Access to financial services by the rural poor has been a complex issue in the agenda of social banking legislation. Measures adopted for massive expansion of retail banking network to rural areas and mandated lending to the priority sector did not, however, ensure outreach of financial services to the real poor. Financial exclusion is mainly featured among the large segment of rural poor.

NABARD with the support of GTZ and SDC organised a Policy Conference in New Delhi in May 2005 with the active participation of microfinance practitioners from India and abroad to share their best practice experiences in microfinance. Academics, policy makers and practitioners made invaluable contributions during the Conference leading towards a Sustainable Microfinance Outreach in India. The various presentations made by microfinance professionals, bankers, NGOs and MFIs representatives, academics and research institutions have been compiled in this book.

The publishers are confident that practitioners and policy makers of microfinance will find this publication useful.

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Towards a Sustainable Microfinance Outreach in India
Experiences and Perspectives
Disclaimer: The findings and interpretations expressed herein are those of the author(s) and do not necessarily reflect the views of the publishing institutions (NABARD, GTZ, SDC). The publishing institutions do not guarantee the accuracy of the data included in this work.
# Table of Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>List of Abbreviations</td>
<td>XI</td>
</tr>
<tr>
<td></td>
<td>Foreword</td>
<td>XVII</td>
</tr>
<tr>
<td>1</td>
<td>Microfinance and its future directions</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>Dr. C. Rangarajan</td>
<td></td>
</tr>
<tr>
<td>1.1</td>
<td>Microfinance and its future directions</td>
<td>19</td>
</tr>
<tr>
<td>1.2</td>
<td>Evolution of thinking on growth and credit</td>
<td>20</td>
</tr>
<tr>
<td>1.3</td>
<td>Origin of SHGs and MFIs</td>
<td>21</td>
</tr>
<tr>
<td>1.4</td>
<td>Progress of SHGs</td>
<td>22</td>
</tr>
<tr>
<td>1.5</td>
<td>Future directions</td>
<td>24</td>
</tr>
<tr>
<td>2</td>
<td>Microfinance in India: Sectoral issues and challenges</td>
<td>27</td>
</tr>
<tr>
<td></td>
<td>Dr. Y.S.P. Thorat</td>
<td></td>
</tr>
<tr>
<td>2.1</td>
<td>Introduction</td>
<td>27</td>
</tr>
<tr>
<td>2.2</td>
<td>SHG-Bank Linkage Programme</td>
<td>31</td>
</tr>
<tr>
<td>2.2.1</td>
<td>Achievements</td>
<td>31</td>
</tr>
<tr>
<td>2.2.2</td>
<td>Impact of the SHG-Bank Linkage Programme</td>
<td>32</td>
</tr>
<tr>
<td>2.2.3</td>
<td>Key learnings</td>
<td>32</td>
</tr>
<tr>
<td>2.2.4</td>
<td>Challenges</td>
<td>34</td>
</tr>
<tr>
<td>2.3</td>
<td>Emergence of MFIs</td>
<td>36</td>
</tr>
<tr>
<td>2.4</td>
<td>MFIs: Critical issues</td>
<td>37</td>
</tr>
<tr>
<td>2.4.1</td>
<td>Critical challenges</td>
<td>37</td>
</tr>
<tr>
<td>2.4.2</td>
<td>Models</td>
<td>38</td>
</tr>
<tr>
<td>2.5</td>
<td>The road ahead</td>
<td>40</td>
</tr>
</tbody>
</table>
# 3 Microfinance and sustainability: International experiences and lessons for India

*Robert Peck Christen*

3.1 Introduction 43  
3.2 Building support functions 47  
3.3 Building the management intervention function 54  
3.4 Promotion and management of proprietary SHGs 59  
3.5 Building integrated models for support and intervention 62  
3.6 Conclusion 64

# 4 SHG-Bank Linkage Programme: Future scenario

*B. Pramod*

4.1 Introduction 69  
4.2 Growth of the programme 69  
4.3 Beneficial impact 70  
4.4 Linkage models 72  
4.5 Participating banks 72  
4.6 Areas of concern 73  
4.7 Sustainability of SHGs 73  
4.8 Weaknesses of SHPIs 74  
4.9 SHGs as vehicles of government sponsored programmes 74  
4.10 Capacity building in financial institutions 75  
4.11 Microfinance to micro-enterprises 76  
4.12 Future agenda 77  
  4.12.1 Regional imbalances 77  
  4.12.2 SHGs which are not credit linked 77  
  4.12.3 Institutionalising the SHG-Bank Linkage Programme in banks 77  
  4.12.4 Cooperative banks 78  
  4.12.5 SHGs under government sponsored schemes 78  
  4.12.6 Design of SGSY 78  
  4.12.7 Capacity building of partners 78  
  4.12.8 District level planning 79  
  4.12.9 Role of State Level Bankers Committee 79
4.12.10 Microfinance to micro-enterprises 79
4.12.11 Product innovations 79
4.12.12 Federations of SHGs 80

4.13 Policy framework 80
4.14 Role of NABARD 81

5 Sustainability of Self-Help Affinity Groups as understood by MYRADA

Aloysius Prakash Fernandez

5.1 Sustainability – how MYRADA interprets it 83
5.2 What does MYRADA understand by Self-Help Affinity Groups? 86
5.3 Our understanding of the features of an SAG which is functioning effectively 91
5.4 MYRADA’s overall strategy for progressing from income generating activities towards micro-enterprises 94
5.5 The SAG’s ability to re-engineer in a professional and business like manner to cope with emerging needs and pressures 95
5.6 The SAG’s ability to set up new apex institutions to cope with emerging needs and pressures 98

6 Conditions in which microfinance has emerged in certain regions – consequent policy implications

M.S. Sriram and Radha Kumar

6.1 Background 103
6.2 A primer on ‘mutuals’ in India 104
6.3 Broad parameters 106
6.4 Specific parameters 108
6.5 Conclusions 115
6.6 Policy implications 119
6.7 Limitations and scope for further research 120
Towards a Sustainable Microfinance Outreach in India

7 Mature SHGs: Way forward

D. Narendranath

7.1 SHGs – a demand system 121
7.2 Mature SHGs 122
   7.2.1 Sustained adherence to basic values and norms 122
   7.2.2 Long-term vision and initiative 123
   7.2.3 Governance 123
   7.2.4 Linkages 124
7.3 Mature SHGs – way forward 124
   7.3.1 Ongoing support 124
   7.3.2 Sustainable livelihoods 125
   7.3.3 Building a livelihood vision in SHGs 126
   7.3.4 Building SHGs as effective financial intermediaries 126
   7.3.5 Identification of potential livelihoods for the poor 127
   7.3.6 Market linkage organisations 127
7.4 Need for convergence 128
7.5 Beyond livelihoods – issues of broader well-being and empowerment 129
7.6 Conclusion 129

8 Indian microfinance sector: The road ahead

Vijayalakshmi Das

8.1 Background 131
8.2 Experiences of Friends of Women’s World Banking, India 132
8.3 The way forward 135

9 Some issues in informal finance:
Perspectives from a Rajasthan village

J. Howard M. Jones

9.1 Introduction 137
9.2 The research setting 138
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.3 Informal finance within the village</td>
<td>140</td>
</tr>
<tr>
<td>9.4 Clients of the moneylender in 2000-2001</td>
<td>142</td>
</tr>
<tr>
<td>9.5 Loan purposes of informal credit</td>
<td>143</td>
</tr>
<tr>
<td>9.6 Scale of informal finance</td>
<td>145</td>
</tr>
<tr>
<td>9.7 Repayment of moneylender credit</td>
<td>147</td>
</tr>
<tr>
<td>9.8 Conclusions</td>
<td>149</td>
</tr>
<tr>
<td>10 The Indonesian People’s Credit Banks (BPR)</td>
<td>153</td>
</tr>
<tr>
<td>Dirk Steinwand</td>
<td></td>
</tr>
<tr>
<td>10.1 Introduction</td>
<td>153</td>
</tr>
<tr>
<td>10.2 Evolution of the BPR</td>
<td>153</td>
</tr>
<tr>
<td>10.2.1 The Colonial Period (1895-1945)</td>
<td>153</td>
</tr>
<tr>
<td>10.2.2 From Independence to financial crisis (1945-1999)</td>
<td>157</td>
</tr>
<tr>
<td>10.3 Comparative analysis of the contemporary BPRs</td>
<td>161</td>
</tr>
<tr>
<td>10.3.1 Overview</td>
<td>161</td>
</tr>
<tr>
<td>10.3.2 Policy, regulation and supervision</td>
<td>162</td>
</tr>
<tr>
<td>10.3.3 Outreach and market share</td>
<td>164</td>
</tr>
<tr>
<td>10.3.4 Funding and investment structure</td>
<td>166</td>
</tr>
<tr>
<td>10.3.5 Performance</td>
<td>169</td>
</tr>
<tr>
<td>10.4 Findings from the Indonesian experience</td>
<td>172</td>
</tr>
<tr>
<td>11 Mainstreaming microfinance for poverty alleviation: Need for a proactive policy and regulatory framework</td>
<td>175</td>
</tr>
<tr>
<td>H. S. Shylendra</td>
<td></td>
</tr>
<tr>
<td>11.1 Introduction</td>
<td>175</td>
</tr>
<tr>
<td>11.2 The rationale for microfinance</td>
<td>175</td>
</tr>
<tr>
<td>11.3 Current status of microfinance in India</td>
<td>179</td>
</tr>
<tr>
<td>11.4 Some key challenges of the microfinance sector</td>
<td>183</td>
</tr>
<tr>
<td>11.4.1 SHG level</td>
<td>183</td>
</tr>
<tr>
<td>11.4.2 Lack of conducive regulatory framework</td>
<td>184</td>
</tr>
<tr>
<td>11.4.3 Lack of capital/funds</td>
<td>186</td>
</tr>
<tr>
<td>11.5 Some macro conditions and microfinance sector</td>
<td>187</td>
</tr>
<tr>
<td>11.5.1 Economic reforms and microfinance</td>
<td>188</td>
</tr>
<tr>
<td>11.5.2 Impact of banking reforms on rural sector</td>
<td>189</td>
</tr>
</tbody>
</table>
### Towards a Sustainable Microfinance Outreach in India

11.5.3 Microfinance as a part of global agenda 190  
11.5.4 Co-option of microfinance by the state 191  

#### 11.6 Role of state in promoting and developing microfinance 192  
11.6.1 A framework for promoting microfinance sector 192  
11.6.2 Policy initiatives for microfinance 196  

11.7 Conclusion 200  

### 12 Creating an enabling environment for microfinance – the role of Governments – experiences from Thailand  
*Marie Luise Haberberger*

12.1 Introduction 205  

#### 12.2 The macro economic environment 206  
12.2.1 Favourable growth rates 206  
12.2.2 Low inflation rates 206  
12.2.3 Poverty reduction through improved export markets for rural products 206  
12.2.4 Infrastructure and bank branch networks 207  
12.2.5 Interest rates 207  
12.2.6 Thailand’s financial sector 207  

#### 12.3 The Bank for Agriculture and Agricultural Cooperatives 208  
12.3.1 General 208  
12.3.2 Governance, ownership and interventions 209  
12.3.3 Major restructuring initiated by policy changes lead to remarkable results 211  
12.3.4 Policy changes lead to innovations in financial service delivery 212  
12.3.5 Service-oriented mindset 215  
12.3.6 Branches become profit centres 216  
12.3.7 Government-secured lending versus viable credit products 217  

12.4 Conclusions 219  
12.5 What lessons can be learnt? 221
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>13</td>
<td>Financing microfinance: The ICICI Bank partnership model</td>
<td>227</td>
</tr>
<tr>
<td></td>
<td><em>Bindu Ananth</em></td>
<td></td>
</tr>
<tr>
<td>13.1</td>
<td>Introduction</td>
<td>227</td>
</tr>
<tr>
<td>13.2</td>
<td>A comparison of three financing models for microfinance</td>
<td>229</td>
</tr>
<tr>
<td>13.2.1</td>
<td>The SHG-Bank Linkage model</td>
<td>229</td>
</tr>
<tr>
<td>13.2.2</td>
<td>Financial intermediation by the microfinance institution</td>
<td>230</td>
</tr>
<tr>
<td>13.2.3</td>
<td>The partnership model: MFI as the servicer</td>
<td>231</td>
</tr>
<tr>
<td>13.3</td>
<td>The partnership model and securitisation: Paving the way for capital</td>
<td>235</td>
</tr>
<tr>
<td></td>
<td>markets access</td>
<td></td>
</tr>
<tr>
<td>13.4</td>
<td>Credit enhancement for microfinance portfolios</td>
<td>236</td>
</tr>
<tr>
<td>13.5</td>
<td>The opportunity for MFIs</td>
<td>237</td>
</tr>
<tr>
<td>13.6</td>
<td>Implications for the financial system</td>
<td>239</td>
</tr>
<tr>
<td>13.7</td>
<td>Creating a conducive environment for capital markets access</td>
<td>239</td>
</tr>
<tr>
<td>14</td>
<td>Designing innovative products, processes and channels for the</td>
<td>245</td>
</tr>
<tr>
<td></td>
<td>promotion of microfinance</td>
<td></td>
</tr>
<tr>
<td></td>
<td><em>Graham A.N. Wright</em></td>
<td></td>
</tr>
<tr>
<td>14.1</td>
<td>Introduction: The diverse needs for financial services amongst the</td>
<td>243</td>
</tr>
<tr>
<td></td>
<td>low income segment</td>
<td></td>
</tr>
<tr>
<td>14.1.1</td>
<td>Product proliferation</td>
<td>244</td>
</tr>
<tr>
<td>14.1.2</td>
<td>The market-led revolution</td>
<td>245</td>
</tr>
<tr>
<td>14.2</td>
<td>New generation products</td>
<td>247</td>
</tr>
<tr>
<td>14.2.1</td>
<td>BURO, Tangail’s ‘contractual savings agreement’</td>
<td>247</td>
</tr>
<tr>
<td>14.2.2</td>
<td>Equity Bank’s <em>Jijenge</em> contractual loan product – with emergency</td>
<td>249</td>
</tr>
<tr>
<td></td>
<td>loan</td>
<td></td>
</tr>
<tr>
<td>14.2.3</td>
<td>The revised ‘Grameen II’ products</td>
<td>250</td>
</tr>
<tr>
<td>14.2.4</td>
<td>Health Care Financing Scheme</td>
<td>253</td>
</tr>
<tr>
<td>14.2.5</td>
<td>FINCA, Tanzania’s <em>Uvibiashara</em> micro-leasing product</td>
<td>257</td>
</tr>
<tr>
<td>14.3</td>
<td>New generation delivery channels/products</td>
<td>259</td>
</tr>
</tbody>
</table>
Towards a Sustainable Microfinance Outreach in India

14.3.1 Equity Banks’ mobile banking service 259
14.3.2 Teba Bank’s A-Card 261
14.3.3 Safaricom/Vodafone – Commercial 262
Bank of Africa: *Faulu* mobile phone banking

14.4 And in India… 264
14.5 The need for systematic product development 266
14.6 A systematic process to product development 267
14.7 Conclusion 275

15 Expanding secular growth: The role for innovations in microfinance
*Mathew Titus*

15.1 Introduction 279
15.1.1 Why innovations? 279
15.1.2 What are the innovations? 280
15.1.3 Innovations and stakeholders 280

15.2 Innovations and the microfinance market 281
15.2.1 Innovative government policy 281
15.2.2 Innovative Central Banks 283
15.2.3 Innovative Apexes 284
15.2.4 Innovative banks 285
15.2.5 Innovative donors 286
15.2.6 Innovative practitioners 287
15.2.7 Innovative third party service providers 288

15.3 Conclusion 289

Concluding remarks by Dr. Y.S.P. Thorat 293
List of Abbreviations

AAR  Africa Air Rescue (a health maintenance organisation in Kenya)
ACAC Asociacion Colombiana para el Avance de la Ciencia
ACCIION International Non-Profit Organisation in Microfinance
ADB Asian Development Bank
AP Andhra Pradesh (a state in India)
APMAS Andhra Pradesh Mahila Abhivruddhi Society
ATM Automotive Teller Machine
AVB Algemeene Volkscreedietbank
BAAC Bank for Agriculture and Agricultural Cooperatives
BCA Banking Companies Acquisition
BI Bank Indonesia (Central Bank)
BIBF Bangkok International Banking Facility
BKD Badan Kredit Desa (Village Based People’s Credit Bank in Java, Madura)
BKK Badan Kredit Kecamatan (People’s Credit Bank [LDKP] of Central Java)
BMIS Branch Management Information System
BoT Bank of Thailand (Central Bank)
BPD Provincial Development Bank
BPL Below Poverty Line
BPR Bank Perkreditan Rakyat (People’s Credit Bank)
BR Banking Regulation
BRI Bank Rakyat Indonesia (State Bank)
BSFL Bharatiya Samruddhi Finance Ltd.
CB Commercial Bank
CBED Community Based Economic Development
CBFI/CDFI Community Based Development Financial Institutions
CBO Community Based Organisation
CCS Cooperative Credit Structure
CDF Community Development Fund
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>CECI</td>
<td>Canadian Centre for International Studies and Cooperation</td>
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<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
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<td>CGAP</td>
<td>Consultative Group to Assist Poorest</td>
</tr>
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<td>CLFS</td>
<td>Community Level Financial System</td>
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<td>CMRC</td>
<td>Community Managed Resource Centre</td>
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<td>COFAC</td>
<td>Cooperativa Nacional de Ahorro y Crédito</td>
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<tr>
<td>CRISIL</td>
<td>Credit Rating and Information Service India Ltd.</td>
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<td>CSI</td>
<td>Credit Saving Insurance</td>
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<tr>
<td>CU</td>
<td>Currency Unit</td>
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<td>DCC</td>
<td>District Consultative Committee</td>
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<td>DDM</td>
<td>District Development Manager</td>
</tr>
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<td>DFI</td>
<td>Development Finance Institution</td>
</tr>
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<td>DFID</td>
<td>Department for International Development</td>
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<td>DPIP</td>
<td>District Poverty Initiative Project (World Bank aided project)</td>
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<tr>
<td>DPN</td>
<td>Demand Promissory Notes</td>
</tr>
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<td>DRDA</td>
<td>District Rural Development Agency</td>
</tr>
<tr>
<td>DRI</td>
<td>Differential Interest Rate</td>
</tr>
<tr>
<td>ECB</td>
<td>External Commercial Borrowings</td>
</tr>
<tr>
<td>EDP</td>
<td>Electronic Data Processing</td>
</tr>
<tr>
<td>EPW</td>
<td>Economic and Political Weekly</td>
</tr>
<tr>
<td>FAO</td>
<td>Food and Agriculture Organisation</td>
</tr>
<tr>
<td>FCRA</td>
<td>Foreign Contribution Regulation Act</td>
</tr>
<tr>
<td>FGD</td>
<td>Focus Group Discussion</td>
</tr>
<tr>
<td>FI</td>
<td>Financial Institution</td>
</tr>
<tr>
<td>FINCA</td>
<td>Foundation for International Community</td>
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<tr>
<td>FLDG</td>
<td>First Loss Default Guarantee</td>
</tr>
<tr>
<td>FUCAC</td>
<td>Uruguayan Federation of Cooperatives of Savings and Credit</td>
</tr>
<tr>
<td>FWWB</td>
<td>Friends of Women’s World Banking</td>
</tr>
<tr>
<td>GATT</td>
<td>General Agreement on Tariff and Trade</td>
</tr>
<tr>
<td>GB</td>
<td>Grameen Bank</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GoI</td>
<td>Government of India</td>
</tr>
<tr>
<td>GPS</td>
<td>Grameen Pension Savings</td>
</tr>
<tr>
<td>GSM</td>
<td>Global System for Mobile Communication</td>
</tr>
<tr>
<td>GTZ</td>
<td>Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH; German Technical Cooperation</td>
</tr>
<tr>
<td>HCF</td>
<td>Health Care Financing</td>
</tr>
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<td>HH</td>
<td>Household</td>
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<td>Abbreviation</td>
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</tr>
<tr>
<td>--------------</td>
<td>-----------</td>
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<tr>
<td>HIV/AIDS</td>
<td>Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome</td>
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<td>HR</td>
<td>Human Resource</td>
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<tr>
<td>IASC</td>
<td>International Accounting Standard Committee</td>
</tr>
<tr>
<td>IDBI</td>
<td>Industrial Development Bank of India</td>
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<tr>
<td>IFAD</td>
<td>International Fund for Agriculture and Development</td>
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<tr>
<td>IIM-B</td>
<td>Indian Institute of Management - Bangalore</td>
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<tr>
<td>IRDP</td>
<td>Integrated Rural Development Programme</td>
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<td>IRMA</td>
<td>Institute of Rural Management, Anand</td>
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<tr>
<td>IT</td>
<td>Information Technology</td>
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<td>JBIC</td>
<td>Japanese Bank for International Cooperation</td>
</tr>
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<td>KAP</td>
<td>Kwalitas Aktiva Produktif (classified assets)</td>
</tr>
<tr>
<td>KCC</td>
<td>Kisan Credit Card (Farmer’s Credit Card)</td>
</tr>
<tr>
<td>KDA</td>
<td>K-Representative Development Agency (a microfinance development agency in Kenya)</td>
</tr>
<tr>
<td>K-Rep</td>
<td>Commercial Bank in Kenya targeting low-end clients</td>
</tr>
<tr>
<td>KUD</td>
<td>Government controlled village cooperatives in Indonesia</td>
</tr>
<tr>
<td>KVK</td>
<td>Kurinji Vattara Kalanjiam (federation of SHGs)</td>
</tr>
<tr>
<td>KYC</td>
<td>Know Your Customer</td>
</tr>
<tr>
<td>LAB</td>
<td>Local Area Bank</td>
</tr>
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<td>LDKP</td>
<td>Lembaga Dana dan Kredit Pedesaan (Village Owned People’s Credit Bank)</td>
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<tr>
<td>LPD</td>
<td>Lembaga Perkreditan Desa (People’s Credit Bank [LDKP] of Bali)</td>
</tr>
<tr>
<td>LPN</td>
<td>Lumbung Pitih Nagari (People’s Credit Bank [LDKP] of West Sumatra)</td>
</tr>
<tr>
<td>MACS</td>
<td>Mutually Aided Cooperative Society (a cooperative registered under the liberal laws of Andhra Pradesh)</td>
</tr>
<tr>
<td>MBB</td>
<td>Micro Banking Bulletin</td>
</tr>
<tr>
<td>MBT</td>
<td>Mutual Benefit Trust</td>
</tr>
<tr>
<td>MCG</td>
<td>Microfinance Consulting Group</td>
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<tr>
<td>MEADOW</td>
<td>Management of Enterprises and Development of Women</td>
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<tr>
<td>MF</td>
<td>Microfinance</td>
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<tr>
<td>MFDEF</td>
<td>Microfinance Development and Equity Fund</td>
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<tr>
<td>MFI</td>
<td>Microfinance Institutions</td>
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<tr>
<td>MFO</td>
<td>Microfinance Organisation</td>
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<tr>
<td>MIS</td>
<td>Management Information System</td>
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<tr>
<td>MoF</td>
<td>Ministry of Finance</td>
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<tr>
<td>MYRADA</td>
<td>Mysore Resettlement and Development Agency (professional NGO)</td>
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<tr>
<td>NABARD</td>
<td>National Bank for Agriculture and Rural Development</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>NAFSCOB</td>
<td>National Federations of State Cooperative Banks</td>
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<tr>
<td>NBFC</td>
<td>Non Banking Finance Company</td>
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<tr>
<td>NBFI</td>
<td>Non-Bank Financial Intermediaries</td>
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<tr>
<td>NCAER</td>
<td>National Council of Applied Economic Research</td>
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<tr>
<td>NGO</td>
<td>Non-Government Organisation</td>
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<tr>
<td>NPA</td>
<td>Non-Performing Assets</td>
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<tr>
<td>NPL</td>
<td>Non-Performing Loans</td>
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<tr>
<td>NPV</td>
<td>Net Present Value</td>
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<tr>
<td>NSS</td>
<td>National Sample Survey (India)</td>
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<tr>
<td>NSSO</td>
<td>National Sample Survey Organisation</td>
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<tr>
<td>OD</td>
<td>Overdue</td>
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<tr>
<td>ODI</td>
<td>Organisational Development Initiatives</td>
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<tr>
<td>OTOP</td>
<td>One Tambon (village) One Product</td>
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<tr>
<td>PAC</td>
<td>Primary Agricultural Credit Societies</td>
</tr>
<tr>
<td>PAR</td>
<td>Portfolio at Risk</td>
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<tr>
<td>PNACS</td>
<td>Primary Non-Agricultural Credit Societies</td>
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<tr>
<td>POS</td>
<td>Point of Sale (outlets/terminals)</td>
</tr>
<tr>
<td>PRA</td>
<td>Participatory Rural Appraisal</td>
</tr>
<tr>
<td>PRI</td>
<td>Panchayati Raj Institutions (local self-government institution)</td>
</tr>
<tr>
<td>PRIME</td>
<td>Planning, Resource Mobilisation, Implementation, Monitoring and Evaluation</td>
</tr>
<tr>
<td>PT</td>
<td>Perseroan Terbatas (limited enterprise)</td>
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<tr>
<td>RC</td>
<td>Resource Centre</td>
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<td>RCH</td>
<td>Reproduction and Child Health</td>
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<tr>
<td>Rd.</td>
<td>Rand (South African currency unit)</td>
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<td>RFA</td>
<td>Revolving Fund Assistance</td>
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<td>RFAS</td>
<td>Rural Finance Access Survey</td>
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<td>RDF</td>
<td>Rural Infrastructure Development Fund</td>
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<tr>
<td>RMK</td>
<td>Rashtriya Mahila Kosh (Apex Fund for Women)</td>
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<tr>
<td>RMS</td>
<td>Rural Management Paper Series</td>
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<td>ROA</td>
<td>Return on Assets</td>
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<tr>
<td>ROSCA</td>
<td>Rotating Savings and Credit Organisation</td>
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<tr>
<td>Rp.</td>
<td>Rupiah (Indonesian currency unit)</td>
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<tr>
<td>Rs.</td>
<td>Rupees (Indian currency unit)</td>
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<tr>
<td>RRB</td>
<td>Regional Rural Bank</td>
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<td>RUDSETI</td>
<td>Rural Development and Self Employment Training Institute</td>
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<td>SACC</td>
<td>Savings and Credit Cooperatives</td>
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<td>SAG</td>
<td>Self Help Affinity Groups</td>
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<tr>
<td>SAMAKHYA</td>
<td>Now known as Community Development Fund</td>
</tr>
<tr>
<td>SAP</td>
<td>Structural Adjustment Programme</td>
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List of Abbreviations and Acronyms

SBA  Small Business Administration
SDC  Swiss Agency for Development and Cooperation
SEWA Self Employed Womens’ Association
SFI   Specialised Financial Institutions
SFMC SIDBI Foundation for Micro Credit
SGSY Swarna Jayanthi Gram Swarozgar Yojana
      (Government sponsored rural livelihood programme)
SHGs Self-Help Group
SHPI Self-Help Promoting Institution
SIC Servicios Internacionales de Consultaoria para el
      Desarrollo (international development consultants)
SIDBI Small Industries Development Bank of India
SIMPEDES Simpanan Pedesaan (saving product)
SKS Swayam Krishi Sangam (national scheme)
SLBC State Level Bankers Committee
SME  Small Medium Enterprise
SMPS Sri Padmavathy Mahila Abyudaya Sangam
      (Federation of SHGs in Chittoor district, Andhra Pradesh)
TDRI Thai Development Research Institute
Tk. Taka (Bangladeshi currency unit)
TRIS Thai Rating and Information Service
Tsh. Tanzanian Schilling
UBC Urban Cooperative Bank
UN United Nations
UP Uttar Pradesh
USAID United States Agency for International Development
USSD Unstructured Supplementary Services Data
UT Union Territories
VHF Very High Frequency (radio frequency range from 30 MHz
to 300 MHz)
VSAT Very Small Aperture Terminal (an earthbound station used
      in satellite communication of data voice and video signals)
WB World Bank
WTO World Trade Organisation
Access to financial services by the rural poor has been a complex issue in the agenda of social banking legislation. Measures adopted for massive expansion of retail banking network to rural areas and mandated lending to the priority sector did not, however, ensure outreach of financial services to the real poor. The recent National Sample Survey Organisation (2003) study shows that less than 50% of the total cultivator households have access to credit from both formal and non-formal sources and a derived conclusion is that only about 27% of farm households access credit from the formal system. There is also a reported bias in favour of larger holdings in accessing credit and financial services from the formal system. Financial exclusion is mainly featured among the large segment of rural poor.

The SHG-Bank Linkage Programme initiated by NABARD in 1992, has emerged to be a major microfinance tool in extending financial services to the poor. As on March 2005, banks had financed 1.62 million SHGs and disbursed cumulative loans of Rs. 68.98 billion. Apart from many NGOs, 41,082 branches of 573 banks were involved in financing SHGs spread over 572 districts in 31 States and Union Territories. The mainstream banks have identified a new ‘market niche’ in servicing the financial needs of the poor. The estimates of Non Performing Assets (NPA) under the programme are at a level of 1.36% which is much lower than the portfolio risk of any other priority sector lending. The massive involvement of the banking sector purely on the conviction that SHGs are good clients has led to the very fast growth of this sector.

Besides banks there are a large number of microfinance institutions (MFIs) of diverse legal forms, providing financial services to the poor. The share of MFIs in terms of outreach has remained small but they have adopted a wide variety of innovations in improving access of financial services to the poor. The emerging trend is that banks and MFIs prefer to work together as partners by supporting each other.
The Indian microfinance experience shows that banks, even commercial banks, can operate a viable window to reach the poor through savings and credit services. The concept acknowledges that financial services to the poor on viable terms could contribute to the sustainability of financial services delivery.

The microfinance sector in India poses many challenges. The uneven spread of the SHG-Bank Linkage Programme has been a matter for concern. Also, a growing number of SHGs are seeking support for setting up productive micro-enterprises while access to insurance and other financial services remains largely unattended.

NABARD with the support of GTZ and SDC organized this conference with the active participation of microfinance practitioners from India and abroad to share their best practice experiences in microfinance. Academics, policy makers and practitioners made invaluable contribution during the conference for drawing up a roadmap for the future. The various presentations made by microfinance professionals, bankers, NGO and MFI representatives, academic and research institutions have been compiled in this book form. I am confident that practitioners and policy makers of microfinance will find this publication useful.

Dr. Y.S.P. Thorat
Managing Director
NABARD
1 Microfinance and its future directions

Dr. C. Rangarajan

1.1 Microfinance and its future directions

It gives me great pleasure to be here with you all this morning and to participate in this Policy Conference on Microfinance in India. The growth of microfinance in India has reached a stage when future policy options have to be carefully weighed so that this movement can become truly a strong one. I am happy that this Conference is being attended by senior officials from banks, NGOs, MFIs, government and academic institutions. An interaction among this select group should produce the desired result.

Microfinance has come to mean the provision of credit and other financial services to the poor so that they can reduce their poverty and raise their living standards. Microfinance has the potential to become an important component of a successful and sustainable poverty alleviation programme. Microfinance has become a worldwide movement. By end 2003, about 80 million clients across the world were being serviced by approximately 2,900 microfinance institutions. India’s share in this global microcredit market is quite impressive. In India, microfinance is being pursued through SHG-Bank linkage model and Microfinance Institution model.

The subject of providing credit to support people in rural areas and to the poor in particular has been explored extensively from time to time in India. The Indian credit system, as it has emerged, is a product of evolution as well as intervention. The broad objectives of policy innovations have been (i) to institutionalise credit, (ii) to enlarge its coverage, and (iii) to ensure provision of timely and adequate credit at reasonable rates of interest to as large a segment of the population as possible. The institutional innovations have been a continuous process
with changes occurring, depending on experience. In providing credit to the rural sector, a multi agency approach has been adopted so as to take advantage of the strengths of different institutional forms.

1.2. Evolution of thinking on growth and credit

As I had remarked on an earlier occasion, the evolution of ideas in relation to credit delivery system has some parallel to the evolution of thought on economic growth and development. In the first stage, the major concern was simply to accelerate economic growth. Growth was identified with the increase in the availability of material goods and services. Eradication of poverty was to be achieved through faster economic growth. In the second stage, a greater concern with the distribution of income emerged. Development was seen as going beyond economic growth and bringing out changes in the structure of economy. Equitable distribution of the benefits of economic growth became an independent goal.

In the third stage, the concept of equity was translated into the provision to everyone of what came to be described as ‘basic needs’ which included the fundamental requirements of life, such as education, safe water and health services. In the current stage of discussion, the concept of basic needs has been widened and the objective of growth is set as human development which means an improvement in the quality of the life of the people. Enhancement of human development implies on the one hand the creation of human capabilities through improved health, knowledge and skills and on the other, the opportunities for the people to make use of these capabilities.

In the case of credit delivery system, one can see similar evolution of thought. While in the early stages, the emphasis was on providing more credit, in later stages the emphasis shifted to ensure that credit went to all segments of society. Even the prescription of a proportion of total credit for priority sectors was not considered to be adequate. Despite the expansion of the organised banking system deep into the rural areas, a very large number of the poor continued to remain outside the fold of the formal banking system. The formal banking system with its systems and procedures was found to be inaccessible to the poor. This led to a search for an alternative delivery mechanism which would meet the requirements of the poor and particularly the women among them.
1.3 Origin of SHGs and MFIs

It is in this background that the idea of organising Self-Help Groups began to take shape. A Self-Help Group is a group of about 10 to 20 persons from a homogenous background who come together for addressing the common problems. They collect voluntary savings on a regular basis and use the pooled resources to make small interest bearing loans to their members. At a later stage, these groups are able to obtain credit from outside sources to support income-generating activities. Very often there is a Self-Help Promoting Institution (SHPI) which enables the Self-Help Group to function effectively.

A stimulus to the rapid growth of Self-Help Groups was provided when the SHG-Bank Linkage Programme was initiated in 1992. It was a pilot project for promoting 500 SHGs. As the idea gained acceptance from the banking system and the results were promising, the Reserve Bank of India encouraged this positive initiative by issuing instructions to banks in 1996 to cover SHG financing as a mainstream activity under the priority sector lending portfolio. A working group set up by the RBI in 1994 came up with wide ranging recommendations on SHG and bank linkage as a potential innovation in the area of banking with the poor. I am happy to have played some role in initiating this development, when I was Governor of Reserve Bank of India. As on March 2005, 1.62 million SHGs comprising 22 million poor households were accessing credit through 41,082 branches of 573 commercial and cooperative banks under the SHG-Bank Linkage Programme. The cumulative disbursement of loans by the SHGs has been Rs. 68.98 billion.

Another approach to providing microfinance has been through the microfinance institutions. Even before the SHG method was perfected, many NGOs were using a variety of delivery mechanisms for providing credit services to the poor with financial support from external donors and later by apex institutions including the Rashtriya Mahila Kosh (RMK) set up by the government, the SIDBI Foundation for Micro Credit, SFMC and NABARD. Since 2000, commercial banks including Regional Rural Banks are providing funds to MFIs for on-lending to poor clients. The exact number of MFIs functioning in the country is not available. However, it is estimated that there are around 800 private MFIs operating in the country with varied legal forms. While most are registered under Societies Registration Act, some are functioning as non-bank financial companies.
1.4 Progress of SHGs

The conceptual thinking behind the SHG initiative is that self-help supplemented by mutual help can be a powerful vehicle in the upward socio-economic transition of the poor. Poor can save and are bankable. Collective wisdom of the poor and peer pressure are valuable collateral substitutes.

NABARD has played a key role not only in promoting SHGs but also in standing behind the SHG-Bank Linkage Programme. The total refinance released by NABARD so far has amounted to Rs. 31.3 billion. The performance of the SHGs has been extremely encouraging. Repayments by members to SHGs have been exceedingly high and on-time payments have hovered around 98%. Many of the expectations behind the basic philosophy underlying the formation of SHGs seems to have been fulfilled. It has, however, to be noted that there is a concentration of SHGs in southern states. Our experience so far has shown that the poor can organise themselves and do things to promote the well-being. It has also had a tremendous social impact. It has made women more self-confident. This impression is largely derived from my experience in Andhra Pradesh.

