Micro-finance in the India: the changing face of micro-credit Schemes

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Abstract: *Micro-Finance is emerging as a powerful instrument for poverty alleviation in the new economy. In India, micro-Finance scene is dominated by Self Help Groups (SHGs) - Banks linkage Programme, aimed at providing a cost effective mechanism for providing financial services to the 'unreached poor'. In the Indian context terms like "small and marginal farmers", " rural artisans" and "economically weaker sections" have been used to broadly define micro-finance customers. Research across the globe has shown that, over time, microfinance clients increase their income and assets, increase the number of years of schooling their children receive, and improve the health and nutrition of their families*

A more refined model of micro-credit delivery has evolved lately, which emphasizes the combined delivery of financial services along with technical assistance, and agricultural business development services. When compared to the wider SHG bank linkage movement in India, private MFIs have had limited outreach. However, we have seen a recent trend of larger microfinance institutions transforming into Non-Bank Financial Institutions (NBFCs). This changing face of microfinance in India appears to be positive in terms of the ability of microfinance to attract more funds and therefore increase outreach. In overall terms an organizational structure will help them achieve more transparence and efficiency.

Indian Economy [1] and Microfinance

Home to about 1.1 billion people as of 2007, India constitutes approximately one sixth of the world's total population. It is the world's largest democracy and a key emerging market alongside China and Brazil. The picture of growing GDP and rising foreign investments shows an environment where wealth is increasing for the nation.

Due to its large size and population of around 1000 million, India's GDP ranks among the top 15 economies of the world. However, around 300 million people or about 60 million households, are living below the poverty line. It is further estimated that of these households, only about 20 percent have access to credit from the formal sector. Additionally, the segment of the rural population above the poverty line but not rich enough to be of interest to the formal financial institutions also does not have good access to the formal financial intermediary services, including savings services.

A group of micro-finance practitioners estimated[2] the annualised credit usage of all poor families (rural and urban) at over Rs 45,000 crores, of which some 80 percent is met by informal sources. This figure has been extrapolated using the numbers of rural and urban poor households and their average annual credit usage (Rs 6000 and Rs 9000 pa respectively) assessed through various micro studies.

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Microfinance Defined

For the purposes of this study microfinance can be defined as any activity that includes the provision of financial services such as credit, savings, and insurance to low-income individuals which fall just above the nationally defined poverty line, and poor individuals which fall below that poverty line, with the goal of creating social value. The creation of social value includes poverty alleviation and the broader impact of improving livelihood opportunities through the provision of capital for micro enterprise, and insurance and savings for risk mitigation and consumption smoothing.

History of Microfinance in India

In India, institutional credit agencies (banks) made an entry in rural areas initially to provide an alternative to the rural money lenders who provided credit support, but not without exploiting the rural poor. There **are 3 main factors** that count to the bringing up of *Microfinance* as a Policy in India

1. The first of these pivotal events was Indira Gandhi's bank nationalization drive launched in 1969 which required commercial banks to open rural branches resulting[3] in a 15.2% increase in rural bank branches in India between 1973 and 1985. Today, India has over 32,000 rural branches of commercial banks and regional rural banks, 14,000 cooperative bank branches.

2. The second national policy that has had a significant impact on the evolution of India's banking and financial system is the Integrated Rural Development Program

(IRDP) introduced in 1978 and designed to be ‘a direct instrument for attacking India’s rural poverty.’ This program is interesting to this study because it was a large program whose main thrust was to alleviate poverty through the provision of loans and it was considered a failure

3. The last major event which impacted the financial and banking system in India was the liberalization of India’s financial system in the 1990s characterized by a series of structural adjustments and financial policy reforms initiated by the Reserve Bank of India (RBI).

The systems and procedures of banking institutions was emphasizing on complicated qualifying requirements, tangible collateral, margin, etc., that resulted in a large section of the rural poor shying away from the formal banking sector. The banks too experienced that the rapid expansion of branch network was not contributing to an increasing volume of business to meet high transaction costs and risk provisioning, which even threatened the viability of banking institutions and sustainability of their operations. At the same time, it was not possible for them to allow a population of close to 300 million - even if poor - to remain outside the fold of its business.

The search for an alternative mechanism for catering to the financial service needs of the poor was thus becoming imperative.

Analysing the current Scene of Micro Finance Services

We are seeing a new type of loan methodology being evolved that is somewhat of a hybrid in nature. It considers itself in the business of improving livelihoods, in which ‘livelihood financial services’ is one piece. It places equal emphasis on the provision of agricultural business development services and technical services in addition to the provision of financial services, which includes credit but is not limited to it. Credit is not sufficient alone to guarantee an improvement in the livelihoods of the rural poor. It is believed that other financial and technical services are necessary and can be provided on a revenue model in order to be sustainable.

Micro-Finance Institutional Structure in India

The different organisations in this field can be classified as "Mainstream" and "Alternative" Micro Finance Institutions (MFI).

