Chapter: 2 Overview of Microfinance sector: A review of related literature

2.1 Introduction to Microfinance:

What is Microfinance?

The Reserve Bank of India (RBI) and National Bank for Agriculture and Rural Development (NABARD) define micro-finance as

Provision of thrift\(^1\), credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and in improving living standards.

To put in simple terms, microfinance means to provide poor families with very small loans (micro credit) to help them engage in productive activities or grow their tiny businesses. This was initially known as Microcredit but over time it was realised that the poor who lack access to formal financial institutions require a variety of financial services like savings, insurance etc apart of credit services. And thus Microcredit was renamed as Microfinance.

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\(^1\)According to the Microfinance Bill 2007, thrift means any money collected (other than in the form of current account or demand deposit) by a microfinance organization from a group or by a group from its members through group mechanism, not exceeding such amounts and subject to such other terms and conditions as may be prescribed.
As per the Microfinance Bill 2007:

Microfinance services means-

a. Providing financial assistance to an individual or an eligible client either directly or through a group mechanism for -
   i. An amount not exceeding rupees fifty thousand in aggregate per individual, for small and tiny enterprises, agriculture, allied activities (including for consumption purposes for such individual) or
   ii. An amount not exceeding rupees one lakh fifty thousand in aggregate per individual for housing purposes or
   iii. Such other amounts for any of the purposes mentioned in items i and ii above or other purposes, as may be prescribed.

b. Financial services to an eligible client or individual borrower through the business facilitator or business correspondent mechanism authorized by the scheduled banks or any such other agency as may be permitted by the Reserve Bank of India.

c. Life insurance or general insurance services and pension services which have been approved by the authority regulating such services.

d. Any other services as may be specified by regulations made by the National Bank.

2.1.1 Microfinance’s origin:

Microfinance or Microcredit as it was initially known came to prominence in the 1980s, although early experiments date back 30 years in Bangladesh, Brazil and a few
other countries. The important difference of microfinancing was that it avoided the pitfalls of an earlier generation of targeted development lending, by insisting on repayment, by charging interest rates that could cover the costs of credit delivery, and by focusing on client groups whose alternative source of credit was the informal sector. Emphasis shifted from rapid disbursement of subsidized loans to prop up targeted sectors towards the building up of local, sustainable institutions to serve the poor. Microfinance has largely been a private (non-profit) sector initiative that avoided becoming overtly political, and as a consequence, has outperformed virtually all other forms of development-lending.

2.2 Literature review for study:

2.2.1 Understanding microfinance

Microfinance, according to Otero (1999, p.8) is “the provision of financial services to low-income poor and very poor self-employed people”. These financial services according to Ledgerwood (1999) generally include savings and credit but can also include other financial services such as insurance and payment services.

Schreiner and Colombet (2001, p.339) define microfinance as “the attempt to improve access to small deposits and small loans for poor households neglected by banks.” Therefore, microfinance involves the provision of financial services such as savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector.

In the literature, the terms microcredit and microfinance are often used interchangeably, but it is important to highlight the difference between them because both terms are often confused. Sinha (1998, p.2) states “microcredit refers to small loans, whereas microfinance is appropriate where NGOs and MFIs supplement the loans with other financial services (savings, insurance, etc)”. Therefore microcredit is a component of microfinance in that it involves providing credit to the poor, but microfinance also involves additional non-credit financial services such as savings, insurance, pensions and payment services (Okiocredit, 2005)
According to Sriram and Upadhyayula, in India, microfinance is generally understood but not clearly defined. For instance, if an SHG gives a loan for an economic activity, it is seen as microfinance. But if a commercial bank gives a similar loan, it is unlikely that it would be treated as microfinance. In the Indian context there are some value attributes of microfinance. According to the authors, Microfinance is an activity undertaken by the alternate sector (NGOs). Therefore, a loan given by a market intermediary to a small borrower is not seen as microfinance. However when an NGO gives a similar loan it is treated as microfinance. It is assumed that microfinance is given with a laudable intention and has institutional and nonexploitative connotations. According to the authors, microfinance is not defined by form but by the intent of the lender. Secondly, microfinance is something done predominantly with the poor. Banks usually do not qualify to be MFOs because they do not predominantly cater to the poor. However, there is ambivalence about the regional rural banks (RRBs) and the new local area banks (LABs). Thirdly, microfinance grows out of developmental roots. This can be termed the “alternative commercial sector.” MFOs classified under this head are promoted by the alternative sector and target the poor. However these MFOs need not necessarily be developmental in incorporation. There are MFOs that are offshoots of NGOs and are run commercially. There are commercial MFOs promoted by people who have developmental credentials. We do not find commercial organizations having “microfinance business.” Lastly, the Reserve Bank of India (RBI) has defined microfinance by specifying criteria for exempting MFOs from its registration guidelines. This definition is limited to not-for-profit companies and only two MFOs in India qualify to be classified as microfinance companies.

(The Transformation of Microfinance in India, Experiences options and future, M.S. Sriram and Rajesh Upadhyayula) Journal of Microfinance, Volume 6 Number 2)

According to Marguerite Robinson in The Microfinance Revolution, the 1980s demonstrated that “microfinance could provide large-scale outreach profitably,” and in the 1990s, “microfinance began to develop as an industry” (2001, p. 54).
According to Anita Campion, in the 2000s, the microfinance industry’s objective is to satisfy the unmet demand on a much larger scale, and to play a role in reducing poverty. While much progress has been made in developing a viable, commercial microfinance sector in the last few decades, several issues remain that need to be addressed before the industry will be able to satisfy massive worldwide demand. (Anita Campion, Challenges to Microfinance commercialization)

According to Sriram and Upadhyayula, Microfinance in India started in the early 1980s with small efforts at forming informal self-help groups (SHG) to provide access to much-needed savings and credit services. Then it grew as national bodies like the Small Industries Development Bank of India (SIDBI) and the National Bank for Agriculture and Rural Development (NABARD) started devoting significant time and financial resources to microfinance. The authors state that the strength of the microfinance organizations (MFOs) in India is in the diversity of approaches and forms that have evolved over time. In addition to the home-grown models of SHGs and mutually aided cooperative societies (MACS), the country has learned from other microfinance experiments across the world.

Microcredit and microfinance are relatively new terms in the field of development, first coming to prominence in the 1970s, according to Robinson (2001) and Otero (1999). Prior to then, from the 1950s through to the 1970s, the provision of financial services by donors or governments was mainly in the form of subsidised rural credit programmes. These often resulted in high loan defaults, high loses and an inability to reach poor rural households (Robinson, 2001).

Robinson further states that the 1980s represented a turning point in the history of microfinance in that MFIs such as Grameen Bank and Bank Raykat Indonesia began to show that they could provide small loans and savings services profitably on a large scale.
They received no continuing subsidies, were commercially funded and fully sustainable, and could attain wide outreach to clients (Robinson, 2001). It was also at this time that the term “microcredit” came to prominence in development (MIX3, 2005). The difference between microcredit and the subsidised rural credit programmes of the 1950s and 1960s was that microcredit insisted on repayment, on charging interest rates that covered the cost of credit delivery and by focusing on clients who were dependent on the informal sector for credit (ibid.). It was now clear for the first time that microcredit could provide large-scale outreach profitably. The 1990s “saw accelerated growth in the number of microfinance institutions created and an increased emphasis on reaching scale” (Robinson, 2001, p.54). Dichter (1999) refers to the 1990s as “the microfinance decade”.

Microfinance Information Exchange (MIX) defines an MFI as “an organisation that offers financial services to the very poor.” (MIX, 2005). According to the UNCDF (2004) there are approximately 10,000 MFIs in the world but they only reach four percent of potential clients, about 30 million people. On the other hand, according to the Microcredit Summit Campaign Report (Microcredit Summit, 2004) as of December 31st 2003, the 2,931 microcredit institutions that they have data on, have reported reaching “80,868,343 clients, 54,785,433 of whom were the poorest when they took their first loan”. Even though they refer to microcredit institutions, they explain that they include “programs that provide credit for self-employment and other financial and business services to very poor persons” (Microcredit Summit, 2004).