Despite this encouraging picture, as of now the total disbursement of credit is very limited and per household credit made available is very small. As on March 31, 2003 the average loan was Rs. 28,600 per SHG and Rs. 1,760 per household. If a serious impact on the economic conditions of the rural poor has to be made, a much larger flow of credit to support a much broader production base is required. It is in this direction the movement has to travel. Self-Help Groups have to graduate into promoting micro-enterprises. Though micro-enterprises are not a panacea for the complex problems and chronic unemployment and poverty in rural and urban areas, yet promotion of micro-enterprises is a viable and effective strategy for achieving significant gains in income and assets for poor and marginalised people.

We can thus see the evolution of Self-Help Groups at three levels:

- At the first level households use microfinance to meet ‘survival’ requirements where small savings and loans serve as a buffer in the event of an emergency or to smoothen consumption or even service previous debt to give themselves more liquidity during lean times.
• At the second level, ‘subsistence’ needs are met through microfinance, where a household begins to utilise microfinance to diversify its basket of income-generating activities, or to meet working capital requirements in traditional activities.

• At the third level as households reach a stage where they can assume a higher degree of risk, microfinance would be used to invest in setting up an enterprise or facilitating entry into employment in one way or the other in order that the household becomes ‘sustainable’.

I had seen how Self-Help Groups have gone through these three stages in Andhra Pradesh. The annual exhibition of Self-Help Groups at Hyderabad has been a tremendous success. However, it has not been possible to obtain any data at an all-India level about the total value of the output produced by the SHGs. Some studies have shown that 70% of the credit is being utilised for production purposes. For the year 2004-2005, taking the annual flow of credit to SHGs and assuming that output is three times the flow of credit, we can derive that the total value output was in the range of Rs. 62 billion. I do hope that NABARD will initiate a study on the value of output produced by SHGs as well as the kind of products that are being produced. This information is absolutely essential for understanding the economic impact of SHGs.

At least in Andhra Pradesh, from pure thrift institutions, SHGs first graduated to producing simple products such as achars and papads (local spicy food products). Then they have moved on to produce a wide variety of commodities using simple machines. The scope for expanding the productive activities remains large. For example, readymade garments have a market even in rural areas. Thus, the choice of products becomes extremely important. The SHPIs (Self-Help Promoting Institutions) have thus a dual role to play. Not only should they facilitate the availability of credit from the formal sector to the Self-Help Groups, they should also assist the Self-Help Groups to identify suitable products which they can manufacture and sell. They need to impart the necessary skills. These institutions are in a very real sense friends, philosophers and guides. Yet another requirement for the success of SHGs is the provision of effective marketing outlets. These are the issues which need to be addressed at the present stage in the evolution of Self-Help Groups. There are interesting examples of successful SHGs who have graduated to the second and third levels. We need to replicate these successes, if the microfinance movement is to have a true impact.
1.5 Future directions

As the SHGs grow in number and in diversity, we need to be clear about the legal status of SHGs. At the moment, as I understand, they are not registered as any form of organisation. The second is the issue of how to combine different SHGs into a much larger organisation which can command greater credibility and therefore greater credit. In Andhra Pradesh, the Mutually Aided Cooperative Societies established under a separate Act were intended to provide a route for this. The expectation was that these societies could be federated at sub district and district levels facilitating the tapping of finance from outside sources better. These issues need to be addressed squarely, if the SHGs are to become organisations which can provide support for income generating activities.

Banks as formal credit agencies have the necessary resources; there is also the willingness on their part to provide credit to people with limited means as the experience has been good. The voluntary organisations should, therefore, provide an effective link between the formal financial system which has the ability to provide credit and the poor who need credit and have shown their ability to organise themselves. That is, in a sense there are three partners in this movement: Banks and other financial institutions who have the ability to provide credit, the poor who need credit and the voluntary organisations who can establish the link between these two.

In relation to the MFI model, it is quite clear that many microfinance institutions have played a pioneering role in organising the poor to obtain credit. They have played an excellent role in guiding the poor in undertaking appropriate productive activities. As indicated earlier, there are around 800 private MFIs operating in the country with varied legal forms. The overwhelming majority of MFIs have 500-1,500 clients and a few MFIs have reached an outreach of 100,000 microfinance clients. A multi agency approach even with respect to microfinance is useful. However, some thinking has to go into determining the appropriate legal form of microfinance institutions.

Microfinance can change the lives of the poor. There may not be a quantum jump in income but it is still possible to ensure a reasonable rise in the income of the poor. In meeting the challenge of widening the scope of microfinance, we need to pay attention to the following:
• As microcredit expands, as it must, banks need to introduce appropriate organisational changes in the various branches in order to play a pro-active role in bringing more and more SHGs under the SHG-Bank Linkage Programme. NABARD in consultation with RBI must also play a part in initiating this change.

• Self-Help Groups must transform themselves from pure thrift institutions into groups promoting micro-enterprises. In that situation, the success will depend upon the choice of products to be produced and the markets to be served and the creation of an appropriate marketing mechanism.

• The legal form of Self-Help Groups needs clarification. This assumes importance if the SHGs are to get federated into much larger organisations which can command greater credibility and, therefore, greater ability to borrow.

• The legal form of microfinance institutions also needs clarification.

I am sure that this conference will discuss these and other issues so that microfinance can become an instrument for pulling the poor out of the trap in which they are caught.
2 Microfinance in India: Sectoral issues and challenges

Dr. Y.S.P. Thorat

2.1 Introduction

This is a policy level conference and I believe that for policy to be effective it must, among others, incorporate the lessons of history. Let me, therefore, briefly set the context by providing the historical perspective on microfinance in India.

The first thing to remember is that in India the history of rural credit, poverty alleviation and microfinance are inextricably interwoven. Any effort to understand one without reference to the others, can only lead to a fragmented understanding. The forces and compulsions that shaped the initiatives in these areas are best understood in context of State and banking policy over time. Thus, for e.g., there were peasant riots in the Deccan in the late 19th century on account of coercive alienation of land by moneylenders. The policy response of the then British Government to this problem of rural indebtedness was to initiate the process of organisation of cooperative societies as alternative institutions for providing credit to the farmers as also to ensure settled conditions in the rural areas, so necessary for a colonial power to sustain itself.

In the development strategy adopted by independent India, institutional credit was perceived as a powerful instrument for enhancing production and productivity and for alleviating poverty. The formal view was that lending to the poor should be a part of the normal business of banks. Simple as that.

To achieve the objectives of production, productivity and poverty alleviation, the stance of policy on rural credit was to ensure that sufficient and timely credit was reached as expeditiously as possible to
as large a segment of the rural population at reasonable rates of interest.

The strategy devised for this purpose comprised:

- Expansion of the institutional structure,
- directed lending to disadvantaged borrowers and sectors, and
- interest rates supported by subsidies.

The institutional vehicles chosen for this were cooperatives, commercial banks and Regional Rural Banks (RRBs).

Between 1950 and 1969, the emphasis was on the promoting of cooperatives. The nationalisation of the major commercial banks in 1969 marks a watershed in as much as from this time onwards the focus shifted from the cooperatives as the sole providers of rural credit to the multi agency approach. This also marks the beginning of the phenomenal expansion of the institutional structure in terms of commercial bank branch expansion in the rural and semi-urban areas. For the next decade and half, the Indian banking scene was dominated by this expansion. However, even as this expansion was taking place, doubts were being raised about the systemic capability to reach the poor. Regional Rural Banks were set up in 1975 as low cost institutions mandated to reach the poorest in the credit-deficient areas of the country. In hindsight it may not be wrong to say that RRBs are perhaps the only institutions in the Indian context which were created with a specific poverty alleviation – microfinance mandate.

During this period, intervention of the Central Bank (Reserve Bank of India) was essential to enable the system to overcome factors which were perceived as discouraging the flow of credit to the rural sector such as absence of collateral among the poor, high cost of servicing geographically dispersed customers, lack of trained and motivated rural bankers, etc. The policy response was multi dimensional and included special credit programmes for channelling subsidised credit to the rural sector and operationalising the concept of ‘priority sector’. The latter was evolved in the late sixties to focus attention on the credit needs of neglected sectors and under-privileged borrowers.
There is a general consensus that the strategies followed:

- Helped to build a broad based institutional infrastructure for the delivery and deployment of credit, and
- ensured a wider physical access of financial services to the poor.

The indicators speak for themselves:

- Access in terms of rural branches increased from 1,833 in 1969 to around 32,200 at present,
- the population per rural branch declined from 201,854 in 1969 to around 16,000 at present,
- the proportion of borrowings of rural households from institutional sources increased from 7 percent in 1951 to more than 60% at present.

This significant increase in the credit flow from institutional sources gave rise to a strong sense of expectation from the state agencies. However, this expectation could not be sustained because the emphasis, among others, was on achieving certain quantitative targets. As a result, inadequate attention was paid to the qualitative aspects of lending leading to loan defaults and erosion of repayment ethics by all categories of borrowers. The end result was a disturbing growth in overdues, which not only hampered the recycling of scarce resources by banks, but also affected profitability and viability of financial institutions. This not only blunted the desire of banks to lend to the poor but also the development impact of rural finance.

This was the position on the eve of reforms, which marks the second watershed, in the history of rural credit.

The basic aim of the financial sector reforms was to improve the efficiency and productivity of all credit institutions including rural financial institutions (RFIs) whose financial health was far from satisfactory. In regard to RFIs, the reforms sought to enhance the areas of commercial freedom, increase their outreach to the poor and stimulate additional flows to the sector. The reforms included far reaching changes in the incentive regime through liberalising interest rates for cooperatives and RRBs, relaxing controls on where, for what purpose and for whom, RFIs could lend, reworking the sub-heads under the priority sector, introducing prudential norms and restructuring and recapitalising of RRBs.
The object of this narrative is to bring home to you two facts and four effects.

The two facts are:

- That right from the time of independence, the overriding concern of development policy makers has been to find ways and means to finance the poor and reduce the burden upon them.

- Between the concern of the policy makers and the quality of the effort, however, there has been a gap. The efforts made were not able to achieve the success envisaged for a variety of reasons; mainly, defects in policy design, infirmities in implementation and the inability of the government of the day to desist from resorting to measures such as loan waivers.

The four consequences flowing from these facts are:

- That the banking system was not able to internalise lending to the poor as a viable activity but only as a social obligation – something that had to be done because the authorities wanted it so.

- This was translated into the banking language of the day: Loans to the poor were part of social sector lending and not commercial lending; the poor were not borrowers, they were beneficiaries; poor beneficiaries did not avail of loans, they availed of assistance.

- The language of the time resulted in an attitude of carefully disguised cynicism towards the poor. The attitude was that the poor are not bankable, that they can never be bankable, that commercial principles cannot be applied in lending to the poor, that what the poor require are not loans but charity. Once this mindset hardened it became more and more difficult for commercial bankers to accept that lending to the poor could be a viable activity. It is significant to note that the system had to wait for almost a decade for the concept of microfinance to become credible.

- **Microfinance – the paradigm:** The financial sector reforms motivated policy planners to search for products and strategies for delivering financial services to the poor – microfinance – in a sustainable manner consistent with high repayment rates. The search for these alternatives started with internal introspection regarding the arrangements which the poor had been traditionally making to meet
their financial services needs. It was found that the poor tended to – and could be induced to – come together in a variety of informal ways for pooling their savings and dispensing small and unsecured loans at varying costs to group members on the basis of need. The essential genius of NABARD in the SHG-Bank Linkage Programme was to recognise this empirical observation that had been catalysed by NGOs and to create a formal interface of these informal arrangements of the poor with the banking system. This is the beginning of the story of the SHG-Bank Linkage Programme.

2.2 SHG-Bank Linkage Programme

The SHG-Bank Linkage Programme started as an Action Research Project in 1989. In 1992, the findings led to the setting up of a pilot project. The pilot project was designed as a partnership model between three agencies, viz., the SHGs, Banks and Non-Government Organisations:

- SHGs were to facilitate collective decision-making by the poor and provide ‘doorstep banking’;
- banks as wholesalers of credit, were to provide the resources;
- NGOs were to act as agencies to organise the poor, build their capacities and facilitate the process of empowering them.

2.2.1 Achievements

The programme has come a long way from the pilot stage of financing 500 SHGs across the country. Of the total SHGs formed more than 1.6 million have been linked with 35,294 bank branches of 560 banks in 563 districts across 29 States of the Indian Union. Cumulatively, they have so far accessed credit of Rs. 68.98 billion. About 24 million poor households have gained access to the formal banking system through the programme.
2.2.2 Impact of the SHG-Bank Linkage Programme

Given these quantitative achievements, what has been the impact of the programme?

The main findings are that:

- Microfinance has reduced the incidence of poverty through increase in income, enabled the poor to build assets and thereby reduce their vulnerability.
- It has enabled household that have access to it to spend more on education than non-client households. Families participating in the programme have reported better school attendance and lower drop out rates.
- It has empowered women by enhancing their contribution to household income, increasing the value of their assets and generally by giving them better control over decisions that affect lives.
- In certain areas it has reduced child mortality, improved maternal health and the ability of the poor to combat disease through better nutrition, housing and health – especially among women and children.
- It has contributed to a reduced dependency on informal money lenders and other non-institutional sources.
- It has facilitated significant research into the provision of financial services for the poor and helped in building ‘capacity’ at the SHG level.
- Finally it has offered space for different stakeholders to innovate, learn and replicate. As a result, some NGOs have added micro-insurance products to their portfolios, a couple of federations have experimented with undertaking livelihood activities and grain banks have been successfully built into the SHG model in the eastern region. SHGs in some areas have employed local accountants for keeping their books and IT applications are now being explored by almost all for better MIS, accounting and internal controls.

2.2.3 Key learnings

Given this scale and impact, what have been the learning points?

- The first point is that the “poor are bankable”. Sounds simple, but, when we view this in context of the attitudinal constraints which
characterised bankers on the eve of the linkage programme, one realises what an immense learning point this has been. But for this, we would still have been in the ‘middle ages’.

- The second point is that the poor, organised into SHGs, are ready and willing to partner mainstream financial institutions, and banks on their part find their SHG portfolios ‘safe’ and ‘performing’.

- The third point is that despite being contra intuitive, the poor can and do save in a variety of ways and the creative harnessing of such savings is a key design feature and success factor.

- The fourth point is that successful programmes are those that afford opportunity to stakeholders to contribute to it on their own terms. When this happens, the chances of success multiply manifold. This has been possible in the SHG-Bank Linkage Programme on account of the space given to each partner and the synergy built in the programme between the informal sector comprising the poor and their SHGs, the semi-formal sector comprising NGOs, and the formal sector comprising banks, government and the development agencies.

- Yet another learning point has been that when a programme is built on existing structures, it leverages all strengths. Thus, because the SHG-Bank Linkage Programme is built upon the existing banking infrastructure, it has obviated the need for the creation of a new institutional set-up or introduction of a separate legal and regulatory framework. Since financial resources are sourced from regular banking channels and members’ savings, the programme bypasses issues relating to regulation and supervision. Lastly, since the Group acts as a collateral substitute, the model neatly addresses the irksome problem of provision of collateral by the poor.

- The last learning point is that central banks, apex development banks and governments have an important role in creating the enabling environment and putting appropriate policies and interventions in position which enable rapid upscaling of efforts consistent with prudential practices. But for this opportunity, no innovation can take place.
2.2.4 Challenges

Regional imbalances: The first challenge is the skewed distribution of SHGs across states. About 60% of the total SHG credit linkages in the country are concentrated in the southern states. However, in states which have larger share of the poor, the coverage is comparatively low. The skewed distribution is attributed to:

- The over zealous support extended by some of the State Governments to the programme;
- skewed distribution of NGOs; and
- local cultures and practices.

Prof. Sriram is going to present a paper on this and I would be delighted to hear what he has to say. Suffice it to say at this stage that NABARD has since identified 13 states where the volumes of SHGs linked are low and has already initiated steps to correct the imbalance.

From credit to enterprise: The second challenge is that having formed SHGs and having linked them to banks, how can they be induced to graduate into matured levels of enterprise, how can they be induced to factor in livelihood diversification, how can they increase their access to the supply chain, linkages to the capital market and to appropriate production and processing technologies.

A spin off of this challenge is how to address the investment capital requirements of matured SHGs, which have met their consumption needs and are now on the threshold of taking off into ‘enterprise’. The SHG-Bank Linkage Programme needs to introspect whether it is sufficient for SHGs to only meet the financial needs of their members, or whether there is also a further obligation on their part to meet the non-financial requirements necessary for setting up businesses and enterprises. In my view, we must meet both.

Quality of SHGs: The third challenge is how to ensure the quality of SHGs in an environment of exponential growth. Due to the fast growth of the SHG-Bank Linkage Programme, the quality of SHGs has come under stress. This is reflected particularly in indicators such as the poor
maintenance of books and accounts etc. The deterioration in the quality of SHGs is explained by a variety of factors including:

- The intrusive involvement of government departments in promoting groups;
- inadequate long-term incentives to NGOs for nurturing them on a sustainable basis; and
- diminishing skill sets on part of the SHG members in managing their groups.

In my assessment, significant financial investment and technical support is required for meeting this challenge.

**Impact of SGSY:** Imitation is the best form of flattery – but not always. The success of the programme has motivated the Government to borrow its design features and incorporate them in their poverty alleviation programme. This is certainly welcome but for the fact that the Government’s programme (SGSY) has an inbuilt subsidy element which tends to attract linkage group members and cause migration generally for the wrong reasons. Also, micro level studies have raised concerns regarding the process through which groups are formed under the SGSY and have commented that in many cases members are induced to come together not for self-help, but for subsidy. I would urge a debate on this, as there is a need to resolve the tension between SGSY and linkage programme groups. One way out of the impasse would be to place the subsidy element in the SGSY programme with NABARD for best utilisation of indirect subsidy support for purposes such as sensitisation, capacity building, exposure visits to successful models, etc.

**Role of state Governments:** A derivative of the above is perhaps the need to extend the above debate to understanding and defining the role of the state Governments vis-à-vis the linkage programme. Let’s be clear: on the one hand, the programme would not have achieved its outreach and scale, but for the proactive involvement of the state Governments; on the other hand, many state Governments have been overzealous to achieve scale and access without a critical assessment of the manpower and skill sets available with them for forming and nurturing groups and handholding and maintaining them over time.
Emergence of federations: The emergence of SHG Federations has thrown up another challenge. On the one hand, such federations represent the aggregation of collective bargaining power, economies of scale, and are a forum for addressing social and economic issues; on the other hand there is evidence to show that every additional tier, in addition to increasing costs, tends to weaken the primaries. There is a need to study the best practices in the area and evolve a policy by learning from them.

Before moving on, let me use this opportunity to sound two notes of caution. One, that while we are upbeat about the success achieved and the potential that the SHG-Bank Linkage Programme offers, we need to be realistic and not to view this instrument as a one-stop solution for all developmental problems. SHGs are local institutions having an inherent potential to flower as decentralised platform for development, but multiple expectations could overload them and impair their long-term sustainability. Second, in focusing on the poor let us not forget the rest. The rural sector is a large field and even today the need for good old-fashioned rural credit and investment in agriculture and infrastructure continues with the same rigour as yesterday.

2.3 Emergence of MFIs

Having indicated my thoughts on the SHG-Bank Linkage Programme, may I now briefly turn to the MFI model? MFIs are an extremely heterogenous group comprising Non Banking Finance Companies (NBFC), societies, trusts and cooperatives. They are provided financial support from external donors and apex institutions including the Rashtriya Mahila Kosh (RMK), SIDBI Foundation for Micro Credit and NABARD and employ a variety of ways for credit delivery.

Since 2000, commercial banks including Regional Rural Banks have been providing funds to MFIs for on-lending to poor clients. Though initially only a handful of NGOs were ‘into’ financial intermediation using a variety of delivery methods, their numbers have increased considerably today. While there is no published data on private MFIs operating in the country, the number of MFIs is estimated to be around 800. One set of data indicates that about a dozen MFIs have an outreach of 100,000 microfinance clients. A large majority of them operate on much smaller scale with clients ranging between 500 to
1,500 per MFI. It is estimated that the MFIs share of the total institution-based microcredit portfolio is about 8%.

2.4 MFIs: Critical issues

MFIs can play a vital role in bridging the gap between demand and supply of financial services if the critical challenges confronting them are addressed.

2.4.1 Critical challenges

Sustainability: The first challenge relates to sustainability. It has been reported in literature that the MFI model is comparatively costlier in terms of delivery of financial services. An analysis of 36 leading MFIs by Jindal & Sharma shows that 89% MFIs sample were subsidy dependent and only 9 were able to cover more than 80% of their costs. This is partly explained by the fact that while the cost of supervision of credit is high, the loan volumes and loan size is low. It has also been commented that MFIs pass on the higher cost of credit to their clients who are ‘interest insensitive’ for small loans but may not be so as loan sizes increase. It is, therefore, necessary for MFIs to develop strategies for increasing the range and volume of their financial services.

Lack of capital: The second area of concern for MFIs, which are on the growth path, is that they face a paucity of owned funds. This is a critical constraint in their being able to scale up. Many of the MFIs are socially oriented institutions and do not have adequate access to financial capital. As a result they have high debt equity ratios. Presently, there is no reliable mechanism in the country for meeting the equity requirements of MFIs. As you know, the Micro Finance Development Fund (MFDF), set up with NABARD, has been augmented and redesignated as the Micro Finance Development Equity Fund (MFDEF). This fund is expected to play vital role in meeting the equity needs of MFIs.

Borrowings: In comparison with earlier years, MFIs are now finding it relatively easier to raise loan funds from banks. This change came after the year 2000, when RBI allowed banks to lend to MFIs and treat such lending as part of their priority sector-funding obligations. Private sector banks have since designed innovative products such as the Bank Partnership Model to fund MFIs and have started viewing the sector as
a good business proposition. Being an ex-regulator I may be forgiven for reminding banks that they need to be most careful when they feel most optimistic. At a time when they are enthusiastic about MFIs, banks would do well to find the right technologies to assess the risk of funding MFIs. They would also benefit by improving their skill sets for appraising such institutions and assessing their credit needs. I believe that appropriate credit rating of MFIs will help in increasing the comfort level of the banking system. It may be of interest to note that NABARD has put in position a scheme under which 75% of the cost of the rating exercise will be borne by it.

Capacity of MFIs: It is now recognised that widening and deepening the outreach of the poor through MFIs has both social and commercial dimensions. Since the sustainability of MFIs and their clients complement each other, it follows that building up the capacities of the MFIs and their primary stakeholders are pre-conditions for the successful delivery of flexible, client responsive and innovative microfinance services to the poor. Here, innovations are important – both of social intermediation, strategic linkages and new approaches centred on the livelihood issues surrounding the poor, and the re-engineering of the financial products offered by them as in the case of the bank partnership model.

2.4.2 Models

Bank partnership model: This model is an innovative way of financing MFIs. The bank is the lender and the MFI acts as an agent for handling items of work relating to credit monitoring, supervision and recovery. In other words, the MFI acts as an agent and takes care of all relationships with the client, from first contact to final repayment. The model has the potential to significantly increase the amount of funding that MFIs can leverage on a relatively small equity base.

A sub-variation of this model is where the MFI, as an NBFC, holds the individual loans on its books for a while before securitising them and selling them to the bank. Such refinancing through securitisation enables the MFI enlarged funding access. If the MFI fulfils the ‘true sale’ criteria, the exposure of the banks is treated as being to the individual borrower and the prudential exposure norms do not then inhibit such funding of MFIs by commercial banks through the securitisation structure.
Banking correspondents: The proposal of ‘banking correspondents’ could take this model a step further extending it to savings. It would allow MFIs to collect savings deposits from the poor on behalf of the bank. It would use the ability of the MFI to get close to poor clients while relying on the financial strength of the bank to safeguard the deposits. Currently, RBI regulation do not allow banks to employ agents for liability – i.e., deposit-products. This regulation evolved at a time when there were genuine fears that fly-by-night agents purporting to act on behalf of banks in which the people have confidence could mobilise savings of gullible public and then vanish with them. It remains to be seen whether the mechanics of such relationship can be worked out in a way that minimises the risk of misuse.

Service company model: In this context, the service company model developed by ACCION and used in some of the Latin American countries is interesting. The model may hold significant interest for state owned banks and private banks with large branch networks. Under this model, the bank forms its own MFI, perhaps as an NBFC, and then work hand in hand with the MFI to extend loans and other services. On paper, the model is similar to the partnership model: the MFI originates the loans and the bank books them. But in fact, this model has two very different and interesting operational features:

- The MFI uses the branch network of the bank as its outlets to reach clients. This allows the client to be reached at lower cost than in the case of a stand-alone MFI. In case of banks which have large branch networks, it also allows rapid scale up. In the partnership model, MFIs may contract with many banks in an arms length relationship. In the service company model, the MFI works specifically for the bank and develops an intensive operational cooperation between them to their mutual advantage.

- The partnership model uses both the financial and infrastructure strength of the bank to create lower cost and faster growth. The service company model has the potential to take the burden of overseeing microfinance operation off the management of the bank and put it in the hands of MFI managers who are focused on microfinance. They introduce additional products, such as individual loans for SHG graduates, remittances and so on, without disrupting bank operations and provide a more advantageous cost structure for microfinance. We need to pilot test this.
2.5 The road ahead

I recently wrote an article together with Graham Wright called “Banking for the Poor and not Poor Banking”. What we wanted to say was that notwithstanding our significant achievements, there are still large sections of the population without access to financial services. A conservative estimate for example suggests that just 20% of low-income people have access to them. Thus, there is an urgent need to widen the scope, scale and outreach of financial services to reach the vast un-reached population.

In this context may I quote from the recent Annual Policy Statement (2005-2006) of the Governor, RBI. Drawing attention to the expansion, greater competition and diversification of ownership of banks leading to enhanced efficiency and systemic resilience in the banking sector, the Governor has said that notwithstanding this “there are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in unorganised sector. While commercial considerations are no doubt important, the banks have been bestowed with several privileges, especially of seeking public deposits on a highly leveraged basis, and consequently they should be obliged to provide banking services to all segments of the population, on equitable basis.”

He has clarified that against this background, the RBI will implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged. Further, the nature, scope and cost of services will be monitored to assess whether there is any denial, implicit or explicit, of basic banking services to the common person. He has advised banks to review their existing practices to align them with the objective of financial inclusion.

I have come to the end of my presentation. Looking back I find that the key players are banks as banks, banks as partners in the SHG-Bank Linkage Programme and emerging MFIs. Banks through their rural branches have played and continue to play an important role in providing financial services to the poor on a stand alone basis. Banks need to introspect on the quality and coverage of these portfolios.
Further as key stakeholders in the SHG-Bank Linkage Programme, they together with other partners need to take forward the good work they have been doing.

The SHG-Bank Linkage Programme has done well, has made a tremendous contribution to ‘scale’ and is on a high growth path. However, the programme is confronted with many challenges and these needs to be addressed through appropriately structured policies and strategies. In so far as MFIs are concerned it is recognised that they hold significant potential. However, MFIs need to be challenged to make an increasing contribution to ‘scale’ consistent with cost, sustainability and efficiency of operations. Given these and other challenges embedded in the microfinance context, this conference has been organised so that we can all deliberate on the issues involved and come up with appropriate recommendations for policy formulation.

We are living through challenging and upbeat times. Yet anyone who has worked in the field of development knows the ‘highs’ and ‘lows’ of working in this sector. Sometimes when I look at the vast unfinished agenda, the tasks undone, done partly or done poorly, when I factor in the forces of apathy and status quo, when I see how slowly things move when in fact they should be moving rapidly I feel a sense of despair – a realisation that in the end human endeavour is meagre and that the distance between effort and achievement is indeed long. At times such as these I recollect a message given to us many years ago when we were emerging from the trauma of the sub-continent’s partition between India and Pakistan, when there was great despair for the future of the two nations. In those dark and troubled days, a poet, Dr. Mohammad Iqbal – later the national poet of Pakistan – said to us, which translated into English means: “when light fails and you are surrounded by darkness, do not despair, take heart – for a thousand million stars must die each night just so that a new dawn can be born tomorrow”.

On this note of hope for a better tomorrow and with a sense of sincere appreciation for all those working in the sector – practitioners and policy makers, researchers and regulators and academicians and activists – I take leave and thank you for having given me this opportunity of sharing my thoughts with you today.
Endnote

1Jindal, K. and Sharma, K.C. Issues in sustainability of MFIs, BIRD, Lucknow.
Microfinance and sustainability: International experiences and lessons for India

Providing support and managing failures in Community Level Financial Systems – the key to long term viability

Robert Peck Christen

3.1 Introduction

Indian microfinance promoters and public sector banks have invested heavily in the Self Help Group (SHG) approach to providing loans to the poor. Today more than 1.5 million groups have been formed and an estimated 16 million clients have received loans, making SHGs the largest microcredit operation in the world by a large margin.¹ The Indian microfinance community rightfully takes great pride in this most impressive achievement, especially when one considers that the SHG movement really took off just over a decade ago. A widespread impression has formed that SHGs, when linked to banks, form a sustainable model for providing access to financial services for India’s low income families. The general perception, reinforced by many bankers themselves, is that SHGs are profitable clients for banks, and that SHGs are the vehicle through which banks can most effectively reach out into rural communities.

Nevertheless, the SHG approach has been heavily criticized both in India and abroad. Fundamental questions remain about SHG’s long term viability as a model for the supply of microcredit to low income families. For the SHG-Bank Linkage model to remain viable over the long-term, key support and maintenance services must be provided to individual community or group-level bodies, and their costs recovered. To date, the support organizations that are best positioned to assume these responsibilities dedicate more resources to promoting new community-level groups rather than maintaining existing ones, or more importantly, eliminating failed SHGs from the system. Scant attention has been paid to building and maintaining the health of the entire system over the long run.
In any retail financial system, local entities, whether they are bank branches, credit unions or Self-Help Groups, require a number of services and support functions to remain viable over the long term:

- **Liquidity**: Local entities must usually operate with an external agent to even out seasonal cash flow variations due to the structure of the local economy and demand for financial services.

- **Standardized products and norms**: Local entities are usually better off when they can offer standardized products that have been developed by a higher level organization that is in a better position to develop supporting MIS, rules, and risk mitigation strategies.

- **Training**: Local entities must receive training in basic operations from an external source if they are to maintain a quality service, especially in the light of the generally weak human resource present at the community level.

- **Direct supervision/intervention in operations**: Local entities must operate with an external agent that can carry out basic control functions to ensure that management is not engaged in corrupt or unhealthy practice. While this function is usually delegated to local committees in Community Level Financial System (CLFS), these committees have not proven particularly adept at ferreting out bad practice in organizations that have often been ‘captured’ by local managers; local entities require constant supervision to keep on track. If they get in trouble, their operations must be intervened and straightened out.

These services can be divided into two groups: (i) the provision of a liquidity facility, staff training, and product design and standardization that are directed at generating consistent performance at the local level, across all units, and (ii) intervention in the management and governance of the local entity to eliminate unhealthy practice from the system. Of the two, the later may be the most important for maintaining the long term health and reputation of a financial system.

In a large retail bank these functions are provided by regional and headquarters staff in support of branch offices, and are included in the overhead cost of the institution and covered by operating income. In CLFS such as the SHGs, credit unions and mutual societies, these functions are typically provided by second tier and promotional organizations. The individual community level organizations that
compose a CLFS do not typically pay for the full cost of providing these support services. Thus, these services are generally under-funded, and under-perform.

Promoters of Indian SHGs are beginning to recognize the importance of providing greater support to groups over the long run, though little discussion as yet has focused on this issue from a systemic perspective. The discussion remains centered on how to inject more support into individual groups, but does not take on the issue of how to build a system that can provide these critical support functions on a sustainable basis, over the long term. There does not appear to be much discussion as of yet on the issue of intervening in the management of governance of poor performers as a means for correcting bad practice or eliminating it from the system.

While the SHG model is a unique community level financial system, it shares many common characteristics with credit union movements, less formal mutual credit and savings societies such as SACCOs (prevalent in Africa), community banks, and municipally owned and operated savings and loans. Of all of these systems, the SHGs are the least formal, lacking even a minimal legal structure. On the other hand, the model of linking of SHGs to commercial banks may be an important alternative for providing the services required for their long term health and credibility.

Community Level Financial Systems have been around for a long time. Yet, they have not lived up to their promise. As a group, CLFS have failed to expand to a point where they represent a sizeable portion of the financial systems of low and middle income countries, in spite of the fact that they may have hundreds of thousands, or even millions of individual accounts. In all but a very few countries, no more than three to five percent of the target population is served by these CLFS and they represent no more than one or two percent of the entire financial system.

In the developing world, they have not earned a strong reputation for safety and soundness, professionalism, or efficiency. The reputation of any retail banking system, whether consisting of a large number of branches of a single entity, or a large number of small entities, depends on its ability to produce consistent results across its entire network, over a long period of time. In a very real sense, it is only as strong as its
weakest link. Poor performance in a few branches where clients cannot withdraw their savings in a timely manner, or where loans are only made to friends and family of the branch manager rapidly undermines the credibility of the entire system.

This paper argues that the failure of most CLFS, including India’s SHG system, to attain a substantial share of the financial market results directly from the failure of these financial systems to deliver consistently high quality service to customers across the system. This is the result of two factors: First, few membership-based CLFS have the resources or skills to ensure strong management of each community-level organization. Second, since most CLFS do not have mechanisms to purge poor-performing individual organizations from the system, the reputation of the CLFS as a whole is damaged.

In the remainder of this paper, we will look at a number of models that promoters of SHGs might consider as they move on to a second, critical stage of development, one in which they consolidate a systemic model in which all required functions for its long term survival are incorporated and provided for through the operational income generated by its activities. We do not take a view that the subsidy should be removed from the SHG system, only that its architects must provide for the second tier support functions, understand their full costs, and build them into the system. Eventually, they may also wish to review just how the subsidy is provided, and where it ought to be directed to maximize its long run impact.

In India, these models are already present in their nascent form. We will add the international perspective to this discussion by bringing in a discussion of a number of CLFS experiences that have successfully addressed the issues of support and management intervention at the local level. All of these models devolve the essential individual decisions and provision of financial services to community groups at the local level. In this, they are distinct from branches of large retail banking institutions, where, no matter how decentralized, there is ultimately a far greater degree of centralization in the manner in which individual loans are granted.

For many, this essential distinction lies at the heart of the justification to support the creation and maintenance of CLFS. They believe that because of its local roots, the CLFS will always keep the interests of its’
clients at the heart of its mission, a characteristic that should tend to favor clients through the development of client responsive products, personalized financial service, and necessary flexibility in handling the impact of localized ‘shocks’ on members. Additionally, most promoters of CLFS, SHGs included, feel that the group plays an important role in reducing the transaction costs (for lenders to the system) by absorbing functions that would otherwise be performed by staff.

3.2 Building support functions

The causes of poor performance at the SHG level are many and often repeated:

- Corrupt or incompetent local staff or managers;
- undiversified local credit risk derived from over investment in a very few activities, or a mono activity local economy;
- too much external funding that changes internal incentives;
- capture by local elites for their own narrow financial purposes; and
- poor initial promotion.

Frequently we hear the refrain that membership based organizations, composed by and large of non-professionals, will always suffer from an inability to govern their affairs and will inevitably lapse into decay. This seems especially true if the organizations were established primarily as a vehicle for channeling funds originating outside the local community.

While all of these causes are undoubtedly true, they are not restricted to membership based CLFS. In fact, they are common in any large retail banking organization. Frequently, managers of local bank branches become captives of local elites, engage in a pattern of insider lending, steal money, and make risky loans. They are often poorly trained and are poor managers of their local staff. Many face political pressures when making loans. To combat these inevitable problems, retail banking institutions provide critical support services including staff recruitment and training, standardized products and operational norms, internal controls, and general supervision from head or regional offices.

