helping poor people widen their economic opportunities, increase their asset base and diminish their vulnerability to external shocks. In rural areas, simple financial services like credit and saving can directly affect small scale producers' productivity, asset formation, income and food security.

Figure 3.1: Access to Finance, India vs. other Countries in 2008



Source: Finance access survey, World Bank (2009)

Table 3.1: Getting Finance Indicators for India, 2001-08

Indicator	2001	2002	2003	2004	2005	2006	2007	2008	Bench-mark (OECD)
Branches per 1,00,000 people	6.42	6.33	6.25	6.26	6.33	6.37	6.35	6.6	10-69
ATMs per 1,00,000 people					1.63	1.93	2.4	3.28	47-167
Deposit accounts per 1000 people	416.77	421	418.7	426.1	432.1	443	459.5	467.4	976-1671
Loan accounts per 1000 people	50.99	53.9	55.84	61.88	71.42	78	83.59	89.03	248-513
Branches per 1000 km^2	22.18	22.3	22.41	22.57	22.99	23.5	24.13	25.49	1-159
ATMs per 1000 km^2					5.93	7.11	9.11	12.68	1-437

Source: Getting Finance in South Asia 2010, Kiatchai Sophastienphong, Anoma Kulathunga, The World Bank

Note: The Benchmark Indicator ranges are for selected high-income OECD member countries (Australia, Canada, France, Germany, Italy, Japan, the republic of Korea, New Zealand and the United States)

India has a relatively deep financial system. However, despite an impressive infrastructure including a huge bank branch network, rural areas suffer from a lack of financial services and most poor do not have access to finance. Although the size of

India's financial system in absolute terms does not impress next to other large countries such as China or Brazil, it compares well with other emerging economies (Sonne, 2010).

Figure 3.1 shows access to finance in India vs. other countries in 2008. Though there is finance in the system and even credit specifically allotted to the rural poor and to entrepreneurs, banks are unwilling to lend.

3.1.1 Indicator of Access to Formal Finance by the Poor

Due to the various steps taken by the Government to make the banking system more conducive to rural financing, the share of institutional sources in rural financing increased tremendously during 70's. Table 3.2 indicates, the share of all institutional agencies in cash borrowing of rural household was 19.7 per cent during 1971-72 which increased tremendously to 54.5 per cent during 1981-82, the main driver of this growth were commercial banks. Share of commercial banks was meagre 1.7 per cent during 1971-72 which increased to 23.1 per cent during 1981-82. Hence Nationalization of banks resulted in tremendous achievements as far as rural financing is concerned. The share of institutional agencies in rural credit remains at most constant after 1981-82.

Table 3.2: Percentage share of different Credit Agencies in Cash Borrowings of the Rural Households during 1971-72, 1981-82, 1991-92 and 2002-03

Agencies	1971-72	1981-82	1991-92	2002-03
Government etc.	3.1	4.2	3.9	2.7
Co-operative Societies/bank	14.9	26.3	25.7	28.0
Commercial banks etc.	1.7	23.1	20.7	22.7
Others[1]	0	0.9	3.0	3.7
all institutional agencies	19.7	54.5	53.3	57.2
Agricultural money lender	18.7	9.7	8.1	9.6
Profession money lender	15.9	7.8	13.3	20.6
Relatives & friends	11.4	12.4	8.9	7.4
Others[2]	34.2	14.4	12.1	5.2
all non- instit. agencies	80.3	44.3	42.3	42.8
unspecified	0	1.2	1.2	0

Source: Household Borrowings and Repayments in India: 2002-2003

Notes: 1. Includes insurance, provident fund, financial corporation/insti., financial company and other institutional agencies

2. Includes landlords, traders, others incl. doctors, lawyers, etc.

Share of commercial banks retarded over the period 1981-82 to 2002-03. If we compare the figures of the two latest NSSO surveys (1991-92 and 2002-03) then it can be concluded easily that the structural adjustment measures adopted by the government during 90's are inhibiting the process of financial inclusion. A significant difference exists between different asset holding classes in accessing credit from formal agencies both in rural as well as in urban areas. According to NSSO survey (2002-03) only 18 per cent people of asset holding class less than Rs. 15000 in rural areas are borrowing from formal sources while the corresponding figure for urban areas is 13 per cent. As the asset holding increases the share of formal sources in cash borrowing for both rural as well as in urban areas increases tremendously (Table 3.3).

Table 3.3: Percentage Share of Institutional and Non-institutional Agencies in Cash Borrowings of Households by Assets Holding Class

Assets holding class (Rs. 000)	Rural		Urban	
	Institutional	Non Institutional	Institutional	Non Institutional
less than 15	18.0	82.0	13.4	86.6
15 – 30	35.5	64.5	40.1	59.9
30-60	26.6	73.4	46.9	53.1
60-100	39.5	60.5	59.0	40.8
100-150	43.6	56.4	65.6	34.4
150-200	48.1	51.9	47.9	52.1
200-300	51.5	48.5	71.7	28.3
300-450	58.7	41.3	72.5	27.5
450-800	63.4	36.6	84.9	15.1
800 & above	73.8	26.2	89.8	10.2
All	57.2	42.8	75.7	24.2

Source: Household Borrowings and Repayments in India: 2002-2003, Report No. 502, NSSO.

A similar picture is depicted in the Table 3.4 which shows the incidence of indebtedness to institutional and non-institutional sources of household assets holding class. Only 3.6 per cent households in rural areas of the asset holding class of less than Rs. 15000 are indebted to formal sources, while 85 per cent households of this asset holding class have no access to any source of credit.

Table 3.4: Incidence of Indebtedness (IOI) of Households as on 30.6.02 by Household Assets Holding Class

AHC (Rs. 000)	Rural		Urban	
	Institutional	Non Institutional	Institutional	Non Institutional
Less than 15	3.6	12.0	1.4	9.5
15-30	6.2	13.9	2.4	12.8
30-60	8.7	17.7	4.5	11.0
60-100	10.9	17.7	7.2	11.9
100-150	13.6	17.9	8.3	12.2
150-200	14.6	17.1	8.9	12.0
200-300	16.2	15.7	11.1	10.1
300-450	18.7	13.2	12.1	8.2
450-800	22.0	13.0	16.9	7.2
800 & above	26.7	10.3	18.5	4.2
All	13.4	15.5	9.3	9.4

Source: Household Borrowings and Repayments in India: 2002-2003, Report No. 502, NSSO.

The proportion of people having any kind of life insurance cover is as low as 10 per cent and proportion having non-life insurance is an abysmally low at 0.6 per cent. People having debit cards comprises only 13 per cent and those having credit cards only a marginal 2 per cent.[5]

3.1.2 Factors behind the Failure of Formal Financial Sector in Serving the Poor

The failure of India's rural banks to deliver finance to the poor may be attributed to a combination of factors. From the banks' perspective, serving the rural poor is a high-risk, high-cost proposition, with high uncertainty, and transaction costs related to small size loan, frequent transactions and government policies which contribute to a financial climate not conducive to rural banking. Commercial banks have their own problems in serving the poor clients such shortage of manpower, unfavourable attitude towards rural services, infrastructure and technology problems in rural areas, etc. (Dev, 2006). From the perspective of rural clients, the banks do not provide conveniently accessible and flexible products and services, high transaction

5 According to the lecture delivered by Duvvuri Subbarao, Governor, Reserve Bank of India at the Bankers' Club in Kolkata on December 9, 2009

costs including cumbersome and costly procedures, hefty bribes, and long processing time and the poor clients can't meet the demand for collateral (Basu, 2006). The factors behind the failure of the formal financial sector in serving the poor may be summarized as follows (Wadhwa, 2007).

From the angle of the poor

I. Due to their social, economic and educational backwardness and being unorganized, they are unaware of various programmes and facilities available from the Government and banks and are generally deprived of access to such benefits.

II. They have an apprehension that the banks are not meant for poor people like them and they would not be able to get loans from the banks.

III. Lack of security to avail bank loan.

IV. Documentation procedures, rigid lending policies and norms of the banks generally make the poor ineligible for bank credit.

V. Funds requirement for consumption, social and even for production purposes- though small- are generally emergent. The uncertainty and long delays in obtaining such loans from the banks discourage them to approach the banks.

VI. In some cases, past unpleasant experience of the poor with the banks and government agencies is also a discouraging factor.

(A) From the angle of banks

I. General mental reservation about financing such poor borrowers mainly due to the fear of bad debts.

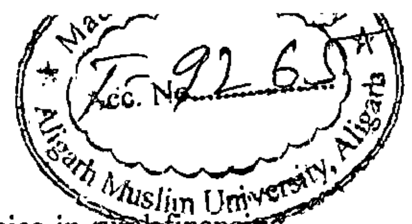
II. Lack of security to back such loans.

III. Non-compliance of documentation and other formalities by the borrowers.

IV. Non-conformity with the usual banking norms.

V. Low returns to the bank on account of lower rate of interest to be charged on such small loans in accordance with the regulations of the central bank/ government.