The differences between these sources highlight a number of points. Firstly, how the two terms, microcredit and microfinance are often confused and used interchangeably, though in the strictest sense microcredit should refer only to the provision of credit to the poor. Secondly, the difference between the statistics shows how difficult it is to get a true picture of how many MFIs are in existence today and how many clients they are reaching. The IMF5 state that “no systematic and comprehensive data on MFIs is collected and there are no authoritative figures on key characteristics of the microfinance industry, such as the number and size of MFIs, their financial situation, or the population
Microfinance has a very important role to play in development according to proponents of microfinance. UNCDF (2004) states that studies have shown that microfinance plays three key roles in development.

It:

a. helps very poor households meet basic needs and protects against risks,
b. is associated with improvements in household economic welfare,
c. helps to empower women by supporting women’s economic participation and so promotes gender equity.

Otero (1999, p.10) illustrates the various ways in which “microfinance, at its core combats poverty”. She states that microfinance creates access to productive capital for the poor, which together with human capital, addressed through education and training, and social capital, achieved through local organisation building, enables people to move out of poverty (1999). By providing material capital to a poor person, their sense of dignity is strengthened and this can help to empower the person to participate in the economy and society (Otero, 1999).

According to Kim (1995), conventional finance institutions seldom lend down-market to serve the needs of low-income families and women-headed households. They are very often denied access to credit for any purpose, making the discussion of the level of interest rate and other terms of finance irrelevant. Therefore the fundamental problem is not so much of unaffordable terms of loan as the lack of access to credit itself.

2.2.2 Microfinance and its dominant models in India

Prabhu Ghate (2006) in the Microfinance report states that Indian microfinance continued growing rapidly towards the main objective of financial inclusion, extending outreach to a growing share of poor households, and to the approximately 80 percent of the population which has yet to be reached directly by the banks. The larger of the two main models, the Self-Help Group (SHG) Bank Linkage Programme (SBLP) covered about 143 million poor households in March 2006 and provided indirect access to the banking
system to another 14 million, including the "borderline poor". Although firm estimates are lacking, the other, Microfinance Institution (MFI) model served 7.3 million households, of which 3.2 million were poor. Even allowing for a degree of overlap of borrowers from both models, the total number of poor households being reached was roughly a fifth of all poor households, as well as a smaller share of the larger number of non-poor households who have yet to be reached by the formal financial sector. Apart from providing financial services to both these segments of the population, there is widespread evidence that much stronger competition provided to the informal sector has significantly improved the terms of credit provided to both segments by the informal sector, which is losing share to both the formal and (semi-formal) MFI sector.

2.2.3 Microfinance and the Self Help Group Bank Linkage Model

According to Fisher and Sriram (2002), microfinance based on Self Help Groups (SHGs) combines the strengths of Rotational Savings and Credit Associations (ROSCAs) and formal financial institutions. They are similar to ROSCAs in being membership and savings based. They are, however, different from ROSCAs in several ways: their membership is restricted to the poor, they are much smaller (10 to 20 members), and they receive loans from banks to supplement their resources.

According to Harper (2002), this model is a very common form of savings and credit. He states that the members of the group are usually neighbours and friends, and the group provides an opportunity for social interaction and are very popular with women. They are also called merry-gorounds or Self-Help Groups.

According to World Bank Economist Priya Basu (2006) there has been growing excitement about SHG Bank Linkage, and many believe it is destined to become the country’s dominant system of mass-outreach banking for the poor. The SHG model was
started in the 1980s by social-development NGOs, many of whom took up group-formation (especially of women) as their main tool. Having group members learn how to pool savings into loans – mostly small, short-term consumption loans – was seen as empowering disadvantaged women, socially and politically as well as financially. By 1992 the NGOs had, heroically, persuaded government to take the idea seriously. Legal obstacles were removed and subsidies made available so that SHGs could take bulk loans from banks that could be on-lent to group members who could use them to take up or expand microbusinesses.

According to Basu, the model evolved so that SHG Bank Linkage today involves having the group save, and then linking it to a bank (usually the rural branch of a state-owned commercial bank, but also RRBs, cooperative banks, etc). Funds saved by SHGs are placed in a group deposit account in the bank. The group then borrows from the bank (at about 12% per annum), using its saving and group guarantee as the collateral. To encourage banks to lend to SHGs, NABARD has provided subsidized refinancing support to banks, although the demand for such refinancing has declines as banks begin to discover that SHG lending is quite profitable, and characterized by default rates (less than 1%) that are, in fact, much lower than the rate of default on their regular lending portfolios (11%-12%). Banks typically provide the group a loan amounting to four times the group’s savings but, as the group matures, and based on the group’s track record, banks are ready to lend more. Borrowed and saved funds are rotated through lending within the group using flexible repayment schedules (usually monthly repayment); SHGs thus save, borrow and repay collectively. SHG funds may be distributed either to one or more members of the group – who are personally responsible for repayment to the group, or spent collectively by the group. The group is free to decide the interest rate charged to its members, but typically, a member borrows from the group at about 24% per annum. After a loan from a bank is fully repaid, the group may borrow again, often a larger amount.

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2 The two main NGOs to start this process were MYRADA in Karnataka and PRADAN in Rajasthan (and later in Tamil Nadu and Jharkhand)
According to Srinivasan in the Journal of Microfinance (2006) each member saves a specified amount with the SHG. The SHG pays interest on this amount. The SHG may initially lend out of its own pool of funds and after gaining some experience with lending (and recovering loans), it may borrow from a bank or microcredit institution for on-lending to members.

According to Andersen and Nina (1998) there is an advantage of the group lending setup. For one, rather than a bank, borrowers themselves undertake the task of credit evaluation; this creates a peer screening effect and reduces the transaction costs as community members have much better information than banks.

According to Stiglitz (1990), Varain (1990), and Banerjee and Newman (1994), there is the peer monitoring effect that induces group members to use their loans in productive ways. The above researchers have developed models that illustrate the working of the peer monitoring effect. Three, the desire to preserve valuable social ties induces borrowers to spend extra effort if necessary to secure timely payments. Social ties are valuable because they allow members to borrow in the future and provide business connections.

According to Andersen and Nina (1998), a very important feature of group lending is the collateral effect. Bank’s losses incurred due to unsuccessful projects are generally reduced as successful entrepreneurs within each group cover part of their losses (Andersen and Nina, 1998).

According to Priya Basu (2006) the success of the SHG–Bank linkage model depends critically on the tasks of promoting, nurturing, strengthening, and monitoring SHGs—tasks that are performed by Self-Help Promoting Institutions (SHPIs). Traditionally, grassroots-level NGOs have performed the tasks of promoting and monitoring SHGs. More recently, rural branches of commercial banks, cooperative banks, RRBs, NBFCs, and then link have all begun to play the role of SHPIs. But, recent evaluation studies reveal the comparatively better performance of SHGs promoted by
NGOs (as opposed to the other SHPIs). SHGs require a large amount of pre- and post-lending monitoring. Most lenders use “facilitators” (who may or may not earn a commission and/or bonus for group repayment and recruiting new groups). Facilitators may be local business people, health workers, government employees, teachers, etc. Before a loan is granted, the group must prove its ability to save over time, learn bookkeeping skills, and show their commitment to continue as a cohesive group. It often takes over a year before an established group can borrow. The facilitator is responsible for introducing the group to the bank, implementing savings patterns, and teaching basic accounting practices. (Although the facilitator may not accept money on behalf of the lender). After the loan is made, the facilitator attends monthly meetings (attendance is a good indicator of the continued success of the group) and enforces repayment. Over the last ten years, SHG–Bank linkage has become the dominant mode of microfinance in India, and has been successful in encouraging significant savings and high repayment rates.
2.2.3.1 Hypothesis formulation for SHG bank linkage model (SBLM)

Null Hypothesis 1: Members of SHG have access to conventional banking system without SHG membership
Alternative Hypothesis 1: Members of SHG do not have access to conventional banking system

Null Hypothesis 2: Longer Membership in the Self Help Group does not generate higher savings
Alternative Hypothesis 2: Longer Membership in the Self Help Group generates higher savings

Null Hypothesis 3: Loan access does not happen in SHG membership
Alternative Hypothesis 3: Loan access happens due to SHG membership

Null Hypothesis 4: A longer SHG membership does not ensure higher amount of loan
Alternative Hypothesis 4: A longer SHG membership ensures higher amount of loan

Null Hypothesis 5: SHGs do not have access to bank loans
Alternative Hypothesis 5: SHGs have access to bank loans.
2.2.4 Microfinance and Individual banking based model – SEWA Bank

According to Prabhu Ghate in Microfinance: A state of sector report 2007, a major development during the last couple of years has been the upsurge of interest in urban microfinance. The urban areas have remained virtually uncharted territory, except by a few prominent exceptions such as SEWA Bank, despite the prospects of (i) huge loan demand, (ii) larger average loan size and higher population density making for lower costs, (iii) the need to reach the growing numbers of the urban poor, and (iv) the example of Latin America where microfinance is predominantly urban. The rate of urbanization in India has increased sharply in the 1990s to almost twice the rural population growth rate, the difference being driven by migration from the rural areas. Moreover, while urban poverty is declining in relative terms, it is increasing in absolute terms. India's metros and large towns have some of the most congested slums in the world and are "home" to some of the worst living conditions anywhere.