Increasingly, promoters of the Indian SHG approach are coming to understand the importance of supporting community level organizations with these same support functions. Most SHGs are promoted by NGOs, government officials, or bank staff. While NGOs may have
subsidy funding that allows them to form and support SHGs for some initial period of time while they get established, many other SHG promoters have no means of long term visible support. At some point, the SHG ends up largely on its own, or relying on the small level of support it might receive from bank staff from the office where it is linked. But building and maintaining SHGs is not something most Indian bankers would consider part of their core competency.

One of the responses has been for banks and promoters to initiate federation structures for clusters of SHGs, and in a very few cases, even seek the means through which these federations might become self-sustaining on the basis of fees they charge to their member SHGs. This process mirrors the development of other successful CLFS internationally where, in a first phase the primary effort was placed on generating the community level organizations and subsequently, many years later, the federative support structures were built to preserve and strengthen the systems. Typically, federative structures in CLFS have carried out a number of support functions including staff training, liquidity provision, some product and operational standardization, and advocacy.

If federations are to contribute to the long term viability of SHG they must not only provide critical services, but must do so in a manner that is sustainable. In other words, they must exist as service providers, not simply as promotional vehicles for channeling funds or advocacy. They must generate fees to cover their costs from either SHGs, or the providers of loans to SHGs, though ultimately their costs must be borne by the individual members of SHG through the interest they pay on their loans.

Providing these services entails a substantial cost. While there are a number of studies that are beginning to look at the issues of costs in the SHG approach, only one (Nair 2002) tackles the issue of the financial sustainability of a superstructure that would provide long term support to SHGs.² Nair’s objective was to determine, on the basis of best practice, whether or not federations could contribute to the long term sustainability of the SHG system. He finds that two leading federations have become self sustaining on the basis of the fees they charge to their members, though admittedly, these federations represent a tiny proportion of the total number of federations nation wide, and an even smaller proportion of SHGs all-India. Reaching the breakeven point takes several years.
Consolidation into National Federations – Desjardins Credit Unions, Québec, Canada and COFAC, Uruguay

Founded at the beginning of the 20th century, by 1944, the Desjardins Credit Union movement in Québec had grown to 877 ‘caisses populaires’ with total assets of 88 million Canadian Dollars, covering the entire province. Between 1944 and 1971, the federations began to assume more and more support functions so that by the end of the period they had achieved a common MIS, products, supervision framework, and reached total assets of over one billion Canadian Dollars. At that point, the role of the ‘Desjardins Group’, the national level structure had become pre-eminent and had begun to generate specialized subsidiaries to provide services such as life insurance. Adopted by Québec in 1988, the new Savings and Credit Union Act enabled the Group to reorganize its subsidiaries. The subsidiaries making up the group’s corporate network were more closely linked to the cooperative network’s strategic objectives, and their range of services was broadened.

In 1995, an ambitious reengineering project was put in place to simplify and modernize caisse operations. The Group’s objective was to optimize returns on technological infrastructures and improve services to members, while reducing operating costs. In the meantime, the reconfiguration of the caisse network was underway. This was necessary due to tighter profitability margins and the phenomenal development of the virtual delivery mode of financial services, among other things.

In 1996, the officers of the caisses reviewed the organizational and decision-making structure of the caisses, and abolished the credit committee structure. At their 1999 congress, they opted to merge the Confédération and the federations into a single organization. It is this organization, responsive to its Caisse membership structure, that sets products and norms, trains staff, funds its activities, exercises internal controls and supervises individual caisse operations. The national level organization is the true driver of the CLFS.

This model has been replicated in a number of developing countries with varying degrees of success. COFAC, ACAC and FUCAC in Uruguay were born out of the effective consolidation of a number of individual credit unions into their federations for operational purposes. The individual credit unions became ‘branches’ of a single financial institution that carried the brand of the credit union federation. Recently, COFAC was intervened by the government for poor results.

Source: Desjardin Website, History
Towards a Sustainable Microfinance Outreach in India

We can use the results of Nair's study to illustrate the kind of analysis that must be conducted to determine the sustainability of a maintenance super-structure for SHG CLFS. In this case, Nair looks at the profitability of a number of successful federations over time using a simple cash based operational self-sufficiency model to track current operational income and running expenses at the federation and SHG levels, while correcting for direct and implicit subsidies. Table 1 presents the key results of Nair's study for two SHG federations, but in a somewhat different format.

In this analysis based on Nair's data, we can see the total operational costs of the system, compared against the total assets at the level of the consolidated SHG balance sheet. We add the operational (administration) costs at the SHG and federation levels to the financial costs at the SHG level to get the total operating costs. We assume that the federations recover their financial costs by passing them on to the SHGs, so do not count them. Since the federations and the APEX only exist to serve the SHGs, this provides us with a sense of the viability of the entire system.

**Table 1: Key results from Nair's study of the sustainability of SHGs in a federated system, 2001**

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<thead>
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<th>KVK ('000)</th>
<th>SMPS ('000)</th>
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<tr>
<td>Apex Operational Expense</td>
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<tr>
<td>Federation Operational Expense</td>
<td>507</td>
<td>1,363</td>
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<tr>
<td>SHG Operational Expense</td>
<td>1,576</td>
<td>1,101</td>
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<tr>
<td>Total Operational Expense</td>
<td>2,437</td>
<td>2,464</td>
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<td>Total Financial Expense SHG level</td>
<td>2,102</td>
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<tr>
<td>Total Expense</td>
<td>4,539</td>
<td>6,137</td>
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<tr>
<td>Total Income at SHG Level</td>
<td>4,229</td>
<td>6,020</td>
</tr>
<tr>
<td>Net Income (Loss)</td>
<td>(310)</td>
<td>(117)</td>
</tr>
<tr>
<td>Operational Self Sufficient</td>
<td>93%</td>
<td>98%</td>
</tr>
<tr>
<td>Total Assets at SHG Level</td>
<td>25,966</td>
<td>44,983</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>(1.2%)</td>
<td>(0.3%)</td>
</tr>
<tr>
<td>Efficiency/Total Assets</td>
<td>9.4%</td>
<td>5.5%</td>
</tr>
</tbody>
</table>

*Operational expense refers to the cost of administration and excludes financial expenses, loan loss provisions and profits.
This different presentation confirms Nair’s basic conclusion, that these two particular CLFS are sustainable, on the basis of the fee and interest rate structures prevailing in the market at the time, without taking into consideration the need to provision for loan losses and without amortizing in any way the initial cost of group and federation formation. However, if, using Nair’s numbers, we provision for loan loss expense and amortize the expense of promoting both the SHGs and their federations, we come up with a less sustainable overall result (Table 2).

We will assume for the purposes of this analysis that the SHGs have a loan loss of only five percent with their funding organizations, which seems to be a level suggested in a number of studies. (Although internal repayment rates are often so low that it seems difficult to believe that repayment rates with funders can be as high as is often reported). We will apply that level to the portfolios of the two SHG systems. In fact, the relationship between internal repayment rates and repayment rates to SHG funders is an area that is ultimately vital to the long-term sustainability of the CLFS, and is one that has received virtually no attention in the literature about the sustainability of the SHG approach. Either, these reported internal repayment rates are an irrelevant indicator of the proportion of loans that are paid within time-frames group members consider reasonable, or they represent a ticking time bomb within the system, that may explode once funders come to understand their exposure and withdraw liquidity from the system. This low rate of internal credit discipline may well be the Achilles heel of the entire SHG movement.

For our further calculations, we will assume that the cost of promoting each SHG is Rs. 8,000, the average that Harper found in his 2002 study and we will assume that the cost of promoting each federation is equal to Rs. 10,000 (per associated SHG) which seems like a reasonable figure given Nair’s calculations. We will assume that these group promotional costs are amortized over a three year period at the SHG level. This would seem to be a reasonable period for those groups to last, in the absence of the maintenance function being exercised by the federations. That cost was included in the current operating cost calculations. We will amortize the costs of promoting the federation over a five year period.
Operating self sufficiency drops to 62% and 55% for the two federations once these costs are factored in. If we take total costs as a percent of the average total assets of the SHGs, they amount to 36% in the case of the KVK system. Operating (administrative) costs would amount to 19% of average total assets. Current yields on average total loan portfolio for the KVK system was about 24%, which is not enough to cover the full cost of the services provided by the federation, or conversely, sufficient revenue to cover loan losses. The Sri Padmavathy Mahila Abyudaya Sangam (SMPS, Federation of SHGs in Chitoor District, Andhra Pradesh) system did not make available data from two years so the calculation was not possible. It seems that its results would be quite similar, based on the ratios for 2001 alone.

This suggests that the cost of providing support is significant, as much as 15% of the total assets of the SHG federated assets, on an
annualized basis. Clients would need to pay an interest rate in excess of 36% on loans in order to cover the all-in costs of building and maintaining their access to financial services, if there were no subsidy involved. Admittedly, the federations involved were quite small, and potentially, there might be scale economy to be had if they were a lot larger.

This would not surprise the managers of the oft maligned microfinance organizations. They have been roundly criticized for being an expensive source of microcredit. These organizations offering microcredit through groups are quite similar to Self-Help Groups, except that, as a rule, they are composed of poorer clients who take smaller loans. These organizations found that at the same scale, they too required interest rates in excess of 36% to build their organizations. They also had to cope with a substantially higher cost of funds and a considerably lower average loan balance, which drove their costs even higher as a percent of total assets.

So, SHG promoters who feel that the poorest clients can be served by sustainable CLFS at interest rates of 15% to 24% are simply not being realistic. At present, the SHG system is sustained and promoted on the basis of subsidy, much of which is hidden. Banks have an artificial view of the profitability of SHGs with which they link since they only consider out of pocket running costs as illustrated by Hans Dieter Seibel in his 2002 study in which he reports an ROA to banks of two to six percent from lending to SHGs.

The problem with this approach to system building is twofold. First, maintaining a direct subsidy into group formation and maintenance either keeps interest rates artificially low to end clients, or in the case where SHGs charge their members high rates of interest, builds internal capital accounts far more rapidly. In either case, the subsidy goes directly to clients, at the expense of the CLFS and its long term viability. Second, by selling the banks on a model that is not in fact fully covering its long term costs, SHG promoters run a serious risk that once operating subsidies run out, and SHGs fall into decline or face internal difficulties, banks will pull their funding out rather than run the political risk of increasing interest rates they charge to SHGs in order to cover the full costs of system maintenance and loan loss risk. Perhaps, internal accounts of SHGs will have grown by that point to such a level that bank linked external funding will no longer be required. Nevertheless, the existence of these robust internal account balances
does not address the need for support functions necessary for long term viability. While the size and the nature of the direct subsidy to SHG members may seem like good social policy, conversely, building financial systems that fail carry great social and financial costs as they are bailed out over and over again.

### 3.3 Building the Management Intervention Function

In the absence of adequate control mechanisms, aberrant behavior is likely to occur anywhere there are substantial funds available for capture by an organization’s staff. According to studies done by the auditing profession, eighty percent of people will engage in unethical or corrupt practice if they are given the right combination of opportunity and motivation. What distinguishes a successful retail banking organization with dozens or even hundreds of local branches, from a typical CLFS that may have dozens or even hundreds of individual member ‘organizations’ is its ability to prevent and correct for this type of behavior that naturally occurs in any large financial network.

In general, membership based CLFS have a poor track record at correcting malfeasance or bad practice when it happens at the level of an individual organization. Many organizations are poorly governed, or simply don’t have the resources or skills to remedy the situation if a manager absconds with funds or makes bad loans to insiders. The resulting loss, in turn, degrades the entity’s image in the community.

This initial weakness of CLFS to address problems at the level of individual organizations is compounded exponentially by the inability of most CLFS to purge poor performers from the system. Bankrupt credit unions, collapsed SACCOs and failed Self-Help Groups, are just left to wither away with no public move to close their operations, dispose of their remaining assets, or recognize that they have formally ceased to function. It’s not uncommon, years after an individual organization of a CLFS has effectively ceased operations to find signs of its existence, a constant reminder to all in the community of the failure.

The inability of most CLFS to purge poor performers creates a situation analogous to that of a microlender that never writes off bad debt. If a well performing MFI were to lose, but never write off 3% of its portfolio every year to bad debt, in ten years it would accumulate a portfolio with 25% NPLs even if it fully replaced the value of those losses through
provisioning. Presenting a portfolio to the general public with a 25% NPL has a lot worse than presenting a three percent NPL, the figure for the latest year. This is of course why banks provision for loan losses and then write them off!

For the sake of simplicity let’s imagine a scenario where 100 community level groups are formed in the base year 2000 and each year 10 get into some sort of difficulty that is not effectively addressed by the sponsoring organization. It wouldn’t take very many years for the majority of these groups to be limping along. As long as plenty of new groups are being formed, the failure of older groups gets swallowed up in the general statistics on the performance of the CLFS. But after a while, the neighbors start to notice that the older groups are getting into trouble, and question whether the approach is viable – in the same way that current borrowers start to notice when their neighbors stop paying micro-loans, which generally leads to a rapid deterioration in repayment discipline.

Given this dynamic, even an activity where 9 out of 10 entities succeed in any given year, failure can grow exponentially and ruin the reputation of the model. In the case of forming new community level groups, the rate of growth will slow or even reverse as potential clients witness the deterioration or dissolution of existing groups. This is a critical shortcoming, especially where trust must lie at the center of the relationship between clients and the organization, as is required when savings are mobilized or where repayment depends on client’s future access to loans.

So, to follow through on the analogy, if CLFS do not ‘write off’ poor performers over a ten, twenty or forty year period, they will arrive at a point where the vast majority of the individual organizations ‘on the books’ will fall into the category of ‘failed’ or ‘problem’ entities, to the discredit of the entire system and the general approach. This analogy fairly describes the current situation of most CLFS in most countries that have been operating for a number of years.

Virtually none of these systems were created, from their inception, with the necessary mechanisms and discipline to keep them ‘clean’ over the long term. In virtually all cases, the responsibility for enforcing performance standards, if this even exists, was placed in the same institution that was charged with promoting the initial creation of the
Nowhere is the contrast between a highly atomized CLFS and a supported, yet decentralized retail banking more clear than in Indonesia, before and after the financial crisis of 1997. Before the crisis, Indonesia could boast of having one of the most thoroughly developed microfinance sectors in the world with deep market penetration. BPRs are secondary banks of an extremely small size (the average total assets is US$ 160,000) without access to the payment system. As of December 1998, there were a total of 2,260 BPRs with around 4 million clients, accounting for 0.4% of total bank assets in the country.

BPRs are supervised by the central bank, Bank Indonesia (BI), through its regional offices. Prudential regulation (Camel system), supervision and reporting requirements for BPRs are basically similar to those for primary banks and have raised the question of whether the regime is appropriate for very small banks. Partly as a result of the Indonesian financial crisis, it is estimated that only about 50% of the BPRs are financially sound; at least 15% are slated for immediate closure by BI. Bank Indonesia has recognized that the supervision of thousands of BPRs is a cumbersome and an expensive task with limited payoff in protecting the stability of the whole financial system*. In May 1999, Bank Indonesia promulgated a new regulation which aims at structural changes in the sector, the minimum capital requirement has been increased and BPR merger and consolidation have been facilitated.

During and shortly after the financial crisis that wrecked havoc on the unsupported BPRs, the BRI/Unit Desas saw an important increase in nominal deposits, number of depositors (from 17 to 23 million), virtually no sustained increase in its historical loan delinquency level, and continued to generate adjusted returns of over four percent on total assets. So, while individual unit desas of BRI are actually smaller and more local than BPRs, the support they receive from the regional branches of BRI made all of the difference in their ability to weather the storm.

*Steinwand, Dirk, 2001, Robinson, Maraguerite. The Microfinance Revolution, V2

individual organizations. Typically, these agencies have given priority to creating new entities and supporting them wherever possible, without taking a systemic view that would suggest that the health of the system is best served by publicly addressing the weaker elements through mergers, sale of assets, suspension of operations, or direct intervention. In many cases, the agency charged with overseeing the CLFS does not even have the legal authority to engage in these practices, only to grant licenses to operate.
In a few countries banking regulators have been given the responsibility and the budget to effectively regulate a CLFS. When they have done so, they find that the total cost of regulating, supervising and cleaning up the CLFS is extraordinary, especially when compared to the cost of supervising the traditional banking sector. Whereas banking authorities typically charge 0.1% or 0.2% of a bank’s total assets to cover its supervision costs, it would need 10 to 20 times that much to supervise credit unions. It is as if a banking authority suddenly had to take on the direct supervision of thousands of bank branches across the country. The task is ultimately impossible, or prohibitively expensive under current budget and staffing regimes, especially in large countries that have built CLFS composed of a very large number of individual units. If the costs of supervising NBFIs in Peru is two percent of total assets, and the average total assets of NBFIs is counted in the millions of dollars, then the cost of applying any sort of effective regime to tiny village level units must be several times greater. Again, no matter how it is calculated, the cost of management intervention and direct supervision of tiny entities must represent a significant portion of their total assets, a cost that must ultimately be borne by their members in the interest rates they pay on loans or membership fees.

**Taking on the Regulation Challenge for CLFS, Rural Banks in the Philippines**

Rural banks in the Philippines are the smallest type of licensed banking entity and can be found in both rural and urban settings. They are supervised by the central bank, are integrated in the payment system, and carry out many microfinance style operations and capture deposits from relatively poor clients. As of September 1997, the 824 rural banks accounted for just over two percent of total assets and total deposits in the entire banking system. On the other hand, they accounted for 83% of the total number of banking institutions (991). The combined number of offices of the rural banks is equal to less than half of the number of branches of the 52 commercial banks. Presently, between US$ 100,000 and US$ 1 million in equity is required to constitute a rural bank, depending on the size of the municipality in which the bank is to be located. The Philippine Central Bank Supervision Department has worked uncommonly hard to effectively supervise the rural banks, dedicating as much as half of its total staff and budgetary resources, according to reliable sources. Since 1992 when rural banks were first created the regulatory authorities have overseen a process that has gradually restructured, merged or liquidated a number of banks down to the present number from an initial high of about 2,000 entities.

Source: Christen, 2000
The high cost of direct supervision: Supervision of Non-Bank Financial Intermediaries, Peru

Peru has seen a proliferation of non-bank financial institutions. The Peruvian Banking Superintendency has set up a special department to oversee more than 30 MFIs, including Cajas Rurales, Cajas Municipales, Edpymes (transformed NGOs), and credit unions. A cost accounting estimate Peru’s Superintendency recently made for its microfinance supervision costs showed that even at the current level of assets, complete supervision cost coverage could be attained with supervision fees equal to 2% of assets. Given that loans are about 2/3 of assets, this would imply that MFIs would have to pass on an additional 3% points to borrowers to cover the full cost-covering fees associated with their supervision (plus an additional 1% point or so for compliance costs). In Peru, MFIs can easily charge interest rates that permit them to pass these costs on fully to clients although the Superintendency has not yet decided to pass the full cost of supervision onto the MFIs.

Source: Christen, 2000

The purpose of this section is not to suggest that India should give its SHGs legal status and incorporate them into some sort of regulated financial entities, much less to place them under the direct supervision of banking authorities. That would be patently ridiculous and astronomically expensive, even if by some miracle the political will emerged to attempt this feat. Instead, this section seeks to demonstrate the high cost of system clean-up. Additionally, those who promote SHG CLFS need to consider that, in the cases of Peru and the Philippines, the banking authorities do not supply the other services required to maintain consistent quality across the system.

If the full costs associated with the provision of liquidity, staff training, and product standardization and operating norms runs around 15% of total assets, adding the ability to intervene in local management must certainly add another three to five percent in the federative SHG model. Again, with scale this cost might decline. But building a model that does not create structures capable of local intervention, and does not create the financial mechanisms that will ensure these structures remain a permanent part of the CLFS landscape, seems shortsighted. Most certainly the SHG movement will silt up just like the Kolkata Harbor. Poor performers will quietly accumulate, unseen on the surface by any but the most dedicated observer, until one day, the system is no longer usable.
3.4 Promotion and management of proprietary SHGs

In India, both the SHG and the Grameen Bank MFO approaches organize groups and use them to make credit available to individual members. On the ground, they don’t look very different one from another, especially when both compared with the wide variety of individual lending, solidarity group and other approaches we see around the world. MFOs represent a fast growing share of the microcredit market and are gaining political clout with banking and finance ministry authorities as an alternative to the SHG movement.

The primary difference of MFOs from the SHG approach is that the MFO assumes all promotional, support and maintenance functions required by its groups. The subsidies received go straight to cover the operational expenses of the MFO and do not end up in the hands of group members either through reduced interest or capitalized internal accounts. Individually, MFOs are far larger than the average federation of SHGs or SHG clusters, though far smaller than the banks with whom SHGs are linked. They typically started life as non-profits, and, as they grew in size and required diversified commercial sources of funding, transformed into licensed financial entities.

In general, MFOs are considered to be the high cost providers of microcredit, a perception born out of an incomplete understanding of the true all-in costs of alternative systems such as the SHG federations. In the earlier section we calculated the all in costs of a sustainable federated SHG model to be somewhere around 36% of average total assets for a smallish system. While there is certainly room for scale economy, the costs are considerably higher than the SHG and bank expenses normally considered when making the statement that “SHGs are an inexpensive alternative.” Most commentators who hold this perception consider only the minimal cost of funds and administrative expenses of the bank linkage relationship and any other incidental costs at the SHG level. The primary cost is the cost of borrowing, which runs at a subsidized rate, usually below 12%, to the SHGs. Clients normally pay between two and five percent on loans they take from the group, so the cost to borrowers might be considerably higher.

The operating (administrative) expenses of self sustaining Grameen Bank MFOs in India run between 19% and 24% (Table 3) of average total assets, without taking into account either loan loss provision or
financial expense. In these MFOs, it looks like an annual average cost per client for the year would run at between 15 to 20 dollars.

### Table 3: Financial ratios for selected Indian MFOs, 28th April, 2005

<table>
<thead>
<tr>
<th>MFO</th>
<th>Operational SS (%)</th>
<th>Efficiency (%)</th>
<th>Cost per borrower (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SKS</td>
<td>97</td>
<td>18.7</td>
<td>17</td>
</tr>
<tr>
<td>Share</td>
<td>118</td>
<td>19.2</td>
<td>17</td>
</tr>
<tr>
<td>Grameen Koota</td>
<td>100</td>
<td>23.4</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: Mix market data, 28th April, 2005

If we do the same calculation for the SHG operational (administrative) costs per member, we see that approach yielding an annual figure of US$ 43 for the KVK system and US$ 34 for the SMPS system, after adding in all amortized and adjusted items. The results of the MFOs in India do clearly suggest that even poor clients can and will bear the costs of these support systems, especially if care and attention is given to achieving scale and efficiency. In fact, before these leading MFOs reached their current scale, they had higher costs (as a percent of assets) and charged higher rates of interest. MFOs are paying between 12% and 16% for commercial loans, on top of which they need to add their operating (administrative) costs.

SHGs have a far lower cost of funds. They can borrow at six percent, or pay their members negligible interest on their internal accounts. In the case of SHGs, the promotional costs of SHGs are largely hidden as they are frequently underwritten by NGOs, local governments, and banks as part of an effort to support the movement. As we saw earlier, these costs are substantial. Studies show that they range between 150 and 450 US dollars per group formed and an equal amount for subsequent annual maintenance. At an average loan of US$ 500 per group, these ‘hidden’ subsidies can amount to a very substantial sum that could easily be greater than a group’s first year loan.

Indian MFOs are paying the price of being a transparent system where all costs are included in their financial statements. In MFOs, these
Direct Proprietary Administration: Grameen Bank, Bangladesh, FINCA International, and Financiera Compartamos, Mexico

In its original conception, FINCA International's village banking methodology greatly resembled India's SHG model. Groups were sponsored by a donor that would provide a small grant to a group of 15 to 25 women who would then administer loans they made to each other. Over time, they would save, and gradually replace the borrowed funds with their own funds, achieving both their own capitalization, as well as a community level fund they could turn to for loans in a time of need. FINCA did not originally intend to remain permanently involved in the group, and certainly not after the group's loan had been repaid.

Over time the organization's tactics changed. They gradually moved to a model where groups never finally repaid their loans, but rather continued to borrow greater amounts which were then on-lent, meaning that in very few groups were savings ever sufficient for the entire funding base of the groups lending. In this FINCA gradually assumed increased and on-going operational role with the groups until the current village banking model was perfected. In this model, the NGO retains a permanent support role, providing the critical product standardization and norms, training, liquidity and supervision that the system requires to keep functioning.

In this, FINCA moved closer to the Grameen Bank methodology, where village level groups and clusters are administered by bank staff through a series of scripted meetings. Grameen replicators have perfected this methodology with a number of variants throughout the world. In most cases, the promoting organization retains permanent relationship with village level groups through an on-going credit relationship, in spite of the fact that the group administers the individual loans to its members. This has become the single most pervasive model of microcredit, at least in terms of the number of organizations that operate in this manner, if not in the total number of clients served. Westley estimates that 47% of 176 leading programs operating in Latin America used some variation of a village banking approach. The ratio is even higher in Asia. Collectively, the Latin American programs reach over 500,000 clients.

The costs of direct administration of village level groups is relatively high. Village banking programs are the most expensive of all microcredit approaches, although, on the whole, they reach down market the farthest. Many of these village banking programs are self–sustaining, or are charging interest rates that will put them on a pace to cover all of their costs within a few years. Many millions of clients in dozens of countries seem quite willing to pay these high rates of interest in exchange for the access to credit.

Source: Westley, 2005
considerable costs of group promotion and maintenance can be found on the income statement at the end of the year. In fact, if all subsidies were accounted for, a sustainable federated SHG model might be more expensive than the MFO model for reaching the same target group. Even non-federated SHG CLFS might be more expensive in some cases, depending on the amount of hidden subsidy in any particular case, and the level of systemic failure that will eventually result from the lack of support functions.

Indian MFOs clearly set a standard against which all other CLFS must be measured – they reach poorer clients, the best among them are sustainable, they have the potential to grow exponentially, and they are relatively transparent in their use of subsidy. Until SHG promoters can generate support and intervention functions that are self-sustaining and analyze their system with more rigor, they will always be viewed with a certain skepticism by the financial sector and the microfinance community. While the achievement to date is tremendous, the SHG model is not yet complete or mature, and is only now entering into its consolidation phase. While many in the SHG movement resist the drive to sustainability, preferring instead to see this initiative strictly as a social mobilization that serves multiple purposes, greater transparency about financial performance, the potential of SHGs to cover their all in costs, including support functions, can only assist in the debate about the wisest and most cost effective use of subsidy. It’s hard to see how greater transparency hurts anyone in the system.

3.5 Building integrated models for support and intervention

Ultimately, a definitive model for Indian microfinance has probably not yet emerged. Only now are certain large banks entering the SHG market with a more commercial focus, one that is more likely to concern itself with the long term viability and stability of the groups it finances. ICICI Bank is actively experimenting with a number of alternatives where it directly addresses the need for system maintenance. These experiments range from the direct hiring of promoters who form and maintain groups (for which the promoter collects a 6% administration fee) to lending to MFOs that in turn on-lend to their own SHGs. The bank has mobilized 13,000 Self-Help Groups with over 250,000 members.
But perhaps the most innovative approach of all is the ‘agency’ model where ICICI Bank ‘hires’ an MFO to make and service loans that then stay on the books of the bank, rather than the MFO. This allows the bank to retain control over its SHG portfolio, cover its costs, but retains the experience of the MFO that has worked so many years at the community level. The merit of this structure is that the funder receives all of the interest and free income from final clients, and is in a better position to drive efficiency and sustainability in the system by fostering a competitive environment among its agents.

**Joint Administration: The Badan Kredit Desa (BKD) System in Indonesia**

Over one hundred years ago small community level financial institutions (Badan Kredit Desas/BKDs) were established throughout Java and Sumatra. Today these are about 5,500 of these and each operates at the level of one village. In 1998, they served 800,000 clients, for an average of 168 clients per unit. Each unit had average assets of six thousand US dollars. Loans averaged 45 US dollars. The system is highly liquid, and very heavily capitalized.

In 1929 the Bank Rakyat Indonesia (BRI), a state owned commercial bank, was given authority for ‘supervising’ the operations of BKDs. To that end the BRI established a Cooperative and Village Banks Division that operates through its regular branch office network. In 1968, the government brought all of the BKD under the ‘guidance’ and ‘supervision’ of Bank Rakyat Indonesia (BRI) and the system was recapitalized again in 1970.

BRI provides an ongoing supervision through monthly and even weekly visits to each BKD. Many BKDs are only open one day a week. Supervisors oversee about twenty BKDs each. BRI supplied bookkeepers visit five branches each and provide monthly financial statements to both BRI and Bank Indonesia on the assigned BKDs. BRI sets interest rates and other operational policies as necessary for BKDs. BRI also handles the cash management function for the BKDs, in addition to being the exclusive repository for any excess liquidity present in the system. For these services the BKDs pay a supervision fee to BRI that is equivalent to about 25% of their total operating expense.

Clearly, the supervisory relationship of BRI with the BKD system has evolved over time to one of close collaboration – not all that different from the manner in which a highly decentralized branch network might develop. By taking on liquidity management, liability management, controller, bookkeeping and policy functions, BRI provides most of the key services that any head office of a large retail bank would provide. The fees charged by BRI are roughly equivalent to the type of overhead branches might expect to pay a head office for administrative support.

Source: Steinwand, 2001, Christen, Rhyn and Vogel, 1995
It keeps massive numbers of clients out of its branches (which couldn’t accommodate them anyway). Over time it ought to be able to discover the optimum level of expenditures required to maintain an SHG system.

Other banks will most likely follow suit. There is great power in the scale effect that a bank can produce on the back of its already extensive investment in branch outlets. To the extent that other, less innovative banks can find ways to take advantage of this opportunity, they might even have a comparative advantage over the current industry leader, ICICI Bank. Supporting SHGs is not particularly hard once a bank accepts the fact that it will need to charge a higher rate of interest, and sub-contract SHG promotion, maintenance and ultimately, management intervention (in those few cases where it becomes necessary). However, for this to occur, banks will need to see SHGs as a true commercial opportunity, and not just as part of a social lending program. Given India’s plethora of underused rural branch networks, once one major bank successfully takes up the challenge, this transition should happen quite quickly.

3.6 Conclusion

In microfinance we have learned that we must charge low income borrowers sufficient interest to cover our full costs if we are to have sufficient budget to maintain a quality service and high repayment rates. If we do not have sufficient budget to visit borrowers on a regular basis, their credit discipline will deteriorate over time. Ironically, it seems that we have not been able to apply that same lesson on a systemic level. We continue to generate large numbers of microcredit channels, without creating the means by which poor performers can be improved or eliminated from the system to protect its overall reputation.

Promoters of Indian SHGs must figure out a systemic approach to ensure the long term performance of the entire CLFS. If they follow the path of countless other CLFS promoters in neglecting to manage failures within the system, they will find that sooner or later, the poor performance of a few will grow to a point that degrades the reputation of the entire model. If SHG promoters do not become ruthless and insert transparency into the SHG system, they will be unable to take corrective measures before it is too late and the movement has been
hollowed out by defaults within groups, that will quickly metastasize into defaults with funding organizations.

Up to this point, the Indian SHG promoters have taken the route chosen by virtually every other CLFS promoter, that of pushing the formation of community level entities over that of creating a sustainable systemic superstructure. The system is at a crossroads, it must take the road less traveled and force the means for its long term survival into the model. If India is to continue to use this approach as the primary vehicle for promoting access to financial services, NABARD needs to take on this role as the ultimate promoter of the SHG system. There are a number of exciting experiments in which leading organizations are actively seeking to solve the systemic riddle. Promoters of CLFS must provide systemic support, and mechanisms for intervening in the management of a few failed local entities if they are to protect the excellent work of the vast majority. This will create the type of reputation that can ensure that community based initiatives eventually become an integral part of the formal financial system.

There have been cases around the world of CLFS that have successfully tackled the daunting task of building support functions. On the whole, the mechanisms they built to provide such support end up taking on the predominant role in driving the system, whether through centralized administration, or simply by force of the professional nature of the services provided to local membership based organizations. While some might see this process as one of capture of the local entities by a central force, others have chosen to see this as a process that empowers local communities by raising the level, scope, and consistency in their access to financial services. Time will tell whether SHGs represent a business opportunity – in which case they may end up with a powerful link to the financial sector, or whether they remain subsidized creatures of the state and eventually wither away; one more case of a failed CLFS.
Towards a Sustainable Microfinance Outreach in India

Endnotes

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4 SHG-Bank Linkage Programme: Future scenario

B. Pramod

4.1 Introduction

The Self-Help Groups (SHGs) of various types have been in existence in rural areas of the country as indigenous, informal organisations. NABARD launched the SHG-Bank Linkage Programme in 1992 with the aim of evolving supplementary credit strategies for meeting the credit needs of the poor by combining the flexibility, sensitivity and responsiveness of the informal credit system with the strength of technical and administrative capabilities and financial resources of the formal credit institutions. It was intended to build mutual trust and confidence between bankers and the rural poor and encourage banking activity in a segment of the population that formal financial institutions usually found difficult to cover. The SHG was defined as a homogenous group of poor people, voluntarily formed to save small amounts within their earnings and to mutually agree to contribute to a common fund which is on-lent to members for meeting their credit needs, either for consumption or income generating activities, on interest rates, maturity terms and other conditions mutually agreed upon by the group members.¹

4.2 Growth of the programme

The SHG-Bank Linkage Programme has passed through three main phases. During the pilot testing phase (1992-1995), a small number of SHGs were organised in different parts of the country to test the efficacy of the linkage concept. Following the success of the pilot phase, mainstreaming of the concept was undertaken during 1996-1998. The expansion phase, starting from 1998, has propelled the Linkage Programme to give it the shape of a microfinance movement by 2003-2004. The programme witnessed massive expansion during 2003-2004 with a growth of 41% over the previous year.
The SHG-Bank Linkage Programme covers 563 districts in all the States and Union Territories of the country. 560 banks, through over 35,000 branches, are participating in the programme. The partner banks include 48 commercial banks, 196 Regional Rural Banks (RRBs) and 316 cooperative banks. Over 3,000 Non-Government Organisations (NGOs) and other agencies are also part of the movement as Self-Help Promoting Institutions (SHPIs). The number of SHGs linked with the banks was 1,079,091 which cover 16.7 million poor families. The estimated number of poor people assisted through the Linkage Programme was 83.5 million. 90% of the SHGs comprised only women members. The cumulative bank loans provided to the SHGs amounted to Rs. 39 billion, with an average loan per group of Rs. 36,180. NABARD had provided refinance support of Rs. 21.24 billion to the participating banks. The timely repayment of the loans by the groups was over 95%. The interest rates charged by banks to the SHGs ranged from 8% to 12% per annum.

4.3 Beneficial impact

The SHG-Bank Linkage Programme has been acclaimed as the fastest growing and highly cost effective microfinance initiative in the world which has enabled millions of poor families to practice thrift and find access to the financial services offered by the formal financial system. The SHG model has been found to be quite flexible as a result of which various types of SHGs are flourishing and meeting diverse requirements of the clientele. The banking ability of the poor has been demonstrated unambiguously, while at the same time reducing the transaction costs both for the borrowers and the banks. Over 90% of the groups have been set up by women, which enables amelioration of the socio-economic conditions of their families and also brings enormous social change by empowering them. The thrift habit among the poor has been propagated as never before. The poverty alleviation process has been hastened on account of proper utilisation of the savings and loans by the group members. The loan recovery rate of over 95% showed that the SHGs could use the bank credit effectively and in a responsible manner.²

Several field studies have highlighted the beneficial impact of the SHG-Bank Linkage Programme. A NABARD supported study showed that initially 70% to 80% of poor households use credit for consumption purpose, but within two years, an increasing proportion of them use credit for non-conventional micro-enterprises.
A study conducted by MYRADA in Karnataka reveals that 45% of members had undertaken income generating activities because of bank loans. Income per member had increased substantially over a period of three years. Standard of living had improved significantly. Members had constructed and repaired houses, worked together to keep dwelling areas clean and many acquired literacy. Members could nearly eliminate dependence on money lenders. They had also created certain community assets, viz., building, bullock carts, sprayers, etc., through their savings and assistance from the SHPI. The biggest impact on the lives of the members was their social empowerment. They had acquired a level of confidence, awareness and pride in themselves. They were able to demand various types of services from external agencies. Poor households have experienced that banks were responding to their financial needs.3

Another impact evaluation study by NABARD (2001) had found that 86% of the members of the SHGs belong to the weaker sections. On account of the SHG-Bank Linkage Programme the value of the assets of the group members had increased by 59%. There was a threefold increase in the average annual savings of each member and doubling of borrowings per annum. Besides, the members had improved their communication skills, learnt handling problem situations and there was a general increase in the level of self-confidence.