Mainstream Micro Finance Institutions

NABARD, Small Industries Development Bank of India (SIDBI), Housing Development Finance Corporation (HDFC), Commercial Banks, Regional Rural Banks (RRBs), the credit co-operative societies etc are some of the mainstream financial institutions involved in extending micro finance.

Alternative Micro Finance Institutions

These are the institutions, which have come up to fill the gap between the demand and supply for microfinance. MFIs were recently defined by the Task Force as "those which provide thrift, credit and other financial services and products of very small amounts, mainly to the poor, in rural, semi-urban or urban areas for enabling them to raise their income level and improve living standards."

The MFIs can broadly be classified as:

- NGOs, which are mainly engaged in promoting self-help groups (SHGs) and their federations at a cluster level, and linking SHGs with banks, under the NABARD scheme.
- NGOs directly lending to borrowers, who are either organised into SHGs or into Grameen Bank style groups and centres. These NGOs borrow bulk funds from RMK, SIDBI, FWWB and various donors.
- MFIs which are specifically organised as cooperatives, such as the SEWA Bank and various Mutually Aided Cooperative Thrift and Credit Societies (MACTS) in AP.
- MFIs, which are organised as non-banking finance companies, such as[4] BASIX, CFTS, Mirzapur and SHARE Microfin Ltd.

The Problems Associated with Mainstream MFIs

To enable the reach of micro finance services to the needy, the problems associated with the legal, regulatory, organisational systems and the attitudes should be addressed to and the desired changes brought in these, to make them more effective.

1. *Borrower Unfriendly Products and Procedures*

With a majority of the customers being illiterate, and a majority of them needing consumption loans and a majority of them requiring high documentation and collateral security, the products are not reaching the rural poor.

2. *Inflexibility and Delay*

The rigid systems and procedures result in lot of time delay for the borrowers and de-motivate them to take further loans.

3 *High Transaction Costs, both Legitimate and Illegal*

Although the interest rate offered to the borrowers is regulated, the transaction costs in terms of the number of trips to be made, the documents to be furnished etc. plus the illegal charges to be paid, result in increasing the cost of borrowing. Thus, making it less attractive to the borrowers.

4 *Social Obligation and not a Business Opportunity*

Micro-finance has historically been seen as a social obligation rather than a potential business opportunity.

Problems for Alternative Micro-Finance Institutions

The main aim with which the alternative MFIs have come up is to bridge the increasing gap between the demand and supply. A vast majority of them set up as NGOs for getting access to funds as, the existing practices of mainstream financing institutions such as SIDBI and NABARD, is to fund only NGOs, or NGO promoted SHGs. As a result, the largest incentive to enter such services remains through the non-profit route. The alternative finance institutions also have not been fully successful in reaching the needy. There are many reasons for this:

- Financial problems leading to setting up of inappropriate legal structures
- Lack of commercial orientation

- Lack of proper governance and accountability
- Isolated and scattered

A Conceptual Model

Let's take a virtual MicroCredit Financing unit *XYZ Corporation*.

Let it be an organization which brings together both , the organizational structures of an Nonbanking Finance Corporation(NBFC) like Samruddhi , and an NGO (Indian Grameen Services (IGS)) under a holding company in order to give itself the benefit of both donor funds for research and development as well greater access to commercial sources of funding.

The figure1 below gives a view of XYZ's products and the segments they are meant to target.

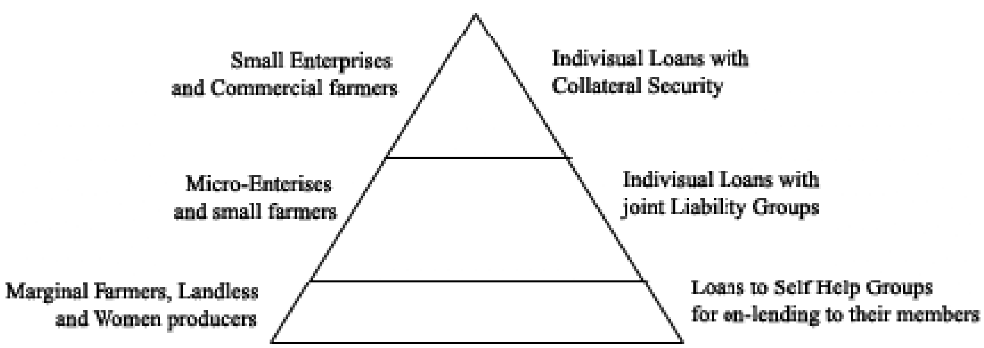

Figure 1 Segment-focussed product line

The functions of XYZ operations are 3 fold

1. Firstly, XYZ targets small enterprises for employment creation through the provision of individual loans with collaterized security to the top of its customer pyramid, the non poor.
2. It then targets the middle of the pyramid, micro-entrepreneurs and small farmers whom we might estimate are the marginally poor or vulnerable with individualized loans to join liability groups (Grameen Model).

3. For the bottom of its pyramid, whom we estimate are the “poorest of the poor,” XYZ offers loans to self-help-groups for onlending to members.