VI. Serving a large number of small loans with frequent transactions spread over a vast area is unwieldy besides involving high cost, making it inconvenient and apparently uneconomic for the banks.



3.2 Evolution of Microfinance in India

The dominant role played by the non-institutional agencies in rural financing necessitate the emergence of some innovative approaches, like microfinance, to fill the demand-supply gap of rural credit in a sustainable manner. Microfinance is one of the most significant financial innovations of the past decade for catering the needs of the rural poor in a sustainable manner. Microfinance offers flexible products which suit needs of the poor. While the poor and low income households do not have access to financial services, they have considerable effective demand (in an economic sense) for such services. According to McGuire & Conroy (2000) It is noted that:

I. Contrary to common perception there is much evidence that the poor have the capacity and willingness to save. They need to save for emergencies, investment, consumption, social obligations, the education of their children, and many other purposes.

II. There is also a demand for credit, both from households and micro-enterprises. Poor households require credit to finance livelihood activities, for consumption smoothing, and to finance large expenses for purposes such as education, housing improvements, and migration.

III. Poor and low income households also have a demand for other financial services, like insurance. Migration, whether international or internal, also tends to create a demand for funds transfer services.

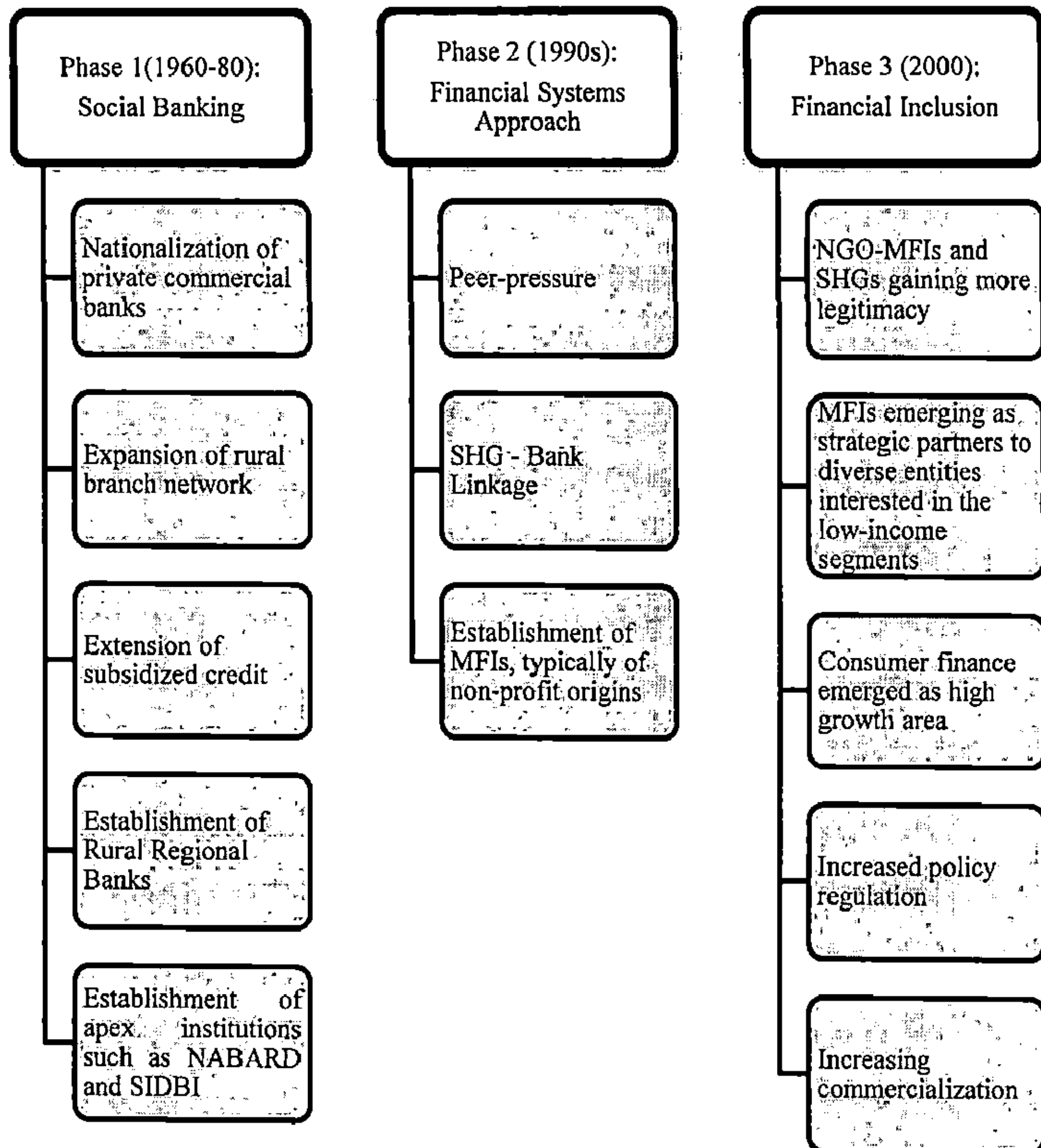
The microfinance sector in India gained real impetus with the establishment of the National Bank for Agriculture and Rural Development (NABARD) in 1982. NABARD's well-known SHG Bank Linkage Programme (SHG-BLP) was initiated through a pilot project in Karnataka and, from the mid-1990s, has now expanded throughout the country. It is now increasingly adopted by government agencies as a vehicle for their programmes. In this model, NABARD refinances commercial bank loans to self-help groups (SHGs) in order to facilitate relationships between the banks and the poor borrowers. SHG-BLP has made significant progress since 1998. The SHG-BLP has greatly increased the outreach of the banking system to otherwise unreached households – especially to women as SHG members and initiated a change in the outlook of banks towards low income families from beneficiaries to customers.

Over the past 30 to 35 years, microfinance has also been initiated through the efforts of influential Development Organizations such as the SEWA Bank (Ahmadabad), Annapurna Mahila Mandal (Mumbai) and Working Women's Forum (Chennai). This movement began to gain momentum in the 1990s with the entrance of a number of NGOs into microfinance. Since 1995, attempts to reform the cooperative system have also resulted in the creation of a new generation of cooperatives, the "Mutually aided Cooperative Societies" (MACS) that lie outside the purview of state control. The new legal system of cooperatives has guaranteed independent management and has resulted in the creation of hundreds of MACS in Andhra Pradesh, for example, many of them directly engaged in microfinance through SHGs of women members.

Starting with a few pilot programmes in the mid-1970s, the MFI sector in India has now grown to over 500 NGO-MFIs, several hundred independent Cooperative Societies focussing on financial services and around two dozen finance companies providing microfinance services. Current estimates of the number of NGOs and MACS engaged in mobilizing savings and providing microcredit services to the poor exceed 1,000 organizations.

The MFI model received a boost with the support from the Small Industries Development Bank of India (SIDBI) through the SIDBI Foundation for Micro-Credit (SFMC) in 1999. Since its establishment, SFMC has played a crucial role in the promotion of the MFI model in India by providing credit for on-lending and capacity building support to NGO-MFIs. Initially, many NGO-MFIs were funded by donor support in the form of revolving funds and operating grants. In recent years, apex development finance institutions such as SIDBI, NABARD and microfinance promotion organizations such as the Rashtriya Mahila Kosh (RMK) have provided wholesale loans to MFIs. This has resulted in the MFIs becoming intermediaries between the large public sector development finance institutions and retail borrowers consisting of groups of poor people or individual borrowers living in rural areas/urban slums.

Figure 3.2: Evolution of Microfinance in India (1960s to Today)



Source: George, Maheswari & Pandian, (2007)

Table 3.5: Legal Framework Microfinance Providers in India

Categories of Providers	Legal Framework governing their activities
a) Domestic Commercial Banks: Public Sector Banks; Private Sector Banks & Local Area Banks	i. RBI Act 1934 ii. BR Act 1949 iii. SBI Act iv. SBI Subsidiaries Act v. Acquisition & Transfer of Undertakings Act 1970 & 1980
b) Regional Rural Banks	i. RRB Act 1976 ii. RBI Act 1934 iii. BR Act 1949
c) Co-operative Banks	i. Co-operative Societies Act ii. BR Act 1949 (AACS) iii. RBI Act 1934 (for sch. banks)
d) Co-operative Societies	i. State legislation like MACS
e) Registered NBFCs	ii. RBI Act 1934 iii. Companies Act 1956
f) Unregistered NBFCs	i. NBFCs carrying on the business of a FI prior to the coming into force of RBI Amendment Act 1997 whose application for CoR has not yet been rejected by the Bank ii. Sec. 25 of Companies Act
g) Other providers like Societies, Trusts, etc.	i. Societies Registration Act '60 ii. Indian Trusts Act iii. Chapter IIIC of RBI Act '34 iv. State Moneylenders Act

3.2.1 The SHG Bank Linkage Model

As mentioned in the previous section, the Indian microfinance sector has two major models for delivery of financial services – the SHG Bank Linkage Programme and the MFI model. While the MFI model is growing rapidly, the SHG-BLP is by far

the more dominant model in terms of outreach. Both the models are very different from each other in methodologies adopted and legal forms of institutions involved in service delivery – SHG-BLP is run by the government while the MFI model is privately managed with some institutions being regulated by the Reserve Bank of India. In SHG-BLP, NGOs are involved in promoting SHGs and linking them to local banks for savings and credit. The NGOs provide development inputs to the groups they work with, but do not mediate directly – or report on – the financial transactions. On the other hand, the MFIs may have started as NGOs but they have, in their work, developed a focus on financial intermediation as a key part of their operations. For them, financial transactions and reporting are a routine part of their system.