According to Pasheva and Desai, CMF 2006, SEWA Bank is one of the oldest microfinance institutions in the world, predating even the Grameen Bank of Bangladesh. Registered as a Cooperative Bank in 1974, it has been pioneering individual lending in the urban setting of Ahmedabad for over 30 years. SEWA Bank is a unique institution in many ways—not only is it one of the only MFIs that offers a comprehensive set of microfinance services (from savings to lending to capacity building), but it has remained financially self-sustainable since the beginning of its operations. Moreover, its unique form of governance defines the development path that SEWA Bank has taken over the years. Each SEWA Bank account holder is entitled to buy shares in the Bank; borrowers are required to be shareholders. Each shareholder has one vote which ensures a democratically governed MFI, giving an equal voice to both more as well as less wealthy members. This has ensured that the Bank evolves together with its members and has inspired it to develop a composite approach to microfinance and a full-range of services.

According to Pasheva and Desai in CMF 2006, recognizing that the diversity of occupational, economic and social backgrounds of SEWA Bank members, with their very different financial requirements, made group lending suboptimal in the urban context,
SEWA was one of the first MFIs to take the more challenging path of individual lending. Starting in 1974 with a simple savings and a simple loan account SEWA Bank has evolved into a composite financial institution offering a variety of savings and recurring deposit accounts, fixed deposits and secured and unsecured loans. Unsecured loans have to be backed only by two guarantors, one of who can be a family member. About a fifth of its roughly 150,000 members are borrowers, of which three-fourths have unsecured loans of up to Rs 50,000 repayable in 35 months at an interest rate of 18 percent. Slightly better off clients with urgent cash requirements can avail of secured loans at 12 percent, backed by a personal asset, usually jewelry. In 1998 the Bank introduced longer-term housing loans in partnership with HUDCO, linked to a requirement to save Rs 20,000 through a 5-year recurring deposit scheme for housing. Finally, in 2001, SEWA introduced daily collection loans to extend outreach to poorer clients with a daily income cycle such as vegetable and flower vendors. This product mimics the money-lender, although at a much lower rate of interest, through bank "sathis", a team of former client with good financial literacy skills, who work on a commission basis, and visit clients daily not only to collect daily loan repayments, but to offer also daily savings collection and other recurring deposit schemes. By introducing various specialized recurring deposit schemes each tailored to a specific life-cycle need (including, now, pensions for old-age) Sewa has greatly reduced the cost of predictable expenditures for life-cycle needs. For unexpected shocks (death, accidents, sickness) it has made insurance compulsory though its insurance wing VIMO SEWA. Based mon close studies of its clients' needs, today SEWA offers more than 40 differentiated products. Jayshreeben Vyas describes the process "We looked at their life-cycle needs and have come up with various savings products to mirror those needs - various recurring accounts, savings for buying gold, for education, for marriage, for old age, etc. Similarly, we have developed a range of products within credit".

According to Pasheva and Desai (2006), From its beginning SEWA Bank has taken the more challenging path of individual lending in its urban operations. It is one of the few MFIs in the world to give large uncollateralized loans to poor individuals. Over the years, SEWA Bank has designed a sound screening mechanism which relies on informal social
networks and allows SEWA to keep its NPA rate under 12% and default rate about 3.4%. Interestingly, these requirements are met despite the fact that SEWA remains flexible and accommodates the irregular income of clients. In the course of its 30 years of experience, SEWA Bank has managed to overcome the problems of adverse selection, moral hazard and lack of collateral inherent in individual lending by applying a four-pronged approach: first, clients must demonstrate regularity of savings for about 6 months before they can take out their first loan, thus developing a financial discipline and history, and establishing their creditworthiness. Second, loan size increases from cycle to cycle allowing clients to establish their credit history and regularity of repayment. Typically, a first loan would be in the amount of Rs 11,700 while the second loan is Rs 17,000. The chart below visualizes the growth in loan size according to the type of loan. As can be expected, the graduation is less pronounced in the case of secured loans. Third, although the loan is individual, SEWA Bank relies heavily on social networks to manage risk and prevent defaults, through guarantors and community leaders. In order to take out a loan, the borrower must find two guarantors to co-sign the loan, one of which can be a family member. Finally, SEWA Bank’s loan officers maintain daily contact with the clients, offering savings collection and loan services, thus closely monitoring the financial situation of the borrower. In addition, a good data management and information system allows SEWA Bank to keep track of its portfolio and promptly notify irregular borrowers.

According to Martha Chen, The SEWA Bank study found that nearly three-fourths of total household savings in the households of SEWA Bank members were held in a SEWA Bank account. Various forms of informal savings were also popular with member households, but few had savings in other banks or in securities. Another important measure of SEWA's impact is the fact that the SEWA Bank members have savings in their own name. SEWA Bank clients can be clearly distinguished from other working class women (and men) in Gujarat in this regard: roughly twice as many SEWA members had savings accounts compared to women from low, medium, and high-income households and to men from low and medium-income households.
According to Sriram and Upadhyayula in the Journal of Microfinance, SEWA Bank is increasingly being recognized as one of the oldest MFOs in India—having been in existence for over 25 years. While there have been several urban cooperative banks across the country, none is recognized as an MFO. SEWA Bank did not go through the pains of transformation, because the moment its parent, SEWA, decided that the poor women of Ahmedabad needed a financial service institution of their own, SEWA lost no time in promoting a women’s bank independent of the NGO. SEWA proves the point that if the client group and geographical focus exist, there is no need to go through the painful process of starting as an NGO and moving towards mainstream. However, under current norms, an urban cooperative bank can only be set up with a start-up capital of Rs. 5 million (Sinha, 2001). Though this is less than the amount needed for setting up a commercial bank, it is still a steep amount if it were to be contributed by poor women to run as a self-governed institution.

2.2.4.1 Hypothesis formulation for SEWA Bank:

Null Hypothesis 1: Clients of SEWA Bank have access to conventional banking

Alternative Hypothesis 1: Clients of SEWA Bank do not have access to conventional banking

Null Hypothesis 2: Increase in years of bank membership does not show positive impact on bank client’s savings

Alternative Hypothesis 2: Increase in years of bank membership shows positive impact on bank client’s savings

Null Hypothesis 3: Longer bank membership time does not increase the availability of loan from SEWA Bank

Alternative Hypothesis 3: Longer bank membership time increases the availability of loan from SEWA Bank
Null Hypothesis 4: Longer bank membership time does not increase the size of loan that can be availed from SEWA Bank
Alternative Hypothesis 4: Longer bank membership time increases the size of loan that can be availed from SEWA Bank

Null Hypothesis 5: Higher amount of savings does not increase the size of loan that can be availed from SEWA Bank
Alternative Hypothesis 5: Higher amount of savings increases the size of loan that can be availed from SEWA Bank

Null Hypothesis 6: Longer Bank membership has no impact on the number of loans that can be availed from SEWA Bank
Alternative Hypothesis 6: Longer Bank membership increases the number of loans that can be availed from SEWA Bank.

Null Hypothesis 7: Larger savings does not increase the number of loans from SEWA bank
Alternative Hypothesis 7: Larger savings increases the number of loans from SEWA Bank

2.2.5 Microfinance and other issues
2.2.5.1. Microfinance as a tool of development

Littlefield, Murduch and Hashemi (2003) state “microfinance is a critical contextual factor with strong impact on the achievements of the MDGs…microfinance is unique among development interventions: it can deliver social benefits on an ongoing, permanent basis and on a large scale”. Referring to various case studies, they show how microfinance has played a role in eradicating poverty, promoting The aim of microfinance according to Otero (1999) is not just about providing capital to the poor to combat poverty on an individual level, it also has a role at an institutional level. It seeks to create
institutions that deliver financial services to the poor, who are continuously ignored by the formal banking sector.

