

Chapter 1

INTRODUCTION

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Chapter 1

INTRODUCTION

Money always matter either for big or for small business activity. Traditionally, the formal banking institutions have been serving only the needs of commercial sector and providing loans for middle and upper income groups. These banks failed to extend their services to the informal sector and low income earners due to non-availability of collateral for the banks to use in case of default.¹

Poor people also need a diverse range of financial facilities to run their small businesses, stabilize consumption, build assets and shield themselves against risks. The basic financial services required by the poor are working capital loans, consumer credit, savings, pensions, insurance and also need money transfer services.² Finance helps the poor to catch up with the rest of the economy as it grows. Finance helps the poor and low income people to improve the quality of their lives and make them able to stand in the fast growing modern economy.

Mostly poor people access financial services through informal financial sources. Poor and low income people all over the world have been connected with money lenders who provide easy access to credit but usually at a very high cost. The cost of interest generally ranges from 36 per cent to as high as 120 per cent.³

By and large, thanks to microfinance, there is now a growing appreciation of the ‘empowerment’ dimension of finance of the extent to which it can give ordinary people and poor access to opportunity and the ability to escape ossified social structure.⁴ Microfinance movement has developed new contractual structures and organizational forms that reduce the riskiness and costs of making small un-collateralized and cheap loans. Though the principle of managing money on a small scale existed for years, the industry of microfinance has only in the last several decades really expanded and provided access to financial services for millions of people who might not otherwise have it.

1.1 Microfinance: A Bird’s Eye View

If poor and low income people are provided access to financial services, they may be able to start or expand their micro-enterprise that will allow them to break out the vicious cycle of poverty. They may survive in the modern economy. This is the basic idea on which microfinance has been established.

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to poor and low income households and their micro enterprises. Microfinance is expected to play a significant role in poverty alleviation and development.⁵

1.1.1 Meaning of Microfinance

The Reserve Bank of India⁶ (**RBI**) and the National Bank for Agriculture and Rural Development⁷ (**NABARD**) have **defined** microfinance as “provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards.”

Consultative Group to Assist the poor (**CGAP**) **defines** microfinance as “the supply of loans, savings and other basic financial services to the poor. People living in poverty like everyone else, need a diverse range of financial instruments to run their business, build assets, stabilize consumption and shield themselves against risks. Financial services needed by the poor include working capital loans; consumer credit, savings, pensions, insurance and money transfer services.”⁸

Marguerite S. Robinson* has **defined** that “microfinance refers to small scale financial services for both credits and deposits – that are provided to people who farm or fish or herd; operate small or micro enterprises where goods are produced, recycled, repaired or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and local groups in developing countries, in both rural and urban areas.” She further clarified that definitions could be narrower and more focused, depending on the topology of lending that “microfinance refers to all types of financial services provided to low-income households and enterprises.”⁹

International Labour Organization **claimed** that “financial market tends to discriminate against people who need smaller transactions.” While Banking in Ghana viewed microfinance as “Provision of financial services in the form of savings and loan to low income earners in both the rural and urban centers.”¹⁰

The term microfinance and micro-credit are often used interchangeably and treated as synonymous but microfinance is much broader in scope as that includes deposits, loans, payment services and insurance to poor.¹¹

(**Note:** * M S Robinson, Ph.D. from Harvard University, is the author of “The Microfinance Revolution: Sustainable Finance for the poor.” She is a social anthropologist and internationally recognized expert on microfinance.)

The Microcredit Summit 2007 defines microcredit as “the extension of small loans to entrepreneurs, too poor to qualify for traditional bank loans.”¹²

Thus Microfinance and Microcredit both are different concepts. The key implication of micro-credit is in its name itself ‘micro’. The concept of micro-credit is to provide only credit to the poor and low income people without any collateral while the concept of microfinance is very broad. Microfinance provides all types of financial facilities to the poor people including micro-credit, savings, deposits, insurances, pension and money transfer services etc.

1.1.2 Clients of Microfinance

The typical microfinance clients are low-income persons that do not have access to formal financial institutions. Microfinance clients are typically self-employed, often household-based entrepreneurs. In rural areas, they are usually small farmers and others who are engaged in small income-generating activities such as food processing and petty trade. In urban areas, microfinance activities are more diverse and include shopkeepers, service providers, artisans, street vendors, etc. Microfinance clients are poor and vulnerable non-poor who have a relatively low stable source of income.¹³ Majority of them are women. The average microfinance client across the globe is a middle aged woman, aged 35 to 45. For her, earning a living is vital. She is part of a five to six person household where the average number of income earners is three and the number of income source is about the same.¹⁴ Generally they are engaged in the business activities like retail facilities, street sale, handicraft production, agriculture, live stock production, or provision of various services.