The SHG Bank Linkage Programme has its origin in a GTZ[6] sponsored project in Indonesia. Launched in 1992 in India, early results of programme achieved by SHGs promoted by some NGOs such as MYRADA, prompted NABARD to offer refinancing to banks for collateral free loans to groups. SHGs thus linked with banks function as micro banks that were able to access funds from the formal banking system. The concept resulted in the reduction of transaction costs of banks through the externalization of costs of servicing individual loans and also ensuring their repayment through the peer pressure mechanism.

According to NABARD (2006), SHG has an average size of about 15 people from a homogeneous class. SHGs are essentially informal voluntary associations of people formed to attain collective goals. People who are homogeneous with respect to social background, heritage, caste or traditional occupations come together for a common cause to raise and manage their collective savings for the benefit of all the group members. The process through which selected people, usually poor, representing a specific economic strata of society, with some specific identity (of caste, occupation, origin, etc.) are encouraged to form small homogeneous groups for the purpose of participating in development activities i.e. savings, credit, income

6 Inspired by the APRACA-GTZ regional project, NABARD carried out its own pilot project during 1992-96. At mid-term, March 1994, 637 SHGs promoted by NGOs had been credit-linked to 28 banks, with a positive impact. On that basis, NABARD initiated mainstreaming of SHG banking, setting up a Credit and Financial Services Fund in 1996 for extensive capacity-building and a Micro Credit Innovations Department (MCID) in 1998, with MCI cells in every state.

Table 3.6: Features of SHGs-Bank Linkage Model

Decision making	Members make decisions collectively. SHG concept offers opportunity for participative decision making on the conduct of meetings, thrift and credit decisions. The participative process makes the group a responsible borrower.
Financial services	SHGs provide the needed financial services to the members at their doorstep. The rural poor need different types of financial services, viz. Savings, consumption credit, production credit, insurance, remittance facilities, etc. The platform of SHG provides the possibility to converge these services.
Supplementary to formal banking	SHG linkage does not supplant the existing banking system, but it supplements it, thus taking full advantage of the resources and other advantages of the banking system.
Cutting costs	SHG linkage cuts costs for both banks and borrowers. In a study sponsored by FDC, Australia, it was observed that the reduction in costs for the bankers is around 40 per cent as compared to IRDP loans. The poor have a net advantage of 85 per cent as compared to individual borrowing. Similar finding was also observed in a NABARD study.
Repayments	The Linkage mechanism has proved that the repayments are as high as 95 - 100 per cent
Peer pressure as collateral	The SHG linkage emphasises peer pressure within the group as collateral substitute.
Quality clients	The SHGs are turning out to be quality clients in view of better credit management, mobilisation of thrift, low transaction costs and near full repayments.
Client preparation	The members of the SHGs could over a period of time, very selectively graduate to the stage of micro entrepreneurship and have been prepared with requisite credit discipline.
Social agenda	Available statistics indicate dependency of 35-40 per cent of rural households on non-institutional sources for credit needs. SHG Linkage offers a better way of dealing with the magnitude of social agenda. Many NGOs/ Governments have recognised the SHG as a vehicle for carrying and deepening of their developmental agenda/ delivery of services.
Exclusive poor focus	SHGs have exclusive focus on absolute have-nots, who have been bypassed by the banking system. Social banking does not have any meaning if the lowest strata and the unreached are not focused.
No-subsidy- dependence syndrome	The programme does not envisage any subsidy support from the government in the matter of credit. The issue is to build capabilities and enterprise of the individual members, blending with group cohesion and solidarity through training provided by a SHPI to set the ball rolling for the SHG.

Source: NABARD, Various Reports

generation, etc. is called 'Group Formation' or 'Group Promotion' or 'Group evolution' (Sharma, 2007). Usually, the focus is on poor and that too on women. They come

together for addressing their common problems. They are encouraged to make voluntary thrift on a regular basis. They use this pooled resources to make small interest bearing loans to their members.

The process helps them imbibe the essentials of financial intermediation including prioritization of needs, setting terms and conditions, and accounts keeping. This gradually builds financial discipline in all of them. They also learn to handle resources of a size that is much beyond individual capacities of any of them. The SHG members begin to appreciate the fact that resources are limited and have a cost. Once the group shows this mature financial behaviour, banks are encouraged to make loans to the SHG in certain multiples of the accumulated savings of the SHG. The bank loans are given against group dynamics without any collateral and at market interest rates. The groups continue to decide the terms of loan to their own members. Since the groups' own accumulated savings are part and parcel of the aggregate loans made by the groups to their members, peer pressure ensures timely repayments. Apart from financial help at the time of need, the group provides social security to its members.

Design and Features of the Product:

1. **Small and fixed savings at frequent intervals**

Small and fixed savings made at regular intervals coupled with conditions like compulsory attendance, penal provisions to ensure timely attendance, saving, repayment, etc. forms a deterrent for the rich to join the SHG system- thereby enables exclusion of the rich.

2. **Self-selection**

The members select their own members to form groups. The members residing in the same neighbourhood ensure better character screening and tend to exclude deviant behaved ones.

3. **Focus on women**

As regular meetings and savings are compulsory ingredients in the product design, it becomes more suitable for the women clients- as group formation and participatory meetings is a natural ally for the women to follow.

4. **Savings first and credit later**

The saving first concept enables the poor to gradually understand the importance of saving, appreciate the nuances of credit concept using their own money before seeking external support (credit) for fulfilling future needs. The poor tend to understand and respect the terms of credit better.

5. **Intra group appraisal systems and prioritization**

The essentials of good credit management like (peer) appraisal of credit needs (checking the antecedents and needs before sanction), (peer) monitoring- end use of credit; (peer sympathy) reschedulement in case of a crisis and (peer pressure) collateral in case of wilful non-payment, etc. all seems to coexist in the system – making it one of the best approaches for providing financial services to the poor.

6. **Credit rationing:**

The approach of prioritization i.e. meeting critical needs first serves as a useful tool for intra –group lending. This ensures the potential credit takers/users to meticulously follow up credit already dispensed, as future credit disbursals rely on repayments by the existing credit users.

7. **Shorter repayment terms:**

Smaller and shorter repayment schedule ensures faster recycling of funds, greater fiscal prudence in the poor and drives away the slackness and complacency that tends to set-in, in long duration credit cycles.

8. **Market rates of interest:**

Self-determined interest rates are normally market related. Sub-market interest rates could spell doom; distort the use and direction of credit.

9. **Progressive lending:**

The practice of repeat loans and often-higher doses - is followed by SHGs in their intra-group loaning, thereby enticing prompt repayments.

10. **A multiple-eyed operation:**

The operations of the SHG are transacted in group meetings thus enabling high trust levels and openness in the SHG system. SHG members facilitating openness and freedom from unfair practices also generally conduct the banking transactions.

The major target groups (Swain & Nayak, 2008)

- Small and marginal farmers (farmers having land up to 2.5 acres). Their own resources are insufficient and their access to credit is very limited.
- Landless agricultural labourers (who usually sell their labour to livelihood. They do have limited access to the formal financial sector due to absence of adequate collateral.
- Rural Artisans- carpenters, barbers, weavers, blacksmiths, potters, basket makers and others who depend on their family run business.
- Petty rural traders earn their income by running small retail outlets, which cater to the need of rural masses. They lack funds to operate their businesses. Hence, they depend on the non-formal credit market for their working capital.

According to Nanda (1995) the financial scheme under the Linkage Program is based on the following broad principles:

- Savings first, no credit without saving.
- Saving as partial collateral
- Bank loans to the group, for on-lending to members
- Credit decisions for on-lending to members by the group
- Interest rates and other terms and conditions for loans to members to be decided by the group
- Joint liability as a substitute for physical collateral
- The ratio between savings and credit contingent upon the credit worthiness of the group; increasing with a good repayment record.
- Small loans to begin with.

There are three variants of the SHG Bank Linkage model (Manoharan & Devi, 2008)

I. **SHGs formed by NGOs and Financed by Banks:** Under this model groups are formed by NGOs or some other agencies acting as SHIPs. They organize groups, inculcate banking habits, train them in financial management and nurture them. Finally banks provide credit to these mature groups. This model is the most popular one in India. Around 74 per cent SHGs fall under this model (Karmakar, 2008).