Littlefield and Rosenberg (2004) state that the poor are generally excluded from the financial services sector of the economy so MFIs have emerged to address this market failure. By addressing this gap in the market in a financially sustainable manner, an MFI can become part of the formal financial system of a country and so can access capital markets to fund their lending portfolios, allowing them to dramatically increase the number of poor people they can reach (Otero, 1999).

More recently, commentators such as Littlefield, Murdach and Hashemi (2003), Simanowitz and Brody (2004) and the IMF (2005) have commented on the critical role of microfinance in achieving the Millennium Development Goals. Simanowitz and Brody (2004, p.1) state, “Microfinance is a key more mng education, improving health and empowering women (2003). The MDGs are (i) eradicate extreme poverty and hunger; (ii) achieve universal primary education; (iii) promote gender equality and empower women; (iv) reduce child mortality; (v) improve maternal health; (vi) combat strategy in reaching the MDGs and in building global financial systems that meet the needs of the most poor people.

However, not all commentators are as enthusiastic about the role of microfinance in development and it is important to realise that microfinance is not a silver bullet when it comes to fighting poverty. Hulme and Mosley (1996), while acknowledging the role microfinance can have in helping to reduce poverty, concluded from their research on microfinance that “most contemporary schemes are less effective than they might be” (1996, p.134). They state that microfinance is not a panacea for poverty-alleviation and that in some cases the poorest people have been made worse-off by microfinance. Rogaly (1996,p.109/110) finds five major faults with MFIs. He argues that:

1. They encourage a single-sector approach to the allocation of resources to fight poverty, microcredit is irrelevant to the poorest people,
2. An over-simplistic notion of poverty is used,
3. There is an over-emphasis on scale,
4. There is inadequate learning and change taking place.

Wright (2000, p.6) states that much of the scepticism of MFIs stems from the argument that microfinance projects “fail to reach the poorest, generally have a limited effect on income…drive women into greater dependence on their husbands and fail to provide additional services desperately needed by the poor”. In addition, Wright says that many development practitioners not only find microfinance inadequate, but that it actually diverts funding from “more pressing or important interventions” such as health and education (2000, p.6).

As argued by Navajas et al (2000), there is a danger that microfinance may siphon funds from other projects that might help the poor more. They state that governments and donors should know whether the poor gain more from microfinance, than from more health care or food aid for example. Therefore, there is a need for all involved in microfinance and development to ascertain what exactly has been the impact of microfinance in combating poverty.

Considerable debate remains about the effectiveness of microfinance as a tool for directly reducing poverty, and about the characteristics of the people it benefits (Chowdhury, Mosley and Simanowitz, 2004).

2.2.5.2. Impact of Microfinance on poverty alleviation

Sinha (1998) argues that it is notoriously difficult to measure the impact of microfinance programmes on poverty. This is so she argues, because money is fungible and therefore it is difficult to isolate credit impact, but also because the definition of ‘poverty’, how it is measured and who constitute the ’poor’ “are fiercely contested issues” (1998, p.3).
Poverty is a complex issue and is difficult to define, as there are various dimensions to poverty. For some, such as World Bank, poverty relates to income, and poverty measures are based on the percentage of people living below a fixed amount of money, such as US$1 dollar a day (World Bank, 2003).

There is a certain amount of debate about whether impact assessment of microfinance projects is necessary or not according to Simanowitz (2001b). The argument is that if the market can provide adequate proxies for impact, showing that clients are happy to pay for a service, assessments are a waste of resources (ibid.). However, this is too simplistic a rationale as market proxies mask the range of client responses and benefits to the MFI (ibid.) Therefore, impact assessment of microfinance interventions is necessary, not just to demonstrate to donors that their interventions are having a positive impact, but to allow for learning within MFIs so that they can improve their services and the impact of their projects (Simanowitz, 2001b, p.11).

Poverty is more than just a lack of income. Wright (1999) highlights the shortcomings of focusing solely on increased income as a measure of the impact of microfinance on poverty. He states that there is a significant difference between increasing income and reducing poverty (1999). He argues that by increasing the income of the poor, MFIs are not necessarily reducing poverty. It depends what the poor do with this money, oftentimes it is gambled away or spent on alcohol (1999), so focusing solely on increasing incomes is not enough. The focus needs to be on helping the poor to “sustain a specified level of well-being” (Wright, 1999, p.40) by offering them a variety of financial services tailored to their needs so that their net wealth and income security can be improved. It is commonly asserted that MFIs are not reaching the poorest in society. However, despite some commentators’ scepticism of the impact of microfinance on poverty, studies have shown that microfinance has been successful in many situations.

According to Littlefield, Murduch and Hashemi (2003, p.2) “various studies…document increases in income and assets, and decreases in vulnerability of microfinance clients”. They refer to projects in India, Indonesia, Zimbabwe, Bangladesh and Uganda which all
show very positive impacts of microfinance in reducing poverty. For instance, a report on a SHARE project in India showed that three-quarters of clients saw “significant improvements in their economic well-being and that half of the clients graduated out of poverty” (2003, p.2). Dichter (1999, p.26) states that microfinance is a tool for poverty reduction and while arguing that the record of MFIs in microfinance is “generally well below expectation” he does concede that some positive impacts do take place. From a study of a number of MFIs he states that findings show that consumption smoothing effects, signs of redistribution of wealth and influence within the household are the most common impact of MFI programmes (ibid.).

Hulme and Mosley (1996, p.109) in a comprehensive study on the use of microfinance to combat poverty, argue that well-designed programmes can improve the incomes of the poor and can move them out of poverty. They state that “there is clear evidence that the impact of a loan on a borrower’s income is related to the level of income” as those with higher incomes have a greater range of investment opportunities and so credit schemes are more likely to benefit the “middle and upper poor” (1996, pp109-112). However, they also show that when MFIs such as the Grameen Bank and BRAC provided credit to very poor households, those households were able to raise their incomes and their assets (1996, p.118). Mayoux (2001, p.52) states that while microfinance has much potential the main effects on poverty have been:

1. Credit making a significant contribution to increasing incomes of the better-off poor, including women,
2. Microfinance services contributing to the smoothing out of peaks and troughs in income and expenditure thereby enabling the poor to cope with unpredictable shocks and emergencies.

Hulme and Mosley (1996) show that when loans are associated with an increase in assets, when borrowers are encouraged to invest in low-risk income generating activities and when the very poor are encouraged to save; the vulnerability of the very poor is reduced and their poverty situation improves.
Johnson and Rogaly (1997, p.12) also refer to examples whereby savings and credit schemes were able to meet the needs of the very poor. They state that microfinance specialists are beginning to view improvements in economic security, rather than income promotion, as the first step in poverty reduction (ibid.) as this reduces beneficiaries’ overall vulnerability.

Therefore, while much debate remains about the impact of microfinance projects on poverty, we have seen that when MFIs understand the needs of the poor and try to meet these needs, projects can have a positive impact on reducing the vulnerability, not just of the poor, but also of the poorest in society.

Weiss, Montgomery and Kurmanalieva (2003) reviewed the evidence of the microfinance impact on poverty in Asia and subsequently Weiss and Montgomery (2005) provided an update including studies using Latin American data. They reviewed only more “rigorous studies” and did not cover studies using qualitative or participatory approaches. Weiss and Montgomery (2005) summarized their review by saying that the conclusion from the early literature, that whilst microfinance clearly may have had positive impacts on poverty it is unlikely to be a simple panacea for reaching the core poor, remains broadly valid. Reaching the core poor is difficult and some of the reasons that made them difficult to reach with conventional financial instruments mean that they may also be high risk and therefore unattractive microfinance clients.

### 2.2.5.3 Microfinance and Livelihood security

Carney (1998, p.4) defines a livelihood as comprising “…the capabilities, assets (including both material and social resources) and activities required for a means of living.” Chambers (1997, p.10) states that livelihood security is “basic to well-being” and that security “refers to secure rights and reliable access to resources, food, income and basic services. It includes tangible and intangible assets to offset risk, ease shocks and meet contingencies.” Lindenberg (2002, p.304) defines livelihood security as “a family’s
or community’s ability to maintain and improve its income, assets and social well-being from year to year.” Concern also state that livelihood security is more than just economic well-being as they define livelihood security as “the adequate and sustainable access to and control over resources, both material and social, to enable households to achieve their rights without undermining the natural resource base” (Concern, 2003). Livelihood security therefore, like poverty, is not just about income, but includes tangible and intangible assets, and social well being.