The SHG-Bank Linkage Programme has helped in credit delivery even to some tenant farmers and was found to be working well even in areas affected by militancy.4

The SHG movement in the country has been found to be extraordinary in its diversity, not least in terms of the development missions with which microfinance is combined. These include poverty alleviation, livelihood promotion, developing the local economy, empowerment, building people’s organisations and changing wider systems and institutions within society.5

The SHG-Bank Linkage Programme had considerable impact on the attitudes of bankers and their business. Whereas in traditional banking, the branch manager devotes more time evaluating loan documents backing the application for loan, SHG lending requires him to attend group meetings, interact with members and then frame his opinion. These interactions have a lasting motivational impact on bank officers.
4.4 **Linkage models**

Three main models have emerged in the SHG-Bank Linkage Programme.

- **Model I – SHGs formed and financed by banks:** The banks themselves take up the work of forming and nurturing the groups. 20% of the total number of SHGs financed by banks was from this category. The number of groups developed under this category has been increasing quite fast as seen from the fact that during the year 2003-2004, they had increased by 52% over the position during the previous year.

- **Model II – SHGs formed by formal agencies (other than banks), NGOs and others, but directly financed by banks:** This model accounts for the largest proportion of the SHGs involved in the Programme. The share of this model was 72% of the total number of SHGs. The associated NGOs and formal agencies act as facilitators for organising, formulating and nurturing of the groups and train them in thrift and credit management. The banks lend directly to the SHGs.

- **Model III – SHGs financed by banks through NGOs and other agencies as financial intermediaries:** This model accounts for 8% of the total number of SHGs financed. The NGOs assume the additional role of financial intermediaries. They avail bulk loan assistance from banks and use the funds for on-lending to the SHGs. In areas where large scale lending to SHGs by banks has taken place, federations of SHGs have been coming up as a link between bank branches and member SHGs. These federations avail finance from banks for on-lending to member SHGs. Some Non-Banking Finance Companies (NBFCs) have also been coming up to take up the intermediary work.

4.5 **Participating banks**

All the three main types of banking institutions in the country, viz., commercial banks (both public sector and private sector banks), RRBs and cooperative banks have been implementing the SHG-Bank Linkage Programme.

Among the commercial banks, all the 27 public sector banks and 21 private sector banks are participating. They had together financed 50% of the SHGs participating in the SHG-Bank Linkage Programme and accounted for 58% of the total credit provided.
All the 196 RRBs participated in the programme. They had financed 38% of the total number of the SHGs participating in the programme and accounted for 33% of the total credit advanced to the groups.

The cooperative banks have entered the SHG-Bank Linkage Programme only lately and the share of the cooperative banks in the programme is 12% of the total number of SHGs with nine percent of the total credit purveyed.

4.6 Areas of concern

The SHG-Bank Linkage Programme has grown enormously during the past few years and the expansion has been phenomenal during the past three to four years. A large number of new partners have joined the movement comprising banks, NGOs, government agencies, donors and other organisations. The application of the SHG concept has been widened to cover a large variety of programmes, much beyond what had been originally conceived. In this background, several areas of concern have emerged which need to be carefully addressed. The future of the programme will very much depend on the corrective action to be taken concerning these issues.

4.7 Sustainability of SHGs

On account of the initial demonstration of the success of the SHG-Bank Linkage concept, the idea has been adopted by governmental and other organisations widely. In this process, these organisations, which were in the position of SHPIs, lost sight of several basic principles governing the SHGs. Often groups have been organised with heterogeneous membership, without paying attention to the aspect of affinity among the group members. Groups have been formed comprising members from poor and better off families with diverse occupational backgrounds. The SHPIs have not been able to give necessary attention to the groups during the formation stage, rendering them fragile and superficial without the much needed cohesion and group dynamics. The groups have little protection against hijacking or capture by vested interests. It is therefore necessary to critically examine the sustainability of large number of SHGs that have been formed, especially by agencies other than NGOs.
4.8 Weaknesses of SHPIs

In the initial phase of the SHG-Bank Linkage Programme, the NGOs were the most important SHPIs. The staff of the NGOs has the requisite skills and attitude for promoting and nurturing the groups. However, with the advent of several organisations of the formal sector like banks, government agencies, etc. as SHPIs, the expansion of SHG movement acquired great speed. These institutions of the formal sector have mostly been ill-equipped in terms of the skills as well as attitudes for implementing the programme. The key concepts of SHG and building up the groups over a period of time into strong, well-bonded units could not be accomplished by these agencies.

4.9 SHGs as vehicles of government sponsored programmes

Keeping in view the efficacy of the SHG concept for organising and assisting the rural poor, the structure of several government sponsored schemes, both centrally sponsored and state sponsored, has been modified to make the SHGs the sole or important vehicle for extending assistance to the poor. The IRDP was the first major programme which was thus modified as the Swarna Jayanthi Gram Swarozgar Yojana (SGSY). Several other schemes implemented by the state governments followed suit. The most recent change that took place is that of the Prime Minister’s Rozgar Yojana in which the concept of SHGs has been introduced.

Various elements of the government sponsored schemes have been adversely affecting the SHGs and, on account of the large reach of the government sponsored schemes, the entire SHG movement is also experiencing the negative impact. The government agencies, which implement the subsidy and credit based government sponsored programmes, are not well prepared to play the role of SHPIs. On account of the targets to be achieved in terms of promoting a given number of groups, the process of group formation gets reduced to a mechanical exercise of putting together certain number of members who qualify the ‘eligibility criteria’, so that the subsidy and loan assistance can be provided to them. Nurturing and development of the groups does not receive much attention.
It is therefore not surprising that the performance of the groups formed for the purpose of availing the benefits of SGSY and similar other government sponsored programmes have already begun to cause concern. In several states such as Assam, Bihar, Jharkhand, Madhya Pradesh, Chhattisgarh, Uttar Pradesh, Uttaranchal, Gujarat and Maharashtra, only a small percentage of SHGs formed could be credit linked. This indicates that the process of forming of the groups and their subsequent development were not good enough to sustain them and make them eligible candidates for credit linkage.  

A high recovery rate has been the hallmark of the functioning of good SHGs and it is one of the principal motivating factors for financial institutions to support the SHG-Bank Linkage Programme. The SHGs promoted by most NGOs have shown recovery rates of 95% and above. As far as the recovery rate achieved by the SHGs promoted under the SGSY is concerned, the performance has been rather discouraging. For instance, as per the data relating to RRBs and cooperative banks for 2003-2004, the recovery rate achieved by the SHGs was 75.90% while it was 35.44% for individual borrowers. The country wide recovery rate under SGSY for the year 2002-2003 was 44.98% and for the year 2003-2004 it was 46.79% for the SHGs and individual borrowers put together. Considering the fact that the share of SHGs in SGSY has increased substantially during the recent years, (e.g. from 17% in 1999-2000 to 63% in 2004-2005), the low recovery rates achieved by these SHGs is a matter of serious concern. Over a period, the overall recovery performance of the SHG segment might suffer substantial decline.

4.10 Capacity building in financial institutions

The large expansion of the SHG-Bank Linkage Programme during the last five years does not seem to have been matched by adequate capacity building measures in the financial institutions. The Advisory Committee on Flow of Credit to Agriculture and Related Activities in the Banking System (The Vyas Committee, 2004) has noted that the quality of linkage has not been up to the mark. The Vyas Committee noted delays or refusal to open savings bank accounts of the SHGs by bank branches, need for repeated visits to the bank by the groups to avail the facilities, inadequacies in amount of credit provided, delays in renewal of the lines of credit and the practice of some of the bank branches to treat the savings of the group as collateral for the credit provided to
Towards a Sustainable Microfinance Outreach in India

them. The quality of the books of accounts maintained by the SHGs was also found to be not good enough. These deficiencies do not augur well in view of the fact that the linkage model where the SHGs are formed and financed directly by the banks comprises 20% of the SHGs covered by the SHG-Bank Linkage Programme and the number of groups covered under this model has been growing very fast.

4.11 Microfinance to microenterprises

Large number of older SHGs have completed few cycles of borrowing and repayment of credit under the SHG-Bank Linkage Programme. These groups and their members have acquired adequate experience in using credit for productive purposes and several of them are poised for taking the next steps for graduating as micro-enterprises. However, in order to do so, they require the support of backward and forward linkages which are often not available. While some of the NGOs are able to create some of the linkages, many small NGOs are unable to do so. The position of the older SHGs is therefore a matter of concern.

4.12 Future agenda

The SHG-Bank Linkage Programme is poised for accelerated growth in the coming years. As per the announcement made by the Union Finance Minister, it is envisaged to bring an additional 585,000 SHGs within the ambit of the SHG-Bank Linkage Programme during the three year period 2004-2005 to 2006-2007. Commercial banks are expected to provide linkage to 60% of these groups and 40% of them will be credit linked by RRBs and cooperative banks.

The enlarged SHG-Bank Linkage Programme, if implemented effectively, will have a significant impact on amelioration of the socio-economic conditions of the rural poor. This will also give a fillip to micro-entrepreneurship and create a large pool of experienced persons for setting up micro-enterprises. However, for this to happen, the various areas of concern discussed earlier and the deficiencies noticed need to be effectively addressed. The Vyas Committee has already suggested that banks may evolve a three year action plan for scaling up the programme. Some key issues which may form part of the agenda for the future are indicated below.
4.12.1 Regional imbalances

The achievements under the SHG-Bank Linkage Programme have been uneven in different regions of the country. As at March 2004, the share of different regions in the programme was:

- Northern: 5%
- East/northeastern: 16%
- Central: 12%
- Western: 5%
- Southern: 62%

Action has already been initiated by NABARD to speed up progress in the regions which have been lagging behind.

The states which have large rural population and poor rural households are the states which need SHGs most. According to the estimates made, the states which have scope for 100,000 or more SHGs are Rajasthan, Assam, Orissa, Bihar, West Bengal, Madhya Pradesh, Uttar Pradesh and Maharastra.¹⁰

4.12.2 SHGs which are not credit linked

There are a large number of SHGs in several states which have not been credit linked even after considerable period of their existence. A systematic study of such SHGs may be taken up by the concerned service area banks with a view to bringing required improvements in the groups for preparing them for credit linkage.

4.12.3 Institutionalising the SHG-Bank Linkage Programme in banks

The banks have to take several steps to institutionalise the SHG-Bank Linkage Programme on more systematic lines in view of their increasing involvement in the programme. Since banks are the major partners in the Linkage Programme, and they will be impacted by the deficiencies acutely, it is imperative that the banking system takes requisite measures to correct various deficiencies as recommended by the Vyas Committee. Banks may adopt strategies for sensitising and training their staff, facilitating promotion and nurturing of SHGs through networking with NGOs and other SHG promoters. Banks may set up adequately staffed microfinance cells at their central offices and at the state level.
4.12.4 Cooperative banks

It has been suggested that the cooperative banks, whose share in the programme at present is small, should take requisite steps to expand their involvement. While cooperative banks are encouraged to participate in the Linkage Programme, care should be taken to see that only banks with sound financials and appropriate staffing arrangements enter into this line of business. The chances of success will have to be carefully assessed before increasing participation in the programme.

4.12.5 SHGs under government sponsored schemes

Sample studies may be undertaken in each state to make a critical evaluation of the SHGs formed for implementing subsidy linked government sponsored schemes. Apart from SGSY, other major schemes which are using SHGs as vehicles may be covered by such studies. The studies should enable identification of the major deficiencies and lead to specific corrective action on the part of the important stakeholders. The banking system should be closely involved in conducting these studies and follow up the action to be taken to bring about the improvements.

4.12.6 Design of SGSY

The Vyas Committee has recommended that there is a need to look again into the design of SGSY programme, especially with regard to moderating the timing and quantum of subsidies. The Vyas Committee has also recommended an in-depth study to be taken up to ensure that group dynamics issues are properly factored into the programme design.

4.12.7 Capacity building of partners

The capacity building of partners is the most important and onerous task in the SHG-Bank Linkage Programme. Especially during the last several years when large a number of new partners have come into the picture, the inadequacy of the capacity building measures is being felt. As a result, formation and nurturing of groups could not be attended as required. The details of a high quality, large scale capacity building programme have to be worked out, involving as many competent agencies as possible, to cover all areas where the SHG-Bank Linkage
Programme has already taken root. Capacity building at various levels in the government agencies and banks is particularly an urgent requirement.

4.12.8 District level planning

Planning for the SHG-Bank Linkage Programme has to be done in a highly focused manner at the district level. The lead bank and the District Development Manager (DDM) of NABARD should jointly prepare detailed plans in co-ordination with the District Rural Development Authority (DRDA), other government agencies and NGOs for refining and strengthening the SHG-Bank Linkage Programme by taking appropriate measures. They should be involved in the evaluation studies to be conducted and take requisite follow up action. The District Consultancy Committee (DCC) forum should be utilised for discussing all aspects of the programme to ensure healthy growth.

4.12.9 Role of State Level Bankers Committee (SLBC)

The State Level Bankers Committee (SLBC) should review the progress achieved under the Linkage Programme on a regular quarterly basis with special reference to the steps taken for streamlining the programme by bringing about required improvement of critical issues like geographical distribution, the efficacy of the role of different organisations functioning as SHPIs, improvement in the quality of SHGs implementing the government sponsored schemes, etc.

4.12.10 Microfinance to micro-enterprises

As observed by the Vyas Committee a number of successful SHGs have mobilised sizeable funds through savings of members and interest collected, besides bank loans. They need escort/hand holding services to take up higher level micro-enterprises. All developmental agencies need to assist these SHGs by providing necessary skills, market linkages, technological support, etc.

4.12.11 Product innovations

With the large scale expansion of the SHG-Bank Linkage Programme, the needs of SHGs in different regions for various types of products are emerging. The banking system so far has worked with a few
standard types of products and there has not been much innovation in this regard. The banks may therefore move ahead with designing appropriate products to suit the needs of the clients. Arrangements may also be made for sharing information about such innovations among the banks.

4.12.12 Federations of SHGs

Two main types of federations of SHGs have been promoted by NGOs:

- Federations which provide umbrella support to member SHGs including book writing/audit services, conflict management, monitoring and cross learning, engaging paid employees, value added services such as insurance, supplementary education, health care, etc.; and

- federations which undertake resource balancing among SHGs and also involve in financial intermediation.

The Vyas Committee has felt that the non-financial intermediary type federations may be encouraged to provide support to member SHGs. It was felt that more experimentation of the financial intermediary type federations is needed to determine their cost and financial effectiveness.

4.13 Policy framework

The Reserve Bank of India (RBI) had set out the policy on microcredit commencing from February 2000 to facilitate mainstreaming of the SHG-Bank Linkage Programme in the banking system. Microfinance has been made a separate segment under the priority sector advances of the banks, and banks have also been advised to include financing SHGs as part of the branch level credit planning under the service area approach. However, banks and SHGs may enter into linkage based on mutual consent without being constrained by the service area restrictions.

The policy provides for flexible lending norms which can be decided by the banks depending on the requirements. Banks have the freedom to choose any model of SHG linkage or formulate new models of linkage. The policy desires to afford maximum flexibility to the banks to give shape to the microcredit programme taking into consideration the local
factors and the convenience of the clientele. The RBI has advised banks to provide adequate incentive to the branches to motivate them to finance the SHGs. The procedures shall be made simple and easy and due importance shall be given to train the field functionaries for participating effectively in the SHG-Bank Linkage Programme. It has been suggested that the group dynamics of working of SHGs may be left to themselves and need neither be regulated nor formal structures be imposed for this purpose.

The policy framework enunciated by RBI gives complete flexibility and provides opportunity to the banks to innovate in all aspects of microcredit. It is for the banks to make the best use of the framework by studying the experiences in different areas and ascertaining the emerging needs and problems, and finding innovative solutions to strengthen the microfinance system.

4.14 Role of NABARD

NABARD has played a vital role in conceptualising the SHG-Bank Linkage Programme and spearheading its dissemination throughout the country. A series of initiatives have been taken to formulate capacity building inputs and to share them with a wide range of partners. Refinance support has been provided to such of the banks who needed it at very attractive concessional terms. NABARD has also played a very prominent role in training bankers, government officials, NGOs and other partners in the concept and operational details of the SHG-Bank Linkage Programme. Exposure visits within the country and abroad have been organised for key personnel in the partner organisations. Newsletters on microfinance and other informative literature has been produced and widely circulated.

Undoubtedly, NABARD has played a most important role in shaping the SHG-Bank Linkage Programme to assume the proportions of a movement. After the phase of phenomenal expansion of the programme during the past five years, there is need to consolidate the gains so that incipient problems are carefully analysed and addressed. The role of NABARD may therefore be reviewed in this background so as to focus attention on important areas of concern.
Endnotes


5 Sustainability of Self-Help Affinity Groups or SAGs as understood by MYRADA

Aloysius Prakash Fernandez

5.1 Sustainability – how MYRADA interprets it

Sustainability is one of those words that are subject to various interpretations depending on the agenda of the interpreter or the ideological lens that he/she uses during interpretation. Other similar words open to various interpretations are ‘participation’ in the development field and ‘god’ in the religion. Therefore, let me begin by defining what sustainability means in the context of SAGs through the lens that MYRADA has viewed it all these years – in fact since 1985-1986 when the SAG movement began to take shape within MYRADA’s projects.

MYRADA has always focused on the sustainability of impact on individual members of SAGs as the goal of its intervention, and not on the sustainability of the SAG itself. The Rural Management Paper (RMS Series, authored by several colleagues in MYRADA), dealing with SAGs that appeared periodically throughout the late 80s and early 90s have repeatedly stated that SAGs are not the final answer that will continue forever. Hence the sustainability of SAGs in this sense was never an issue or a goal. On the contrary, SAGs were expected to fulfil current needs of members and thereafter, either remain and evolve to meet emerging requirements under changing circumstances or dissolve amicably (and professionally), having served a purpose.

With close to two decades of SAG experience behind us, it seems like a good time to look around and see what has actually happened to the SAGs that had been formed by us ‘a long time ago’.

Sustainability of SAG for MYRADA has been viewed with reference to its performance, more specifically with reference to its ability to function effectively for about six to eight years. The period of six to eight years is
not an arbitrary choice but roughly the time required for capacity building and empowerment processes to be personally experienced by each member (who started out by being identified by the village as ‘poor’) through challenges faced in their lives, and for each member to go through at least five to six loan cycles with incremental loan sizes.

By ‘effective functioning’ we mean that the SAG demonstrates all the characteristics of a well-managed institution that is transparent, democratic and professional in its functioning. Such an SAG not only helps each member to get a secure footing on the path to livelihood development and economic growth, it also builds confidence in each member to accept and face the many challenges of life without giving in to feelings of vulnerability and stress. Its institutional strengths forge relationships of trust and mutual support between members that are sustained for as long as they feel the need to hold together as a group.

Functioning effectively therefore implies:

- That the SAG is able to help each member to take the first concrete step at least towards building a sustainable livelihood base;
- that its institutional strengths enable it to function and build stronger relations of trust, mutual support and commitment to a common good among its members, and to acquire greater skills in order to support new and more complex functions in response to emerging needs and priorities of the members during these eight years.

In this process, it may also happen that the SAG feels the need to re-engineer itself to meet new and emerging needs of members, and to become a part of networks or apex institutions that have a much broader role than one of financial intermediation. Experience in MYRADA has shown that these developments have taken place usually after six to eight years of effective functioning. We therefore added on two more features to our understanding of what ‘functioning effectively’ means:

- The SAG is able to re-engineer itself in a professional and businesslike manner; our experience with SAGs is that in several cases they undertake this re-engineering if they decide to take on new roles and if they decide to divide the common fund and start again, as many have done; and
• its ability to set up and support (organisationally and financially) new apex institutions which provide services that the members of the SAG require to meet their emerging needs after the supporting NGO withdraws or winds down its programme in the area. Incidentally, the SAGs that have decided to form these apex institutions in areas from where MYRADA has scaled down its programme have given them a much broader role than one of financial intermediation.

This paper deals with the topic within this framework. ‘Sustainability’ of SAGs is variously interpreted by others; sometimes it refers to the formation of the SAGs – whether the formation itself is a sustainable activity'; at other times it refers to the life of the SAGs. The word sustainability figures in the dictionary only as a derivative of the adjective ‘sustainable’. The meaning in this context is closer to the Latin root or origin, namely – ‘sub’ (from below) ‘tenere’ (hold) – which reflects the role played by the SAG – it is an institution (constructed on a network of relationships which build affinity among members) which supports the members from below; they have created these relationships before the intervention of an outsider – an NGO – which can help to build or strengthen these relationships so that the members can decide what roles or functions to adopt, what linkages to establish, what skills to acquire, what institutions to support, whether and when to re-engineer themselves and when to dissolve.

Before proceeding further with an analysis of ‘sustainability’ of SAGs, it may be useful to describe what MYRADA understands by an SAG; this is important since over the past five years the name Self-Help Groups has been given to all kinds of groups; even worse, in most states, groups were formed in a hurry to achieve targets, membership was based on externally set criteria for membership, not on affinity; further hardly any investment has been made in the institutional capacity building of the group. Instead, allocations for training groups have been spent on organising large gatherings, promoting political rallies and at most in conducting one day sessions for leaders of SHGs to introduce them to the ‘scheme’ or a ‘project’.

To a large extent the SHG movement has been taken over by official government agencies which have little experience in and less time to invest in building institutions. Government views all groups as extensions of their delivery system to carry out a programme, and not as people’s institutions in their own right – the only exception was the
RBI and NABARD’s recognition of SHGs as independent institutions in the context of finance management. It is precisely because of this recognition that the Self-Help Group movement – largely devoted only to the microfinance management component – has spread throughout the country.

5.2 What does MYRADA understand by Self-Help Affinity Groups?

The history of how they emerged may shed some light on MYRADA’s interpretation. Between 1983 and 1985 several of the cooperative societies\(^2\) started by MYRADA with over 100 members broke up because of lack of confidence in the leadership and poor management. Members met MYRADA staff in small groups; they expressed their willingness to repay their loans to MYRADA, but not to the cooperative society, which was a large and heterogeneous group and dominated by one or two individuals. We informed them that they had not taken the loans from MYRADA; hence the issue of repayment to MYRADA did not arise. We asked: “Why not repay to the small group of people assembled here?” They agreed. The large cooperative broke down into several small groups and the group members repaid their loans to whichever group they chose to join. Thus was born the first set of ‘Self-Help Affinity Groups’.\(^3\)

On analysis, MYRADA realised that there was a strong feeling of ‘affinity’ which linked the members of each of these small groups together. This affinity was based mainly on relationships of trust, relations that were non-exploitative, on certain social features (like a degree of homogeneity among the members, of voluntarism and self reliance and willingness to support one another in need), on certain structural features like a common origin (blood or ancestral village) or the same livelihood base (all daily wage earners, landless or marginal farmers, even though from different castes, religions or communities), on gender bonds (all women, or all men, though about 5% of the groups were mixed). In a few cases they were based on similar activities undertaken by each member (like basket weavers – though caste also had a role to play here; besides a large group of households undertaking a similar activity often decided to break up into smaller groups of 10 to 15 on the basis of affinity). Interestingly no groups were formed on the basis of political party affiliations. Briefly, the affinity groups were unpolished diamonds hidden under stones, some of which
we ourselves had placed; we just happened to kick these stones aside by accident. All that we can be credited for is that we stopped to look, to learn, to identify people’s strengths or the potential of the diamond and then to build on them.

**Origin of Self-Help Affinity Groups**

When these affinity based groups emerged in MYRADA in 1984, they were called Credit Management Groups. The focus was on management of savings and credit rather than on the provision of credit. When MYRADA entered into a contract with NABARD in 1986-1987 to take up a pilot project to promote these groups, the name was changed to Self-Help Groups. Several studies were carried out between 1988 and 1990 to assess whether the SHGs really offered a sound alternate credit strategy which could be accepted by official institutions. This was accepted in 1990 by the Reserve Bank and NABARD launched the Bank Linkage Scheme in 1992 whereby the banks extended loans directly to groups – not to individuals in groups – without asking for the purpose of the loan to the individual member in advance. In the late 1990s the SHG strategy was accepted by the Government of India as a major programme to mitigate poverty. Funds were allocated in the Budget, targets were set and groups promoted by Government all over the country often without adequate capacity building. It was then that MYRADA changed the name to Self-Help Affinity Groups or SAGs. In this paper, these groups will be referred to as SAGs instead of SHGs. This distinction will help to focus on the affinity required to bind the members as well as to distinguish between genuine Self-Help Groups and those groups that were formed under pressure to achieve targets, which were given grants a few days after formation with little or no investment in institutional capacity building and whose membership is based on external criteria rather than on affinity.

It is important to note that the affinity relationships existed before the intervention of an outside agent like MYRADA. They were adequate to support traditional actions like mutual help in times of sickness or childcare. We often referred to this complex of relationships as ‘traditional social capital’. Our strategy is built on these strengths. However, with new functions emerging in the Self-Help Affinity Groups, this traditional capital had to be built up to cope with the demands of effective financial and organisational management, as well as with the social role that the groups had begun to play. For example, to initiate change in society and in the home, to protect and further their interests, as well as to establish linkages with supporting services and institutions. MYRADA does not take the position that ‘traditional social capital’ in every situation is static and presents an obstacle to change.
Rather, given adequate institutional and social space in small affinity groups and with adequate capacity building support to develop organisational skills, traditional social capital has the potential to provide a base on which institutions can build ‘social capital’ that is adequate to cope with new roles. These institutions can also be empowering, provided the structure and the rules, functions and the supporting systems are designed by the people.

Identifying affinity groups is only the first step. More important is the investment required to build the institutional capacity of these groups. This is where most of the Government sponsored groups fail, as Government departments do not realise the importance of building people’s institutions. They either assume that they exist or that their function is to implement Government programmes. In several cases only the leaders of the groups are trained, thus increasing the gap between them and the others. The capacity building modules which MYRADA offers to all the members of each SAG over a period of 12 to 16 months include:

1. A structural analysis of society
2. Analysis of local credit sources
3. Self-Help Affinity Group – a concept
4. How a meeting of the community based organisation is conducted
5. Communication
6. Affinity
7. Vision building
8. Organisational goals
9. Planning, resource mobilisation, implementation, monitoring & evaluation (PRIME)
10. Rules and regulations
11. Responsibilities of group members
12. Bookkeeping and auditing
13. Leadership
14. Conflict resolution
15. Collective decision making
16. Common fund management
17. Self-assessment
18. Group graduation
19. Linkages with other institutions
20. Building credit linkages
21. Federations
22. Credit Plus
23. Analysing gender relations in the family and community.

These modules have been published in a training manual entitled “The MYRADA Experience: A Manual for Capacity Building of Self-Help Affinity Groups” which has been translated into several languages.
The relationships that members of a group establish among themselves are motivated not only by material gain – which the word ‘capital’ popularly implies. These relationships are motivated by a mix of social and material needs. Based on existing evidence, it is even fair to say that in an affinity group, which has been fostered along the lines advocated by MYRADA, the motivation of the members in the initial stage is equally divided between the perceived fulfilment of social needs and the expectation of material gain. In the case of women’s Self-Help Groups, social needs, however, often tend to get priority. Women need space in our traditional rural societies to meet freely, to share concerns, to express a sense of togetherness and fellowship. Women in particular, need a place to call their own, as they are unable to meet (like men) at the village corner or around a shop. As spots that traditionally provided women with a level of security and privacy have become scarce – like water points some distance from the village – the privacy and security of an affinity group meeting is a godsend. This is why women’s affinity groups take a strong stand against men trying to interrupt their meetings.

It is interesting to note that when other villagers are asked to express their opinion of a women’s Self-Help Group, their assessments focus more on the social habits developed by the members, rather than on their material progress. The most appreciated qualities of the groups include their regular meetings, the ability of members to manage their affairs in an organised and transparent manner, to take collective decisions, to impose and accept sanctions for dysfunctional behaviour and to take the lead in improving their surroundings. These are the features that others appreciate, far more than their capital (which they build up by savings which are deposited in the groups’ common fund) or material progress. These are also indicators of a well functioning institution with a high quality of governance.

This approach also flows from MYRADA’s vision and the strategy for empowerment that it endeavours to promote. It builds on people’s strengths, not on their needs. What are their strengths? Examples are: relationships of affinity, willingness to make sacrificial savings once they are confident that the savings are safe and can be easily accessed for their priorities. MYRADA does not consider quick increases in household income as the primary objective of its microfinance (savings and credit) strategy. It has other and equally important objectives, namely empowerment of the members both as a group and as individuals.
MYRADA’s strategy is to use finance management as an instrument of institution building, which in turn lays the basis for empowerment. The pace and progress of the empowerment of individuals however differs from member to member. In some cases individual members leave the group after four to five years. They are able to hold their own in society, have confidence to forge and maintain linkages with other institutions and service providers and relate directly for larger loans with the bank, which had previously extended a line of credit to the group to which the member belonged. In other cases, they are accepted by traditional ‘chit fund’ groups which save and lend to the highest bidder with the organiser enjoying certain privileges. These members report that they themselves did not have the confidence to join these traditional groups (or for that matter to approach the banks), prior to their membership and experience in the affinity group which gave them an opportunity to increase their incomes and a degree of credibility.

While MYRADA realises that for practical reasons, groups will continue to be formed within the context of a ‘project’, yet, to reduce the negative impact on institutional building that this project context imposes, it is important to ensure the following:

- Groups need to be formed on the basis of affinity, not on the criteria for beneficiary selection. This requires a change in the traditional approach to costing of the community organisation component which is guided by the number of beneficiaries.
- At least six to eight months must be devoted to institutional capacity building before the group is asked to prepare plans for investment in infrastructure or to apply for grants for individual assets.
- During this period a significant investment in capacity building is required. This should focus on helping the group to build a vision and a strategy which is not limited by the ‘project’ on hand, but by what the group envisages in the long term.
- If the project envisages provision of credit, the group should be assessed on the basis of its institutional strengths (not on the viability of each individual loan) and a line of credit provided to the group, leaving the group to decide on the purpose of each loan, on the interest rates, repayment schedules, and on sanctions where members fail to conform to agreed schedules or accepted norms of social behaviour.
In this scenario, an SAG is deemed to be ‘sustainable’ if it functions well enough to achieve the goal of a member’s self-development. Even more precisely if it succeeds in achieving the goal of each member’s self-development, no one in the SAG could be left out. Sustainability, therefore, was not understood in the sense that the SAG would live forever. In fact if it lived forever and continued to perform the same functions, it would indicate that it was not really sustainable, in the sense that it did not have the inner institutional strength to morph into new institutions or group into new federations and undertake new roles and functions to respond to the changing needs of the members. Living forever could also imply that it was dominated by one or two members whose interests were protected by prolonging the life of the SAG.

5.3 Our understanding of the features of an SAG which is functioning effectively

The features of effective functioning include the following:

The SAG has functioned effectively for six to eight years. Confidence to take decisions that each individual has not been accustomed to is not built in a flash of revelation. It takes time and more importantly the variations of experience. The period of six to eight years is not an arbitrary choice but roughly the time required for capacity building and empowerment processes to be personally experienced by each member (who started out by being identified by the village as ‘poor’) through challenges faced in their lives personally, at home and in society, and for each member to go through at least five to six loan
cycles with incremental loan sizes. Part of the monitoring system set up within MYRADA is to train SAG members to assess themselves. During the first two years, this assessment is done in a participatory manner with staff from MYRADA assisting the SAG and often with experienced members of older SAGs also participating.

The criteria for assessment includes social indicators (like changes in gender relations at home and in society, issues related to effective participation of all members in decision making, change in SAG representatives/leaders) as well as financial indicators related to access to loans (whether all had accessed loans and maintained the discipline of repayments as decided by the group, or were there significant biases that were not addressed), changes in the purposes and size of loans (for example if the loans for consumption which were larger in number during the first year or two decreased after that) are other criteria. MYRADA focuses not only on the provision of credit but more on the management of credit and the ability to change social relations and establish new linkages. Studies indicate that it is the experience gained in managing credit and in influencing the supporting environment that empowers – not just the provision of credit. Gathering this experience and profiting from it, therefore takes time. MYRADA believes that given the social, political and economic hurdles that the poor have to negotiate, it is not enough to teach people to fish when individually they cannot reach the river. Sustained group action, particularly by the SAGs has helped to overcome most of these hurdles.

The SAGs have been able to help each member to take at least the first step towards establishing a sustainable livelihood base. Basically this means that the members have borrowed for income generating projects, not once but many times. The loans may be small, but several have been taken over a period of six to eight years. This feature needs to be stressed, because one regularly finds comments (often disparaging) in well-authored papers that the SAGs only “smoothen consumption needs”. This is not a true picture. I just picked up data from one MYRADA project which is in a drought prone area. The data covers 1,815 SAGs (total common fund is Rs. 174 million of which Rs. 73 million is savings and Rs. 53 million is interest earned on loans). The data indicates that the total number of loans given is Rs. 147,128 of which 36,222 were for agriculture, 56 for agricultural equipment, 438 for irrigation, 1,256 for land development, 25 for bullocks, 13,290 for cow/buffalo, 73 for poultry, 22 for piggery, 1,204 for sheep, 566 for cottage
industries, 4,224 for petty business and trading, 210 for sericulture and 6,290 to repay loans taken from money lenders at high interest rates.

The largest average was Rs. 18,252 for equipment, Rs. 12,021 for poultry, Rs. 7,310 for petty business/trading and Rs. 6,617 for cottage industries. I agree that these were not large loans, but are comparable (and even greater) to the average size of loans provided by MFIs. Further, the same members took several such small loans over six to eight years. To say that SAGs only provide loans for consumption smoothening is therefore not quite correct. What is even more intriguing is that several highly paid livelihood consultants who made field studies of what livelihoods projects should promote come up with a similar, though less exhaustive list than the purposes of loans taken by SAG members.

However, there is no doubt that after this first step there is need to support the other steps towards larger enterprises that the members may opt to take. If the loans in the SAGs were for income generating purposes, the larger investment required could be termed micro-enterprises (agriculture based as well as on farm and off farm). These micro-enterprises would require not only larger loans ranging above Rs. 50,000, but they would also require roads, power, water, transport and information systems. This is where we have major blocks. To given one example. Two members of an SAG recently asked for a loan of Rs. 25,000 to start a small flour grinding business. The SAG sanctioned this loan. A month later they returned it to the SAG because they had to pay a bribe of Rs. 10,000 to get an electric connection. How can micro-enterprises succeed in a scenario of shortages of essential inputs like electricity, water, and adequate infrastructure and transport?

You cannot eradicate poverty without power (not just political power – which perhaps plays a disproportionate role in our affairs) to add value to products. For the poor to climb out of poverty and stay there, therefore, requires not only easy and quick access to resources but also adequate infrastructure, power, water and information. Adequate investment in these sectors is a matter of Government policies and priorities. The present level of investment in infrastructure is far from adequate. China for example invests over US$ 30 billion annually, while India invests US$ 2 billion only. As for power, 60% of the manufacturing units in India need to have captive power generating units. Let us not compare it with China (16%). Perhaps comparison with Pakistan will be more effective – it is 42% there.
Given these shortages, it is difficult for an NGO to support the poor to take the next step from income generating investments using loans from SAGs to take up micro-enterprises. On-farm micro-enterprises related to agricultural product processing requires electricity on demand. The popular trend to invest in animal husbandry for milk often fails to take into account the shortage of fodder and water throughout the year. Non-farm enterprises enter a domain where NGOs are not comfortable and find it difficult to compete with the private sector, both with regard to design and marketing. Therefore MYRADA decided to tie up years ago with the private sector.