II. **SHGs Formed and Financed by Banks:** Under this model SHGs are formed directly by the banks where banks themselves act as SHIPs in forming and nurturing the groups, opening a saving account for them and providing bank credit after the maturity of the group. This is the second most popular model with a 20 per cent share in total SHGs.

III. **SHGs Formed and Financed by NGOs:** In this model SHGs are formed by NGOs, which perform the financial intermediation role as on the lender to SHGs after securing loans from banks.

The high transaction cost of rural credit is a core problem and the viability of the system is critically affected by it. But it was that the intermediation of SHG led to a reduction in time spent by bank staff on identification of borrowers, documentation, follow-up and recoveries. This resulted in a 40 per cent reduction in transaction cost which could increase further with the increase in loan sizes. The intermediation also significantly reduced transaction costs for the borrower due to elimination of cumbersome documentation procedure and time spent and cost incurred on repeated visits to banks etc. The reduction was placed at 85 per cent.

Under the SHG-BLP, NGOs usually act not as MFIs but as SHG Promotion Agencies (SHPAs) – a different model of microfinance in which the role of the NGO is to provide developmental support to the SHGs, that open group deposit account in a Bank and then can borrow directly from the Bank. This model was initially promoted by NGOs such as MYRADA (in Karnataka) and PRADAN (in Tamil Nadu and in Bihar). Since the mid-1990s, when the model began to be scaled up, promotional work has been undertaken by specialized government agencies, such as the District Poverty Initiatives or the Velugu project in Andhra Pradesh and the Kudumbashree project in Kerala, the Women's Development Corporations in the states of Tamil Nadu and Maharashtra, the Women and Child Development departments, and the District Rural Development Agencies (DRDAs) in other states.

1. Growth of SHG bank Linkage Model:

From a relatively on lending model, the SHG Bank Linkage Model of microfinance has grown into a very complex system since 1992-93, when the first few SHGs were linked to banks by NABARD. Since its inception the growth of bank linkage has been phenomenal. The number of groups linked has doubled every year

for about a decade and the loan amount has doubled every year for more than a decade, between 1992-93 and 2003-04. Though the growth rate has decelerated a little in recent years, the absolute loan amount has been increased by higher amounts year after year. The absolute loan amount has increased by Rs. 2, 996 Crore in 2004-05, by 4,498 Crore in 2005-06 and 6,643 Crore 2006- 07.

Table 3.7: Progress of SHG Bank Linkage Program in India

Years	No. of SHGs Cumulative	No. of SHGs During the Year	Bank loan Cumulative (Rs. Crore)	Bank loan During the Year (Rs. Crore)	Refinance Assistance Cumulative	Refinance Assistance During the Year
1992-93	255	255	0.29	0.29	0.27	0.27
1993-94	620	365	0.65	0.36	0.46	0.19
1994-95	2122	1502	2.44	1.79	2.13	1.67
1995-96	4757	2635	6.06	3.62	5.66	3.53
1996-97	8598	3841	11.84	5.78	10.65	4.99
1997-98	14317	5719	23.76	11.92	21.39	10.74
1998-99	32995	18678	57.07	33.31	52.09	30.70
1999-00	114775	81780	192.98	135.91	150.13	98.04
2000-01	263825	149050	480.87	287.89	400.74	250.61
2001-02	461478	197653	1026.34	547.47	796.50	395.76
2002-03	717360	255882	2048.67	1022.33	1418.80	622.30
2003-04	1079091	361731	3904.20	1855.53	2124.20	705.40
2004-05	1618456	539365	6898.46	2994.26	3092.00	967.80
2005-06	2238565	620109	13397.46	4449.00	4159.70	1067.70
2006-07		1105749		6570.00	5452.56	1292.86
2007-08		1227770		8849.26	7068.06	1615.50
2008-09		1609586		12253.51	9688.09	2620.03

Source: NABARD, Various Reports.

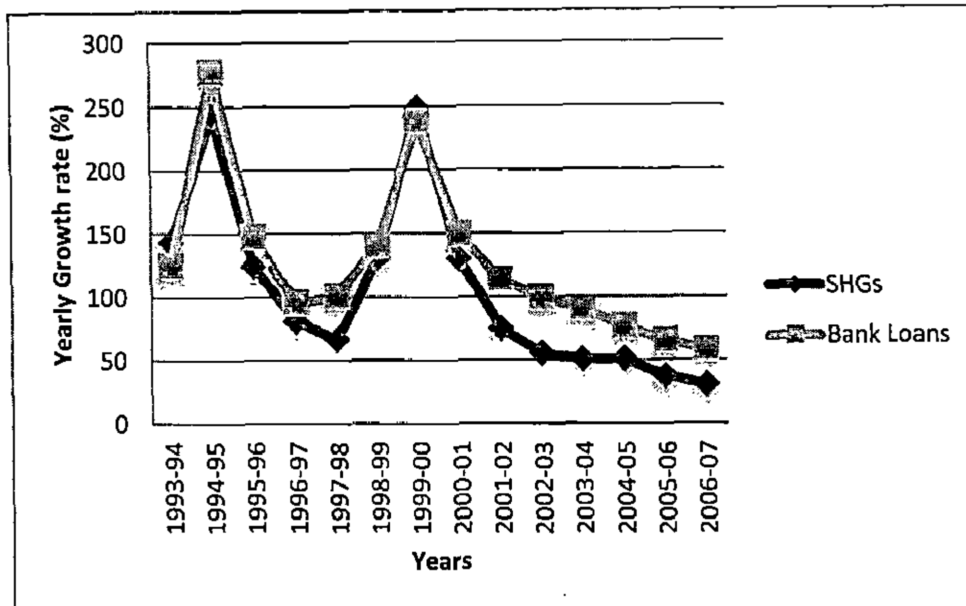
Note:

I. Data for 2008-09 are provisional

II. Data relates to Commercial Banks, RRBs and Co-operative Banks

III. From 2006-07 onwards, data on the number of SHGs financed by banks and bank loans are inclusive of 'Swarnajayanti Gram Swarozgar Yojna' (SGSY) SHGs and existing groups receiving repeat loans. Owing to this change, NABARD discontinued the publication of data on a cumulative basis from 2006-07 onwards.

Figure 3.3: Growth of SHG Model



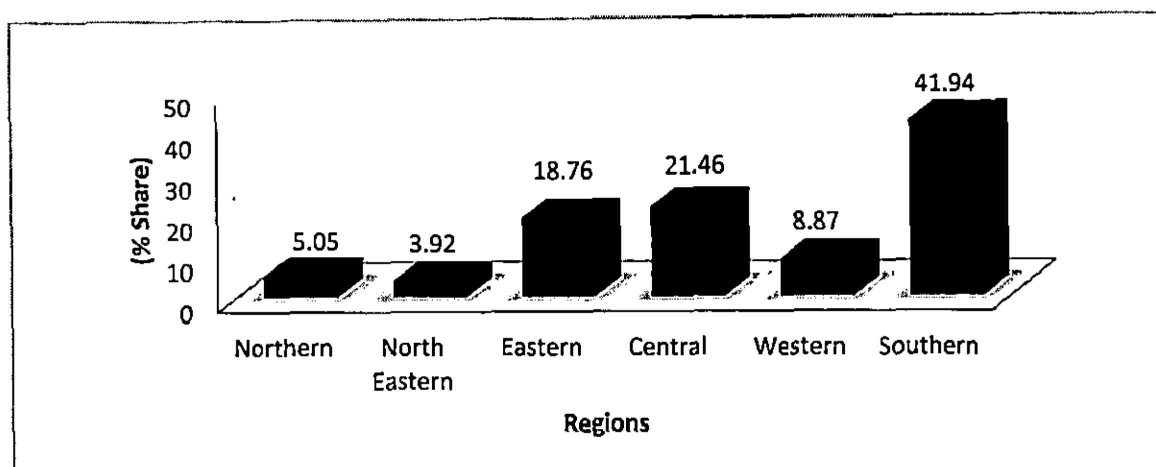
2. Limitations of SHG Bank Linkage Programme

Despite tremendous quantitative achievements SHG programme faces a number of constraints and challenges. These include: (a) Uneven spread of the SHGs across the country, (b) Inability to take up livelihood promotion, (c) Inability to take up larger issues of gender and social inequality and women empowerment, etc. (d) Limitations of promoters to provide capacity building and other necessary inputs at a desired scale, and (e) Inability of banks to understand and accommodate the needs of the SHGs in some parts of the country, especially in under serviced regions. These are briefly explained:

I. Uneven Spread of SHGs

While the SHG - bank linkage model has experienced exponential growth over the past decade, there remain large regional disparities in the growth of the SHG movement with limited progress in the north and northeast (Kumar & Golait, 2009). In the total cumulative number of SHGs, as of March 2006, over 40 per cent are in Southern region followed by the Central (21.46 per cent) and Eastern (18.76 per cent) regions. The northern region accounts for only 5 per cent and north-eastern region accounts for less than 4 per cent of total SHGs.