Johnson and Rogaly (1997, p.122) state that “NGOs aiming for poverty reduction need to assess the impact of their services on user’s livelihoods.” They argue (1997) that in addressing the question of the impact of microfinance, NGOs must go beyond analysing quantitative data detailing the numbers of users, and volumes and size of loans disbursed, to understanding how their projects are impacting on clients’ livelihoods. They state (1997, p. 118) that the provision of microfinance can give poor people “the means to protect their livelihoods against shocks as well as to build up and diversify their livelihood activities”. Therefore when analysing the impact of microfinance the overall impact of the microfinance services on the livelihoods of the poor needs to be taken into consideration.

A livelihood security approach according to Concern (2003) aims for a holistic analysis and understanding of the root causes of poverty and how people cope with poverty. They identify livelihood shocks such as natural disasters and drought, the social, political and economic context, and people’s livelihood resources such as education and local infrastructure as factors affecting people’s livelihood security (ibid.).

**2.2.5.4 Microfinance and Social impact**

Traditionally, the impact of microfinance projects was assessed by the changes in the income or well being of the clients. Mansell-Carstens, cited in Rogaly (1996, p.103) argues that such a focus is flawed because respondents may give false information. It is also very difficult to ascertain all the sources of income of a client, so a causal effect is
difficult to establish, and it is also difficult to establish what would have happened if the loan was not given. Therefore a broader analysis is needed that takes more than economic impact into consideration. We have seen that poverty and livelihood security consist of economic and social conditions, therefore, when analysing the impact of microfinance, social impact must be assessed.

Kabeer (2003, p.106) states that wider social impact assessment is important for an organisation’s internal learning process, as an MFI should be aware of the “full range of changes associated with its efforts and uses these to improve its performance”. She considers social impact to relate to human capital such as nutrition, health and education, as well as social networks (2003). Impact must be assessed on each of these issues if a true picture of the impact of microfinance is to be obtained. However, Kabeer moves beyond individual or household analysis to state that analysis should also be conducted at community, market/economy and national/state levels (2003). She refers to these as “domains of impact” because societies are comprised of different institutional domains each with their own rules, norms and practices which can be influenced by microfinance interventions in different ways (2003, p.109).

Kabeer (2003, p.110) not only refers to domains of impact but also highlights dimensions of change that should be assessed. She lists cognitive change (Changes in the way in which people understand and make sense of the world around them.), behavioural change (The different types of actions that people undertake in order to achieve their goals), material change (Changes in access to a variety of tangible resources.), relational change (Changes in the terms on which people interact with one another) and institutional change (Changes in the rules, norms and behaviour at an institutional level) as dimensions of change that need to be taken into account if the wider effects of microfinance interventions are to be understood.

Zohir and Matin (2004, p.301) make a similar point when they state that the impact of microfinance interventions is being under-estimated by “conventional impact studies which do not take into account the possible positive externalities on spheres beyond
households”. They propose that impact should be examined from cultural, economic, social and political domains at individual, enterprise and household levels (2004).

McGregor et al. (2000, p.3) states that wider social and economic impacts can occur through the labour market, the capital market, the market for goods consumed by poor people, through production linkages and through clients participation in social and political processes.

Chowdhury, Mosley and Simanowitz (2004) argue that if microfinance is to fulfil its social objectives of bringing financial services to the poor it is important to know the extent to which its wider impacts contribute to poverty reduction.

2.2.5.5 Microfinance and household level impacts

Health and education are two key areas of non-financial impact of microfinance at a household level.

Wright (2000, p.31) states that from the little research that has been conducted on the impact of microfinance interventions on health and education, nutritional indicators seem to improve where MFIs have been working. Research on the Grameen Bank shows that members are statistically more likely to use contraceptives than non-members thereby impacting on family size (ibid.).

Littlefield, Murduch and Hashemi (2003, p.3) also acknowledge the sparse specific evidence of the impact of microfinance on health but where studies have been conducted they conclude, “households of microfinance clients appear to have better nutrition, health practices and health education than comparable non-client households”. Among the examples they give is of FOCCAS, a Ugandan MFI whose clients were given health care instructions on breastfeeding and family planning. They were seen to have much better health care practices than non-clients, with 95% of clients engaged in improved health
and nutrition practices for their children, as opposed to 72% for non-clients (Littlefield, Murduch and Hashemi, 2003).

Microfinance interventions have also been shown to have a positive impact on the education of clients’ children.

Littlefield, Murduch and Hashemi (2003, p.4) state that one of the first things that poor people do with new income from microenterprise activities is to invest in their children’s education. Studies show that children of microfinance clients are more likely to go to school and stay longer in school than for children of non-clients. Again, in their study of FOCCAS, client households were found to be investing more in education than non-client households. Similar findings were seen for projects in Zimbabwe, India, Honduras and Bangladesh (ibid.).

Robinson (2001) in a study of 16 different MFIs from all over the world shows that having access to microfinance services has led to an enhancement in the quality of life of clients, an increase in their self-confidence, and has helped them to diversify their livelihood security strategies and thereby increase their income.

Following a three-year study of 906 clients, ASA17 an MFI working with 60,000 rural women in Tamil Nadu, India, found that their project had many positive impacts on their clients (Noponen, 2005). The programme was having a “positive impact on livelihoods, social status, treatment in the home and community, living conditions and consumption standards” (2005, p.202). Compared with new members, some of the findings showed that long-term members were more likely to live in tile roofed and concrete houses, to have a higher percentage of their children in school, to have lower incidence of child labour, to be the largest income provider or joint provider in the home, and to make decisions on their own as regards major purchases (Noponen, 2005). Clients also reflected significant increases in ownership of livelihood assets such as livestock, equipment and land (ibid.).
In 2002, FINRURAL, a microfinance networking organisation in Bolivia, carried out impact assessments on eight of its partner MFIs focusing on economic and social impacts at an individual, household and community level on both clients and non-clients (Marconi and Mosley, 2004). Many of the impacts on income were positive for the less poor and negative for the poorer clients, a trend that we have already seen.

Marconi and Mosley (2004) state that this should not be surprising as poorer clients are more risk adverse and less likely to invest in fixed capital and so are more vulnerable to having to sell productive assets in the event of a shock. However, it was found that social networks played an important part in helping clients escape from poverty. Access to social networks provided clients with a defence against having to sell physical and human assets and so protected household assets (ibid.).

Chowdhury and Bhuiya (2004, p.377) assessed impact of BRAC’s poverty alleviation programme from a “human well-being” perspective in a programme in Bangladesh where they examined seven dimensions of ‘human-well being’ which are Increased income, improved women’s lives, control over fertility, sustainable environment, decreased mortality, decreased morbidity and increased nutritional status (Chowdhury and Bhuiya, 2004, p.377) The project included the provision of microfinance and training of clients on human and legal rights (ibid.). They noted that the project led to better child survival rates, higher nutritional status, improvement in the basic level of education, and increased networking in the community. Children of BRAC clients suffered from far less protein-energy malnutrition than children of non-members, and the educational performance of BRAC member’s children was also higher than that of children in non-BRAC households (ibid.). BRAC member households spent significantly more on consumption of food items than poor non-members did and per capita calorie intake was also significantly higher. Therefore, various studies and findings indicate that microfinance can, and is having very positive and diverse impacts at a beneficiary level.
2.2.5.6 Microfinance and Women Empowerment

A key objective of many microfinance interventions is to empower women. Mosedale (2003, p.1) states that if we want to see people empowered it means we currently see them as being disempowered, disadvantaged by the way power relations shape their choices, opportunities and well-being. She states that empowerment cannot be bestowed by a third party but must be claimed by those seeking empowerment through an ongoing process of reflection, analysis and action (2003).

Kabeer, quoted in Mosedale (2003, p.2) states that women need empowerment as they are constrained by “the norms, beliefs, customs and values through which societies differentiate between women and men”. She also states that empowerment refers to the “process by which those who have been denied the ability to make strategic life choices acquire such an ability”, where strategic choices are “critical for people to live the lives they want (such as choice of livelihood, whether and who to marry, whether to have children, etc)” (Kabeer, 1999, p.437). Therefore MFIs cannot empower women directly but can help them through training and awareness-raising to challenge the existing norms, cultures and values which place them at a disadvantage in relation to men, and to help them have greater control over resources and their lives.