Of all our initiatives the one that has stood out is the collaboration with Titan Watches which outsourced the assembly/polishing of watchstraps, assembly to clocks and of gold jewellery. MYRADA did not take up the contract but invested in organising and training people selected by the SAGs. MYRADA also helped these people to form their own company and supported it with one experienced staff. Titan provided the training, design and marketing. MYRADA’s total investment was around Rs. 1.2 million. Today eight years later over 220 women own and run their company (MEADOW – Management of Enterprises and Development of Women), pay for the staff and have an annual turnover of over Rs. 10 million.

5.4 MYRADA’s overall strategy for progressing from income generating activities towards micro-enterprises

This strategy has the following components:

- **Provision of larger loans**: Our experience indicates that banks hesitated to give loans larger than Rs. 25,000. Then Sanghamithra, the MFI promoted by MYRADA started lending Rs. 100,000 to SAGs. Banks then raised their limit to Rs. 50,000. Sanghamithra is today lending over Rs. 300,000 to SAG. The banks’ loans however have hovered around Rs. 100,000 except under programmes like the SGSY where they have been compelled to lend more.

- **Analysis of the purposes of loans taken by SAG members**: The software developed by MYRADA helps us to identify patterns in the purposes of loans. The assumptions are that since the SAG member is not under any pressure to conform to predetermined loan purposes
he/she is able to clearly state the purpose of the loan required without trying to make it fit to what is considered acceptable. Further, we know that the SAG checks whether the loan was used for the purpose mentioned at the meeting in order to establish the members credibility. If certain patterns emerge, our assumption is that there must be some comparative advantage.

We do not find that loans for similar purposes are taken by all the SAG members – a strategy which many Government programmes foster – but we do find that one or two members from several SAGs in a particular area take loans for similar purposes. For example we find that two or three members from each SAG in a particular area take loans for buying and selling hides or for small poultry units.

- **Common training:** MYRADA brings these members together and trains them. In the case of those buying and selling hides, training was given to do tanning. In the case of poultry, training focused on larger units and better management. These members return to their SAGs and borrow from there if they intend to invest further. MYRADA also suggests that these members (not SAGs) can come together to purchase inputs or do marketing in bulk. However, the biggest stumbling block here to increase the portfolio of enterprises is the lack of cold storages, hygienic handling, power, water and transport. Information is not a problem any longer as cell phones and telephones are available.

- **Participation:** MYRADA also encourages the SAG members to stand for elections to the PRIs so that priority can be given to investment at least in village roads and to lobby so that better management systems related to power and water can be introduced.

### 5.5 The SAG’s ability to re-engineer in a professional and business like manner to cope with emerging needs and pressures

After six to eight years MYRADA scales down its programme in the project area and withdraws entirely after a further two to three years. There are however exceptions as regards this duration due to the requirements of some donors. During the scaling down period, the SAGs find themselves in a new situation since MYRADA cannot support them financially and otherwise as before. MYRADA informs the people
that it will withdraw after a period, but people tend to forget and to take it for granted that it will continue. Several meetings between the SAGs and MYRADA were held to evolve a strategy to cope with the emerging situation.

Briefly the following emerged:

• The SAGs wanted some kind of MYRADA presence in the area. Agreement was reached to retain a senior staff who had experience in the area and in whom the people had confidence.

• The SAGs came up with a whole list of emerging support services which they require. Agreement was reached that they would have to pay for these services.

• MYRADA suggested that the SAGs would have to decide on a new management structure over which they had full control.

• Some SAGs expressed the need to restructure their membership as well as their common fund. Agreement was reached that they would decide on a case by case basis and if they required outside help to facilitate the process, it would be provided.

Several studies are in progress launched by MYRADA as well as by the Microfinance Group set up in the IIM Bangalore in collaboration with MYRADA. These studies focus on the SAGs which have decided to re-engineer themselves. These studies have not been completed as yet. But one rapid study from MYRADA’s Holalkere project has come, which provides some insights into this feature which can be presented here.

The study conducted covered 35 groups which had ‘re-engineered’ themselves. Of these 35 groups, (i) six groups decided to share their income which comprised membership fees, fines, interest or service charges, bank interest earned, donations and income earned from a few group activities and from visitors who came to study their functioning. All these groups started anew with all the members. The reasons for their decision will be discussed below. (ii) A further three groups decided to disband and share their income. They started again but a few members decided not to join. (iii) A further 20 groups decided to divide only the interest earned and the income from group income generating activities, but they did not distribute their savings. All the members continued in the SAG. (iv) Finally, six groups disbanded and reorganised as Stree Shakti groups. These were new groups (less than
one and a half years old). The Stree Shakti programme is a specific Government sponsored programme where each group receives a grant of Rs. 5,000. This was the major motivating factor.

Apart from the groups which joined the Stree Shakti programme, the other groups debated their decision over several meetings. They agreed on what to divide, whether to continue functioning and gave the option to all members to continue or to leave. None of them took these decisions because of internal conflict which could not be resolved.

The reason for their decisions were the following:

• With reference to some of the SAGs in groups (i) and (iii) some of the groups were concerned that members may not be able to repay large loans. Hence these groups limited the amount to a maximum of Rs. 10,000. This resulted in accumulation of lot of money in the common fund. As the bank interest is also low, the group decided to share a portion of the common fund.

• Other SAGs of these two categories (i) and (iii) did not impose a limit to the loan amount to each member. Each of the members was given loans as per her necessity. In many cases Rs. 50,000 had been given to the member who was regular and whose repayment was good. Yet the group had a lot of money accumulated in the common fund, hence they decided to share a portion of the amount mainly for the following reasons:
  – Knowing that the group has a lot of money, many people from outside the group asked for donations, so it was felt by the group that if it continues accumulating money these requests will increase, hence they decided to distribute part of their common fund and restart.
  – Seeing large sums of money, husbands used to come and demand for more loans and money.
  – Members feel that the group is earning because of their investment and hence they should get a return for their investment, hence a portion of the group's own fund was distributed.
  – Whatever some of the groups earned through ‘group income generation programmes’ was invested in the common fund. After a period of five years they thought they should take a share from this amount.
• With reference to the three SAGs in group (ii), some of the members wanted to quit. They felt that they could manage without the support of the group. Hence, it was decided to disband the group sharing the entire group’s own fund.

In general however, it was clear that except for the young SAGs which decided to join the Stree Shakti programme in order to receive the grant of Rs. 5,000, all the other groups took decisions that were discussed and accepted by all. The result was that each member benefited from lump sums and the SAGs continued to function in many cases even more effectively than before, having gained from the experience of re-engineering in a professional manner.

5.6 The SAG’s ability to set up new apex institutions to cope with emerging needs and pressures

MYRADA’s experience indicates that when MYRADA withdraws its other programmes from an area where it has worked for five to eight years, many SAGs continue to require services and support to meet emerging needs. In most project areas, while MYRADA’s programmes were in full flow, SAGs had formed federations. The number of SAGs in one federation differed as the organisers left the choice to join or not to each SAG. The federations met regularly, usually monthly. Their structure and functions were decided by the SAGs. It was significant that none of the 200 plus federations were given the function of managing finance. This was kept by each SAG. The federations were asked by the SAGs to organise rallies and common action whenever required to lobby for peoples rights and needs. They were also asked to sort out issues which arose locally or to resolve them when they arose within the SAG. Each SAG contributed small amounts for the federation to function.

However, the federations did not have permanent staff or offices which provided an adequate base. They could not afford to maintain executive staff on a regular basis. Once MYRADA left the area or scaled down its services and staff, the federations found it difficult to employ regular staff since the SAGs refused to contribute adequate funds. Generally, MYRADA felt that the SAGs are nervous that the federations, once they acquired funds, could easily be taken over by local politicians (once MYRADA withdrew) to further their own interests and agendas; and hence hesitated from giving them funds.
The SAGs wanted MYRADA to maintain some presence in the area – like keeping the sector officer who had worked in the area and had gained the confidence of the people – after the programmes were scaled down. MYRADA on its part was willing to do so, but told the SAGs clearly that it had no funds to pay for the staff and services since the programmes were scaled down. Furthermore there had been adequate NGO investment in the area and if the SAGs claimed that they were functioning effectively they should be able to progress after MYRADA had supported them to take the first step. Further, most private donor NGOs had decided to move to the northern states and therefore the chances of raising further funds were limited. If they required further support and services, they would have to pay for them, including the salary of the MYRADA staff.

What emerged from this situation were the ‘Community Managed Resource Centres’ (CMRCs) which serve about 100 to 120 SAGs. These CMRCs are managed by a management committee composed of elected representatives from the SAGs and are supported by one experienced MYRADA staff and several community resource persons selected by the SAGs. The SAG members (and even others) pay for all the services that the CMRCs extend to them. In this context, MYRADA believes that if the SAGs are to be sustainable and if they require these services, then the costs of maintaining the entire CMRC (including the salary of the MYRADA staff) have to be met by the CMRCs. Within three years, 59 CMRCs have emerged in MYRADA’s projects. Of these, already 15 are meeting their running/maintenance costs.

The following have been identified by evaluators as the core features of these CMRCs. The CMRCs decided on their governance structure, rules and functions. Local Governments and Panchayats have donated land and buildings in many cases to establish the Community Managed Resource Centre offices.

- Only institutions (community based organisations) are eligible for membership, not individuals. The majority of the CBOs who have opted for membership are the SAGs; but there are also watershed management associations.

- Membership in the CMRC depends on the quality of the CBO which is assessed by the CMRC in a participatory manner. The CBOs are assessed annually. If they fail to reach the standards required, they
lose membership of the CMRC. Even if the CBO exists in the ‘service area’ of the CMRC and even if it is a MYRADA sponsored CBO, it does not become eligible automatically for membership. Interested NGOs in the area are approached to retrain such CBOs in order to bring them up to standard.

- Each member CBO pays a monthly membership fee to the CMRC which entitles it to certain services decided by the RC management committee. Most CMRCs have started with a figure of Rs. 50 per month per CBO. This figure is emerging as the standard norm and it entitles the CBO to certain services which are mutually agreed upon.

- All other services are paid for on ad hoc basis.

- The CMRC is managed by a management committee elected from the CBOs annually. The management committee meets monthly. Annual general body meetings are held and printed annual reports and audited accounts are circulated.

- One CMRC serves around 100 to 120 CBOs. If more CBOs emerge another RC is formed to support them. The number of CBOs served depends on the distance. However CMRCs with less than 100 CBOs find it difficult to meet all costs at present. It costs around Rs. 18,000 to Rs. 20,000 per month to run a CMRC including the MYRADA staff’s salary. CMRCs have to be supported financially till they become sustainable, which takes about three years. In more remote areas it could take longer.

- The CMRC manager must be competent, committed and with entrepreneurial skills who is trusted by the people. He/she reports to the RC management committee. The CMRC manager is an experienced staff of MYRADA who played a key role in promoting and training the CBOs and has good relationships with the CBOs in the area. After the MYRADA withdraws, he/she is engaged by the CMRC, if the committee is satisfied with her/his performance;

- The functions of each CMRC are determined by the demand coming from the CBO members. Each visitor enters his/her name and the purpose of his/her visit to the CMRC in a register which is analysed weekly to decide whether the CMRC can respond to a particular need. Each CMRC decides whether to respond to non-CBO members and if they decide to respond, on the terms and conditions.
Most in fact respond to non-CBO members but charge higher rates for their services.

- Lending money has not been identified as a function of the CMRC – this has been left to the financial institutions.

An analysis of the services provided by the CMRCs falls in the following broad categories:

- Training for CBOs, mainly for SAGs, book writers, animators: These trainings are conducted initially by the CMRC manager. However, within a few months trainers are selected from experienced SAG members. Several of these CMRCs have been asked by NGOs and Government departments to conduct trainings for SAGs and paid for their services.

- Organisation of camps and campaigns: Examples are health camps, dental camps, eye camps, cancer detection and advice camps, animal husbandry camps, reproductive and child health RCH/STI/ HIV-AIDS campaigns, tuberculosis campaigns and legal awareness campaigns.

- Information support and utilities: The CMRC provides members with updated prices of agricultural products in surrounding markets on a day-to-day basis. Members of CBOs and others visit the CMRC to use the internet, fax, etc. They also approach the CMRC to help them to write applications for old age pensions and for other Government programmes.

- Mobilisation of bank loans under the SHG-Bank Linkage Programme and Government schemes for toilets, bathrooms, housing, agricultural inputs, grain storage, rainwater harvesting, etc.

- Insurance agencies: The CMRCs mobilise life insurance, animal insurance and help to settle claims.

- Service to CBOs: They help CBOs to sort out problems with accounts, arrange annual audits, and help them to grade themselves.

- The CMRCs have also begun to identify skilled resource persons who could train families in various livelihood skills particularly in off-farm enterprises.
Endnotes

1MYRADA’s experience shows that the support services required to set up a well functioning SAG fall broadly into three categories: i) Interventions to identify an affinity group; these involve extensive participatory exercises to identify the poor in a village, followed by meetings to share the concept of an SAG and the roles and functions expected of SAGs and finally, the exercise that leaves the poor free to form affinity groups and select their representatives. This set of interventions requires experienced NGO staff to take the lead and needs to be fully subsidised. ii) Institutional capacity building for the whole SAG not just for the representatives (leaders); the content of this training has been described below; this intervention can be conducted at low cost in the villages but involves subsidies ranging from 30% to 100% and iii) financial services, basically the provision of credit; this function if carried out by a professionally managed MFI can break even and remain sustainable within three years as proved by Sanghamithra, an MFI set up by MYRADA which lends only to SAGs.

2The cooperative societies in the rural areas at the primary level are composed of better off and poor, dominated by the landed, especially by the farmers who have irrigation, and usually controlled by aspiring local politicians who use these societies as a stepping stone for their rise in politics. Several studies of these societies have been conducted by committees set up by Government. They all agree on the reasons for the poor performance of these cooperatives, namely: Poor governance, the lack of adequate supervision and the excessive influence of politicians which has resulted in most of these societies incurring regular loss. There are examples of success, but they are few and are due either to their leaders capturing political power which they use to further the societies’ interests or because of dedicated individuals; demands for recapitalisation by political parties have been a major and recurrent feature.

3Subsequently MYRADA identifies affinity groups through the following process: It conducts PRA exercises like wealth ranking which helps people to identify who are the poor and poorest in the village; then sessions are held with this group to explain to them what affinity means. They are then requested to form groups on their own based on affinity among members.

4For further details refer to Putting Institutions First Even in Micro Finance by this author and to Rural Management Systems Papers available on our website.
6 Conditions in which microfinance has emerged in certain regions – consequent policy implications

M.S. Sriram and Radha Kumar

6.1 Background

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to poor and low income households and their micro-enterprises. India has two strands of microfinance; the ‘mutual’ strand, where microfinance is organised around the concept of mutuality covering an entire range of experiments such as informal Self-Help Groups and formal thrift and credit cooperatives incorporated under cooperative legislation. The other strand may be termed that of ‘providers’, wherein an external agency commonly known as an MFI offers the financial services without opening up its own governance structure to the clients. SHGs provide scope for a two-way transaction, starting on the base of small savings – rotating that and later linking for loans that could address the issue of livelihoods. In some places attempts are being made to provide exclusively designed risk mitigation products for the poor and vulnerable. Microfinance has become an attractive mechanism to reach financial services to the poor and the methods evolved reduce certain types of transaction costs, eliminate basic problems of incorrect client identification and mitigate repayment risks to a great extent (Sriram, 2002)\(^1\). Therefore there is great enthusiasm amongst various players in the financial services market to participate in this sector.

While there are some places where men participate in microfinance type of activities, by design, the movement has been women centric. Though the ‘mutuals’ have been in the country for about two decades and the ‘providers’ have been operating for over a decade, the movement has not spread throughout the country. We find that microfinance activities seem to happen only in certain pockets of the country, irrespective of whether they follow the ‘mutual’ or the ‘provider’ strategy. While microfinance has had the patronage of successive governments
irrespective of party affiliation at the centre, the regional spread of the movement is very disparate. Even within states, we find that certain pockets develop as microfinance pockets. We would like to understand if there are specific reasons or external conditions that are conducive to the growth of microfinance in certain regions that are not there elsewhere. For the purposes of analysis, we shall focus only on ‘mutuals’. While it is possible to recognise some thought leaders in the design of ‘mutuals’, the spread of the movement cannot be attributed either to a small set of individuals or organisations. Therefore these ‘mutuals’ operate with different parentage, diverse funding sources, different cost absorption models and different operational details that foster trust and bondage. However the common thread amongst all these are that the participants meet regularly, undertake financial transactions and try to scale up as they go along.

6.2 A primer on ‘mutuals’ in India

In India, the statistics put out by NABARD attribute three types of parentages to the mutuals. The first set, where the bankers themselves help in formation of these groups and then finance them. Under this model the cost of the formation is usually borne by the bank, and possibly treated as an investment for a good business with moderate risk. Alternatively the bank might do this as a part of its contribution towards social responsibility. The second set of mutuals are those promoted by an external party other than the banks, but eventually linked to banks. Most of these would be promoted by Non-Government Organisations (NGOs) and the cost would have been met by developmental funding. The third set of mutuals are those that are not only promoted by NGOs, but also funded by them. In such cases the NGOs get linked with the financing institutions or banks and interact with the mutuals themselves.

Irrespective of the parentage, the mutuals have the following salient features:

- The mutuals usually have between 10 to 20 members. Each of the promoting agencies would have criteria that specify how these groups should be formed. The basic consideration being that they have to be cohesive, able to save and borrow and eventually conduct meetings and maintain books.
All mutuals would meet regularly. These meetings happen at the frequency of a week, fortnight or a month depending on the promoting agency’s advise and the type of activity they carry out.

The mutuals start their activity by all the members saving a specified amount to be remitted every week. This would be compulsory thrift. In addition some groups might have voluntary savings schemes as well. The money collected is lent to some members within the group as per the norms. The interest rate charged on loans is decided locally. Some groups pay interest on deposits, some pay year-end dividends based on savings and some just accumulate these as group funds.

The mutuals typically start their external borrowing programme after six months of rotating savings. This is termed as the SHG-Bank Linkage Programme. The banks typically lend a multiple of the group fund, usually not exceeding four times.

In areas where there are multiple mutuals within a given area, they might form into cluster organisations and/or federations. In such cases the federal institutions usually deal with the bank and do financial intermediation for the mutuals.

Mutuals are more liberal than the ‘providers’ in terms of discipline. Repayment terms could usually be more friendly and genuine default treated with compassion. Mutuals do not usually report a 100% recovery rate, unlike most ‘providers’.

With the above features it can be assumed that there have to be certain conditions for mutuals to flourish. Since most mutuals are externally triggered, it may be important to have a promoting agency that does the initial work of group forming and stabilisation. In states that have been in the forefront of this model of microfinance it is possible to identify some large organisations that do the promotional work. In Karnataka and parts of Tamil Nadu we have MYRADA, one of the original thinkers of the mutual model. Apart from this, Dhan Foundation in Tamil Nadu has been promoting mutuals in a big way, for a long time. In Andhra Pradesh, it is difficult to identify one single organisation that has an encompassing size, but it could be safely said that the Government has been one of the largest promoters of this movement. This phenomenon is, what triggers similar efforts in North Rajasthan – Alwar where PRADAN has had a big role to play in promoting these activities. The same applies to Jharkhand where PRADAN is active.
For the purpose of this paper, we undertake a comparative analysis of southern states – Karnataka, Andhra Pradesh, Tamil Nadu and Kerala with that of the western states of Maharashtra, Gujarat and Rajasthan, to see whether there are some natural conditions that seem to explain the development of these mutuals only in certain pockets. We have deliberately left out the northern and eastern parts of the country, because there are so many extraneous factors that come to play and we may not be able to isolate factors that foster the mutuals.

6.3 Broad parameters

We start by looking at the broad parameters of the states we are examining. Table 1 gives the growth in State Domestic Product in percentage terms from 1961-1962 onwards.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>3.11</td>
<td>3.46</td>
<td>6.58</td>
<td>5.52</td>
</tr>
<tr>
<td>Karnataka</td>
<td>4.36</td>
<td>3.38</td>
<td>5.09</td>
<td>7.51</td>
</tr>
<tr>
<td>Kerala</td>
<td>4.00</td>
<td>2.30</td>
<td>3.34</td>
<td>5.74</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>2.59</td>
<td>2.10</td>
<td>5.71</td>
<td>6.25</td>
</tr>
<tr>
<td>Gujarat</td>
<td>4.83</td>
<td>4.31</td>
<td>5.99</td>
<td>6.34</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>2.95</td>
<td>4.51</td>
<td>6.12</td>
<td>5.74</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>5.78</td>
<td>4.10</td>
<td>4.35</td>
<td>4.47</td>
</tr>
</tbody>
</table>

Source: Bureau of Applied Economics and Statistics, Government of India

From the table it is evident that Rajasthan is one state that has been growing at a slow pace, in the decades starting 1981-1982. We therefore will have to treat Rajasthan as an outlier in all our analysis and look at that state carefully as far as the roll out of financial services is concerned. Possibly the issue of financial services in Rajasthan will be closely linked to broader developmental parameters and an isolated intervention might not have a big impact unless the other issues are addressed. The only other state that has grown slow in net terms is Kerala, but it has also caught up in the decade of 1991-1992.
At this juncture it might be useful to look at the other parameters of development that might impact the emergence of mutuals. Table 2 gives some statistics on connectivity. We assume that regions that are well connected should have more formal institutions and regions that are not well connected would have the propensity to promote their own local solutions. If this proposition were to be true, then the ideal candidates for the spread of local institutions should have been Kerala and Rajasthan where the number of connected habitations is low in percentage terms. However there seems to be no relationship between the habitations that are connected, the road length and the spread of microfinance. We cannot even use the counter argument that if the connectivity is high, then the external agencies would have easy access and therefore there is a natural tendency for microfinance to grow.

Table 2: Statistics on connectivity

<table>
<thead>
<tr>
<th>State</th>
<th>Road length (km) (31 March 2002)</th>
<th>Connectivity (May 2001)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Per 100 sq. km of area</td>
<td>Per 100,000 of population</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>65.2</td>
<td>239.0</td>
</tr>
<tr>
<td>Karnataka</td>
<td>79.2</td>
<td>294.4</td>
</tr>
<tr>
<td>Kerala</td>
<td>381.7</td>
<td>462.1</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>117.7</td>
<td>249.3</td>
</tr>
<tr>
<td>Gujarat</td>
<td>47.6</td>
<td>195.3</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>124.1</td>
<td>422.3</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>41.2</td>
<td>266.3</td>
</tr>
</tbody>
</table>

Source: www.indiastat.com

The other aspect we need to examine is if there is an explanation in figures such as density of population, overall poverty ratios, that trigger external agencies to come in and work with these sections of the population. If the poverty ratios are high, then naturally the development oriented organisations would like to make an intervention in such areas. At the same time, in order to be more effective they might want to work in areas where the population is dense. Getting to form groups and
transact would need a natural meeting place for the beneficiaries and therefore density and the way the local society is organised might make a difference. Table 3 gives some data that could be used in our analysis. From Table 3, using the poverty incidence, Maharashtra and Tamil Nadu would be the destinations for developmental oriented organisations to operate. Surprisingly the incidence of poverty in Rajasthan seems to be lower than many of the other states and almost comparable to Gujarat. Possibly why Rajasthan scores low on other parameters is because of its population density. With such sparse population, it possibly does not make sense to form groups. Even in the non-desert areas of south Rajasthan groups do not get naturally formed because of the way the tribal society is organised. Therefore promotion of microfinance in Rajasthan possibly would need an out-of-the box model.

Table 3: Population density and incidence of poverty

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>275</td>
<td>11.05</td>
</tr>
<tr>
<td>Karnataka</td>
<td>275</td>
<td>17.38</td>
</tr>
<tr>
<td>Kerala</td>
<td>819</td>
<td>9.38</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>478</td>
<td>20.55</td>
</tr>
<tr>
<td>Gujarat</td>
<td>258</td>
<td>13.17</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>314</td>
<td>23.72</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>165</td>
<td>13.74</td>
</tr>
</tbody>
</table>

Source: Population density from www.indiastat.com; Poverty ratio from Planning Commission, Government of India

6.4 Specific parameters

If we were to look at some specific parameters that have a bearing on the development of financial markets, particularly of the nature that we are discussing, we will have to look at how the formal markets have emerged and what sort of gaps they have left on the rural landscape. The first question that we ask is whether mutuals naturally emerge in places where the formal markets have failed to reach out to the poor.
The formal sources of savings and credit would include bank branches and cooperatives. The macro trends indicate that across the country, the formal sources are moving away from the poor – the share of neighbourhood outlets such as cooperatives is falling and the average size of the loans disbursed by the banks are going up, with number of accounts in the rural areas actually falling. In addition after the branch licencing policy was modified in 1991, there has been a fall in the rural and semi-urban branches of commercial and Regional Rural Banks (World Bank, 2003). Therefore the question is whether mutuals emerge in areas where the formal sources have either failed or are having a shrinking role.

The mutuals could be treated as semi-formal sources while the informal sources could include externally triggered ROSCAs and local finance companies and moneylenders. It would be useful to look at some numbers from the supply side. While the development of mutuals serve the dual purpose of providing avenues for savings as well as purveying of credit, we focus on the access to credit to start with. Table 4 has statistics about the number of outlets of formal sources and mutuals.

From the figures it is evident that Maharashtra has the maximum number of formal sector outlets, largely owing to the spread of Primary Non-Agricultural Credit Societies (PNACS). The PNACS perform a role similar to mutuals, and though are formally registered with the Registrar of Cooperative Societies, have similarities with ROSCAs and mutuals in their operation. The studies by Thorat and Bouman (1989) demonstrate these similarities. In a way it might be appropriate to club these PNACS with mutuals. The limited growth of mutuals in Maharashtra may perhaps be explained by the fact that there are a large number of PNACS. As we can see, Maharashtra has the largest number of formal sector outlets, and these outlets are predominantly neighbourhood institutions such as cooperatives. So it might be possible to explain why the microfinance movement has not gained momentum in this state.

This possibly holds true for Gujarat which has the penetration of formal sector, though not as intensive as Maharashtra. By the same argument, it appears that Andhra Pradesh and Tamil Nadu, which have the least penetration on the basis on number of households to be serviced per outlet of formal institutions, become fit candidates for microfinance to naturally emerge. This leaves three states that do not fit into the pattern.
Table 4: Number of financial services outlets

<table>
<thead>
<tr>
<th>State</th>
<th>Rural house-holds (million)¹</th>
<th>Rural/semi urban bank branches²</th>
<th>Number of outlets as on March 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>PACs</td>
<td>PNACs³</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>12.68</td>
<td>3,652 (1.4)</td>
<td>4,104 (1.6)</td>
</tr>
<tr>
<td>Karnataka</td>
<td>6.2</td>
<td>3,237 (6.82)</td>
<td>4,653 (9.81)</td>
</tr>
<tr>
<td>Kerala</td>
<td>5.01</td>
<td>2,748 (13.45)</td>
<td>1,914 (9.36)</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>8.28</td>
<td>3,001 (4.22)</td>
<td>3,609 (5.08)</td>
</tr>
<tr>
<td>Gujarat</td>
<td>5.88</td>
<td>2,367 (10.31)</td>
<td>6,785 (29.55)</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>11.17</td>
<td>3,390 (5.30)</td>
<td>20,598 (32.18)</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>7.05</td>
<td>2,629 (12.70)</td>
<td>4,780 (23.10)</td>
</tr>
</tbody>
</table>

No. of households to be serviced per outlet

<table>
<thead>
<tr>
<th>State</th>
<th>Bank branches</th>
<th>PACs</th>
<th>PNACs³</th>
<th>Formal sector</th>
<th>SHGs</th>
<th>Total outlets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>3,474</td>
<td>3,090</td>
<td>3,374</td>
<td>1,101</td>
<td>52</td>
<td>50</td>
</tr>
<tr>
<td>Karnataka</td>
<td>1,915</td>
<td>1,332</td>
<td>2,452</td>
<td>595</td>
<td>167</td>
<td>131</td>
</tr>
<tr>
<td>Kerala</td>
<td>1,823</td>
<td>2,618</td>
<td>4,926</td>
<td>882</td>
<td>339</td>
<td>245</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>2,759</td>
<td>2,294</td>
<td>4,734</td>
<td>991</td>
<td>132</td>
<td>116</td>
</tr>
<tr>
<td>Gujarat</td>
<td>2,484</td>
<td>867</td>
<td>1,363</td>
<td>436</td>
<td>619</td>
<td>256</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>3,294</td>
<td>542</td>
<td>547</td>
<td>252</td>
<td>569</td>
<td>174</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>2,682</td>
<td>1,475</td>
<td>9,792</td>
<td>867</td>
<td>561</td>
<td>341</td>
</tr>
</tbody>
</table>

¹Data from Primary Census Abstract based on 2000 Census.
²Statistical tables relating to banks in India, 2002 published by RBI. Only rural and semi urban branches have been considered in the analysis.
³The data for PACs and PNACs is from the database of NAFSCOB. PNACs Data pertains to 1999-2000. Figures in parentheses are percentages.
Karnataka, where the formal sector has a better presence also has a good network of microfinance activities. One is not sure if this is to be explained by the extraneous factor of the presence of a promoting institution like MYRADA. Kerala stands out as a state where the banking penetration is not as deep as Karnataka, but at the same time, microfinance has not emerged in a big way. This might be due to the presence of non-formal institutions such as chit funds that are not captured in the statistics, while Rajasthan may be explained by general backwardness.

The most telling figure in Table 4 is that with the penetration of microfinance – particularly in the case of Andhra Pradesh – we find an outlet for every 52 households. If these outlets are used as a base network, the potential for penetration of credit and other financial services would be immense.

The next question we need to examine is whether there is any correlation between the number of mutuals and the amount of loans that flow through these channels. Are the states that have more formal channels getting more credit per household than those that are dependent on informal sources or mutuals? Table 5 has the total amount outstanding against each of the outlets. We have chosen to take the stock figure instead of the flow figure because the stock figure would perhaps give a more stable picture.

When we look at the amounts outstanding, Kerala and Maharashtra stand out as states that have a high outstanding per household from the formal sector. In case of Kerala, most of the money is flowing through the primary cooperatives, while in Maharashtra it is the PNACS that are playing a significant role. Rajasthan shows low amounts of formal credit as well as microfinance. This might be due to the overall backwardness of the state. Gujarat presents a surprising figure of lower per-household credit outstanding than Karnataka and Tamil Nadu. Andhra Pradesh in comparison maintains the pattern where the penetration of formal sources is lower than the other states (except Rajasthan) and therefore a place where alternate channels emerge.

What is clear from the above table is that wherever the penetration of microfinance is high, the average loans through the mutuals have also been higher than the rest. This may indicate that the network developed in Andhra Pradesh, Tamil Nadu and Karnataka can actually bear more
Towards a Sustainable Microfinance Outreach in India

Table 5: Amounts outstanding by different outlet types

<table>
<thead>
<tr>
<th>State</th>
<th>Rural households (million)</th>
<th>Total amount outstanding as of March 2002 (Rs. million)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bank branches</td>
<td>PACs</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>12.68</td>
<td>14,820 (20.05)</td>
</tr>
<tr>
<td>Karnataka</td>
<td>6.2</td>
<td>11,508 (26.43)</td>
</tr>
<tr>
<td>Kerala</td>
<td>5.01</td>
<td>13,098 (14.48)</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>8.28</td>
<td>12,536 (18.40)</td>
</tr>
<tr>
<td>Gujarat</td>
<td>5.88</td>
<td>6,922 (19.73)</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>11.17</td>
<td>11,506 (9.26)</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>7.05</td>
<td>6,357 (38.39)</td>
</tr>
</tbody>
</table>

Amount outstanding per household (March 2002)

<table>
<thead>
<tr>
<th>State</th>
<th>Bank branches</th>
<th>PACs</th>
<th>PNACs&lt;sup&gt;3&lt;/sup&gt;</th>
<th>Formal sector</th>
<th>SHGs</th>
<th>All sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>1,167</td>
<td>3,921</td>
<td>326</td>
<td>5,419</td>
<td>411</td>
<td>5,826</td>
</tr>
<tr>
<td>Karnataka</td>
<td>1,856</td>
<td>3,734</td>
<td>1,318</td>
<td>6,908</td>
<td>115</td>
<td>7,024</td>
</tr>
<tr>
<td>Kerala</td>
<td>2,614</td>
<td>14,648</td>
<td>723</td>
<td>17,985</td>
<td>68</td>
<td>18,053</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>1,514</td>
<td>5,848</td>
<td>619</td>
<td>7,981</td>
<td>245</td>
<td>8,226</td>
</tr>
<tr>
<td>Gujarat</td>
<td>1,177</td>
<td>4,314</td>
<td>462</td>
<td>5,952</td>
<td>14</td>
<td>5,967</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>1,030</td>
<td>5,358</td>
<td>4,695</td>
<td>11,082</td>
<td>38</td>
<td>11,121</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>902</td>
<td>1,400</td>
<td>14</td>
<td>2,316</td>
<td>33</td>
<td>2,349</td>
</tr>
</tbody>
</table>

<sup>3</sup>The data for PACs and PNACs is from the database of NAFSCOB. PNACs Data pertains to 1999-2000. Figures in parentheses are percentages.
Conditions in which microfinance has emerged in certain regions

credit and effectively supplement the formal channels. However, as a word of caution it may not be appropriate to look at the statistics pertaining to all channels including SHGs as there could be an element of double counting – the mutuals in most cases have been financed by banks and those numbers could be subsumed in the overall outstandings of the banks. Therefore it might be better to look at figures pertaining to the formal sources as far as amounts are concerned.

The other figure that is regularly used in order to find out if the banking system is performing its role locally is the Credit-Deposit (CD) ratio. The policy makers get unduly worried if the CD ratios of certain regions are not favourable, indicating a certain skewness in just collecting deposits or disbursing loans. It has been known traditionally that the regulators get worried in areas where the CD ratios are low, thereby indicating a flight of capital from the local area to the outside world. There have been task forces set up to look at adverse CD ratios, particularly in the north-eastern region and states like Kerala, West Bengal and Rajasthan. We present the figures of the CD ratios of the selected states in Table 6. However a look at the figures in Table 6 gives no indication as to whether this could be the trigger for spread of alternative channels of finance.

Andhra Pradesh has the best performance on CD ratios in its rural branches and is almost number one in semi-urban branches. What could this mean? Since we maintained that the SHG loans are subsumed in the overall figures, do we then assume that the funding for microfinance has swung the CD ratio in favour of banks in these states? Prima facie, it appears so, when we look at the CD ratios in the states where microfinance has spread fast – Andhra Pradesh, Karnataka and Tamil Nadu. Gujarat and Kerala are behind. Maharashtra is an outlier, and Rajasthan indicates a double failure of the banking system as well as that of microfinance.

However, if we did arrive at the conclusions that in states where the CD ratio is good, it could be a result of better spread of microfinance, we might be attributing more than the due share of glory to microfinance. This is because the overall numbers in terms of deposit collected and credit disbursed through microfinance might not be large enough to significantly impact the CD ratios. From Table 4 it is evident that the share of SHGs in the overall financing of the rural and semi-
urban households is usually a very small percentage, except in Andhra Pradesh, where it is around seven percent. If we assume this figure to be the one we have resorted to double counting, this could not have an overbearing impact on the direction of the CD ratios, particularly when the funding by the banks is a small multiple of the group funds generated.