Figure 3.4 Share of Different Regions in Cumulative SHGs (2010)



Source: NABARD, Status of Microfinance in India 2005-06

II. Inability to Promote Livelihoods

It is a well-known and established fact that micro-finance is a necessary but not sufficient condition for the promotion of livelihoods. Livelihood promotions need procurement of inputs, organizing many support services and marketing of the output. A small group of 10 to 20 members, illiterate and uninformed, cannot take up these complex tasks.

III. Inability to Address the Larger Issues

Though SHGs have contributed to social issues like women's mobility, interactions with the outside world, access to financial resources, and leadership qualities, to some extent they are unable to address the issues like women empowerment and social and gender equity

IV. Quality of SHGs

The quality of the group comes under stress due to the fast growth in numbers. This is reflected in poor maintenance of books and accounts at SHG level and diminishing skill sets on the part of SHG members in managing their groups (Singh, 2008). Several other issues are

- Most of the groups are dominated by some members while others are passive.
- Social intermediation which is a major objective of the approach is weak. Group formation is determined by the needs of the members and groups are neither natural nor voluntary.

- Level of financial literacy is extremely low among SHG members.
- Financial management and book-keeping of SHGs are totally inadequate.

V. Sustainability of SHGs

The sustainability of SHGs depends to a great extent on the quality of SHGs. Due to the poor attention paid by SHPI at the formation stage and excessive focus on achieving targets affects the sustainability of the SHGs in the long run.

VI. **From credit to enterprise**

One of the challenging tasks is that having formed SHGs and having linked them to banks, how can they be induced to graduate into matured levels of enterprise? How can they be induced to factor in livelihood diversification? How can they increase their access to the supply chain, linkages to the capital market and to appropriate production and processing technologies?

A spin-off of this challenge is how to address the investment capital requirements of matured SHGs that have met their consumption needs and are now on the threshold of taking off into the 'enterprise'. The SHG-Bank Linkage Programme needs to introspect whether it is sufficient for SHGs to only meet the financial needs of their members, or whether there is also a further obligation on their part to meet the non-financial requirements necessary for setting up businesses and enterprises (Thorat, 2006).

VII. Reluctance of Banks

Some banks in some parts of the country have been reluctant to adopt the linkage programme wholeheartedly, and this has been coupled with poor banking infrastructure and performance. (Some states in the north, some central states and most states in the east of the country fall in this category.) However, NABARD has made serious and sustained efforts to correct this imbalance. These efforts have been helped by IFAD projects in these areas, for example in Assam, Manipur and Meghalaya in the northeast, Uttaranchal and Haryana in the north, and Jharkhand, Chhattisgarh, Orissa and Madhya Pradesh in Central India. All of these projects include SHG promotion, training and mentoring in their design (Fernandez, 2006).

VIII. Excessive Focus on Credit

SHG approach focuses on 'one-dimensional' strategy to eradicate poverty. This approach places more importance on credit provision, while neglecting the other initiatives required for all-round development. These initiatives create livelihood options and opportunities for the effective use of credit to improve livelihoods in a sustained manner by reducing risk and providing appropriate infrastructure and inputs to increase productivity. So far SHG approach fails in taking into account these initiatives. There is now an urgent need for micro credit providers to shift from a minimalist approach – that is offering only financial intermediation – to an integrated approach to poverty alleviation taking a more holistic view of the client including provision of enterprise development services like marketing infrastructure, introduction of technology and design development.

IX. Impact of SGSY

Government sponsored programmes such as SGSY due to subsidy components affect the sustainability of SHGs negatively. SGSY has a subsidy Component of Rs. 15000, which prompts many SHGs members to leave the programme to join these subsidy based programmes. Such schemes have a dampening effect on SHG-BLP (Karmakar, 2008).

3.2.2 Microfinance Institutions Model

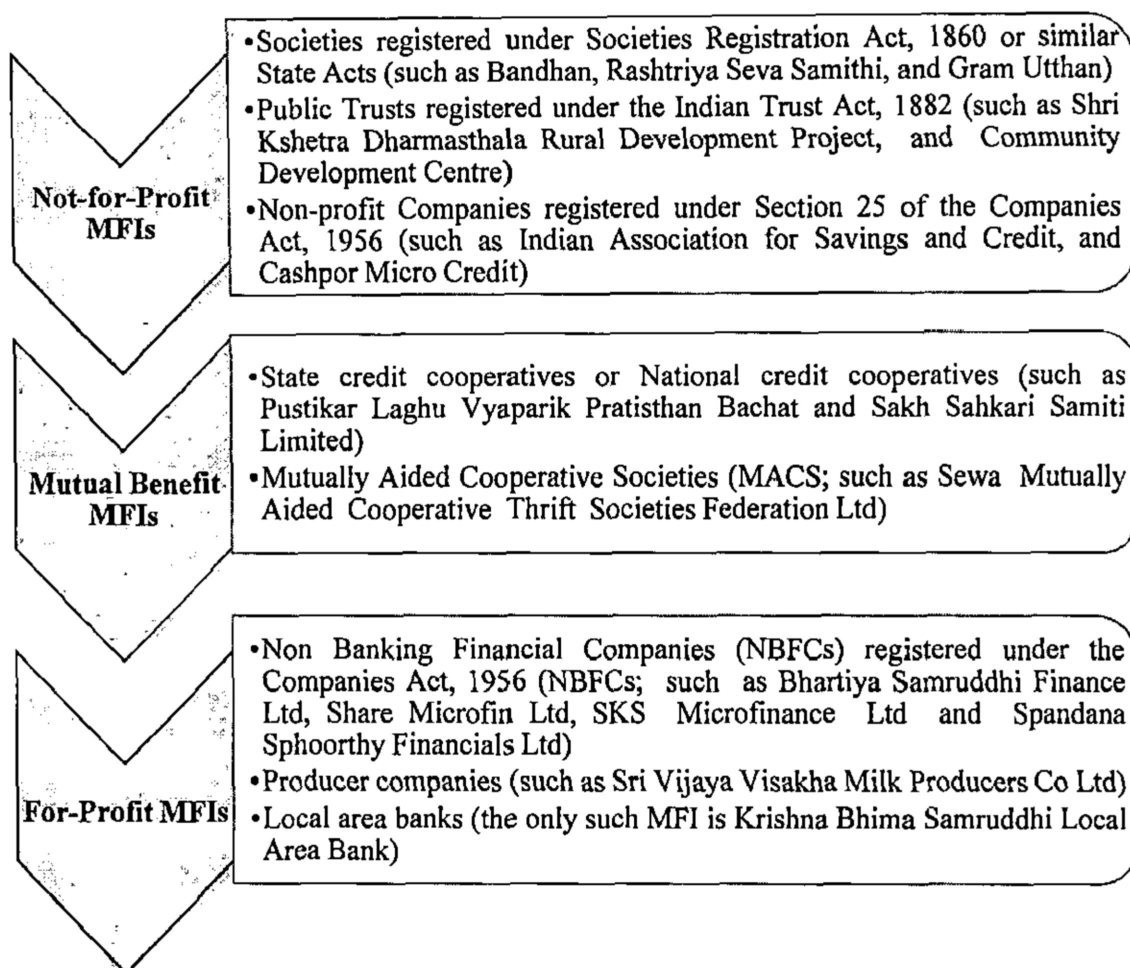
This meteoric rise of the MFIs has its roots in the liberalization of the banking system and its failure to meet the demands of the rural poor, especially women. Initially the MFIs were started in response to the program of financial inclusion. The SHG-BLP was started by the National Bank for Agriculture and Rural Development (NABARD) where non-government organizations (NGOs) and not-for-profit institutions played an intermediary role in promoting and facilitating the link between self-help groups and banks. Thus many MFIs started as not-for-profit NGOs and then began to expand their operations to make direct contact with the clients. Thus SKS Microfinance (which is the largest MFI in the country today) started as a not-for-profit institution and converted itself into a non-banking financial company in 2004.

A range of institutions in the public sector as well as private sector offers the micro finance services in India. They can be broadly categorized into two categories namely, formal institutions and semi-formal institutions. The former category is

comprised of Apex Development Financial Institutions, Commercial Banks, Regional Rural Banks and Cooperative Banks that provide micro finance services in addition to their general banking activities and are referred to as micro finance service providers. On the other hand, the semi-formal institutions that undertake micro finance services as their main activity are generally referred to as micro Finance Institutions (MFIs). While both private and public ownerships are found in the case of formal financial institutions offering micro finance services, the MFIs are mainly in the private sector. This second model of microfinance in India is mainly a private sector initiative. Semi-Formal institutions that undertake microfinance services as their main activity are referred as microfinance institutions (MFIs). MFIs are an extremely heterogeneous group comprising Non-Banking Finance Companies (NBFC), societies, trusts and cooperatives. They have provided financial support from external donors and apex institutions including the Rashtriya Mahila Kosh (RMK), SIDBI Foundation for Micro Credit and NABARD and employ a variety of ways for credit delivery.