Littlefield, Murduch and Hashemi (2003, p.4) state that access to MFIs can empower women to become more confident, more assertive, more likely to take part in family and community decisions and better able to confront gender inequities. However, they also state that just because women are clients of MFIs does not mean they will automatically become empowered. Hulme and Mosley (1996, p.128) also make this point when they refer to the “naivety of the belief that every loan made to a woman contributes to the strengthening of the economic and social position of women”. However, with careful planning and design women’s position in the household and community can indeed be improved.

According to Littlefield, Murduch and Hashemi (2003), the Women’s Empowerment Program in Nepal found that 68% of its members were making decisions on buying and
selling property, sending their daughters to school and planning their family, all decisions that in the past were made by husbands. They refer to studies in Ghana and Bolivia, which indicated that women involved in microfinance projects, had increased self-confidence and had an improved status in the community (ibid.).

Hulme and Mosley (1996) state that microfinance projects can reduce the isolation of women as when they come together in groups they have an opportunity to share information and discuss ideas and develop a bond that wasn’t there previously. From studies of the Grameen Bank and BRAC they show that clients of these programmes suffered from significantly fewer beatings from their husbands than they did before they joined the MFI (ibid.). However, in a separate study of a BRAC project Chowdhury and Bhuiya (2004, p.383) found that violence against women actually increased when women joined the programme, as not all men were ready to accept the change in power relations, and so resorted to violence to express their anger. This violence did decrease over time. The study found that when the violence did rise, the members, because of their increased awareness, reported back to the group on their martial life and got support from the group (ibid.).

Jeffery Sachs (2005) in a visit to a BRAC project was amazed to find that women he spoke to had only one or two children, when he was expecting them to have five or six as he had become accustomed to for Bangladeshi women. When he asked those with no or one child how many children they’d like to have, the majority replied two. He calls this a “demonstration of a change of outlook” (2005, p.14). He refers to a new spirit of women’s rights, independence and empowerment among clients, showing the positive empowerment effects the project has had on the women (ibid.).

Osmani (1998) analysed the impact of credit on the well being of Grameen Bank women clients. Women’s well-being is defined in terms of three sets of capabilities: (i) the degree of autonomy with which women can live their lives, (ii) their ability to control decision making within the family and (iii) their relative access to household resources such as food, education, etc. (Osmani, 1998, p.31) The project was found to have
increased their autonomy in that they were able to spend family income more freely than non-clients. They had greater control over family planning, but the project was not shown to have had an impact on clients’ control over other decision-making but they were found to have greater access to household resources than non-clients did.

However, Johnson (2004, p.5) states that having women as key participants in microfinance projects does not automatically lead to empowerment, sometimes negative impacts can be witnessed. She refers to increased workloads, increased domestic violence and abuse. This leads her to ask a crucial question of whether targeting women is just an efficient way of getting credit into the household, since women are more likely than men to be available in the home, attend meetings, be manageable by field staff and take repayment more seriously, even if they do not invest or control the loan themselves? Or on the other hand, if such targeting is fully justified on the grounds of enhancing gender equity. She claims the answer is probably somewhere between the two alternatives (ibid.). She argues that MFIs must analyse both the positive and negative impacts their interventions are having on women, and that MFIs need to work with men to help pave the way for a change in attitudes to women’s enhanced contribution to the household (2004, p.6).

2.2.5.7 Microfinance and beyond
Imp-Act (2004b) gives examples where the impact of microfinance projects goes beyond clients. They refer to studies on CERUDEB, an MFI in Uganda, which show that loans given to small farmers have resulted in substantial increases in part-time and permanent wage labour of non-clients (ibid.). Even though the clients themselves were usually above the poverty line, the people they employed were not, thereby showing the positive knock-on effects of such an intervention, even if the poorest were not targeted.

Mosley and Rock (2004, p.467) in a study of six African MFIs found similar results. They concluded from their study that MFI services provided to the non-poor can reduce poverty by “sucking very poor people into the labour market as employees of microfinance clients”. They also state that microfinance services often enhance human
capital through increased spending on education and health that may extend to poor households through intrahousehold and inter-generational effects (ibid.).

Zohir and Matin (2004, p.318) state that many MFI loans are used for agricultural production, trading, processing and transport, resulting in an increase in the use of agricultural inputs and increased output of agricultural production. This leads to enhanced employment opportunities in these sectors for the wider community and a reduction in the prices of such produce due to increased supply. They also state that trading activities financed by MFIs can help to establish new marketing links and increase the income of traders, and this can lead to reduced migration due to increased employment opportunities and increased income (Zohir and Matin, 2004). From a social perspective, they state that reduced migration increases family cohesion and greatly contributes towards improving child-upbringing (ibid.).

Kabeer (2003, p.110) refers to a study conducted by the Grameen Bank which showed that nonmembers of a Grameen village were significantly more likely to use contraception than non-members in a non-Grameen village. This was due to a diffusion of the “small family norm” of Grameen women through social networks within the village as the Grameen Bank emphasises women’s productive roles, as opposed to their reproductive role, and non-members picked up this norm from members. Studies have also shown that Grameen-style projects, based on collective activism, can lead to a greater level of legal and political awareness among clients, with a greater likelihood of clients taking part in political campaigns the longer they had been a member (Kabeer, 2003, p.111).

Zohir and Matin (2004) state that the interaction within MFI groups can create cooperation and trust that not only facilitates the microfinance activities, but also contributes benefits beyond the service provided, such as a greater sense of community, trust and reliance on the group in times of crisis. These networks can lay the foundations for other social capital developments in the community. They state that examples of cultural impacts of social intermediation that affect the greater community could be a
change in attitude of society towards the acceptable age of women’s marriage, domestic violence, dowry, etc. (ibid.). Therefore, impact of microfinance projects should not just focus on the individual and household levels if the true impact is to be assessed.

Manfred Zeller and Richard Meyer (2002) argue in their book titled “The triangle of Microfinance” that future research needs to untangle the impact of financial services like loans and savings instruments from the impact of nonfinancial services like training programs. But MFIs are clearly no panacea against poverty, and their usefulness varies by community and economic context. While MFIs clearly do best in areas with better infrastructure, market access, and complementary services, the most reliable indicator of impact is their continued use by clients and their ability to function without direct subsidies. Marketing studies of MFI customer satisfaction, therefore, are likely to generate more immediately useful information for policymakers than long-term impact assessments.

2.3 The Schools of Thought in Microfinance
The success of microfinance lies in improving the livelihoods and living standards of the poor in a sustainable way. The keywords in the financial sector today are therefore poverty alleviation, empowerment and sustainability. Keeping these in mind, analysis of the available literature shares that theoretically, there are different approaches and schools of thoughts. These are the financial systems, poverty lending and livelihood finance schools.

2.3.1 The Finance system of school of thought
The financial system school of thought is also known as the minimalist approach. According to this school, viability and sustainability of the institution is much dependent on delivering the financial product efficiently and effectively. It sees institutional self sufficiency as the only way to meet the widespread demand of clients for convenient
suitable financial services delivery. It assumes that there is a simple missing piece to for poverty reduction and growth of enterprise, which is access to capital. Followers of this school or practitioner identify themselves as a bank. Their area of specialization is financial management and accounts. Their main aim is to bank to the poor customers in both urban and rural areas. They are strong in MIS, Human Resource Management (HRM) and Information and communication technology that helps in reducing their cost of operation and are able to manage a large rate that is high enough to cover interest and adjustment expense that reasonable, affordable and competitive interest rates can be charged to cover these costs (David Hulme and Paul Mosley, 2005) to enable them to be viable and sustainable. The school of thought discourages subsidy, as this would not make them sustainable. Their argument is that they do not only bridge the gap that exists among the poor and non-poor in terms of making financial services available, but also provides small but reliable services that enable the poor to meet their emergency needs. Implicit in their position is the assumption that such provision of credit in and out of itself through judicious use by borrowers will lead to the desire outcome of improved incomes.