Table 6: Credit Deposit Ratios of banks in various states

<table>
<thead>
<tr>
<th>State</th>
<th>2000</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rural branches</td>
<td>Semi-urban branches</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>76.0</td>
<td>52.2</td>
</tr>
<tr>
<td>Karnataka</td>
<td>69.0</td>
<td>55.1</td>
</tr>
<tr>
<td>Kerala</td>
<td>54.7</td>
<td>34.3</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>61.9</td>
<td>51.3</td>
</tr>
<tr>
<td>Gujarat</td>
<td>43.8</td>
<td>31.4</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>58.4</td>
<td>43.3</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>45.7</td>
<td>32.9</td>
</tr>
</tbody>
</table>

Source: Banking Statistics of RBI

The above data might actually indicate the relative failure of the banking system in these areas, where, the disbursement of credit is generally impressive on the base of the deposits, but the deposits themselves might not have been collected in a significant manner.

The other issue that would possibly impact the emergence of microfinance, particularly the mutual model might be the presence of post offices. Post offices do not provide credit services, but they do provide savings services. In a recent study it was found that in the states of Andhra Pradesh and Uttar Pradesh, only two percent of the sample households surveyed had an account in the post office, and it also had the maximum overlap with people who had transactions elsewhere in the formal sector (NCAER/World Bank, 2003). Therefore this data is to be treated with caution. However, it might be worthwhile to examine the data on the penetration of post offices.
The data is readily available from the 1991 census and it indicates a deep penetration of post offices in Kerala. However, the figures are low from Maharashtra and Karnataka (see Table 7). With the low penetration of microfinance in Maharashtra, we may not be able to establish the importance of the post offices. Even the NCAER study found that the mean distance from the households surveyed to the nearest post office was the highest amongst all the financial institutions, while the median distance was low. This essentially means that there are some really far flung villages that bring the mean figure to be high and the variability of distance from the location to the post office might be very high. However, it would not be appropriate to focus on the post offices, as they do not offer full-fledged financial services.

### Table 7: Percentage of inhabited villages having Post & Telegraph (P&T) offices and telephone connections (1991)

<table>
<thead>
<tr>
<th>State</th>
<th>Any P&amp;T facilities</th>
<th>Post office</th>
<th>Telegraph office</th>
<th>Telephone connections</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>55.49</td>
<td>52.35</td>
<td>6.67</td>
<td>12.82</td>
</tr>
<tr>
<td>Karnataka</td>
<td>31.62</td>
<td>30.30</td>
<td>9.06</td>
<td>16.05</td>
</tr>
<tr>
<td>Kerala</td>
<td>98.70</td>
<td>94.73</td>
<td>53.83</td>
<td>59.39</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>55.72</td>
<td>47.93</td>
<td>7.53</td>
<td>14.09</td>
</tr>
<tr>
<td>Gujarat</td>
<td>55.58</td>
<td>46.22</td>
<td>4.00</td>
<td>28.62</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>28.91</td>
<td>25.60</td>
<td>2.64</td>
<td>6.08</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>51.08</td>
<td>48.83</td>
<td>2.00</td>
<td>8.06</td>
</tr>
</tbody>
</table>

Source: www.indiastat.com

### 6.5 Conclusions

All data examined till now indicate that there are no macro economic or demographic reasons as to why microfinance emerges in certain places. Using the summary of the above data, if we were to assume that microfinance naturally emerges in places where the economic growth is slow, the connectivity is low, the poverty incidence is high, with dense population and a failure of formal financial institutions, then the ideal states where microfinance should have naturally emerged would have been Rajasthan, followed by Kerala and Tamil Nadu.
If we were to consider the singular factor of failure of formal sector outlets, then the data seems to fall in place, as far as Andhra Pradesh and Karnataka is concerned, but this does not explain the growth in Tamil Nadu and also why Rajasthan is an outlier.

### Table 8: Parameters that could lead to spread of microfinance

<table>
<thead>
<tr>
<th>State</th>
<th>Growth of Net GDP</th>
<th>Connectivity</th>
<th>Incidence of poverty</th>
<th>Population density</th>
<th>No. of formal sector outlets</th>
<th>Amount outstanding per household</th>
<th>Post offices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Karnataka</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Kerala</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td></td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Gujarat</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

(✓ indicates the hypothesis that the state has the potential to have more microfinance)

In the absence of any statistically significant data to show any one or a group of factors that could explain the presence of mutuals in any one state and absence in another, we decided to look at the data of ‘parentage’ and promoting institutions in the above states. **Table 9** gives a break up of the parentage of mutuals.

From the data in **Table 9**, two things emerge clearly. The role of banks in promotion of SHGs seems to be limited, while their role in directly financing them seems to be the preferred route. Except in case of Karnataka, where the SHG movement is strong and the banks have also taken a keen interest in promoting SHGs, in other significant states of Andhra Pradesh and Tamil Nadu, there is evidence that NGOs and other agencies have largely assumed the role of promotion of SHGs. The outlier here is Maharashtra, where the role of banks seems to be significant, but the number of SHGs and the amount disbursed through
SHGs are really small. Therefore, it appears that the bank-promotion has largely happened with central targets rather than a natural tendency for the formation of mutuals. This gets further illustrated by Table 10, where we can see the number of partner agencies and the cumulative number of groups that has been promoted and linked by them.

**Table 9: Distribution of SHGs as per the promoting agency**

<table>
<thead>
<tr>
<th>State</th>
<th>% of SHGs formed and financed by banks</th>
<th>% of SHGs formed by NGOs but directly financed by banks</th>
<th>% of SHGs financed by banks through NGOs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>1</td>
<td>98</td>
<td>1</td>
</tr>
<tr>
<td>Karnataka</td>
<td>33</td>
<td>38</td>
<td>29</td>
</tr>
<tr>
<td>Kerala</td>
<td>15</td>
<td>26</td>
<td>59</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>7</td>
<td>81</td>
<td>12</td>
</tr>
<tr>
<td>Gujarat</td>
<td>7</td>
<td>90</td>
<td>2.5</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>51</td>
<td>49</td>
<td>0</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>40</td>
<td>60</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Micro Credit Innovation Department, NABARD

From the Table 10 it is clear that in states where microfinance has taken off, the number of agencies involved is not only high, but the number of groups are higher where the NGOs had a larger role to play. The exception to this might be Karnataka, where we have already found that the bank branches have had a significant role in promotion of microfinance (Table 9). From the above analysis, the story that emerges is that it is difficult to find external explanations for the regional development of microfinance in certain regions. One of the reasons why a pattern might not be emerging may be because even after so much of focus on microfinance, the quantum of credit and savings managed by this system – even to the extent of the most optimistic figures that are available – are not significant vis-à-vis the size of the rural financial markets. Therefore it might at this point be difficult to find patterns, unless the numbers and the amounts become significant enough.
Towards a Sustainable Microfinance Outreach in India

Table 10: Details of number of partner agencies and groups promoted (March 2002)

<table>
<thead>
<tr>
<th>State</th>
<th>Number of partner agencies</th>
<th>Cumulative no. of groups promoted by partner agencies</th>
<th>Of which no. of groups promoted by NGOs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>113</td>
<td>240,257</td>
<td>231,654</td>
</tr>
<tr>
<td>Karnataka</td>
<td>442</td>
<td>126,256</td>
<td>76,696</td>
</tr>
<tr>
<td>Kerala</td>
<td>180</td>
<td>33,400</td>
<td>2,200</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>330</td>
<td>109,694</td>
<td>721</td>
</tr>
<tr>
<td>Gujarat</td>
<td>80</td>
<td>16,563</td>
<td>–</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>21</td>
<td>2,365</td>
<td>–</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>90</td>
<td>31,008</td>
<td>20,450</td>
</tr>
</tbody>
</table>

Source: NABARD

However there are a series of anecdotal evidence to suggest that the government and external agencies like NGOs and international development agencies have taken a great deal of interest in the SHG movement in states like Andhra Pradesh. For instance, Andhra Pradesh has routed several of its poverty reduction schemes via the SHG route. The Velugu programme was one of the largest of these. This Rural Poverty Alleviation Programme was taken up by the state government in two phases, covering all the districts in the state; the first phase between 2000 and 2005 and the second phase commencing two years after the first. The project had the support of the government at the highest level: the Chief Minister was the Chairperson of the programme. The project was supported by the World Bank, cost Rs. 20.79 billion and targeted 2.9 million people in 22 districts.

The Tamil Nadu government has also extended a lot of support to the SHG movement through the support of International Fund for Agriculture Development and the Tamil Nadu Women’s Development Programme. In Karnataka, MYRADA was an early collaborator with the commercial banks. With several commercial banks having their headquarters in Karnataka and having had the legacy of looking at rural markets positively, it was possible to get the involvement in a significant manner. In fact numbers suggest that Karnataka had the most
significant share in SHGs before the Andhra Pradesh avalanche took it over, with fair amount of state support.

The story of Andhra Pradesh reveals something more. Since the state has been topping the numbers in SHG-Bank linkage, the language and syntax of microfinance is understood well there. Therefore there possibly is a natural environment for other models of microfinance to emerge there. That possibly explains why four major microfinance agencies that do not necessarily follow the ‘mutual’ model – BASIX, Share, SKS and Spandana are headquartered there. This could be a cluster effect, but this needs to be studied in greater detail.

6.6 Policy implications

It seems from the available data that the spread of microfinance hence is possibly not so much a natural movement whose emergence indicates conditions ripe for growth of micro-enterprise, as is often commonly supposed. Rather it would seem that it in fact requires some degree of sustained external intervention, whether of the local government or of NGOs. While from the above data it appears that Rajasthan seems to be the right state where there should be large scale intervention in microfinance, it would be much more difficult to make it successful, given the geographical conditions and the density of population. However, it could take off in certain pockets of north Rajasthan and then naturally spread across the state. For this, there needs to be systematic and synergistic intervention from three players – the state government, the non-profits operating in the area and the banking systems. If we are thinking of alternative methods of reaching financial services to the poor beyond the existing sources and with the limitations of infrastructure, it is imperative that there has to be some significant external push.

What is even more interesting would be to look at the growth of the movement in states where it has already spread. In these states, the density of outlets that provide savings and credit services have penetrated deep, with Andhra Pradesh claiming to have one SHG for every 50 households. The challenge in these states will be to leverage these outlets to provide greater variety and quantum of financial services.
6.7 Limitations and scope for further research

A serious limitation of the study is that only those Self-Help Groups that fall under the NABARD purview have been included. This may not factor in efforts of some large NGOs in the movement. However there is a problem of availability of consolidated data in this respect. A second severe constraint has been that the efforts of NGOs and state governments have been largely understood only through anecdotal evidence. There is no quantifiable way of comparing these data. These and the role of clustering present opportunities for further research. The role of individual commercial banks in spreading the movement in their area of coverage also can be studied.

Endnotes


3Thorat, Y.S.P. Rural Financial Services Market: Findings from a Field Study (mimeo).


7 Mature SHGs: Way forward

D. Narendranath

7.1 SHGs – a demand system

It is quite topical that the issue of mature SHGs has come up now, after more than a decade of linkage banking. It is not that the question of SHG quality, disenchantment of older SHGs, regional disparity in the programme, inadequate financing, the need for broader livelihood support, and so on had not come up earlier. SHGs and NGOs have been talking about these since a long time, but it is now that the issue has come up in a focussed manner in a national level consultation.

I believe this is because the problem has assumed such large proportions with the number of old, mature SHGs in the country demanding attention easily touching the half a million mark. This proves the argument that microfinance through SHGs is not just about streamlining the supply side but is about creating a demand system. These SHGs, puny as they may be, would have to be heard, whether one liked it or not. It is true it has taken more than a decade for the groundswell to reach a cognizable scale, but it does also take a Mohammed to move the policy mountain! Nevertheless the groundswell cannot be wished away and we can ignore it only at the peril of allowing such a wonderful movement to wither. I will revisit this point in a little while to discuss further what are the issues.

It might be worthwhile at this point to look at the theme of SHG maturity. What do we mean by mature SHGs? Are they three year plus groups; are they five year plus groups? Are they groups that have received lot of finance from banks? Are they the vocal, articulate groups? Are they the groups that show up at the local bank or the government office every alternate day and demand this or that? We have to strive seriously to understand this elephant and cannot be caught having only a partial understanding of what are mature SHGs.
However, before that we need to look at something more basic about the maturity aspect.

As I understand mature, adult beings are those with whom one has a relationship of being equal. This is as against the patronising, protecting relationship one has with a child. Psychologically speaking, it is said that if one of the actors has a patronising approach, the other would have the tendency to slip into the child mode, either to rebel against what is being proposed or to meekly submit. Neither is the reaction one would expect in a mature transaction. Thus to expect mature reactions from SHGs we also need to build a relationship of equality with them, consider them as mature adults. In other words the proposition is that we must stop patronising poor people but treat them as equals. SHGs are not in need of any charity; they only demand to be treated as market entities. They would like to earn what they get. SHGs have to be assessed for their quality, their ability to deliver the goods and not on any extraneous factors.

7.2 Mature SHGs

Maturity in an SHG at the first cut surely is about age, size of financial transactions and financial track record both internal as well as with the bank. If the age is more than three year, and the size of financial transactions – savings mobilised, bank loan mobilised – are substantial depending on the local economy, and the repayment track record internal as well as external are high, then the group may be considered as a strong mature group. However, are these criteria enough? Or do we need to see the group in a broader perspective? I think that when we are assessing a group for its maturity, with a view to build a partnership and make larger commitments, then we must look at the group also from a broader point of view.

7.2.1 Sustained adherence to basic values and norms

Starting at the basics, a mature SHG is one, I would say, that does not start relaxing its core values, basic norms of meeting, attendance, internal discipline, governance, financial rigour including loan sanctioning and ensuring repayment, accounting and reporting, etc. even after it has become old. Many old SHGs tend to become very lax with their internal repayments and be proper on their external repayments. While this might be okay to a limited extent, in the long
run can adversely effect the external repayments also, especially when the loan sizes get larger. Any slackness in the basic systems can show adverse results fairly quickly. The success of the group lending methodology lies a lot in the phenomenon of peer pressure, but quite a bit of it lies in the regimentation within the group also. That is the reason why a neighbourhood group automatically does not translate into a strong SHG. The quality of training that the group receives in the first six to eight months is very crucial.

7.2.2 Long-term vision and initiative

In addition to these basic systems, what I would look for in a mature SHG would be the level of awareness the members display, primarily about the long-term vision of the group. What does the group seek to achieve in the long run? It is important that the group should have articulated this. This might be the difference between a group that has been formed with the limited purpose of channelling some funds in the short run, vis-à-vis a group that has been formed by members who have come together with plans to achieve their livelihood and well being goals.

Moreover, in a mature group, not just two or three prominent members but each and every member emerges as a distinct individual, with her individual goal and plan well articulated and integrated with the group vision. This group would talk in terms of the medium to long terms, and would seek to build sustainable relationships with the banks and other stakeholders. A mature group in this regard also would be the one who has already taken a few steps of its own before approaching the stakeholders. It may be about resolving to send all children to school or about getting the infants immunised, but such initiatives show the broader perspective the members have developed.

7.2.3 Governance

Maturity of a group is also about the understanding of the members of their own roles in the SHG, about their collective ownership and their ability to re-look at the goals, norms and systems periodically to keep adjusting them to the changing requirements. Does the SHG deliberate on its governance systems periodically? Does the SHG periodically look at its own savings rate, loan products, loaning norms and so on in order to best meet the members’ requirements? Does the SHG keep setting
more and more challenging goals for itself, which leads to growth rather than stagnation?

### 7.2.4 Linkages

Finally one also needs to look at the quality of linkages that the group has established. Has the SHG started branching out to establish linkages with other SHGs, and other stakeholders such as the rest of the villagers, the bank, the Panchayat, the Block, etc.? A mature SHG is one that realises that it is not an entity that can operate in isolation but would need to collaborate with a number of other actors to achieve its goals. Maturity is also in reaching out to others for seeking help when required. This is typically visible in time of some internal conflict in the group. The group tries to solve the problem by itself, and if it does not work out it takes the problem to the cluster (or federation) meeting, and if that also does not work out it comes to the NGO office. But it would explore all options of how the problem can be solved.

Well, the list could go on. But I believe it is important to take a larger view of an SHG than just look at its age and size of bank loan. Irrespective of who was the group promoter the group needs to display these attributes, which also means, in a sense, that substantial amount of time would have been spent in the group in setting systems and strengthening the group. Additionally the external stakeholder, the banker in case of financing, would need to pick up the wherewithal to assess these attributes.

### 7.3 Mature SHGs: Way forward

What is the direction forward for the mature SHGs? There may be about half a million mature SHGs in the country now, with a total membership of 7.5 million poor families. Even if we said that many of these groups do not match up with the ‘maturity’ criteria, we are still looking at three to four million poor families organised into vibrant institutions waiting to take the next challenge and leap forward. Where do they go?

#### 7.3.1 Ongoing support

One thing that has emerged from discussions with old SHGs is the issue of systems for ongoing support even after the promoter has reduced time commitments. Some areas where they need support are
those of ensuring continuing adherence by all members to the values and norms, tiding over conflict situations, changing group leaders, establishing external linkages and so on. Some systems need to be put in place by the promoter to see that ongoing support is provided to the SHGs. It may not be all right to assume that if the SHGs have been functioning well for the initial months and have made good repayments in the initial bank loans, they will continue doing so. They are after all human organisations and do go through major up’s and down’s, when they require close support.

In PRADAN, the SHGs are organised into Panchayat level federations called clusters, where SHG representatives meet regularly to provide peer support. The PRADAN staff also attends these meetings and reviews performance and looks for early signals of any impending problem. There is also a strong management information system wherein information of group performance comes in regularly to PRADAN office. Both these together enable staff to provide need-based support to the SHG.

7.3.2 Sustainable livelihoods

A sustainable livelihood for each and every SHG member is mission of the SHG. These SHG members are looking for ways to stabilise their lives and livelihoods in a way that it enhances their dignity and contributes to the broader well being of the family members. There is extensive documentation establishing that access to microcredit in itself is not a sufficient qualification for ensuring livelihoods, particularly in case of the very poor. Microcredit does benefit all the SHG members in the way that it gives them access to a savings facility, helps them manage their household finance, gives access to small loans to tide over emergencies as well as to strengthen existing livelihood activities.

Some members in the SHGs who are slightly more enterprising also make good use of the bank loans available, to expand their livelihood portfolio. But beyond that the livelihood impact of microcredit is not substantial. Take for example the pockets of extreme poverty such as the central and eastern hilly and tribal regions, which are sometimes termed the poverty heartland of the country. This is interestingly an area richly endowed in natural resources, but characterised by endemic poverty, leading from a discernible under-utilisation of these resources.
Towards a Sustainable Microfinance Outreach in India

Poverty here is characterised by lack of public investments in infrastructure, dysfunctional public systems including those of education and health care, under-developed markets, and large tracts of isolated communities lacking basic capabilities in dealing with changing economic realities, technologies and markets.

What are the kinds of investments such a set of people would need to secure their livelihoods? There is a need to really look for ‘out-of-the-box’ solutions here, going far beyond the single dimensional SHG-Bank linkage system. First step would be to mobilise investments into revamping public infrastructure, services and markets. These are large-scale investments and some of it such as for roads communication etc., will have to be made by the State itself, while also inviting private capital.

7.3.3 Building a livelihood vision in SHGs

Parallel to this is the task of promoting large number of SHGs reaching out to all the poor people in a given area. Promotion of livelihoods, especially in infrastructure-poor regions will have to be done on a concentrated area or cluster basis for reasons of economy of scale. This requires that the target population has to be organised into SHGs well in advance. In addition to setting up a financial system at the community level, the SHGs also provide the social infrastructure to build on.

The promotional agency would need to work very intensely with these groups over a reasonable period of time (eight months to a year) in building in the members the capabilities of working together, handling group dynamics, dealing with service providers, negotiating with external stakeholders, handling large finances, and in planning for bettering their livelihoods. The promoter has to spend good quality time at the group level in helping each member to articulate one’s life and livelihoods vision, in building the motivation and entrepreneurial abilities.

7.3.4 Building SHGs as effective financial intermediaries

The SHGs are linked with banks once they are ready with their plans. As mentioned earlier, as long as the members take up initiatives such as strengthening existing livelihoods, primarily with the focus of self-consumption or at best for local small markets, the SHGs and the SHG-
Bank finance will stand them in good stead. One thing that has to be mentioned emphatically here is that the SHG-Bank linkage in its current form has very limited potential for anything other than provide funds for consumption smoothening. The loan sizes have to substantially go up if it has to finance a limited number of members. The bank finance even now is in most places limited by the 1:4 ratio of own funds to bank loan, which many a time ends up under-financing whatever the group members have proposed.

### 7.3.5 Identification of potential livelihoods for the poor

Once the SHGs have got going, then it is time for expanding the livelihood portfolio by special interventions. First, livelihood ideas suited to the bottom 30% to 40% of the population in the local area have to be identified. A large number of options would have to be generated, some may be traditional and some may be non-traditional. This is because we are dealing with families that belong to poor or very poor categories with low levels of resources, skill, inter-generational experience, understanding of markets, investment capability or risk-taking ability and they would need a basket to chose from. We would need to look at ideas that have possibility of being scaled up to such as those around food and food processing, processing of forest produce, related to clothing and so on.

### 7.3.6 Market linkage organisations

Large-scale production also would entail that the local markets soon run out of absorption capacity, and larger (and distant) markets would have to be tapped. Linking to distant, difficult-to-access markets for either forward or backward linkages would mean creation of linkage organisations – specific to each enterprise. One point to remember here is that SHGs are not these organisations. They are microfinance and solidarity groups, and must remain so. It is also to be remembered that the economic reality of individual members are different, therefore it is not at all necessary that all the members would be interested in taking up the same activity.

We have to have specifically created enterprise organisations that would have a different logic of organisation with different operational and governance systems. Different members of the same SHG might join different enterprise organisations depending on what activity they
choose. These organisations would deal with all aspects of the business such as planning, production supervision, quality control, inventory management, wholesale and retail markets, price negotiation, finance mobilisation, deal with statutory authorities and so on. These are quite sophisticated functions and would need to be managed professionally. Staff from the NGO will have to play the leadership role in such linkage organisations, till the time the members themselves are capable of hiring and managing skilled people from the market.

The need for such linkage organisations has to be recognised. Then ways of financing and capitalising them have to be worked out.

### 7.4 Need for convergence

The summary of the above could be stated as saying that the financial implication of setting up viable livelihoods for a large number of poor people in remote rural areas is that a variety of financial solutions are required, and SHG-Bank finance tends to be very uni-dimensional. The members require the routine SHG loans for their individual purposes, both consumption and whatever else; they also require working capital for the livelihood activity that has started. These are possible to be channelled through SHGs. Then they would need financing for creating assets, which may or may not be channelled through the SHGs. These asset loans would have to be substantially larger than the normal SHG loans and may not be taken by all members in a particular SHG.

Then there are financial requirements by the linkage organisations – the producer cooperatives, producers’ companies, mutual benefit trusts and so on. These structures would need their start up capital that will have to be found through members’ contributions and upfront grants. Based on this the organisation could mobilise finance from the banks, primarily for their working capital. Then there would be large investments for common infrastructure, such as a dairy chilling plant, a poultry feed mix unit or an agri-service centre. The organisation will need finance for this, either as grant or as a long-term loan. One could also explore options of bringing the private sector in for providing such common services. Nevertheless the finance for such investments has to be found.

This means that the enabling organisations such as the Government agencies involved, NABARD, the banks and the NGOs need to
converge their energies and have to think of creative ways of working with these people’s organisations – both SHGs and linkage organisations – so that a holistic livelihood programme can be put in place.

7.5  **Beyond livelihoods – issues of broader well-being and empowerment**

Livelihood programmes lead to food security and increase incomes, but the SHG women demand much more – access to basic services and a role in the wider social and political processes, enhancing their public status.

How can the external stakeholders that work with the SHGs and their federations creatively engage them in the broader processes? For example, Are there ways in which the SHGs/federation can work with the local government machinery, increasing the effectiveness of the delivery of various schemes and services such as health care facilities, literacy, development programmes such as food for work, rural roads, etc. These peoples’ organisations can be made part of the planning processes of these schemes and services, which would mean tailoring the delivery to benefit the very poor people. But that means the development of a great amount of trust and mutuality between these agencies, and a readiness to take risks on the part of the government agencies.

Experiences elsewhere have shown that when such responsibilities are handed over to SHG women, they have displayed tremendous leadership qualities and resolve, irrespective of their poverty or literacy status. The results have not just been empowerment for these women but also have resulted in a better delivery of the programme. Thus it is imperative to push for such proactive involvement of the SHGs in public roles, which also would mean training inputs to these women to get into such roles and carry out their responsibilities.

7.6  **Conclusion**

The SHG movement has the potential to bring about a transformation in the lives of rural poor women given the way it is able to mobilise them around their own resources and initiatives; therefore the paramount need to broad base this movement. Yet it is important not only to create
new SHGs but also support and strengthen the mature SHGs to provide broad-based benefits to all the members. For that the low volume, single dimensional financing through the current SHG-Bank Linkage Programme is not enough. Increasing the loan sizes could be one immediate and important starting point. Additionally, comprehensive livelihood financing models have to be worked out, which could be a mix of variety of financial products, including upfront subsidies. Appropriate institutional mechanisms outside of SHGs also have to be created to provide sustainability to the livelihood programmes. This would actually require the concerted efforts of the Government agencies, NABARD, banks and the NGOs to converge at the level of the people’s institutions.

Equally important is to enable these women to access basic services and address their well-being issues. The social infrastructure that has been built up in the form of the SHGs and their federations could be extremely effective mechanisms to improve the quality of delivery of various schemes and services. For this it is important to involve the SHG women in planning and implementation and enhance their role in local governance.
8 Indian Microfinance sector: The road ahead

Vijayalakshmi Das

8.1 Background

The growing recognition for microfinance (MF) in India is evident from the plethora of articles appearing in the last few months in the press and leading journals. The role of microfinance as one of the effective tools in poverty reduction is being recognised and the success of SHGs and other microcredit delivery models in selected pockets of the country has created a favourable image for the microfinance sector. The mainstream banks are coming in a big way to provide the necessary loan fund to microfinance institutions (MFIs), a trend that is leading to sudden flux of loan fund in the hands of few MFIs. Many of them are yet to strengthen their system to absorb huge funds.

While the annual demand for credit support from the estimated 75 million poor households has been assessed at Rs. 450 billion, we are yet to know exactly how much of this demand is met by the formal banking sector and the MFIs. Some of the micro level studies\(^1\) indicate that the poor still continue to depend largely on informal sources of credit and these sources account for 40% to 60% of the household demand. The challenge for the mainstream banking institutions and the MF sector is how to bridge this huge gap.

India is fortunate to have a well established network of banking infrastructure and the government has always been concerned about the poor household’s limited access to financial services. The various pro-poor schemes (with the emphasis on subsidised credit) introduced by successive governments failed to make the expected impact on the poverty level. The emergence of MFIs, though limited in number, had proved that what is needed is an appropriate delivery mechanism for financial services and the poor are willing to pay for reliable services at their door step.
Indian microfinance sector is known for its diversity of delivery models. With the support of NABARD the SHG model had grown rapidly. A Significant number of institutions have adopted the Grameen methodology. Cooperatives are yet to take the lead in reaching out to the poor. Banks like ICICI have taken the initiative in collaborating with the MFIs to ensure continuous flow of funds to the members of the collectives, a major constraint that persisted for almost a decade.

The recognition from the government and the regulator for microfinance, along with the banking sector’s willingness to work in collaboration with intermediaries, has necessitated the task of taking stock of the capacity of the existing network of NGOs and MFIs to reach out to larger number of poor households in the urban and rural areas.

The banking sector could play a major role in reaching out to the poor, but they have limitations due to their involvement in multiple services, and it is expensive for them to service small loans in huge volume. This brings us to the role of NGOs/MFIs as partners or intermediaries.

8.2 Experiences of Friends of Women’s World Banking, India

Friends of Women’s World Banking (FWWB), India, was established in 1982 to promote direct participation of poor women in the economy through ensured access to financial services. The focus on women, especially the poor, was based on the fact that women account for more than 80% of the growing informal sector in the country. These economically active women were not able to access the formal banking sector for their working capital needs. The cooperatives and the banks by-passed this section of the working population. The ‘informal’ nature of their business and their requirement of capital (small and frequent) came in the way of establishing the link with the formal banking sector. The initiatives taken in the early seventies by institutions like SEWA and Working Women’s Forum in providing financial services to the urban poor women and the subsequent attempts in reaching out to rural women through collectives (SHG/Cooperatives) by MYRADA and SAMAKHYA (now known as CDF) have proved that banking with poor women is viable and they need both savings and credit services.

FWWB worked with Rajkot Nagarik Cooperative Bank from 1982 to 1989 to provide credit support to self-employed women of Rajkot city.
through a loan guarantee mechanism. Since this did not work out well, it had decided in 1989 to work with NGOs to emphasise on the need to organise the poor women in any form of ‘collectives’ and link them to banks for financial services. In the early nineties, FWWB was working with nearly 200 organisations across seven states. The lukewarm response from the banking sector necessitated the need for setting up a revolving fund to provide loan support to the women’s groups through the promoting NGOs. With the initial support from Industrial Development Bank of India (IDBI) in the form of a soft loan of Rs. 1.5 million and grant support of Rs. 300,000 for capacity building, FWWB started working with NGOs that have organised women’s savings groups and gradually moved to cooperatives, federations and MFIs working with joint liability groups.

FWWB was successful in mobilising loan fund from Indian financial institutions and it had provided till now loans to the tune of Rs. 1,850 million. Currently it works with 88 organisations and the outstanding portfolio with these organisations is Rs. 730 million.

FWWB’s experience in the sector for nearly two decades reveals that:

- Poor women are bankable and they need the entire package of financial services – savings, credit, insurance and old age pension.

- The focus of the MFIs/NGOs we are working with has remained the poor households in the urban and rural areas and many of them are operating in resource-poor regions (drought/disaster prone areas).

- It is important to organise the women in ‘collectives’ to encourage savings, create peer pressure in lieu of collateral and monitoring the usage of loans. It builds leadership among women where the focus of the promoting institution is to build a strong community based institution that will gradually take up the financial intermediary role.

- The Indian microfinance sector will have a mix of credit delivery methodology and it should be nurtured. While the SHG-Bank Linkage Programme model has been successful in reaching out to larger number of poorer households, the flow of credit from banks to the SHGs has been skewed, with southern states accounting for major share of the bank support. Inspite of its great growth the average loan size available to a SHG member varies between Rs. 500 to Rs. 2,000, which is hardly enough to make any significant dent in the household’s income earning capacity.
FWWB’s experience shows that the Grameen methodology had helped institutions to reach out to larger number of women and their systems are effective in ensuring good repayment rate. Over the years we found that many institutions have adapted this methodology. Non-availability of grant funds for group (SHG) promotion and the ease with which such credit-focused groups could be formed could be the reasons for the switchover. The ability to expand the outreach, with assured fund support was also an important factor for funding institutions to support this model.

The cooperatives are to be nurtured and we believe that it is a model that ensures member participation and control in managing the resources. Since it does not have the constraint of an SHG in membership size and is legally entitled to mobilise member savings and could become a viable institution (barring political interference), strategies should be evolved to encourage their growth in microfinance sector.

• Capacity building needs to be combined with loan support for the start-ups. Since 1989 FWWB has invested in building the capacity of nearly 100 institutions providing financial services to the poor. Only 25% of these institutions could show significant growth in their outreach and were able to access loans from the formal banking sector. This brings to the fore the question of limited capacity of the vast majority of the NGO/MFIs to upscale. The access to assured loan fund was always sited as a constraint for growth, but we found that there are organisational factors that are inhibiting the growth. Unless this is addressed we will not be able to have sufficient number of intermediaries to strengthen the demand stream of the microfinance sector.

• The main focus of microfinance is reaching out to the poorer households and ensuring for them much needed financial services on continuous basis. Within the context of a rather feeble base of non-farm activities and a prevalent subsistence agriculture, a large number of poor households remains at a level where their consumption as well as poor income often keep them in a state of marginal position. Combined with this is their need to respond to lifecycle social events and different sets of exigencies. Unless the loan absorbing capacity of the household is enhanced through appropriate and timely provision of somewhat larger sizes of loans
for investing in agriculture and other productive activities with the potentials of ensuring viable returns, the current efforts in reducing poverty through credit support will have very limited impact.\textsuperscript{2} Neither the MFIs nor the banks are ready to take the risk of making this move.

- The whole movement of microfinance was initiated keeping women in the centre with the conviction that any intervention through her will have the desired impact on the household economy. Various studies brought out that women contribute substantially to the income in poor households and this made them the focal point for receiving financial services. The SHG methodology was geared towards strengthening the capacity of these women in managerial and leadership skills. With the increasing emphasis on organising more SHGs at a faster pace has diluted the quality of the SHGs. The investment in terms of time and resources in building the capacity of the members of the SHG has been reduced, resulting in the formation of weak groups with the short term vision to access credit from banks and the government programmes that are designed to reach out to the poor/women through SHGs only.

- Sufficient efforts are yet to be made to ensure that women have the control over the usage of the loans and ownership of the assets created through loans. Concerted efforts are also to be made in enhancing their skills to graduate from micro-borrowers to micro-entrepreneurs. Very few institutions have the strategy in place to help this graduation.

- The microfinance sector has been engaged in policy dialogue, through Sa-Dhan since 1998, seeking the government’s support in providing an appropriate legal framework for the sector to carry on the activities in a transparent manner. From a non-profit entity some of them have switched over to a for-profit entity and some more are planning to do so. The implications of such transformation is yet to be assessed from the capacity point of view.

8.3 The way forward

The existing policy and regulatory environment is favourable for the growth of a vibrant microfinance sector in our country. Recognition of the role of microfinance in poverty reduction and the need for closer ties between mainstream financial institutions and the MFIs is encouraging.
Towards a Sustainable Microfinance Outreach in India

If we are serious about reaching out to the poor households with appropriate financial services that will enhance their income level and reduce their vulnerability, we need to develop strategies to establish and strengthen partnership among all the stakeholders.

To bridge the existing demand and supply gap and to reach out to under-served states where concentration of poverty is high, it is important to invest in the capacity of the existing social intermediaries/NGOs in organising the poor. Such a strategy will help in building the local capacity to initiate area-specific interventions.

India, with its geographic, economic, social and cultural diversity, will require variety in delivery mechanisms of financial services. This should be encouraged and recognised by the mainstream financial institutions.

Micro-loans alone will not reduce poverty, though they are helpful in arresting the poor from further fall in times of crisis. There should be clear strategy to help them to move up through diversified loan products, bigger loan for productive activities and measures to provide safety nets (insurance, savings) to reduce their vulnerability.

Promoting livelihood opportunities and developing skills to undertake micro-enterprises will help in increasing the household income. The mainstream institutions should allocate funds for building the capacity of members and promoters of collectives, since it is an investment they make for building the demand base for their services. NABARD should take the lead in nurturing new initiatives and strengthening the existing microfinance institutions and promoters of community-based financial institutions.

Endnotes


Some issues in informal finance: Perspectives from a Rajasthan village

J. Howard M. Jones

9.1 Introduction

This High Level Policy Conference on Microfinance provides a most welcome opportunity to consider the role of the informal financial sector. Although the *raison d’être* of microfinance is to reduce financial exclusion, it is wrong to assume that high proportions of the world’s poor have no access to financial services. This is not the case, for neither rural nor urban financial landscapes are blank canvases waiting for the arrival of banks and Microfinance Institutions (MFIs). High proportions of the poor may not have access to formal sector finance, but they do have access to a wide range of informal financial agents supplying credit, and also, to a lesser degree, savings facilities (Rutherford, 2002; Ruthven, 2002).

Although there are debates over the exact distinguishing features of informal finance (for example a lack of regulation, or effective regulation, by the banking authorities) and debates concerning how informal agents may best be classified (e.g. for profit, user-owned, and reciprocal) it is generally recognised that this sector still accounts for a substantial proportion of financial transactions, particularly in rural areas of many developing countries (Ghate, 1992; Johnson and Rogaly, 1997). However, just in the same way that the informal financial sector constitutes the hidden part of the financial services iceberg (Mahajan and Ramola, 1996) so too there is generally very little consideration of this sector in policy debate (Bouman, 1990).