The microfinance initiative in the private sector can be traced to the initiative undertaken by Ms. Ela Bhat for providing banking services to the poor women employed in the unorganized sector in Ahmedabad City of Gujarat State. Shri Mahila SEWA (Self Employed Women's Association) Sahakari Bank was set up in 1974 by registering it as an Urban Cooperative Bank. Since then, the bank had been providing banking services to the poor self-employed women working as hawkers, vendors, domestic servant, etc. The microfinance sector went on to evolve in the 1980s around the concept of SHGs, informal bodies that would provide their clients with much-needed savings and credit services. From humble beginnings, the sector has grown significantly over the years to become a multi-billion dollar industry, with bodies such as the Small Industries Development Bank of India and the National Bank for Agriculture and Rural Development devoting significant financial resources to microfinance. Today, the top five private sector MFIs reach more than 20 million clients in nearly every state in India and many Indian MFIs have been recognized as global leaders in the industry.

Figure 3.5: Organizational Forms of MFIs in India



With the current phase of expansion of the SHG – Bank linkage programme and other microfinance initiatives in the country, the semi-formal micro finance sector in India is now beginning to evolve. The MFIs in India can be broadly sub-divided into three categories of organizational forms as given in Figure 3.5. While there are no published data on private MFIs operating in the country, the number of MFIs is estimated to be around 1000. An overwhelming majority of MFIs are operating on a smaller scale with clients ranging from 500 to 1500 per MFI. It is estimated that the share of MFIs in the total micro credit portfolio of formal & informal institutions is about 8 per cent.[7]

NGO-MFIs

There are a large number of NGOs that have undertaken the task of financial intermediation. The Majority of these NGOs are registered as a Trust or Society.

7 NABARD, (www.nabard.org/microfinance/NABARDStrategy.asp) accessed on 10-02-2010

Many NGOs have also helped SHGs to organize themselves into federations and these federations are registered as Trusts or Societies. Many of these federations are performing non-financial and financial functions like social and capacity building activities, facilitate training of SHGs, undertake internal audit, promote new groups, and some of these federations are engaged in financial intermediation. The NGO MFIs vary significantly in their size, philosophy and approach. Therefore these NGOs are structurally not the right type of institutions for undertaking financial intermediation activities, as the bylaws of these institutions are generally restrictive in allowing any commercial operations. These organizations, by their charter, are non-profit organizations and as a result face several problems in borrowing funds from higher financial institutions. The NGO MFIs, which are large in number, are still outside the purview of any financial regulation. These are the institutions for which policy and regulatory framework would need to be established.

Non-Profit Companies as MFIs

Many NGOs felt that combining financial intermediation with their core competency activity of social intermediation is not the right path. It was felt that a financial institution including a company set up for this purpose better does banking function. Further, if MFIs are to demonstrate that banking with the poor is indeed profitable and sustainable, it has to function as a distinct institution so that cross subsidisation can be avoided. On account of these factors, NGO MFIs are of late setting up a separate Non-Profit Companies for their micro finance operations. The MFI is prohibited from paying any dividend to its members. In terms of Reserve Bank of India's Notification dated 13 January 2000, relevant provisions of RBI Act, 1934 as applicable to NBFCs will not apply for NBFCs (i) licensed under Section 25 of Companies Act, 1956, (ii) providing credit not exceeding Rs. 50,000 ($1112) for a business enterprise and Rs. 1, 25,000 ($2778) for meeting the cost of a dwelling unit to any poor person, and, (iii) not accepting public deposits.

Mutual Benefit MFIs

The State Cooperative Acts did not provide for an enabling framework for the emergence of business enterprises owned, managed and controlled by the members for their own development. Several State Governments therefore enacted the Mutually Aided Co-operative Societies (MACS) Act for enabling promotion of self-reliant and

vibrant co-operative Societies based on thrift and self-help. MACS enjoy the advantages of operational freedom and virtually no interference from government because of the provision in the Act that societies under the Act cannot accept share capital or loan from the State Government. Many of the SHG federations, promoted by NGOs and development agencies of the State Government, have been registered as MACS. Reserve Bank of India, even though they may be providing financial service to its members, does not regulate MACS.

For Profit MFIs

Non-Banking Financial Companies (NBFC) are companies registered under the Companies Act, 1956 and regulated by Reserve Bank of India. Earlier, NBFCs were not regulated by RBI but in 1997 it was made obligatory for NBFCs to apply to RBI for a certificate of registration and for this certificate NBFCs were to have minimum Net Owned funds of Rs. 25 lakhs and this amount has been gradually increased. RBI has introduced a new regulatory framework for those NBFCs who want to accept public deposits. All the NBFCs accepting public deposits are subjected to capital adequacy requirements and prudential norms. There are only a few MFIs in the country that are registered as NBFCs. Many MFIs view NBFCs more preferred legal form and are aspiring to be NBFCs but they are finding it difficult to meet the requirements stipulated by RBI. The number of NBFCs having an exclusive focus on microfinance is negligible.

Models of MFIs in India

In India there are various models of MFIs, these models vary in their legal form, in the channels and methods of delivery, in their governance structure, in their approach to sustainability, and also in their approach to microfinance. Yet all of them have an overarching view of microfinance as a very effective tool of poverty alleviation. Some of the models have a minimalist approach to Microfinance and others have a Credit Plus approach, depending on the way they approach Microfinance (Sa-Dhan, 2006). The MFI model uses a variety of methodologies ranging from the very popular SHG methodology traditionally pursued in the country to Grameen and joint liability groups, as well as individual banking arrangements. Over the years, through an ongoing process of experimentation and innovation Indian

MFIs now largely follow a mixed approach customised to their target segment and area of operation.

The Self Help Group Model

The SHG model, like other models in Microfinance, has evolved in the NGO sector. Proponents of this model believe that the poor have the capacity of self-help and the NGOs primarily have the functions of enabling, educating and networking.

Self Help Groups are small (membership 10 to 20), informal groups that have socially and economically homogeneous membership of poor people drawn from the same hamlet or from nearby hamlets. People who are homogeneous with respect to social background, heritage, caste or traditional occupations come together for a common cause to raise and manage their collective savings for the benefit of all the group members. The members are self-selected, meaning the potential members have a choice of being in this group or that group depending on their level of affinity with the other potential members. Thus the basic design of the SHG is robust and makes it easy for the NGO facilitator to build it into a strong social and financial institution.

There are some features that make the SHG-model not so desirable to some:

1. The group promotion process is a long; the poor have to wait considerable amounts of time, before they can start availing loans of reasonable amounts.
2. The amounts available in the beginning are very small, and all the members cannot take loans at a time.
3. The functioning of the group relies totally on group dynamics, peer pressure, etc. These are difficult to build in and require a high order of facilitation that every NGO may not have access to.
4. Conflicts arise on seemingly trivial reasons, which would lead to a total group break down. It is very difficult to rebuild a group that has broken once.
5. The group promotion process is intricate and long drawn and therefore costly. And this cost has to be met by the NGO through grants, because these are community building costs.
6. Many NGOs have a broad agenda of taking up a variety of programmes and not just Microfinance.

Despite these disadvantages, the perceived advantages of the SHG have far outweighed its disadvantages and have made the SHG the popular model for

Microfinance in the country, that even the government programmes have SHG as the core of their strategy.

The Grameen Bank Model

The Grameen methodology has been a case of exceptional success. Though Grameen bank evolved its methodology in Bangladesh, with its well-recognised success, many organisations in India, like SHARE, ASA and CASHPOR have adopted this methodology with little variations. Some of the salient features of Grameen Model are mentioned below:

- Homogenous, affinity groups of five members are formed at village level
- The field worker facilitates the process of forming groups
- All the group members undergo a 7 day compulsory training of 1-2 hours each day
- Some groups undergo the Group Recognition Test (GRT). The GRT is a screening mechanism that can distinguish between serious and non-serious groups. It has been recognised as an effective targeting tool.
- Once the preliminary groups have passed the GRT, then the women should become members of the Bank (Grameen) by paying a onetime membership fee.
- Eight joint liability Groups affiliate together to form a centre.
- Centre meets every week, at a defined time. The meetings are very structured and Bank Assistant attends the meeting.
- Group discipline is enforced through peer pressure and is seen as a very important aspect of creating and building credit discipline in the program. It is mandatory for the members to attend the weekly meeting and all the loan applications have to be approved by other group members as well as centre members. The loan disbursement is from the Bank fund and it is not linked with the savings. Loans are given to the individuals and not to the group or the centre. The loan disbursement is always done at the centre and during the centre meeting at the village meeting to build and maintain the Peer Pressure. The housing loans are disbursed at the Branch to maintain documentation.