The strengths of the financial system of thought:
1. MFIs that practice this thought are specialized and their main focus is the delivery of financial products such as credit savings and insurance including remittances/money transfer to the poor who are otherwise thought to be unbankable by formal financial institutions.
2. Specialisation in financial services leads to increase in efficiency of operations and diversity of products. Also, lesser resources are spent on staff capacity building.
3. The cost of capacity building is one dimensional as it (MFIs) trains staff in enhancing their skills repeatedly by practicing and doing the same kind of work. The approach has a potential for greater outreach and a chance of upscaling and is mostly viable and sustainable from the point of view of the MFI.
4. The products and services are amenable to pricing: hence borrowers are likely to pay without questioning. It is possible to design a revenue model for a product that would enable sustainability.
5. The MFI can easily attract and access the capital market. It acts as a bank, which leads to easy identification by borrowers. This contributes and enhances better internalization within the organisation and clients.

Weakness of the financial system school of thought are:

1. It does not provide for or build the capacity of the customer/poor clients. It is doubtful if loans are repaid well.
2. It only promotes finance from the point of view of the financiers in delivery of services, without taking into account that of clients. This ignores the human aspects.
3. All activities and services lack the views of the poor. MFIs, which can scale up and achieve greater outreach for a few years, but beyond this, it becomes difficult to sustain the provision of services, more so that of bringing about sustainable poverty reduction.
4. It is a number oriented and lacks the deeper understanding or feel of the social fabric.
5. It is also presumed that the staff of MFIs are technically qualified and are tuned into human and social relationships. On the contrary, most MFIs, staff are not suitably qualified and lack social and emphatic skills.

2.3.2 Poverty lending school of thought
This school of thought is also known as the integrated approach or institutional and welfarist approach (Woller et al. 2000). It contends that although financial sustainability may be desirable it is not a goal in and itself. The goal is poverty alleviation. Practitioners who follow this approach provide financial services at a subsided rate, typically at below market interest rates often along with complementary services such as imparting training and skills, education, health, nutrition and other basic needs. They view microfinance as a tool for development and poverty alleviation. These ideas are found in the works of SEWA (Self employed women association), Dhan foundation etc. The goal of the practitioners is usually to promote people’s institutions encompassing a range of development activities. SEWA started with promotion of welfare activities for trade unions and started a cooperative bank, owned and managed by women. Later, it undertook other developmental activities. Today SEWA provides a range of savings, loans and insurance products and other services such as productivity loans, emergency loans, housing and infrastructure loans, integrated work security schemes on a contributory basis (providing life insurance, works security, insurance and maternity
benefits) varieties of savings products such as daily collection scheme etc., comprehensive insurance products covering natural and accidental death, health and asset loss, personal financial counseling, business counselling/advice/education and training in how to avail of and operate financial services effectively. SEWA’s integrated approach is based on its long experience. The rationale for this approach is that, if adverse conditions affecting the quality of life are to be tackled by addressing poverty, it needs to employ multiple strategies. Therefore, it takes up a whole range of activities, especially those that affect women’s lives and are more productive and security enhancing.

Strength of this approach:
1. This approach combines both the financial and social aspects. It takes into consideration that the poor suffer from the lack of sustainability features such as capacity, skills, assets, knowledge, information, networks and other resources.
2. It allows for more outreach, because the package include not only financial services but also other relevant social services.
3. The approach allows facilities such as handholding by the promoting institutions. This makes credit less risky and more attractive to the poor communities.
4. Poor communities are able to use the financial products in a better way since they are assisted by NGO-MFIs. Mere provision of financial services could be inefficient, wasteful and a failure in the long run.
5. This approach has more impact on the lives of the poor. Hence, empowerment is possible. The addictive effect of empowerment results in higher levels of empowerment vis-à-vis the market. Availability of information from various sources to members increases self system and confidence in the social intervention process.

Draw back of this approach:
1. In this approach the main focus is savings, credit, insurance and building of people’s institutions (even people managed institutions) with capacity building of women, though in some instances men may be involved, but the main thrust is only on women. Thus, this retards the process of meaningful and sustainable poverty reduction.
2. In microcredit, the loan duration is short; say one to maximum of two years.
3. Members of SHGs are taught only how to manage finance and accounts including leadership. This is good but valid only to group’s members.

4. It does not address issues related to livelihood protection, though it works towards livelihood enhancement. It does not engage the community in creating meaningful, sustainable infrastructure.

5. It does not address issues related to livelihood protection, though it works towards livelihood enhancement. It does not engage the community in creating meaningful, sustainable infrastructure.

6. Finally, it only addresses livelihood issues peripherally (Vijay Mahajan 2005)

2.3.3 The Livelihood Finance School of thought

It was Mahajan who first used the term “Livelihood Finance”. He defines Livelihood finance as a “comprehensive approach to promoting sustainable livelihoods for the poor” (Vijay Mahajan, 2005). It has four dimensions which includes financial services, agriculture and business development services, institutional development services and pro-poor market services.

1. Financial services:
   (i) Savings
   (ii) Credit both short and long term, for investment in natural resources – land, water, trees, livestock, energy
   (iii) insurance for the lives and livelihoods of the poor, covering health, crops and livestock.
   (iv) infrastructure finance-roads, power, market places, telecom as needed and
   (v) investment in human development including nutrition, health, education and vocational training.

2. Agriculture and Business Development Services
   (i) Productivity enhancement
   (ii) Risk mitigation, other than insurance (such as vaccination of livestock)
   (iii) local value addition
(iv) alternate market linkages.

3. Institutional Development Services
(i) Forming and strengthening of various producer organisation such as self help groups, water user association, forest protection committees, credit and commodity cooperatives, panchyats.
(ii) Establishing systems for accounting, performance measurement, incentives, MIS etc.

4. Pro-poor market services:
This includes interventions in areas such as
(i) land
(ii) financial
(iii) food
(v) housing and other markets at local regional, national and even at international levels.

2.4 Microfinance in India: Its Rise and Development

While no accurate estimate of the size of the Indian microfinance market exists, M-CRIL (Micro-Credit Ratings International), a leading micro credit rating agency based in Gurgaon, puts the estimated demand at Rs. 480 billion ($10.7 billion). That is calculated for 60-70 million households at an average household credit demand of Rs. 8,000 (less than $200). (Knowledge@wharton)

As discussed earlier, it all started with the Government pursuing developmental objectives in the financial sector in the 1960s by focusing on delivering agricultural credit through cooperatives. Thereafter attention shifted in the second phrase to commercial banks, 14 of which were nationalized in 1969, while the network of Regional Rural Banks was established in 1970s. It can be considered as a landmark since India has one of the largest banking networks in the world: there is a bank branch for every 15,000 rural households and a cooperative in almost every village. The government also established the Integrated Rural Development Programme (IRDP) in 1980-81 to direct subsidized loans to poor self employed people through the banking sector. Over almost two decades
IRDP extended assistance to about 55 million families. It was around the mid 1980s when savings and credit groups (self-help groups or SHGs) began emerging all over the country, most catalysed by non-governmental organisations (NGOs) without the involvement of the state. In 1989, the first official loan waiver was introduced that severely undermined what was left of any credit discipline. As 1990s progressed, a fast growing number of savings and credit groups (known in India as self-help groups or SHGs), predominantly with women members, also emerged, as well as a range of specialized MFOs (Microfinancing organisations) had been put in place, including active promotion by the public national bank for Agriculture and Rural development (NABARD) of bank lending to SHGs and a Foundation for microcredit set up by the Small Industries Development Bank of India (SIDBI).

2.4.1 Consequences that gave rise to Microfinance

The financial sector in the 1980s were characterized by expanded bank branches and cooperative network, a new organizational forms like RRBs. A great focus was on credit than other financial services like savings and insurance, although the banks and cooperative did provide deposit facilities. And an important aspect was the mindset that finance for poor was a social obligation and not a potential business opportunity. What followed was not exactly unpredictable.

a. There were high default rates as the IRDP saw 40 million of defaulters, undermining the creditworthiness of the poor and the government waiver supported it all the more.

b. Resulting corruption and cynicism was high among bankers regarding the creditworthiness of poor people.

c. Further government intervention and control badly eroded the autonomy of the financial sector, making it highly dependent on subsidies even though it had access to a huge base of savings and creating groups with large vested interests.

d. Inflexible and inappropriately designed financial products by the formal financial sector ill suited the poor finding less takers and more defaulters.