India has a very long history of activity by informal financial agents. The Census of 1921 mapped the presence of indigenous bankers and moneylenders in pre-independence India, with such groups as the Jains, the Marwaris, the Chettis and the Khatris providing an early indication of the diversity of informal agents within the present-day
boundaries of the country. Although such agents have traditionally been regarded with suspicion, and policies implemented to curtail their activities, macro-level data and micro-level studies have suggested they have not yet been superseded (Jones, 1994; Srivastava, 1992). In this conference it is reported that the proportion of borrowings of rural households in India from institutional sources increased from seven percent in 1951 to more than 60% at present (Thorat, 2005), but this still leaves a substantial proportion provided by non-institutional sources of finance – the informal sector.

Moreover, in reality, it is likely that the proportion of borrowings from the informal sector is even higher. As Darling noted in 1925, the poor are always anxious to throw the purdah (veil) over their debts, a reticence which is unlikely to be reduced by time and the use of survey questionnaires. In addition, measures used to assess the relative importance of different sources of finance (stock of debt, loan value) commonly underestimate the significance of the informal financial sector (Ghate, 1988). Where more qualitative research approaches have been used, particularly anthropological micro-level studies in India, then data suggest a greater presence and use of informal agents than that indicated by national surveys (Jones, 1994).

This paper examines these questions from the perspective of a village in Rajasthan. After introducing the research setting and informal financial provision within the village, the following sections of the paper concentrate on analysing data based on the account books of a moneylender in the village. The paper concludes with the policy implications of these findings.

9.2 The research setting

This paper is based on research on financial services and livelihoods conducted in a Rajasthan village during 2000 and 2001. The writer first lived in the village for over a year in the late 1970s and has continued to plot changes in livelihood diversification at the household and individual level to the present day. A parallel research interest concerns the work of moneylenders in the village and the impact of introducing bank finance on their activities (Jones, 1994). The writer lived with a shopkeeper/moneylender family and it is on this lender’s account books that the data presented in this paper are based.
To provide anonymity to the villagers the village is called Chandrapur. It is situated in Dungarpur district in the southern part of the state of Rajasthan. Villages in Dungarpur district are largely of two types: pals (dispersed settlements) inhabited by the majority population, the tribal Bhils; second, nucleated settlements inhabited largely by caste Hindus, a type of village which often serves as a kind of service centre providing goods and services to the tribal hinterlands. Chandrapur itself combines both features: a nucleated part of the village inhabited largely by caste Hindus (including the shopkeepers and moneylenders) and a dispersed part of the village inhabited by Bhil households, the whole being surrounded by a very substantial number of dispersed Bhil settlements.

The household and population figures for the village are given in Table 1. A distinction is made between households with resident members in the village (an increase from 134 to 244 over the period) and households with no resident members in the village (an increase from three to 44). Although inclusion of the latter category may seem unnecessary, it is one of the indications of increased migration (the most extreme form) away from the village, an important component of livelihood diversification. Another indication of the importance of migration is the increase in those resident household members working away from the village (from 85 to 210). The total resident population of the village in 2001-2002 was nearly twelve hundred persons.

Table 1: Overall household (HH) and population data 1976-1977 and 2001-2002

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) No. of HHs with resident members in village</td>
<td>134</td>
<td>244</td>
</tr>
<tr>
<td>(B) No. of HHs with no resident members in village*</td>
<td>3</td>
<td>44</td>
</tr>
<tr>
<td>Resident population of HHs (A)</td>
<td>794</td>
<td>1197</td>
</tr>
<tr>
<td>Non-resident population of HHs (A)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>i.e. members of resident HHs working away from the village</td>
<td>85</td>
<td>210</td>
</tr>
</tbody>
</table>

*HHs often holding rights to property and/or land in the village but with no resident members in the village
For a village in what is usually considered to be a rather remote and ‘backward’ part of Rajasthan, the economy has long been quite complex. To varying degrees and in varying combinations, livelihoods are based on land and natural resources, caste-based activities, non-caste based enterprises, employment in the public sector, and wage employment in the private sector. Moreover, location of these livelihood activities now stretches from the village itself to the Middle East. Combinations of livelihood activities and location of these activities varies enormously between the different communities in the village.

The three groups with the most marginal livelihoods in the village consist of the tribal Bhils (41% of resident households), the Jogi (a low-caste group of mendicants, 12% of resident households) and the Bhangi (a very low-caste group of sweepers, three percent of households). As we shall see, these three groups, especially the Bhils, figure prominently in the moneylender’s account books. In addition to their particularly small and poor quality landholdings, the livelihoods of the Bhil households have three main characteristics. First, there is very little enterprise development, such enterprises that do exist being very small scale and sometimes illegal. Second, there is very little public sector employment, and what there is, largely consists of lower status, poorly paid jobs, except amongst a few closely related families, often with some education, which have, managed to secure relatively better employment in this sector. Third, there is substantial private sector wage employment, though often in the form of menial and irregular jobs in the service and construction sectors, and in many instances through migration to Gujarat and Mumbai.

Even so, however small the enterprise and menial the ‘outside’ employment, finance is still needed to pursue these activities. Let us now look at informal financial provision in the village and consider how the lending records of one of its agents can inform us about financial service needs of the rural poor.

9.3 Informal finance within the village

Informal finance in the village comes from two main sources:

- First, there are a number of Rotating Savings and Credit Associations (ROSCAs) whose members contribute sums of money to the group on a monthly basis; the lump sum then being allocated to each
Some issues in informal finance: Perspectives from a Rajasthan village

member in turn. The ROSCAs are usually based on caste and occupation, and membership limited to those with a regular source of income (Jones, 1994). For this reason, poorer households in the village do not have access to such group based finance.

• Second, the shopkeepers in the village, largely from the Jain community (Carrithers and Humphrey, 1990), provide two main types of credit: shop goods on credit and cash credit. The provision of the former is also largely confined to those with a regular monthly income e.g. school teachers in the village who are able to pay for the goods when they receive their salary payments. Cash credit given by the shopkeepers is provided to clients depositing jewellery as collateral, and largely to clients coming from the poorer tribal households in the village and surrounding tribal hinterland. With over twenty shopkeepers providing such pawnbroking credit in the village, this type of finance plays a vital role in the local economy (Jones, 1994). Interest charges for such credit are three percent a month, and there is an additional charge of ten percent of the loan amount when the credit is provided.

Although informal lenders are notoriously reluctant to discuss their business activities, where possible, access to the account books of such lenders can provide a unique window into the world of informal finance. In this case, data gleaned from the daily lending records of one of the Jain shopkeepers informs us of:

• Who is needing/using informal finance (e.g. by community, gender, etc.);
• location/spread of clients in relation to the lender;
• loan purposes – why credit is needed;
• when finance is required – the seasonality of loan provision;
• frequency of finance – how often loans are needed;
• scale of finance – size of loans;
• the cost of finance;
• repayment rates and repayment ability of those using informal finance.
Towards a Sustainable Microfinance Outreach in India

Taken together, these pieces of information provide a clear picture of the financial service needs of the rural poor, a picture based on fact rather than conjecture. Let us begin the process of building up such a picture by first looking at the clients of the moneylender.

9.4 Clients of the moneylender in 2000-2001

Over the course of the year 2000-2001 the moneylender provided 342 loans. The great majority of these loans (84%) were to clients in surrounding tribal villages. The majority of loans given in the village (32 of 54) were to tribal clients in the dispersed part of the village. Table 2 shows the distribution of loan provision by caste/tribe.

Table 2: Clients of the moneylender (2000-2001) by community

<table>
<thead>
<tr>
<th>Caste/tribe</th>
<th>Loans (No.)</th>
<th>Loans (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bhil (tribe)</td>
<td>309</td>
<td>90</td>
</tr>
<tr>
<td>Jogi (mendicant)</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Bhangi (sweeper)</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Vadi (grinding stone dressers)</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Panchal (blacksmith)</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Others</td>
<td>0</td>
<td>–</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>342</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Overall, the great majority of loans (90%) were provided to tribal clients. A further six percent of loans were provided to two very low-caste communities, the Bhangi and the Jogi. Ten loans were provided to a rather low caste group, the Vadi, a caste of grinding stone dressers living in neighbouring settlements, and just three loans were provided to a relatively better off caste group in the village, the Panchals (Blacksmiths). Thus the account books show a continued reliance on this type of informal finance by tribal families and very low caste families in the village and in the surrounding tribal settlements. Conversely, as in the 1980s, the higher caste groups in the village do not pawn their jewellery for loans, at least not within the village.
9.5 Loan purposes of informal credit

Having established that the clients of the moneylender largely come from poor tribal and low-caste households, let us now see what the account books tell us about the purposes of such informal loan provision, i.e. why these clients needed to take such credit. From Table 3 it is clear that this single moneylender provides credit for a very substantial range of financial service needs, by no means all of which relate to consumption expenditures. Table 3 shows the major categories of loan purpose, with the number and percentage of loans for each of these, and also identifies, in declining order, the different loan purposes within each of these categories.

Table 3: Loan purposes for informal credit 2000-2001

<table>
<thead>
<tr>
<th>Loan categories by number and percentage of loans</th>
<th>Loan purposes within loan categories by number of loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan categories</td>
<td>Number of loans</td>
</tr>
<tr>
<td>Life-cycle</td>
<td>56</td>
</tr>
<tr>
<td>Household</td>
<td>159</td>
</tr>
<tr>
<td>Finance</td>
<td>10</td>
</tr>
<tr>
<td>Business</td>
<td>8</td>
</tr>
<tr>
<td>Travel</td>
<td>55</td>
</tr>
<tr>
<td>Agriculture</td>
<td>52</td>
</tr>
<tr>
<td>Other</td>
<td>2</td>
</tr>
</tbody>
</table>
Loans for life-cycle needs account for just over 16% of provision, with marriage expenditures accounting for as many as 40 loans. Even this single loan purpose includes a variety of expenditures (e.g. direct expenses for the marriage of family members or expenses to simply travel with a marriage party). Household expenditures cover a wide range of individual loan purposes and together account for just over 46% of loan provision. Here, the large number of loans needed for medical and food expenditures are particularly striking. Education expenditures include exam fees, the cost of books etc. The use of one loan to pay for a phone call shows the creeping advance of technology and the need to finance the use of this.

Although loans for finance purposes comprise just 2.9% of provision, they illustrate interesting interactions with other agents in the informal sector (e.g. payment of other informal loans) and with the formal sector (e.g. to open a deposit account in the village bank to deposit an insurance cheque). Business loans also account for a very low percentage of overall provision (just 2.3%) but the fact that this is so low is interesting in itself (an indication that very few poor tribal households start enterprises), and the businesses that are financed are often pitifully small and sometimes illegal – e.g. the mixing and selling of adulterated ghee. Loans for travel account for just over 16% of loans provided. The significant point here is that these loans are almost all for non-local travel, indicating the high migration out of the area by poor families, and the role of the informal sector in financing this movement.

Loans for agricultural purposes cover quite a wide range of individual loan purposes, the most important being to pay for labour for various tasks e.g. levelling fields, sowing crops, transplanting rice, cutting of grass for livestock etc. The two litigation loans were needed by the borrowers to give money to the police.

Comparison of data in Table 3 with that for loan purposes in 1988-1989 shows few differences in terms of overall proportions. In terms of numbers of loans, household loans still account for the largest grouping of credit provision, life-cycle loans account for similar proportions, as do loans for agricultural purposes. Similarly, in terms of proportions of loan value, there are only some small differences between these two time references. Even so, little change can also be significant. For example, by value, the proportion of loans for agricultural purposes increased to 21% in 2000-2001 from 19% in 1988-1989. So, at the start of the 21st
century, seventeen years after the establishment of a commercial bank branch in the village, and many more years after the establishment of a primary agricultural credit cooperative in the village, just over one-fifth of credit advanced by the moneylender is still used for agricultural purposes.

Two individual loan purposes show striking increases over the time period. In terms of number of loans, the proportion of credit provided for medical purposes (e.g. medicine, hospital expenses) has increased from 10% to 20%. The proportion of loans for non-local travel has increased from 10% to 16%. The former is a reflection of poor diet (itself a reflection of sparse monsoon rains in recent years) and the incidence of malaria. Similarly, increased non-local travel is a reflection of greater migration out of the area to secure wage employment, particularly in Mumbai and Gujarat. Thus this form of informal finance plays a crucial role in health expenditures and in helping to finance livelihood diversification.

9.6 Scale of informal finance

We have seen that the clients of the moneylender are largely from tribal households which are borrowing money for a wide range of consumption and productive loan purposes. What about the scale of finance? What can data from the account books tell us about the size of loans taken by the clients? A first indication is given in Table 4 which shows the size distribution of loan taken.

From Table 4 it can be seen that 30% of all loans were up to a value of just Rs. 250. Similarly, 65% of all loans were up to a value of just Rs. 550. Thus the moneylender, in large part, is providing very small value loans: too small in value as individual transactions to be of interest to the formal sector.
**Figure 1: Size distribution of loans (%) 2000-2001**

![Size distribution of loans](image)

**Table 4** shows the size distribution of loans by the main categories of loan purpose, and gives the average, minimum and maximum values for each of these.

**Table 4: Minimum and maximum loans by category of purpose 2000-2001**

<table>
<thead>
<tr>
<th>Category of purpose</th>
<th>Average value of loan (Rs.)</th>
<th>Minimum loan (Rs.)</th>
<th>Maximum loan (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life-cycle</td>
<td>991</td>
<td>66</td>
<td>10,000</td>
</tr>
<tr>
<td>Household</td>
<td>650</td>
<td>55</td>
<td>5,000</td>
</tr>
<tr>
<td>Finance</td>
<td>1,402</td>
<td>165</td>
<td>3,000</td>
</tr>
<tr>
<td>Business</td>
<td>360</td>
<td>110</td>
<td>900</td>
</tr>
<tr>
<td>Travel</td>
<td>319</td>
<td>55</td>
<td>1,200</td>
</tr>
<tr>
<td>Agriculture</td>
<td>990</td>
<td>110</td>
<td>5,000</td>
</tr>
<tr>
<td>Other/litigation</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Overall</td>
<td>728</td>
<td>55</td>
<td>10,000</td>
</tr>
</tbody>
</table>
The range of value varies from Rs. 55 to Rs. 10,000. The former denotes the size of the smallest medical and travel loan, while the largest loan was taken to finance a family marriage. The smaller loans tend to be for household, business and travel purposes, with larger size loans used for life-cycle, finance and agricultural purposes. Litigation needs were also relatively expensive. What is clear is the flexibility of informal finance in this respect. The moneylender will provide the exact amount requested by the client, however small this may be; the client is not obliged to take more than is required simply to fulfill minimum lending requirements.

9.7 Repayment of moneylender credit

The moneylender does not normally note the date of repayment in his books. Once a loan is repaid, this is simply crossed out in the accounts. However, for the purposes of this research the moneylender did note the date when loans taken during the reference periods were repaid. A subsequent visit to the village in February 2004 made it possible to record repayment dates for loans repaid, or not, as the case may be, after 2000-2001.

For all loans taken during 2000-2001, 30% were repaid within three months, 46% within six months, and just over 60% of the loans were repaid within 12 months. This still meant that nearly 40% of loans were not repaid within a twelve months period, and, with interest charges of three percent a month, were thus incurring substantial costs for the borrowers. There is one striking change compared to the 1988-1989 repayment figures. For the earlier period the repayment rates were noticeably better for women clients compared to those for men: in 1988-1989, nearly 80% of loans taken by women were repaid within six months compared to 48% for men. In 2000-2001, although women still evidenced better repayment rates than men, the difference was much less: just over 50% for women, compared to 45% for men, within the six months time period. The moneylender suggested no reason for this other than to comment on the general economic difficulties of the times, and further investigation is necessary to assess this rather worrying trend.

With information about repayment dates for all loans repaid, it is possible to identify any variation with respect to loans purposes. These are shown in Table 5. The Table plots the repayment rates of the seven categories of loan purpose against the mean repayment rate of nearly
Towards a Sustainable Microfinance Outreach in India

85% by February 2004, bearing in mind all the loans were taken between October 2000 and November 2001.

Repayment rates for the business loans are strikingly lower than the average. This is a worrying finding given the present worldwide emphasis on micro-enterprise development for poverty alleviation. The relative difficulty in repaying such loans may be one reason for little evidence of enterprise development on the part of the poor tribal families, i.e. the families may not want to incur the risk. However, we should bear in mind that the businesses concerned are really tiny enterprises, some of which are illegal. The latter are run by the poorest of the tribal families in the village and some barter-based enterprises are run by the lowest caste group in the village. Even so, such an example warns caution against the assumption that every poor person is a budding entrepreneur and that micro-enterprise development is not without risk.

Table 5: Repayment rates by February 2004 for categories of loan purposes (in %)

<table>
<thead>
<tr>
<th>Loan purpose</th>
<th>Repayment rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life cycle</td>
<td>84.2%</td>
</tr>
<tr>
<td>Household</td>
<td>81.3%</td>
</tr>
<tr>
<td>Finance</td>
<td>84.2%</td>
</tr>
<tr>
<td>Business</td>
<td>71.4%</td>
</tr>
<tr>
<td>Travel</td>
<td>84.2%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>80.8%</td>
</tr>
<tr>
<td>Other/litigation</td>
<td>84.2%</td>
</tr>
<tr>
<td>Repayment rates</td>
<td>87.5%</td>
</tr>
<tr>
<td>Average</td>
<td>88.9%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>
Loans for agricultural purposes are also below the average repayment rate. Only just over 50% of agricultural loans were repaid within a twelve months period, a reflection of the relatively long time to recoup such investment. This is also clearly problematic, with a large proportion of agricultural loans incurring substantial interest payments.

In contrast, the loans taken for travel purposes were relatively quick to repay, perhaps a reflection of increased repayment ability through migratory labour earnings. Loans for litigation showed the highest repayment rate – 100%. Just two loans were taken for this purpose and although they both had a relatively high value (Rs. 2,000) they were both repaid.

9.8 Conclusions

For a village situated in a part of India long regarded as poor, tribal and ‘backward’, the economy is surprisingly complex. Over the years there has been an increased diversity and multiplicity of livelihood activities, and an ever expanding horizon for the location of these activities. Households are not simply farming households, they simultaneously engage in a wide variety of income generating activities, both inside and outside the village. Such diversification is evidence of a rural revolution, not just an agricultural revolution.

The combinations and locations of these livelihood activities vary greatly between the different communities in the village. The poorest and most deprived households in the village largely belong to three particular communities, the tribal Bhils, and the low-caste Jogis and Bhangis. For the Bhil and Jogi households, livelihood diversification has largely been through migration to Mumbai and Gujarat, to work which is often menial, irregular and low paid. The Bhangi households have diversified their livelihoods a little through petty enterprises in the locality, but these largely consist of barter-like activities in the surrounding tribal villages and provide no surety of income.

For households in all three communities, and for households in the surrounding tribal hinterland, moneylender credit continues to be widely used. The moneylenders have not disappeared from the financial landscape and their credit continues to cover a very wide range of both production and consumption needs, needs which, given the small scale of finance required, are unlikely to be met, at least on an individual
basis, by either formal financial intermediaries or MFIs. The moneylender may offer only a single loan product to such poor clients, but the inherent flexibility in loan use, along with speed of transaction, ensure a continued demand. Moreover, clients are always treated with respect by the moneylender, and this can be in contrast to the attitudes of bank managers towards the rural poor (Jones et. al., 2003). Moneylender interest rates have not decreased with the advent of bank credit in the village. However, this particular moneylender does not now charge an additional 10% ‘cut’ of the loan amount for loans of Rs. 1,000 and above. This change he attributes to the greater financial awareness amongst the local tribal population, perhaps an awareness that could be usefully considered as warranting enhancement in future policy considerations.

This paper has been largely concerned with the work of one moneylender in one village in India. Given that there are over six hundred thousand villages in India, what are the policy implications of the findings? It goes without saying that one cannot generalise from such micro-level findings. However, one major value of micro-level studies is that they can give pause for thought with respect to the assumptions, categories and findings of macro-level questionnaire surveys. This is particularly the case with informal finance, a part of the financial services sector largely invisible to such research methodologies.

Another advantage of microlevel studies is that, together, they can help to build up a more macrolevel picture, moreover a picture with all its constituent diversity and range of players. This paper is not the only micro-level study of informal financial agents in India, but somehow, detailed knowledge and understanding of the informal financial sector in India is yet to be integrated. A useful task for NABARD would be to synthesise existing microlevel studies on the informal sector in India, and also to update knowledge about the presence and activities of indigenous moneylending communities in the country. In addition the organisation could identify new types of agents entering the informal financial sector and examine how traditional moneylending groups and these new entrants perceive and respond to the introduction and expansion of bank and MFI finance.

In short, NABARD could usefully build up its own present-day map of indigenous bankers and moneylenders across the country, rather like
that of the 1921 Census, but in much greater detail and with a specific view to inform policy. Such a detailed map of the informal sector would not only provide insights into the impact and efficacy of policy towards the formal financial sector, but it would also provide an invaluable pointer to possible alternative policies towards the informal financial sector. The relative advantages and disadvantages of facilitating the informal financial sector, learning from this sector, replicating this sector, and/or linking the formal and informal financial sectors, also need to be investigated. A detailed mapping of the existing status quo would show that the financial services landscape, even without banks and MFIs, is far from being a blank canvas. It is full of informal agents, who once recognised and understood in all their diversity, may have new and different roles to play in future implementations of policy to provide financial services to the rural poor.

References


Towards a Sustainable Microfinance Outreach in India


10 The Indonesian People’s Credit Banks (BPR)

Dirk Steinwand

10.1 Introduction

Indonesia has a complex and diversified landscape of microfinance institutions (MFIs). Besides the international well-known state bank BRI and its unit desa (units system) there exist some 9,000 small decentralised MFI commonly referred to as Bank Perkreditan Rakyat (BPR), or People’s Credit Banks. These BPRs can be categorised in three different groups, which differ substantially with regard to their history of establishment, ownership and governance, and size and volume of operations. Hence, the different BPRs provide an interesting field for observation and comparison of different decentralised MFI models.

The following paper will first look into the more than 100 years of history of the BPRs; followed by a comparative analysis of the different BPR systems; and the final chapter summarises the major findings from the Indonesian experience.

With few exemptions all empirical data used in this paper are drawn from my book: The Alchemy of Microfinance – The Evolution of the Indonesian People’s Credit Banks (BPR) from 1895 to 1999 and a Contemporary Analysis, Berlin, 2001. For more detailed information about the Indonesian BPR the interested reader may refer to this source.

10.2 Evolution of the BPR

10.2.1 The Colonial Period (1895 – 1945)

The Indonesian People’s Credit Banks (BPRs) have a long-lasting history. As early as 1895 the Dutch colonial administration tried to set up cooperative rural banks based on the Raiffeisen model, which has been introduced to the Netherlands only a couple of years earlier than
Towards a Sustainable Microfinance Outreach in India

Germany. Concerned about the widespread rural poverty and the ‘desperate credit thirst’ of the rural population, the Dutch administration started to fight usury. Under its so-called ‘New Ethical Policy’ usury was regarded as the main reason for rural poverty.

The European experience has shown that the endogenous development of cooperatives takes considerable time in the beginning. The Dutch colonial officials had the same experience in Indonesia, and the government felt a lack of support for the cooperative movement among the population.

In order to speed up the development process the government soon became actively involved in the institution building process. It offered seed funds for the establishment of ‘district banks’ in the district capitals, which were blended with funds of private investors. Until the mid 1930s some 90 district banks had been set up in Indonesia.

During the entire colonial time the controversy about a cooperative based system versus a government initiated rural banking system never really ended. From time to time the colonial government undertook new efforts to foster the cooperative movement, however with little success. It is interesting to note that government interventions like this occurred in Europe as well, when governments became impatient with the rather slow development of cooperative banks. In Europe most of these interventions failed, whereas the genuine self-help based cooperatives became a success story. In colonial Indonesia things developed the opposite way: the cooperatives failed, or better, never took off, while the government initiated banks did fairly well.

Against the backdrop of the fast growing number of rural financial institutions the Dutch installed the so-called Volkscredietwezen as one out of four welfare services under the authority of the Ministry of Internal Affairs in 1912. Additionally a ‘Centrale Kas voor het Volkscredietwezen’ was set up. The Centrale Kas was equipped with government funds and was supposed to operate as a kind of second tier organisation for the district banks. Its tasks were to supervise the district banks, as well as to lend to them in case of liquidity shortage and to accept deposits in case of excess liquidity, both at commercial terms. In 1927 the Volkcreditwezen was integrated into the Centrale Kas. And in 1934 the government merged the 90 district banks and the Centrale Kas into the newly established Algemeene Volkscredietbank (AVB).
After independence the AVB was renamed in Bank Rakyat Indonesia (BRI), under which name it operates until today.

Soon after the establishment of the first district bank in 1900, the colonial official De Wolff van Westerrode initiated the formation of so-called lumbung desa (village barn) all over Java and Madura. In De Wolff’s plan to erect a cooperative rural banking system according to the Raiffeisen model in Indonesia, the Lumbung Desa ought to form the basic tier of credit cooperatives at the village level, while the district banks were to form the second tier at the district level.

The major purpose of the Lumbung Desa was to level out the pronounced seasonal fluctuations of rice supply. Normally people borrowed paddy during the time of rice shortage ahead of the forthcoming harvest. Loans had to be repaid at the latest one month after the harvest. Interest rates on these two to five month loans varied from 10% for the early Lumbung Desa and 25% to 50% to the later style Lumbung Desa. In annualised terms these interest rates easily surpassed 100% and did not differ substantially from the rates charged by moneylenders.

In the early 1900s some Lumbung Desa in the more developed regions of Java started to lend out money. As a reaction, in 1904 the colonial administration decided to set up village banks operating on a currency base instead of paddy at those places where the Lumbung Desa started to lend out money. The organisational structure of the Bank Desa followed those of the Lumbung Desa, i.e. they were headed by the village chief, supported by a treasurer and secretary who were compensated by a fee of 3% of the loan amount disbursed for their services. The Bank Desa operated through the office (or residence) of the village chief, avoiding any fixed overhead costs (like many early German Raiffeisen Banks). This early model of the involvement of the village authorities in the loan business has been copied by the later BPR.

The capitalisation of the Bank Desa followed slightly different patterns from region to region. The main sources of initial funds were loans from the government, the district banks, or the local Lumbung Desa, as well as repayable shares of the villagers. However, besides these initial subsidies both Lumbung Desa and Bank Desa worked on a strictly commercial basis and charged cost covering interest rates.
They increased their asset base mainly through retained earnings. They were the first commercial microfinance institutions in the world.

The set up of the Lumbung Desa happened in a hasty trial and error manner. Between 1900 and 1910 more than 12,000 Lumbung Desa had been set up. As a result many of them collapsed over the following years. By 1940 only some 6,000 Lumbung Desa still existed. The establishment of the Bank Desa was undertaken at a much slower pace – and presumably – more carefully. Thus, the widespread collapse of institutions, which could be observed at the Lumbung Desa could be avoided.

After independence Lumbung Desa and Bank Desa were renamed into Badan Kredit Desa, BKD (Village Credit Institution). Under this name they exist and operate until today (see next chapter). However in times of war and hyperinflation they had to be recapitalised several times by the government.

With regard to supervision, the Bank Desa were treated in the same way as the Lumbung Desa. Besides a – rather ineffective – internal control through two villagers who acted as commissioners, the external control was executed through the local government before the establishment of the Volkscredietwezen, and from 1913 onwards through the Volkscredietwezen. After its merger with the Centrale Kas in 1927 the Centrale Kas became responsible for Bank Desa supervision, and, finally, after the formation of the AVB, the task was transferred to the former district banks, the branches of the AVB, and is today done by BRI, the successor of AVB.

The first governmental decree regulating the business of the BKD (i.e. Bank Desa and Lumbung Desa) originates from 1907. It was modified several times over the years. The last version from 1927, which regulates supervision, management, business activities, and ownership of the BKD, is valid until today.

To conclude, the Dutch colonial administration set up a three-tier commercial microfinance system, which exists in its basic structures until today. Although there was a strong focus on satisfying the ‘credit needs’ of the rural population, the institutional design of the system aimed right from the beginning at the sustainability and viability of the institutions.
Interest rates had been set high enough not only to cover costs but to increase the institutions’ equity base through retained earnings (BKD). Subsidies were limited to initial start-up support after which the institutions had to become viable. Maturities and repayment schedules of the loan products were designed according to the needs of the customers. Unsecured, ‘character-based’ lending was common, and, especially the BKD experienced the benefits of low information cost due to the social and spatial proximity to their clients. Innovative techniques like group-lending and joint liability were developed and tested (and given up again). Strict loan enforcement was common and resulted in satisfying loan performance throughout most of the time; and the fee-based compensation upon loan collection worked as an incentive for BKD staff.

However, the establishment of the rural financial system was neither smooth nor without setbacks. The institution-building process followed a courageous, quite experimental, and sometimes hasty trial and error approach rather than a cautious planned action – a pattern that would not change until the end of the 20th century.

May be the most striking feature of the colonial rural financial system was that it was to a large extent financed by public deposits. And moreover, the net flow of funds between the three levels went the opposite way than planned by the colonial administration, i.e. from the BKD to the district banks and from them to the Centrale Kas (i.e. both of them had surplus savings same as the BRI Unit Desa today). Amazingly, Indonesian banking history never commented at this fact, which obviously contradicted the assumption of a ‘chronic credit thirst’ of the rural population.

10.2.2 From Independence to financial crisis (1945 – 1999)

While BKD originated from the colonial period as described in the previous chapter, two additional BPR systems emerged only after independence – the ‘BPR unit banks’ and the LDKP (Village Credit and Funds Institutions).
Towards a Sustainable Microfinance Outreach in India

BPR unit banks

BPR unit banks were set up during the Soekarno era under various names and legal entities (cooperative, limited company, or public enterprise). While the private establishment of unit banks was rather rare, starting in the early 1960s the district governments became increasingly active in establishing Bank Pasar (market banks) in order to provide financial services to the re-strengthened trade-sector. In contrast to the 1980s financial sector reform policy which actively promoted competition, the 1960s policy rather tried to avoid competition. Therefore many local governments prohibited the operation of private unit banks in places where a government run Bank Pasar already existed. The public Bank Pasar mainly operated in those markets which were run by the local government and often the head of the market played an active role in the management of the respective Bank Pasar.

In the absence of any prudential regulations and institutionalised supervision the unit banks frequently ran into trouble. Some of those banks were closed down and re-capitalised up to four or five times during the 1950s and 1960s. Besides internal problems, the unstable economic environment had a negative impact on the unit banks as well. Especially hyperinflation and currency reform of the 1960s forced many of the unit banks to close down – at least temporarily.

After Soeharto took over power in 1967, among the first tasks of the new government was the consolidation of the financial sector. One step of the consolidation process was to register all existing BPR unit banks, and to examine their business operations. Due to the fact that BPR were small decentralised banks, this was a time consuming process. Although the task was – at least partly – delegated to BRI, the cleaning up took longer than expected. Hence in August 1970, the Ministry of Finance prohibited the establishment of new BPR (as well as of commercial banks) as long as a separate act would stipulate detailed regulations for their operations.

The situation changed fundamentally only with the financial deregulation, which started in the mid 1980s. With decree of the Ministry of Finance, from 1988 Indonesian private persons, enterprises, as well as local governments were granted the right to establish new BPR outside the national, provincial and district capitals with a
minimum equity of only US$ 30,000. Within only a couple of years more than 1,000 new BPR sprang up in Indonesia, 90% of them in Java and Bali and the majority as limited private enterprises (PT).

It is interesting to note that all investment capital for setting up these banks came from a wide range of domestic investors, since ownership of BPR is limited to Indonesian citizens, regional governments or legal entities fully owned by Indonesian citizens. This stands in sharp contrast to many MFI in Latin America and Africa which have been capitalised only with the help of the international donor community. In Indonesia, on the other hand, without any donor involvement but solely by a domestic policy measure, within 10 years some US$ 200 million had been invested in equity for setting up new BPR, financed completely by local resources. This development is even more surprising, taking into account that the vast majority of these new BPR (1,364) are privately financed enterprises. Neither donors nor the Indonesian government provided any incentives like guarantees, subsidised funds, tax redemption, etc. to lure private investors into these investments. Hence, the widespread belief that local private capital cannot be attracted for investments in domestic microfinance sectors – at least not without external support – has been proved wrong by the Indonesian experience.

Among the investors were wealthy private persons, industrial companies, commercial banks, religious groups, and domestic socially responsible investors, mainly groups of urban based migrants who wanted to invest into the development of their rural home towns.

In 1999, as reaction to the financial crisis, a new Bank Indonesia Decree increased the minimum capital requirements for BPR unit banks to US$ 50,000 in rural areas, US$ 100,000 in provincial capitals, and US$ 200,000 in larger municipalities, which is still low compared to international standards. By end 2004 there exist some 2,164 BPR, most of them under private ownership in Indonesia.

LDKP

Only shortly after the prohibition of the establishment of new BPRs by the Ministry of Finance in 1970, Bank Indonesia issued a circular which permitted provincial governments to continue the establishment of financial institutions, however, with a ‘non-bank’ status. Starting in West
Towards a Sustainable Microfinance Outreach in India

Java in 1970, over the following decade 12 provinces in Indonesia established district or village based non-bank savings and credit institutions. The generic term for this kind of institution is Lembaga Dana dan Kredit Pedesaan (LDKP). In most provinces the LDKPs are under guidance and supervision of the provincial development banks (BPDs).

The development of the LDKP is very complex. Their names, institutional and legal structure, ownership and governance differ from province to province, and we cannot discuss them here in detail. Most of them have been set up with a seed capital of only US$ 500 to US$ 2,000 and increased assets through retained earnings (like the BKD) and mobilising deposits from the public or their members. After the 1988 deregulation of the financial sector those LDKPs which fulfilled the BPR requirements became licensed BPR unit banks (except for LDKP in Bali). The banking act from 1992 requested all non-licensed LDKPs to transform into licensed BPR unit banks within five years. For those LDKPs not being able to fulfill the requirement within this period, a special regulation would be elaborated (which is still under preparation in 2005).

In the following sections we will concentrate on three types of LDKPs and their most important features:

• The BKKs of Central Java are district-based institutions. Like most of the LDKPs, they are owned 50% by the provincial government, 35% by the district government and 15% by the BPD. Initially the BKKs only mobilized mandatory deposits and grew only moderately. After they started mobilising deposits from the public in 1987 (one year after the successful introduction of the SIMPEDES savings product at the BRI unit desa) their growth rate accelerated rapidly. Today there exist 512 BKKs. 70% of them already obtained a BPR license. Besides the BRI unit desa the BKKs gained international reputation as a successful and sustainable microfinance system.

• The LPNs of West Sumatra have been set up as member-owned, clan-based organisations at the traditional nagari-level (one nagari comprised several clans, but it has lost its importance today) and resembled small cooperatives. Between 1972 and 1982, 591 LPNs have been set up. However, their development took a less auspicious way compared to the BKKs of Central Java. Only 72 of them managed the transformation into a BPR and the remaining more than
500 LPNs became, to a large extent, inactive. As the following chapter will show, the main difference between those LPNs which survived and those which failed was that the former have been actively engaged in savings mobilisation, while the latter mainly depended on loans from banks.

- The LPDs in Bali were set up since 1984 under ownership of the desa adat (traditional village). Until today Bali is organised into desa dinas (government villages), through which the government administration works, and the desa adat (traditional or custom village) that are in charge of social and religious matters. For all aspects of daily life the desa adat and its customary law is of utmost importance. According to my own assessment the LPDs of Bali is by far the most successful microfinance system in Indonesia, more successful than the internationally better known BKKs and BRI unit desa. One reason therefore is the integration in the traditional village structure, a second one is the fact that the LPDs – as the only LDKP system – engaged in savings mobilisation right from the establishment.