- Loans are provided for all kinds of the major categories of loans - General Loans, Supplementary loans, special general loans, Sanitation and housing Loans.
- The savings are compulsory for the members. This amount is deposited with the Bank. With this deposit the Bank funds their consumption needs. This strategy has paid off, because members are less likely to default on their own money as opposed to when funds are provided by outside institutions.
- The group leader collects the loan repayments and savings prior to the meeting and hands it over to the Centre leader who in turn during the meeting gives it to the field worker. The collected money is never used for fresh loans. It is deposited in the branch the same day. In a sense it is a good practice as it discourages all possible leakages in monetary transactions.
- Collateral is replaced by Peer Pressure. The incentive to timely repayment is repeat loans and continuous access to increasing credit from the Bank. There is a provision of loan utilisation check. The field worker with the help of group members mainly does this.

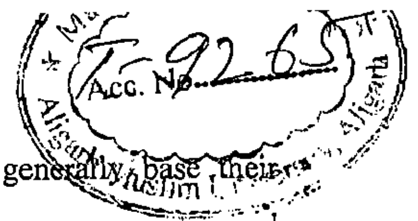
Some of the significant elements of this methodology are:

- Low Transaction Cost- peer Appraisal
- No collateral- Peer Pressure
- All kind of Loans- productive and Consumption
- Repayment in small, regular and short intervals
- Quick loan sanction- not much formalities, paper work

The most remarkable aspect of the Grameen bank's has been its high loan recovery rate. This has contributed to the bank having a low cost of credit and has attracted low cost of funds from the government and international donors. While the Grameen model is limited to less than a dozen major NGO-MFIs or NBFCs, it is an important alternative credit delivery system to mainstream finance.

Individual Model

In Individual lending method, MFIs provide loans to an individual based on his/her own personal credit worthiness. 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 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 the liability of repaying the loan, should the borrower fail to do so. If the loan is significantly larger, MFIs may also take some collateral security.

Typical characteristics of micro-entrepreneurs qualifying for the individual lending segment are:

- Businesses usually owned and managed by men, who typically are reluctant to form groups and attend group meetings.
- With present access to microfinance, use typical group–based loans for the business, which are inadequate to meet their working capital needs. Women are often used as surrogate borrowers for these group loans.
- They demand and are willing to pay for features such as doorstep collections, as micro-entrepreneurs are unable to leave their businesses to attend meetings or visit branches.
- Infusing working capital into these businesses typically yields higher rate of returns, hence this segment is able to absorb higher interest rates for conveniences like doorstep collections and individual loans.

MFIs of different legal forms have made rapid strides and expanded their outreach through SHGs, Joint Liability Groups (JLGs) and individuals by way of providing them doorstep financial services. Under SHG-BLP, apart from banks financing SHGs directly, they have financed MFIs for on-lending to SHGs and other small borrowers. As on 31 March, 2009, 1915 MFIs had loan outstanding of Rs.50091 million under this route. Besides, the MFIs have pursued aggressive expansion mode. Notwithstanding their growth in business portfolio, outreach and financial services, the issues and challenges of multiple-financing, over-indebtedness, weak governance/internal checks and control system, high interest rates, lack of transparency of operations, etc. have surfaced in the MFI front.

Table 3.8: Operational Features of Different Microfinance Models in India

	SHG	Grameen	IB
Clients	Primarily Women	Primarily Women	Primarily Men
Groups	15 to 20 clients per group	Usually 5 clients per group (organized into centres of 4-6 groups)	Individual Clients
Service Focus	Saving and credit	Credit-regular cycle	Credit
Role of MFIs Staff	Guide and facilitate(groups may develop autonomy)	Organize (groups dependent on staff)	Organize
Meetings	Monthly	Weekly	Individual transactions (often daily)
Saving Deposits	Rs. 20-100/month	Rs. 5-25/week	Flexible
Interest on Savings	Bank rate (4.25 per cent + profit share)	6-9 per cent	6 per cent+
Initial Loan Size	Rs. 5-10,000	Rs. 2-5000	Rs. 5-15000
Effective Interest Rate (Usual range)	24-28 per cent	32-38 per cent	23-38 per cent

Source: EDA Rural Systems, 2005.

NBFCs are registered under the Companies Act, 1956. They are also required to be registered with the RBI under the RBI Act, 1934, and must comply with directions issued by the RBI. Section 25 companies are not-for-profit NBFCs registered under Section 25 of the Companies Act. Under certain conditions, they are exempted from a number of legal requirements under the RBI Act.

There is no specific law catering to NGOs. Microfinance NGOs can be registered under the Societies Registration Act, 1860, the Indian Trust Act, 1882, or the relevant State Acts. The grassroots level formations or groups (Self Help Groups or Credit and Savings Groups), through which other financial institutions are channelling their financial services, are informal and unregistered. The main funding sources for NGOs are donors, government departments and to a small extent bank credit as well as the savings of the poor. The SHG-BLP opened up the banking system as an additional source of funds. Cooperative societies registered under the "MACS Act" – promulgated by some of the States – are eligible to mobilize savings from their members. For mobilizing savings, these societies also need to be registered with NABARD under the proposed Bill.

Most MFIs in India are solely engaged in extending microcredit: a few also extend saving/thrift, insurance, pension, and remittance facilities. For providing insurance facilities, MFIs have tied up with insurance companies and mutual networks (funds created by community-owned organisations); some MFIs also do underwriting on their own.

Status of MFIs in India

Table 3.10 provides data on some indicators of top performing (in terms of number of active borrowers) MFIs of India during 2009.

Table 3.9 Top 20 MFIs by Outreach as on 31st March 2009

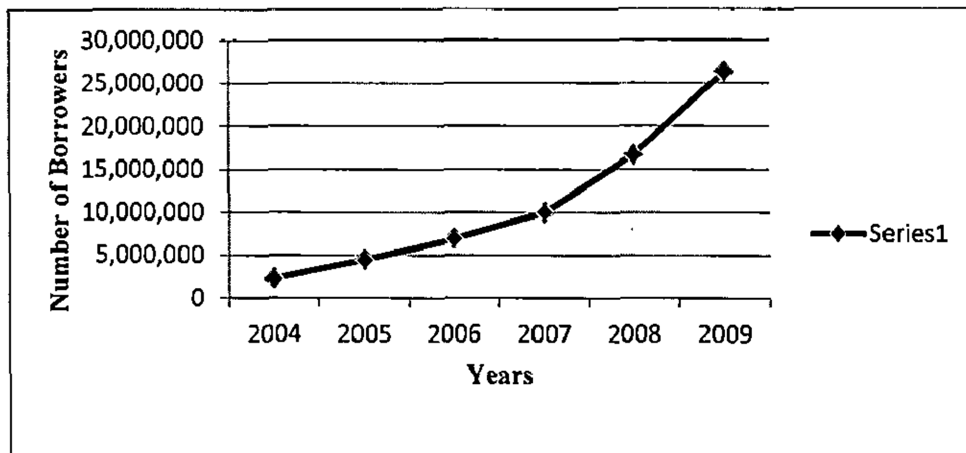
Name	Number of active borrowers	Gross loan portfolio ($)	Total assets	Total borrowings	Total women borrowers
SKS	5795028	960793988	897871054	599215512	5795028
Spandana	3662846	787304262	647250710	487964681	3368115
SHARE	2357456	376593362	576914660	453194629	2357456
Bandhan	2301433	332462204	424220483	297493694	2301433
AML	1340288	315439786	389278748	314694990	1340288
SKDRDP	1225570	136728666	165501622	129249425	783364
BASIX	1114468	172484946	302608641	213806693	739581
Equitas	888600	134597374	165739228	96018850	888600
Grama Vidiyal	772050	134568751	134179664	108717776	772050
Ujjivan	566929	82447140	90499265	52692529	566929
Cashpor MC	417039	59461459	62074316	51548523	417039
GFSPL	352648	73420428	68138395	54733752	350514
BISWA	305679	58971572	73737807	50161875	302167
FFSL	257991	54332892	63535655	47532265	257991
ICNW	250834	2289882	3873322	867734	250834
MMFL	250208	33140461	36683602	23551466	250208
BFL	220645	25837861	35387135	29031065	187548
ESAF	220011	34610035	40807896	32280308	218301
SMILE	214280	31657694	37110799	27998268	214280
SEIL	199731	77876659	144620292	42255996	55388

Source: MIX Market, (http://www.mixmarket.org) accessed on 23-4-2010.

SKS microfinance has the highest number of active borrowers in 2009. As reported by SKS 100 per cent clients of SKS are women. Other institutions are lagging far behind SKS in terms of number of active borrowers.

Figure 3.5 shows the growth in the number of active borrowers for a sample of households. There is an exponential increase in the number of active borrowers over the period 2004-2009.

Figure 3.6 Number of Active Borrowers



Source: MIX Market, (http://www.mixmarket.org) accessed on 23-4-2010.