Thus, the formal financial sector failed to recognize the mismatch between the hierarchy of credit needs and credit availability, resulting in “adverse usage” of credit. Credit needs
start with consumption purposes, which are only being met through informal sources at high costs. Higher needs come into play only when the lower needs are satisfied (Maslow). However, credit (often at subsidized rates) is usually available for new enterprises. Since money is fungible, loans are therefore taken for diversification but used in lower rungs of the hierarchy. This means that any appraisal of the loan is not honoured, resulting in adverse usage and hence adverse repayment performance. Predictably enough rural credit diminished in the 1990s, a decade which also saw the restructuring of the RRBs. All these developments resulted in fall of the formal financial system, leaving space for informal sources and more importantly SHGs and MFOs. (Thomas Fisher and M.S. Sriram, “Introduction to the financial sector in India, Pg. 33-40, Beyond Microcredit: Putting Development Back into Microfinance, Vistaar Publications)

2.4.2 Microfinance providers and legal framework

Figure 1: Table of Microfinance providers and legal framework governing them

<table>
<thead>
<tr>
<th>Categories of Providers</th>
<th>Legal Framework governing their activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Domestic Commercial Banks:</td>
<td>(i) RBI Act 1934/</td>
</tr>
<tr>
<td>Public Sector Banks;</td>
<td>(ii) BR Act 1949</td>
</tr>
<tr>
<td>Private Sector Banks &amp;</td>
<td>(iii) SBI Act</td>
</tr>
<tr>
<td>Local Area Banks</td>
<td>(iv) SBI Subsidiaries Act</td>
</tr>
<tr>
<td></td>
<td>(v) Acquisition &amp; Transfer of Undertakings Act 1970 &amp; 1980</td>
</tr>
<tr>
<td>(b) Regional Rural Banks</td>
<td>i. RRB Act 1976</td>
</tr>
<tr>
<td></td>
<td>ii. RBI Act 1934</td>
</tr>
<tr>
<td></td>
<td>iii. BR Act 1949</td>
</tr>
<tr>
<td>(c) Co-operative Banks</td>
<td>i. Co-operative Societies Act</td>
</tr>
<tr>
<td></td>
<td>ii. BR Act 1949 (AACS)</td>
</tr>
<tr>
<td></td>
<td>iii. RBI Act 1934 (for sch. banks)</td>
</tr>
<tr>
<td>(d) Co-operative Societies</td>
<td>(i) State legislation like MACS</td>
</tr>
<tr>
<td>(e) Registered NBFCs</td>
<td>(i) RBI Act 1934</td>
</tr>
<tr>
<td></td>
<td>(ii) Companies Act 1956</td>
</tr>
<tr>
<td>(f) Unregistered NBFCs</td>
<td>(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</td>
</tr>
<tr>
<td></td>
<td>(ii) Sec. 25 of Companies Act</td>
</tr>
</tbody>
</table>
(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

(Microcredit: Lifeline for the poor, www.rbi.htm)

NGO mFIs: There are a large number of NGOs that have undertaken the task of financial intermediation. Majority of these NGOs are registered as Trust or Society. Many NGOs have also helped SHGs to organise 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 byelaws of these institutions are generally restrictive in allowing any commercial operations. These organisations by their charter are non-profit organisations 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. (www.nabard.org)

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
A Study of Microfinancing Models in Ahmedabad District

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.(www.nabad.org)

**Mutual Benefit mFIs:** The State Cooperative Acts did not provide for an enabling framework for 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.(www.nabard.org)

**For Profit mFIs:** Non Banking Financial Companies (NBFC) are companies registered under 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 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 exclusive focus on mF is negligible.(www.nabard.org)

**Capital Requirements**

NGO-mFIs, non-profit companies mFIs, and mutual benefit mFIs are regulated by the specific act in which they are registered and not by the Reserve Bank of India. These are therefore not subjected to minimum capital requirements, prudential norms etc. NGO mFIs to become NBFCs are required to have a minimum entry capital requirement of Rs.
20 million ($0.5 million). As regards prudential norms, NBFCs are required to achieve capital adequacy of 12% and to maintain liquid assets of 15% on public deposits. (www.nabard.org)

**Foreign Investment**

Foreign investment by way of equity is permitted in NBFC MFIs subject to a minimum investment of $500,000. In view of the minimum level of investment, only two NBFCs are reported to have been able to raise the foreign investment. However, a large number of NGOs in the development-empowerment are receiving foreign fund by way of grants. At present, over Rs.40,000 million ($889 million) every year flows into India to NGOs for a whole range of activities including microfinance. In a way, foreign donors have facilitated the entry of NGOs into microfinance operations through their grant assistance. (www.nabard.org)

**Deposit Mobilisation**

Not for profit MFIs are barred, by the Reserve Bank of India, from mobilising any type of savings. Mutual benefit MFIs can accept savings from their members. Only rated NBFC MFIs rated by approved credit rating agencies are permitted to accept deposits. The quantum of deposits that could be raised is linked to their net owned funds (www.nabard.org)

**Borrowings**

Initially, bulk of the funds required by MFIs for onlending to their clients were met by apex institutions like National Bank for Agriculture and Rural Development, Small Industries Development Bank Of India, and, Rashtiya Mahila Kosh. In order to widen the range of lending institutions to MFIs, the Reserve Bank of India has roped in Commercial Banks and Regional Rural Banks to extend credit facilities to MFIs since February 2000. Both public and private banks in the commercial sector have extended sizeable loans to MFIs at interest rate ranging from 8 to 11 per cent per annum. Banks have been given operational freedom to prescribe their own lending norms keeping in view the ground realities. The intention is to augment flow of micro credit through the conduit of MFIs. In regard to external commercial borrowings (ECB) by MFIs, not-for-profit MFIs are not permitted to raise ECB. The current policy effective from 31 January 2004, allows only corporates registered under the Companies Act to access ECB for
permitted end use in order to enable them to become globally competitive players. (www.nabard.org)

2.4.3 The Microfinance Development fund

There is 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. In this context, the setting up of the Micro Finance Development Fund marks an important step. Pursuant to the announcement of Union Finance Minister in his budget speech for the year 2000-01, this Rs. 100 crore Fund has been created in NABARD to support broadly the following activities: (a) giving training and exposure to self-help group (SHG) members, partner NGOs, banks and govt. agencies; (b) providing start-up funds to micro finance institutions and meeting their initial operational deficits; (c) meeting the cost of formation and nurturing of SHGs; (d) designing new delivery mechanisms; and (e) promoting research, action research, management information systems and dissemination of best practices in micro finance. This Fund is thus expected to address institutional and delivery issues like institutional growth and transformation, governance, accessing new sources of funding, building institutional capacity and increasing volumes. RBI and NABARD have contributed Rs. 40 crore each to this Fund. The balance Rs. 20 crore were contributed by 11 public sector banks.

(Microcredit: Lifeline for the poor, www.rbi.htm)
2.4.4 Critical Issues

2.4.4.1 Interest Rates

The interest rates are deregulated not only for private microfinance players but also for formal baking sector. In the context of softening of interest rates in the formal banking sector, the comparatively higher interest rate (12 to 24 per cent per annum) charged by the mFIs has become a contentious issue. The high interest rate collected by the mFIs from their poor clients is perceived as exploitative. It is argued that raising interest rates too high could undermine the social and economic impact on poor clients. Since most mFIs have lower business volumes, their transaction costs are far higher than that of the formal banking channels. The high cost structure of mFIs would affect their sustainability in the long run. (www.nabard.org)

3. The Poor in India: The microfinance market

“Its stupendous population consists of farm labourers. India is one vast farm – one almost interminable stretch of fields with mud and fences between. Think of the above facts: and consider what an incredible aggregate of poverty they place before you”

Mark Twain, Following the Equator, 1897.

The poor in India still remain a largely untapped segment continuously ribbed by subsidised government programmes largely ill fitted to their requirements but hopefully enough winds of change have been blowing, generating firms and models that might deliver to the poor what suits them better. India, a country with a population of 1117 million(www.Indiastat.com) and a total land area of 3,287,590 km2. Having a coastline of more than 7000km, it has 28 states and 7 union territories. (www.wikepedia.com).

Although India occupies only 2.4% of the world’s land it supports over 16% of the world’s population. Being the second most populous nation on the Earth, it will replace China as the most populous nation in less than 40 years. More than 71% of the people (742,617,747) who live in more than 550,000 villages form the rural population and the reminder population termed as urban live in more than 200 towns and cities. The