Explaning this Triad

In terms of demand for micro-credit, there are three segments:

1. At the very bottom in terms of income and assets, are those who are landless and engaged in agricultural work on a seasonal basis, and manual labourers in forestry, mining, household industries, construction and transport.

   This segment requires, first and foremost, consumption credit during those months when they do not get labour work, and for contingencies such as illness. They also need credit for acquiring small productive assets, such as livestock, using which they can generate additional income.

2. The next market segment is small and marginal farmers and rural artisans, weavers and those self-employed in the urban informal sector as hawkers, vendors, and workers in household micro-enterprises.

   This segment mainly needs credit for working capital, a small part of which also serves consumption needs. This segment also needs term credit for acquiring additional productive assets, such as irrigation pumpsets, borewells and livestock in case of farmers, and equipment (looms, machinery) and worksheds in case of non-farm workers.

3. The third market segment is of small and medium farmers who have gone in for commercial crops such as surplus paddy and wheat, cotton, groundnut, and others engaged in dairying, poultry, fishery, etc. Among non-farm activities, this segment includes those in villages and slums, engaged in processing or manufacturing activity, running provision stores, repair workshops, tea shops, and various service enterprises. These persons are not always poor, though they live barely above the poverty line and also suffer from inadequate access to formal credit.

If XYZ is indeed able to provide a much wider range of services to a wider range of poor individuals , it would provide compelling reasons for considering the benefits of MFIs becoming NBFCs but also retaining a nonprofit arm for the purpose of preserving one of the largest benefits of an NGO-MFI, the ability to innovate through researching and testing products that could enhance the lives of the poor in India.

XYZ's Program Design

The main objectives of a Neo-*Hybrid* microfinance unit such as one taken above wil include the following:

• Catalyze market-oriented MFIs through direct investment

• Attract additional independent service providers by demonstrating the viability of the market

This hopes to bridge the gap between the current state of microfinance in India and the positive social impact that catalyzing microfinance can have on India's communities and families

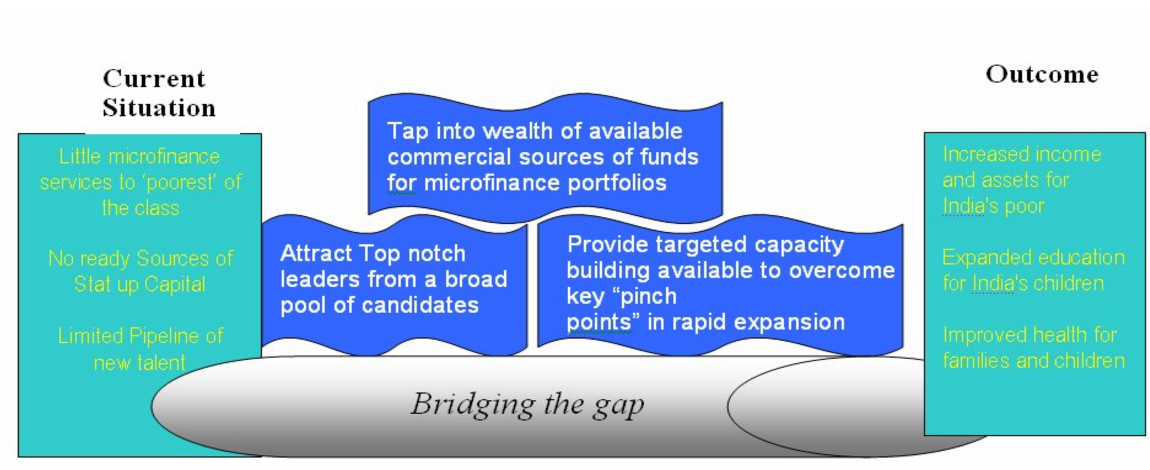

Figure 2 : A Neo-Design Model

In this model we propose a basic concept of a Microfinance unit combined within a structure of a NBFC . Its main aim must be to :

1. Catalyze and grow access to microfinance in India's rural areas. Directly invest in market-oriented MFIs to serve millions of clients in India's villages over the next 10 years

2. Attract additional independent service providers by demonstrating the viability of the microfinance market through measurable results .

3. Invest in a portfolio of financially sound, operationally effective, microfinance start-up institutions to bring financial services to the poor.

4. Bring commercial banks to the table from the inception of the MFIs to ensure they are configured to support rapid growth through access to expanding commercial sources of funds

5. Attract new leaders who can combine world class management skills with the vision for massive social impact to build scalable institutions to serve the millions of poor micro-entrepreneurs

Conclusions

The major constraints identified in the case studies regarding microfinance in India are ; greater and more diverse sources of funding ; a meaningful set of poverty impact indicators in order to make meaningful statements about social impact , and , lack of an enabling policy environment for microfinance.

Presenting an idea of coalescing the NGOs within a financial institution (NBFC) framework may in eyes of some be detrimental to the core intention of a MFI i.e *alleviating the poverty* . But the changing face of microfinance in India appears to be positive in terms of the ability of microfinance to attract more funds and therefore increase outreach.

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