Notes: 1. Graph shows the number of active borrowers (Sum) of MFIs reporting data to MIX.
2. Number of MFIs are correspondingly 78, 79, 88, 69, 86, 86 for the period2004-09

Key financial, efficiency and outreach indicators for a sample of households for the period 2004-2009 have been provided in Table 3.11. There is a marginal improvement in the financial performance of included MFIs over the period as evidenced by the median values of operational-self-sufficiency and Return on assets. The Interest rate charged decreases during the period as value of yield on gross portfolio decreases from 0.25 to 0.14. There is a significant increase in the average loan balance which may be a sign of shift towards better off clients.

A global comparison shown in Table 3.12 indicates Indian microfinance sector performs well in terms of financial performance. Average loan size is only next to Bangladesh which shows better poverty outreach of Indian microfinance sector.

Table 3.10: Key Indicators of Indian MFIs over the Period 2004-09

Fiscal Year	MFIs (count)	Operational-self-sufficiency (median)	Return on assets (median)	Yield on gross portfolio (real) (median)	Cost per borrower (median)	Debt to equity ratio (median)	Average loan balance per borrower (median)
2004	75	0.9324	0.00625	0.2524	11.6134	10.52	74.505
2005	79	1.0416	0.0106	0.15215	8.7386	13.1	97.96
2006	90	1.0155	0.0027	0.14415	10.15615	11.67	101.57
2007	78	1.08605	0.0075	0.1497	12.3341	8.59	141.32
2008	93	1.0916	0.0198	0.14605	14.38505	6.21	108.04
2009	86	1.07055	0.01415	0.1429	15.08795	5.76	144.395

Source: MIX Market, (http://www.mixmarket.org) accessed on 23-4-2010.

Table 3.11: Global Comparison of Indian Microfinance Sector in 2010

Country	OSS	ROA	Profit Margin	Average Loan US $	Yield on Gross Portfolio
Kenya	118.1	-1	-0.2	463	31.3
Uganda	116.1	2.7	9.4	325	53.7
Bangladesh	106.6	-0.3	-1.2	80	24.3
Pakistan	85.1	-6.6	-47.4	187	27.9
Philippines	113	0.5	6.7	288	38.5
Brazil	133.6	6.4	19.4	820	41.5
Mexico	113.2	3	10.2	468	62.8
Indonesia	142.8	3.1	15.4	915	22.5
India	111.4	0.7	7.9	146	21.2

Source: MIX Market, (http://www.mixmarket.org) accessed on 23-4-2010.

Emerging Challenges for MFIs

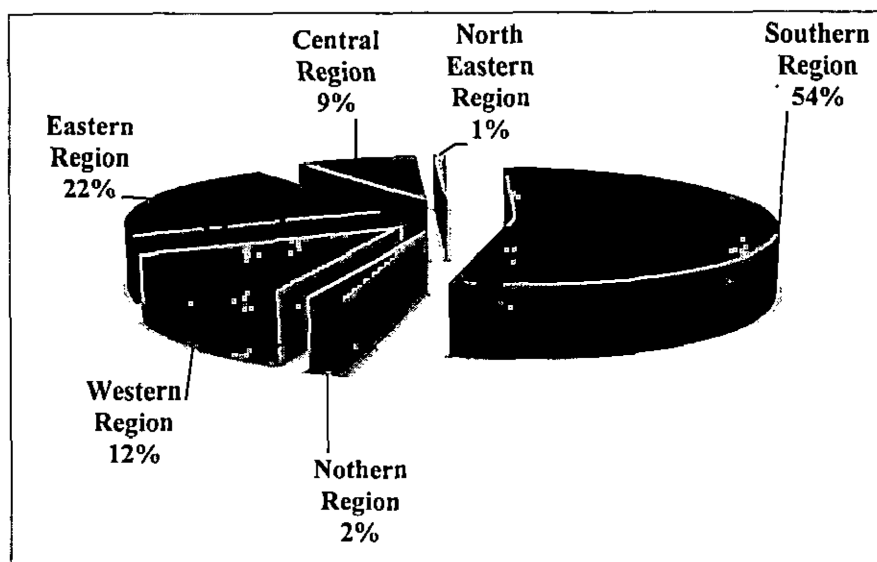
Microfinance is now recognized as an effective method for providing financial services to the poor and thereby reducing poverty. Total outreach of MFIs in India is still a small proportion of total financial needs of the poor. Still there is a large number of poor in the country who have no access to financial services. A number of challenges in this regard are:

Regional Imbalances

Concentration of MFIs in some Southern states is a cause of worry. One out of every two clients is from Southern states. Southern region had a share of 54 per cent

clients, but accounted for 58 per cent of loans (Figure 3.6). Not unsurprisingly AP, Karnataka, WB, Tamil Nadu and Orissa are the top five states in terms of total client outreach. WB has more MFI clients than Tamil Nadu which is considered to be an intense competitive microfinance market.

Figure 3.7 Regional Outreach of Indian MFIs



Source: State of the Sector Report 2009.

Sources of Fund

In the current global financial and economic climate, the source of funding will emerge as a crucial factor in the continued growth of the microfinance sector. With the exception of Bangladesh, all other countries have yet to harness the power of savings as a crucial source of capital. In Bangladesh, where NGOs dominate the sector, a large share (30 per cent) of the sources of funds for microcredit comes from member savings, with Grameen funding 56 per cent of its total loan portfolio from savings (Bedson, 2009). A vast majority of MFIs are NGOs registered under the Societies Act or Trust Act, and they cannot mobilize large amount of savings due to the inappropriate legal and financial structure. A few MFIs which have registered as Non-Banking Finance Companies (NBFCs) are able to mobilize equity from development financial institutions and leverage these with borrowing from commercial banks. However, the regulatory framework is not conducive for these MFIs.

Technology

Technology enables an organization to provide a wider range of products and to tailor them as per the individual needs. The use of hand-held point of sale devices, smart cards, bio-metrics and mobile telephones can accelerate the growth and depth of outreach of the microfinance sector in the next decade.

Provision of other Financial Services

One of the major controversies about the role of MFIs is the credit versus credit plus approach. Is it enough to provide only credit to the poor for poverty alleviation? This issue is debated constantly. Some argue that in the absence of any income-generating activity the poor may fall into a debt trap. For the sustainability of their operations, MFIs should not go in for a minimalist approach of providing credit. The poor need a constant and steady source of income and for this reason MFIs need to go in for a holistic approach. However, provision of services should not be on a mandatory basis, but should be provided on a voluntary basis.

Financial Sustainability and Poverty Outreach

The major on-going debate is related to the outreach and sustainability of microfinance. MFIs are being promoted with the ostensible objective of serving the poor. But in order to attain financial sustainability, MFIs are charging very high interest rates, which the poor find difficult to pay. Balancing the twin objectives of commercial viability and serving the poor in a cost-effective and efficient manner is the biggest challenge confronting MFIs. Another important challenge is human resource management of MFI operations in the current context of globalization. Conflicts of interest with the government and unwarranted political expectations and interference are some of the most important threats to MFIs. If MFIs want to have a long term impact on the larger goal of poverty alleviation, they need to rethink their strategy in terms of managing the emerging challenges and problems in the sector more effectively.

Capacity of MFIs

It is now recognized that widening and deepening the outreach to the poor through MFIs has both social and commercial dimensions. Since the sustainability of MFIs and their clients complement each other, it follows that building up the capacities of the MFIs and their primary stakeholders are pre-conditions for the

successful delivery of flexible, client responsive and innovative microfinance services to the poor. Here, innovations are important for social intermediation, strategic linkages and new approaches centred on the livelihood issues surrounding the poor, and the re-engineering of the financial products offered by them as in the case of the Bank Partnership model (Thorat, 2006)

3.3 Conclusions

Comprised of two parts, the first part of the chapter discusses outreach of formal banking system to the poor and deficiencies of formal banking. The second discusses two major approaches of microfinance, viz. SHG-Bank Linkage Model and Microfinance Institutions in detail.

By using aggregate level facts and figures first section of this chapter shows, despite tremendous quantitative achievements (branch expansion), rural areas suffers from a lack of financial services and most of the poor do not have access to finance. A large proportion of rural masses still depend upon informal sources of finance as evidenced by national sample survey data. The failure of India's rural banks to deliver finance to the poor may be attributed to a combination of factors. From the banks' perspective, serving the rural poor is a high-risk, high-cost proposition, with high uncertainty, and transaction costs related to small size loan, frequent transactions and government policies which contribute to a financial climate not conducive to rural banking. From the perspective of rural clients, the banks do not provide conveniently accessible and flexible products and services, high transaction costs including cumbersome and costly procedures, hefty bribes, and long processing time and the poor clients can't meet the demand for collateral.

The dominant role played by the non-institutional agencies in rural financing necessitate the emergence of some innovative approaches, like microfinance, to fill the demand-supply gap of rural credit in a sustainable manner. Microfinance is one of the most significant financial innovations of the past decade for catering the needs of the rural poor in a sustainable manner. Indian microfinance sector has two major models for delivery of financial services to the poor- the SHG-Bank linkage Programme and MFI model. While the MFI- model is growing rapidly, the SHG-Bank Linkage Model is by far the more dominant model in terms of outreach.