Counting the net number of people who crossed from below the USD 1.25 a day consumption in India between 1990 and 2010, a study by India Development Foundation (IDF) shows that nearly 9 million Indian households involved in microfinance - including approximately 45 million family members moved above USD 1.25 threshold during the last two decades.¹⁵ According to a notification of RBI the loan is to be extended to a borrower whose household annual income in rural areas does not exceed ₹60,000/- while for non-rural areas it should not exceed ₹1,20,000/-.¹⁶

But financial services, particularly loans or microcredit, are not always favourable for all. They are the most appropriate for those who recognized economic opportunity for making profit, if they have access to satisfactory amount of money. Regardless of the way of loan, microfinance institutions may provide long term and stable access to money only if the clients are ready and able to respect repayment terms.

The poorest households, about 10% of them, are not traditional clients of microfinance since they do not have stable money inflow for the loan repayment. They need grants or other public sources of finance for repayment of their economic situation. That is also the most efficient form of support for them since the majority is not able to repay the loans.¹⁷

1.1.3 Difference between Corporate Finance and Microfinance

Finance is a broad field that deals with money matters, whether they pertain to private shareholders, the government, the public, individuals and even companies. Essentially, corporate finance deals with businesses, large businesses, whereas, microfinance deals with really small businesses. In other words, corporate finance is more business-focused, whereas, microfinance is more individual focused.

Traditional and/or commercial banks can easily assess loan risk through automated processes and controls of businesses in bulk, perhaps by using ERP (Enterprise Resource Planning) solutions that run complicated calculations to determine detailed risk profiles of several businesses at a time, based on factors such as annual revenue, sales forecast, dividend payout etc. However, when it comes to microfinance, each business is dealt with individually, and often records are insufficient or poorly kept, or even non-existent, in case of new applicants. In that case, bank employees have to assess risk profiles by physically visiting the entrepreneur, determining his/her social and business reputation, judging the skill level, and so on. All these are pretty difficult to quantify, hence a highly personal approach is applied and this lowers the level of efficiency in operations.¹⁸

1.2 Rationale of the study

Poverty is wide spread in India. One way to help the world's poorest comes in the form of microfinance, which brings basic banking tools to the world's most needy people. Thus, microfinance is often considered as the most effective and flexible strategies to fight against the global poverty. In last few decades the volume and scope of microfinance has expanded. Microfinance has got substantial social impacts. Number of studies are carried out to study the social impacts state wise or may be for particular MFI or group of MFIs. However, it was very difficult to find any study dealing with the financial aspects of the microfinance. Therefore, the present study is carried out to analyse the financial aspects of the microfinance.

Among all financial services of microfinance, credit is found to be the most important financial service which is given to the poor people without taking any

collateral. In microfinance, one is not abide to give any collateral for having a credit facility. But if the credit facility is given without any collateral all microfinance providers have to face credit risk. Though good repayment rate was found from the poor people, but still credit risk is there for any microfinance provider. Credit risk is the most common risk for microfinance institution. If any borrower fails to repay the credit, it creates a credit risk for microfinance provider. Therefore, the most challenging area for microfinance providers is repayment. Repayment capability of the borrowers is affected by the two major factors *i.e.* social factors and financial and/or economical factors. It is very important to identify the effects of both the factors on the level of defaults. Additionally, loan repayment is also affected by internal management system of the MFI. Thus, it is equally important to identify the factors affecting loan repayment and level of defaults from the side of the MFI. The researcher has specially focused on the same and also examined the causes of defaults from both the sides such as demand (borrowers) side and supply (MFI) side.

1.3 Objectives of the study

In the back ground discussed in 1.2 the present study intends to know the current status of microfinance in India and especially in Gujarat Region. Precisely the objectives of the study are:

1. To know the theme of microfinance, role of microfinance institutions (MFIs) and the microfinance users.
2. To analyze the development of regulatory framework for microfinance institutions in India.
3. To understand the functioning of MFIs working in different states of India and to study the important financial indicators of MFIs.
4. To examine the status of overdue loans, loans bad and doubtful of recovery and NPA in view of different types of loans as well as purposes of the loans of the SEWA Bank.
5. To understand the behaviour of the borrowers regarding loan taking and repayment of the same with sample of borrowers of SEWA Bank.
6. To study the factors affecting to defaults leading to non performing assets (NPA) in microfinance and to find out some solutions to reduce the level of defaults.
7. To understand the role of bank's frontline workers (Banksathis) and bank's facilitators (Hand Holders) regarding recommendation and monitoring of the loan to borrowers.

1.4 Organization of the Study

The study is divided into following ten chapters

1. Introduction
2. Literature Review
3. Research Design
4. Legal Framework
5. Microfinance in India: An Overview and Analysis
6. SEWA Bank and Its Financial Services
7. Data Analysis: Pilot Survey
8. Data Analysis: Borrowers
9. Data Analysis: Banksathis and Hand Holders
10. Conclusions and Recommendations

Chapter-1 gives the basic idea about the theme of microfinance, explains the rationale of the study, objectives of the study and explains the chapter scheme of the study. The major contributions of the study have also been discussed over here.

Chapter-2 gives the reviews about the books, e-books, articles published in journals, news papers and online published articles. The researcher gives some important reviews related to rate of defaults and NPAs in microfinance as the study focused on the causes of defaults and NPAs in the sector of microfinance.

Chapter-3 presents the Research design adopted for the purpose of the study starting from selection of region and organization. It further goes on to explain sample selection, data collection for three main components of microfinance *i.e.* Borrower, Bank's frontline workers (Banksathis) and Bank's facilitators (Hand Holders). The list of all hypotheses tested for the study is presented in the chapter.

Chapter-4 attempts to examine the development in legal framework of microfinance over a period of time. To regulate the MFI, numbers of initiatives are taken by RBI and NABARD. This chapter intends to present the same in logical and chronological order.

Chapter-5 gives the broad idea about the microfinance sector in India with its historical back ground. It provides the detailed discussion about Microfinance Institutions (MFIs) working in different states of India with important financial indicators by comparing the data from two different sources. (MIX market and Sa-dhan).

Chapter-6 illuminates the SEWA Bank, Ahmedabad and its financial services as the same is selected for the study. It gives the detailed idea about how SEWA got established and how successfully they are handling the poor self employed women today. Over and above this, it also presents brief about the loan portfolio of SEWA Bank over a period of time.

Chapter-7 discusses about the responses collected through the pilot survey and analyses the data. It explains the procedure of final questionnaire based on the responses received during the pilot survey.

Chapter-8 presents the detailed discussion about the responses received through final questionnaire from the borrowers of the SEWA bank. It analyzes the responses of the borrowers through the testing of hypotheses. Based on analysis certain important conclusions are drawn.

Chapter-9 shows the analysis of the responses (of the final survey) from the banksathis and hand holders of the SEWA bank. It discusses the analysis of data of the banksathis and hand holders and also discusses the results through the hypotheses testing.

Chapter-10 summarizes the major findings of the study and gives final conclusion of the research. It gives solutions for the research problem too. It provides some important recommendations based on the findings of the study. The scope of the future study is also discussed here.

This is followed by bibliography, webliography, appendixes for three questionnaires monitored on three groups of respondents, viz. borrowers, banksathis and hand holders and appendixes for list of economic activities as well as MFIs.

1.5 Contribution of the Study

The study helps to understand about the overall structure of microfinance, the concept which is noticed to be an old concept. Further, the study helps to understand the legal and regulatory frame work of microfinance.

The data relating to microfinance have been compiled and published on wide scale by two main agencies viz. MIX Market and Sa-Dhan. Many variations are observed between the published by them. Thus, the study contributes the comparative analysis of the data of both the sources and differentiates the important aspects. The study gives a comparative analysis of many financial indicators for each MFI working in different states of India. With this analysis, financial status of numerous MFI working in India could be categorized.

Microfinance being basic lending activity is also exposed to credit risk. The study mainly focuses on the same. The study helps to identify the causes of defaults according to the demand and supply side both. The study examines the causes of defaults and NPA by examining the borrowers related factors as well as loan related factors. The study provides the comparative analysis regarding borrowings and advances between both the sides *i.e.* demand side (borrowers) and supply side (MFI). The analysis of the same helps to realize the difficulties of the borrowers regarding loan repayment. It also recognizes the effects of the behaviour of bank's frontline workers and bank's facilitator regarding loan sanctioning, loan monitoring and loan repayment. The study intends to recommend modifications in loan sanction procedure as well as modifications in certain steps for monitoring the loan to minimize the level of default. It also provides the suggestions regarding the change required in internal management system for the chain of loan recommendations (from bank's frontline workers and facilitators) to loan repayment (from borrowers). Accordingly, the credit delivery methodologies, loan repayment schedules and/or loan repayment collection methodologies can be changed by the SEWA bank to reduce the rates of defaults.



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