- The Balinese government defined the medium term target to set up an LPD in every desa adat in Bali. Today, with 1,214 LPDs (September 2004), this target is nearly reached. In contrast to all other LDKP, the LPD collectively refused to transform into licensed BPR unit banks although many of them easily fulfill the capital requirements (in fact, some of them could even apply for a bank license). The reason therefore is mainly a tax issue. Until now LPDs are not taxed and their profits remain in the desa adat. Licensed BPR unit banks, however, would be subject to government taxation. Only recently the provincial government of Bali obtained a special status for the LPDs, which allows them to operate the LPDs as non-banks entitled to mobilise deposits from the public.

10.3 Comparative analysis of the contemporary BPRs

10.3.1 Overview

As the previous chapter has shown, Indonesia has a long and complex history of microfinance. Besides the well-known system of the village units of the state-owned bank BRI, the ‘BRI unit desa’ (which actually do not operate at village but at district or sub-district level), over the last 100 years three different BPR systems emerged. Against the
background of this strong institutional development, NGO-like MFIs in Indonesia play only a marginal role, at least in the more developed islands.\(^1\)

### Table 1: The BPR System – basic features

<table>
<thead>
<tr>
<th>BPR Unit Banks</th>
<th>BPR</th>
<th>LDKP</th>
<th>BKD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>West Sumatra (LPN)</td>
<td>Bali (LPD)</td>
</tr>
<tr>
<td>Ownership</td>
<td>Majority private</td>
<td>Members</td>
<td>Traditional village</td>
</tr>
<tr>
<td>Institutionalisation</td>
<td>Full (initially semi)</td>
<td>Full (initially semi)</td>
<td>Full</td>
</tr>
<tr>
<td>Bank license</td>
<td>All</td>
<td>Partly licensed</td>
<td>none</td>
</tr>
</tbody>
</table>

#### 10.3.2 Policy, regulation and supervision

At least since the early 1970s the building of an infrastructure for the supply of financial services – not only for the agricultural sector – was a major concern of the Indonesian government. Even during the time of financial repression, when the establishment of new banks and BPRs was prohibited, provincial governments actively established LDKPs. And while bank interest rates were regulated, the Indonesian BPRs were, throughout the entire history, always allowed to charge cost covering interest rates. Unlike for example the Philippines, where the government channeled most of its agricultural credit lines through the rural banks, in Indonesia the government always used its state owned banks (namely BRI and BPD) for the implementation of its lending schemes and left the BPRs untouched.

With the deregulation measures, from 1988 the government explicitly promoted the establishment of new BPRs. The new BPR policy has been a deliberate step in accordance with the general rationale of the ongoing financial sector reform: creating a competitive environment and
contestable market by abolishing entry barriers and reducing sunk cost for new participants in the market; restraining from state intervention and promoting private sector investments instead; and, at the same time establishing a framework of legal and prudential regulations within which the market should operate.

The legal basis for operation of BPR unit banks has been laid down in the Banking Law of 1992 and several decrees by the Central Bank. BKD still operate under the regulation from colonial times. Only those LDKPs which have not yet obtained a BPR license operate in a kind of grey zone, however, tolerated by the government. Unlike many other countries Indonesia has always been benevolent towards its rural financial institutions, imposing too less rather than too many regulations on them.

Basically BPRs (with and without license) have to operate in a limited geographical area and until 1999 they were not allowed to set up business in the large urban centres. Their operations are restricted to loans, savings and time deposits. They are not allowed to do foreign exchange business, a fact that helped them to survive the financial crisis of 1997-98 without any harm. Moreover, they are not allowed to enter the payment system, which might become a comparative disadvantage soon, if this regulation is not changed.

Given the vast number of tiny financial institutions in rural areas, most of them collecting deposits from the public, supervision becomes a major challenge. Since colonial times Indonesia practices a system of delegated supervision. Only the licensed BPR unit banks are supervised by the Central Bank. The LDKPs are supervised by the regional development banks (BPDs) and the BKDs by BRI. Although the quality of supervision gives large scope for improvement it is a pragmatic solution which works fairly well.

Since the financial crisis, Indonesian policy makers are more concerned about proper supervision of the financial sector, including the BPRs. This resulted in a shift in policy. The previous goal, to create as many BPRs as possible, has been replaced by a policy which aims at the consolidation of the sector. Since even the supervision of the more than 2,000 licensed BPRs is a heavy burden for the central bank, there are ongoing discussions to create a separate institution for BPR supervision.
The following figure gives an overview of the regulation and supervision of the different types of BPR.

**Figure 1: Regulation and supervision of BPRs**

10.3.3 Outreach and market share

We first look at the absolute size of the different BPR systems measured in number of units, clients and total assets.

On an average the BPR unit banks have the largest number of clients and total assets per unit, followed by the LDKPs and BKDs. With less than 2,000 clients per unit, the BPR unit banks, the largest BPR system, are amazingly small compared to international MFI standards.

In order to assess the share of the BPR systems in the microfinance sector, we have to include the BRI unit desa system as the other important microfinance system in Indonesia into our analysis. All BPRs together account for 70% of all microfinance units in Indonesia. However, they account for only 18% of the combined assets of the microfinance sector compared to 82% for the BRI unit desas.
A comparison of average loan size and assets size per unit of the respective BPR systems and the BRI unit desa discloses a clear correlation.

**Figure 2: BPR Systems – loan size/total assets per unit**
The larger the units (measured as total assets), the larger the average loan size. Village based BPRs like the BKDs, LPDs and LPNs are necessarily smaller in size than sub-district based BKKs, BPR unit banks or the BRI unit desas because of their limited area of operation. But the correlation with loan size indicates that location matters to reach the lower end of the market. The main reason therefore is transaction cost both on the side of the banks as well as borrowers. Especially information and transportation costs increase depending upon the distance between the client and the bank. While the BPR unit banks can reduce transportation costs by offering door-to-door services, since costs that occur on the side of the bank can be divided over many customers, the BRI unit desa only operates out of its offices and fully burdens their customers with individual transportation costs. By this, BRI automatically sets an indirect lower limit for the loan size, below which customers will not avail for a loan due to high transaction costs. The fact that the BKK – although located at sub-district level – nevertheless range within the village based LPDs and LPNs regarding loan size, can be explained by the fact that they operate through a dense network of village posts.

10.3.4 Funding and investment structure

The funding and investment structure of the BKD resembles more a part-time village moneylender rather than a financial institution. Equity and mandatory savings constitute 94% of their assets. The low investment rate is also remarkable. Only 56% of the BKD assets are invested in loans while 37% are deposited with BRI.

Regarding the funding structure of the other BPR systems, two aspects are noteworthy. First, all of them generate more than half of their assets from deposits. But while the private BPR unit banks’ deposits consist mainly of time deposits, the public LDKP deposits consist mainly of savings. Moreover, average size of time deposits of the BPR unit banks is nearly four times higher than those of the LDKPs. One reason for the lower share of time deposits at the LDKPs might be that they offer lower interest rates than the BPR unit banks and serve a poorer segment of society, which is not able to make large time deposits. But a closer look into the structure of the BPR unit banks’ time deposit reveals that they frequently consist only of a few large deposits. In many cases depositors are private persons or enterprises somehow related to the owners, and sometimes the owners themselves deposit large sums with
The Indonesian People's Credit Banks (BPR) and their banks. Hence, at least part of the BPR unit banks' deposits are not really ‘public deposits’ but could rather be seen as a kind of subordinated equity. As a matter of fact, this particular funding structure exposes the BPR unit banks to substantial risk.

The asset structure of the BPRs shows that there is a substantial flow of funds either from the commercial banks to the BPRs or the other way round, depending on the respective system. These funds clearly exceed the sole function of liquidity requirements. The following figure shows the net flow of funds between the BPR systems and the commercial banks measured as ‘BPR deposits at banks’ minus ‘bank loans to BPR’ as percentage of total BPR assets.

Table 3: BPR Systems – funding and investment structure

<table>
<thead>
<tr>
<th>(1997)</th>
<th>BPR Unit Banks (%)</th>
<th>LDKP (%)</th>
<th>BKD (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>LPN</td>
<td>LPD</td>
<td>BKK</td>
</tr>
<tr>
<td>Assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>1</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Deposits at banks</td>
<td>11</td>
<td>10</td>
<td>22</td>
</tr>
<tr>
<td>Loans outstanding</td>
<td>79</td>
<td>80</td>
<td>73</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>5</td>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td>Other assets</td>
<td>4</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Equity + Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Savings</td>
<td>21</td>
<td>48</td>
<td>39</td>
</tr>
<tr>
<td>Time deposits</td>
<td>37</td>
<td>12(^a)</td>
<td>33</td>
</tr>
<tr>
<td>Loans from other banks</td>
<td>17</td>
<td>3</td>
<td>1.0</td>
</tr>
<tr>
<td>Equity (including retained earnings)</td>
<td>19</td>
<td>33</td>
<td>24</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>6</td>
<td>4</td>
<td>3.0</td>
</tr>
</tbody>
</table>

\(^a\)Including mandatory savings \(^b\)Only mandatory savings
The differences in the availability of deposits from the public on the one hand and the opportunities and incentives to invest these funds in loans on the other, make the respective BPR systems either to be chronically over-liquid or be additional external funds depending on systems. It is interesting to note that the BRI unit desa and the BKD, both of them either a part of or closely linked to BRI, are those MFI systems that have the largest share of surplus funds which are transferred to the commercial banking sector. But the LPN and LPD too are highly over-liquid and transfer a substantial portion of their assets to the commercial banking sector. Only the private BPR unit banks and the BKK are net-receivers of funds from commercial banks. The private BPR unit banks face more difficulties in mobilising funds from the public since they are regarded as less safe compared to public banks, and the BKK traditionally obtain substantial refinancing facilities from state-owned banks.
However, it can be concluded that the majority of the rural microfinance systems in Indonesia are highly over-liquid, above all the BRI unit desa system.

10.3.5 Performance

Against the background of the vast experience with different models of rural unit banks in Indonesia we like to know: First, which BPR system has been most successful? And, second, are there any structural determinants for success beyond the enabling macroeconomic conditions and institutional design on the one hand and skillful – or less skillful – management on the other hand?

Banks’ financial statements offer a wide range of data to calculate ratios which can be used as performance indicators. From a financial system perspective ‘sustainable growth’ is the most important performance indicator. In order to measure sustainable growth we have to assess the combination of three ratios: the growth of assets, the profitability of the institution, and the loan performance.

Table 4: BPR Systems – sustainable growth indicators

<table>
<thead>
<tr>
<th></th>
<th>BPR Unit Banks (%)</th>
<th>LDKP (%)</th>
<th>BKD (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>LPN</td>
<td>LPD</td>
<td>BKK</td>
</tr>
<tr>
<td>Compounded annual growth of total assets (average per unit):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 years (1988–1998)</td>
<td>(1.7)</td>
<td>12.8</td>
<td>29.2</td>
</tr>
<tr>
<td>4 years (1994–1998)</td>
<td>4.0</td>
<td>15.2</td>
<td>26.2</td>
</tr>
<tr>
<td>Non performing loans (KAP) 1997</td>
<td>18.7</td>
<td>14.2</td>
<td>7.1</td>
</tr>
<tr>
<td>Return on assets 1997</td>
<td>1</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Return on equity 1997</td>
<td>5</td>
<td>17</td>
<td>34</td>
</tr>
</tbody>
</table>
According to these figures the LPDs of Bali are the most successful BPR system. They show high nominal growth rates both over the ten and four years period, the lowest non-performing loan ratio and the highest return on equity. Adjusted for inflation which fluctuated between 6% and 9% from 1988 – 1997, growth rates are still impressive.

The BKKs are second regarding loan performance and profitability. With 32.2% BKKs showed the highest growth rate over the 10 years period. Over the four years period however, it declined to 12.2%. The difference in short term growth between LPDs and BKKs can be explained by the fact that all of the BKKs of the sample are already operating for more than 10 years while the LPD sample contains many new start ups, which naturally grow faster in percentage terms during the first years of operation. The LPNs are third in the ranking. The BKDs are fourth, with growth rates just slightly above inflation. All of these institutions are either district or village based and owned, and they make intensive use of these structures for loan appraisal and enforcement.

The private BPR unit banks are clearly ranked last with the lowest growth rates, the lowest profitability and the highest non-performing loan ratio. As the only BPR system the later show negative nominal growth rates for the 10 years period and adjusted for inflation the growth rate for the four years period is negative as well.

Based on these data one can conclude that the community based LDKPs are the most successful BPR system and evidently outperform especially the private ones, a finding quite in contrast to international mainstream thinking which clearly favours private MFI s. It is also remarkable that the rather dormant BKDs, which many observers regard as inactive and dead, nevertheless managed an annual long-term growth of nearly 15%, well above average annual inflation rate of 8.2% for the same period. Moreover, the high non-performing loan ratio of the BKDs is mainly accumulated bad debt from the past. They still operate under colonial legislation (from 1929) which allows only very moderate seasonal write-offs of bad debt.

The search for structural factors or determinants for success beyond the already mentioned integration into the communities accompanied me over several years in Indonesia. The regional, economic and cultural heterogeneity of the country, bringing so many different potential factors into play, made it a difficult task. Every hypothesis I tested was ruled out
The Indonesian People’s Credit Banks (BPR)

by conflicting empirical findings. For example, ‘economic development of the region’, ‘dominance of trade versus agriculture in the region’, ‘population density’, and ‘BPR density (competition) in the region’ correlated with our success indicators proved of no significance.

The experience of the European MFIs in the 19th century led me to test a final hypothesis: ‘Do savings matter?’ It proved to be very successful. The analysis of the empirical data proved that a strong base of (voluntary) savings is the most important structural factor or determinant for success. It provided significant results on all levels. BPRs with savings (and small time deposits) as the prevailing source of refinance grow faster, suffer less loan losses and are more profitable than those BPRs that either focus on self-finance or other sources of funding. Hence, community based BPRs outperform private ones, since they can attract deposits from their communities much more easily and at cheaper costs compared to private MFIs.

To explain these findings we look at the three performance indicators separately:

• **Growth**: In a rudimentary developed rural financial system like in Indonesia there is a lack of sophisticated refinancing instruments for financial institutions, and the amount of refinancing loans available from commercial banks is limited by the physical collateral a BPR can provide. On the other hand, as the empirical data convincingly prove, the population of rural Indonesia has a strong demand for savings facilities. Hence, deposits from the local population are the only source of funding which allows rural financial institutions to continuously grow at a fast pace.

• **Loan performance**: There are several strings of arguments to explain the better loan performance of BPR with a strong savings base. First, there is the aspect of ‘hot’ versus ‘cold’ money. Moral hazard both on the side of the bank as well as on the side of the customers can be contained if bank staff and borrowers know that they deal with their neighbours’ money. This argument counts especially for small community-based (or even owned) BPRs like the LPDs. Second, since potential borrowers are normally savings clients of the respective bank too, information costs can be reduced and the quality of loan appraisals can be improved considerably (economies of scope). And third, since savings are the cheapest source of funding, BPR with a strong savings base can afford to allocate their
assets into lower yielding but less risky investments without jeopardising profitability.

- **Profitability**: Since demand for savings is extremely price-inelastic, savings are the cheapest source of funding and allow for higher profits. And since savings-based BPRs perform better than those depending on other sources of funding, the former have to make less provisions for loan losses. Moreover, savings are also by far the most stable source of funding (next to equity) even in times of a financial crisis, reducing the cost of liquidity provision for the BPR.

### 10.4 Findings from the Indonesian experience

- Right from the beginning Indonesian MFIs have been set up as commercial financial intermediaries. They mobilised deposits from the public and lent them out again. Interest rates were always allowed to be set at a cost-covering basis.

- The institution building process followed a courageous, quite experimental, and sometimes hasty trial and error approach rather than a cautious planned action.

- With very limited subsidies a wide range of decentralised community-based microfinance institutions have been set up (basically only some seed capital). Growth of assets originates mainly from retained earnings and mobilisation of deposits, rather than from re-financing schemes.

- Indonesia managed to set up nearly 2,000 private MFIs, all of them funded by domestic investors without external donor support.

- The genuine self-help based Raiffeisen model of MFIs never gained ground in Indonesia.

- Community-based MFIs in Indonesia are most successful because they make use of the community structure and can easily access the deposits from their community.

- The most important determinant for success for MFIs is their ability to mobilise deposits. The higher the share of savings/total assets, the faster the growth, the higher the profitability and the lower the loan losses.

- Most rural MFIs in Indonesia are highly over-liquid, indicating a higher demand for savings products compared to loans by the rural population.
• There is a clear correlation between the size of an MFI and its average loan size. That is, the smaller the institution the smaller the loans, and the higher the outreach to the poor.

• Compared to international standards, Indonesia has a very large number of very small decentralised MFIs. Therefore supervision of the majority of these MFIs has been delegated to state-owned banks.

Endnotes

¹For a complete picture of the Indonesian microfinance landscape one also has to mention the government controlled village cooperatives (KUDs). Most of them operate a savings and credit unit. However they are not separate MFIs and should not be mixed up with the 1,100 cooperative rural banks which are included in the BPR unit banks.
11 Mainstreaming microfinance for poverty alleviation: Need for a proactive policy and regulatory framework

H. S. Shylendra

11.1 Introduction

Poverty alleviation still is an unfinished agenda in India. Even going by the official estimates about 260 million people both in rural and urban areas were living below the poverty line at the turn of the new millennium (Government of India, 2002). The true face and magnitude of this continuing poverty is reflected in the fact that a significant chunk of our population are deprived of basic developmental needs like schooling, housing, water, health, sanitation and electricity. The result of continuing poverty and deprivation is the growing inequality in the society leading to various socio-economic tensions and conflicts. The prevalence of poverty and inequality has been attributed both to the failure of growth to trickle down adequately to the poor as well as the limitation of state-led poverty alleviation programmes to make sustained impact on poverty conditions. There is recognition of the fact that poverty and deprivation must be ended as soon as possible. Search for newer approaches and instruments of poverty alleviation continues. It is in this context, microfinance has come to acquire significance as an innovative and potential instrument of poverty alleviation and empowerment.

11.2 The rationale for microfinance

It would be useful here to look at the rationale for emergence of microfinance as a tool for poverty alleviation. The rationale is based on the available evidence and experience about the role of microfinance in poverty alleviation and the continued large scale failure of both state and market to meet the savings, credit and insurance needs of the poor.

At the core of microfinance is the idea of addressing the problem of poverty and deprivation by enabling the poor to access financial capital
hitherto denied to them. With the help of loan, savings and insurance obtained from microfinance institutions (MFIs), the poor are expected to take up on their own economic activities which would generate incremental income and employment to cross the poverty line. Access to microfinance is also expected to provide stability to the poor in times of shocks and fluctuations. Thus, microfinance is expected to play both the promotional and protective role in poverty alleviation.

There is fairly good evidence which suggests that microfinance interventions have not only contributed significantly towards direct poverty alleviation of the participating members but have even contributed indirectly in reducing overall poverty of villages or areas in which they have been implemented (Hossain 1988, and Khandker 1998). It is evident that contribution of microfinance to poverty alleviation takes place mainly through improvements in the asset base, employment and income levels, reduced dependence on moneylenders and even diversification of occupation. As a result of these changes, the participants have experienced improvements in their living standards, which is reflected in increased consumption levels, better housing, clothing and education, and many other qualitative changes (ibid).

There is also the empowerment role of microfinance. Besides leading to reduction of poverty in ways mentioned above, the increased access and control over financial resources by women can itself become an empowering instrument. The available evidence indicates that women are able to experience many positive changes as a result of their participation in microfinance programmes. A major study about the impact of microcredit programmes in Bangladesh concluded that, “Women have clearly benefited from microcredit programmes. Programme participation has enhanced women’s productive means by increasing their access to cash income generation from market-oriented activities and by increasing their ownership of non-land assets. These improvements should enhance women’s empowerment within the households, influencing their own and their children’s consumption and other measures of welfare” (Khandker 1998: 150). It is based on such evidence that an increased emphasis is being given to expand the role of microfinance in order to achieve the twin goals of poverty alleviation and empowerment.
At the level of developmental paradigm, microfinance has emerged as a response to the failure of market and state to ensure for the poor a sustained access to capital. Market failure occurs when formal agencies and programmes operating in the market fail to meet the capital needs of the poor to take up productive investments. As a result of such failure, not only the poor are unable to make investments for income and employment generation but are also forced to depend upon informal sources of finance, which are either exploitative or not fully reliable. The formal institutions like commercial banks and cooperatives have failed to serve the poor for reasons like their focus on collateral based lending, information asymmetry, small sized loans or savings leading to high cost of transactions and attitudinal bias against the poor and women. There is another dimension to this issue of market failure. As the formal financial institutions become inaccessible the poor either try to avoid them or look towards alternative sources of credit, savings and insurance. These alternatives are mostly informal agencies like private moneylenders, traders, and commission agents who, using their monopolistic position, tend to exploit the poor by charging exorbitant rates of interest or force the clients to take part in inter-linked transactions for credit, labour and commodities in the pretext of giving collateral-less loans. This is the case of typical market failure for the poor.

There is also the angle of failure of state in the rationale for microfinance. A developmental state has a clear onus for poverty alleviation. The state under such a situation has to ensure that capital needs of the poor are also adequately met. The failure of state can occur when the state is either not able to make formal agencies respond to the needs of the poor or unable to create any alternate mechanisms for the poor to access savings, credit and insurance on a sustainable basis. The state in India has come out with many policies including imposing certain obligations on formal agencies to devote part of their resources to meet the credit needs of the weaker sections like small and marginal farmers, agricultural labourers and rural artisans. Some of the initiatives of the state for the poor include credit based self-employment programmes like Integrated Rural Development Programme (IRDP) and Swarna Jayanathi Swarozgar Yojana (SGSY), Differential Interest Rate (DRI) scheme, and creation of separate institutions like Regional Rural Banks (RRBs).
The assessments of the initiatives taken by the state have revealed that despite these programmes, the poor have not been able to avail regular services from the formal agencies. Despite the good intention of the state in initiating these schemes, the outcomes have not been favourable to the poor. Some of the major problems identified with these programmes are:

- Target based approach focusing on achieving quantitative results in reaching the poor;
- Linkage to subsidies resulting in large-scale leakage of the benefits to non-poor;
- High rate of failure of self-employment schemes due to poor project formulation and implementation;
- High loan repayment problems both due to failure of projects and creation of widespread impression among the scheme participants about loan as non-returnable grant.

As a result the schemes have come to be perceived by the banks in general as risky, making them reluctant to increase their lending to the poor. Overall, the state led initiatives have not succeeded fully in creating sustainable financial services for the poor.

These failures get corroborated by some of the studies conducted to estimate debt and investment position of rural households. As per the All-India Debt and Investment Survey of 1991, only 15.6% of the rural households had borrowed from various formal sources (NABARD, 2000). For the poor, this proportion was even lower. Further, though the institutional agencies accounted for about 64% of the debt of all the households in 1991, for the households in the three lower asset value groups (less than Rs. 5,000, Rs. 5,000 to Rs. 10,000 and Rs. 10,000 to Rs. 20,000) it was the non-institutional agencies which accounted for bulk (58%, 53% and 56% respectively) of their debt.

Even the recent situation also remains largely the same. This is corroborated by the recent Rural Finance Access Survey (RFAS) of NCAER and World Bank in two major states of India, Andhra Pradesh and Uttar Pradesh (Basu and Verma, 2003). The survey revealed that while only about 21% of the rural households accessed formal loan, the proportion was only 13% for the poor households who are landless or owning less than one acre of land. In other words about 87% of poor
were without any formal loan. However, about 48.2% of the poor households borrowed from informal sources as against about 44% for all the households. This indicates the continued dependence of the poor on informal sources for meeting their credit needs. Even with regard to savings and insurance, the RFAS survey revealed that the access by the poor is still very limited. As per the survey while about 58.8% of all the rural households had no deposit accounts, in the poor category 70.4% of the households did not have any deposit account. Overall, only about 15% of the rural households had subscribed to insurance schemes.

The formal agencies thus, despite their growth, have not been able to meet the needs of the poor adequately. It is because of this failure of the formal agencies, that the role of microfinance interventions has assumed significance. The response of various microfinance initiatives, especially in the Indian context, has been broadly on the following two lines.

- **Creation of alternative delivery mechanism for the poor**: In many ways microfinance can be considered as an attempt to create newer institutions or mechanisms for the poor as an alternative to both the formal and informal agencies which have failed them. The main aim of microfinance interventions in this regard is to help the poor to reduce the difficulties they face with the banks or moneylenders by creating separate institutions which can fully understand and appreciate their needs. The idea is to create pro-poor agencies or institutions which can deliver financial services to the poor. Much of the microfinance activities so far have been on these lines.

- **Reforming the formal agencies**: Looking at the success of NGO-led initiatives in delivering savings and credit to the poor, the state and formal agencies are trying to make amendments in their systems so that they are also able to reach out to the poor. The reforms include adapting methods and innovations tried out by NGOs and other microfinance agencies. The fast growing SHG-Bank Linkage Programme in India is one such example of the response from the formal agencies in reforming their earlier systems.

### 11.3 Current status of microfinance in India

An attempt is made in this section to highlight the current status of the microfinance sector in India in terms of potential demand for
Towards a Sustainable Microfinance Outreach in India

microfinance services, current level outreach and supply in relation to the potential, and extent of involvement of various types of institutions.

There are no clear and systematic estimates available regarding the actual as well as potential demand and supply of microfinance in the country. Regarding the estimation of target groups for MF services, one can base it on the official estimation of the number of poor in the country as indicative of the total potential, given the fact that microfinance is meant for the poor. The estimated size of the below poverty line (BPL) population gives some idea about the potential client base of the sector.

Taking the official estimation of BPL population of 260 million during 1990-2000 (Government of India, 2002) and the average household size, we find that there are about 52.04 million households who are in the BPL category. The number of BPL households in rural areas comes to 38.6 million; the same in urban areas comes to about 13.4 million. There are, however, arguments whether the entire BPL households should be considered for the purpose of providing microfinance. But given the fact that even very poor households need service like savings and insurance, if not credit always, one can safely consider almost all the households below BPL as potential client base of microfinance. Adjusting for changes like population growth and households crossing poverty line during the interval, one can say about 50 million households in the country presently constitute the basic target group of the MF sector.

As regards the demand, based on the available estimates in the Task Force of NABARD on microfinance it was indicated that the potential annual credit requirement could be in the range of Rs. 150 billion to Rs. 500 billion per year (NABARD, 2000). A recent unofficial estimate puts the total credit demand by the poor households in the order of Rs.150 billion to Rs. 450 billion (Mahajan and Ramola, 2003). These estimates are based on the actual credit usage as reported by various studies and not the potential demand. Due to variations in the average household credit use as estimated by different studies, there is a wide gap in the total estimated range of credit demand.

Again, there are no clear estimates about savings and insurance demand by the poor. The same unofficial study (ibid), based on the assumption that the poor can save up to five to 10% of their annual
Mainstreaming microfinance for poverty alleviation

income and can pay insurance premium equivalent to three to five percent of their income, puts the annual demand for savings products in the range of Rs. 50 billion to Rs. 100 billion, and demand for insurance premium in the range of Rs. 30 billion to Rs. 50 billion. Taking together the estimated demand for credit, savings and insurance, the annual total demand for microfinance by the poor households has been put in the range of Rs. 230 billion to Rs. 600 billion in the country.

Given such a demand potential, the actual coverage of the target group and the extent of supply of microcredit by various agencies indicate that there is a big gap in the demand and supply of microfinance in the country. Since there are no clear figures available on the actual supply of microfinance, here we look at the level of lending and outreach of the target group attained by the major apex level microfinance institutions in the country. Table 1 gives some macro level details about the lending and outreach performance of the major apex level microfinance institutions or schemes in the country based on 2003 and 2004 data. It is possible that there may be some overlaps in the coverage of these agencies as some of the MFIs and NGOs may be simultaneously getting assistance from more than one agency. There may be also some MFIs,

<table>
<thead>
<tr>
<th>Apex agencies or schemes involved</th>
<th>No. of FIs NGOs/MFIs</th>
<th>No. of SHGs (`000)</th>
<th>Outreach of households (millions)</th>
<th>Cumulative loan disbursement (million Rupees)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. NABARD’s SHG-Bank Linkage (2004)</td>
<td>560</td>
<td>1,079</td>
<td>16.00</td>
<td>39,042</td>
</tr>
<tr>
<td>2. SFMC (2003)</td>
<td>169</td>
<td>–</td>
<td>0.91</td>
<td>1,181</td>
</tr>
<tr>
<td>3. RMK (2004)</td>
<td>749</td>
<td>24</td>
<td>0.48</td>
<td>1,034</td>
</tr>
<tr>
<td>4. FWWB (2003)</td>
<td>247</td>
<td>–</td>
<td>0.17</td>
<td>607</td>
</tr>
<tr>
<td>5. NABARD’s RFA (2003)</td>
<td>27</td>
<td>–</td>
<td>–</td>
<td>120</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,752 (1,192)</strong></td>
<td><strong>1,103</strong></td>
<td><strong>17.55</strong></td>
<td><strong>41,984</strong></td>
</tr>
</tbody>
</table>

NB: Figure in brackets indicates no. of NGOs/MFIs involved. Figures are sourced from the annual reports or websites of the respective organisations. SFMC: SIDBI Foundation for Microcredit. RMK: Rashtriya Mahila Kosh. FWWB: Friends of Women’s World Banking. RFA: Revolving Fund Assistance. Under RFA, NABARD directly provides finance to MFIs/NGOs for their on-lending.
NGOs or government-sponsored microfinance programmes like SGSY which may not be fully covered under these apex level programmes. Hence, one needs to take the figures in Table 1 only as indicative of the total actual outreach and supply.

In terms of the actual number of agencies or institutions involved at the grassroot or retail level, from Table 1 one can make out that about 1,752 institutions of different types were involved in delivering microfinance during 2003-2004. Under the SHG-Bank Linkage Programme of NABARD, about 560 financial institutions, cooperatives, RRBs and Commercial Banks have participated across the country. Under the SHG-Bank Linkage Programme, the financial institutions have financed about 1,080,000 SHGs which are promoted either directly by them or by the NGOs. NABARD provides refinance to these financial institutions for on-lending to SHGs. Besides these financial institutions, a large number of NGOs and microfinance institutions are also involved in delivering microfinance.

About 1,192 NGO/MFIs had received loan assistance from various apex institutions like SFMC, RMK, FWWB and NABARD for their on-lending programme. These 1,192 NGOs/MFIs have approached the apex agencies for getting various types of loan assistance for on-lending to their groups or members. Cumulatively, these NGOs/MFIs have reached out to over 1.56 million households and have received about Rs. 2,942 million loan assistance from apex agencies for on-lending. In addition to these 1,192 NGO/MFIs, it is estimated that another about 500 NGOs with an outreach of 0.32 million households are also involved in delivering microfinance in the country. These are mostly smaller NGOs which are managing their microfinance programmes either using donor funds or with savings mobilised by their SHGs. Taking even these NGOs into account, one can say that as of 2003-2004, about 1,700 NGOs/MFIs are involved in delivering microfinance in the country, apart from the 560 mainstream financial institutions involved under the SHG-Bank Linkage Programme.

Taken together, the microfinance agencies in the country have reached about 17.87 million households, which accounts for little over one-third of the estimated number of poor households in the country. The MF agencies hence still have a long way to go in reaching the ultimate potential. If we look at the credit needs being met, the gap in the demand and supply is even more glaring. Cumulatively, from 1989 till
2004 the major microfinance agencies have disbursed about Rs. 41.98 billion loans. Even this cumulative loan figure of 15 years accounts for only about 28% of an estimated annual credit demand on the lower side (Rs. 150 billion) or only about 9.3% of the estimated credit demand on the higher side (Rs. 450 billion).

Instead of cumulative loan disbursement, if one were to take the actual annual loan disbursement of these agencies, then the gap would be even bigger. The gap probably could be even bigger if we were to take the total potential demand and not one based on the actual credit use. As regards savings and insurance, again there are no clear macro level statistics available. But going by the fact that the microfinance agencies in the country so far have focused their attention mainly on credit, and also that many local microfinance institutions are not able to mobilise savings in a full fledged way due to legal restrictions, the extent of gap in the demand and supply for these services would be definitely much higher than the credit. Thus, given the need and their current level of achievements, the MFIs and other agencies have still a long way to go in meeting the needs of the poor.

11.4 Some key challenges of the microfinance sector

In the last ten years or so the microfinance sector, both under the SHG-Bank Linkage Programme and under the NGO on-lending programme, has shown an impressive growth in terms of the outreach. However, there have been many serious constraints or challenges faced at SHGs and NGO/MFIs level which seem to be coming in the way of promoting microfinance in a more effective way for poverty alleviation. Some of such constraints are highlighted below.

11.4.1 SHG level

A massive growth is witnessed in the number of SHGs in the last one and a half decades in the country. A large number of agencies like NGOs, banks, cooperatives, governmental agencies, farmers’ clubs and individuals are involved in the formation and nurturing of SHGs. SHGs are being formed under various programmes like SHG-Bank Linkage Programme, SGSY, DPIP, Swa-Shakti, and NGO add-on activities. It is estimated that there were over 1.2 million SHGs functioning in the country during 2004. Any institution which grows fast is likely to face problems in terms of quality and effectiveness. One major fallout of the
fast growth of SHGs has been on their quality. SHG promotion needs both time and resources.

Though there are no clear assessments, fears are being expressed that a significant proportion of SHGs are of poor quality, which may have a bearing on their ability to access savings and credit on a sustained basis. In one of the assessments carried out by APMAS it was found that about 40% of the SHGs were of inadequate quality to access bank linkage (Mahajan and Ramola, 2003). Inability to ensure sound growth of SHGs is being attributed to inadequate resources for training and capacity building, inexperience of many agencies involved in promoting SHGs and target based approach followed especially under government programmes in SHG formation, etc. Since the SHGs are at the core of microfinance delivery, any further deterioration of their quality may hamper the sound progress of the sector.

Under the SHG-Bank Linkage Programme, though a very large number of SHGs have been linked to banks, SHGs continue to face many difficulties in accessing credit smoothly. Many bank branches are found to be constrained due to staff shortage in covering all potential SHGs in their area of operation. The outreach achieved is only of limited nature (Fernandez, 2004). Further, the lending to SHGs appears to be still mainly based on savings. As a result, not only is there continued impounding of savings, SHGs are also not able to get adequate credit support. Many SHGs are compelled to ration credit in order to meet the credit needs of all their members. As a result not only members are unable to get adequate credit, but are also forced to accept shorter repayment or maturity period, defeating the original purpose (Shylendra and Saini, 2003). At the all-India level only about 32% of the SHGs have been able to access credit more than once from the banks by 2004 (Dasgupta, 2005). Overall, the ability of SHGs to access credit from formal agencies appears to be still constrained and limited. For many older and mature SHGs, the problems also pertain to utilisation and investment of their accumulated savings and identifying livelihood opportunities.

11.4.2 Lack of conducive regulatory framework

Despite having proved its mettle as a sound financial intervention for the poor, microfinance today stands in a state where the future path of its growth in the country, especially in terms of the institutional form it
will take, still remains uncertain. MF has enabled the policy makers and planners to discover a potential tool for poverty alleviation but the enabling environment for its own growth looks elusive (Shylendra, 2003). It is recognised that successful scaling up of MF intervention for a larger impact requires promoting strong network of institutions delivering microfinance with sound practices. However, the MF sector is faced with many problems in this regard.

Excluding the formal financial institutions, the sector consists of a large number of unregulated NGOs dealing with the poor and other small clients (Satish, 2005). Much of the MF intervention by the NGO sector is in the form of a project, lacking the much needed organisational form and capacity. As estimated above, there are over 1,700 NGO-MFIs involved in microfinance. A large number of these NGOs are either trying to promote or even transform themselves into full-fledged microfinance institutions (Shylendra and Saini, 2003). The NGOs, having crossed the stage of infancy in microfinance activity more under an informal framework, are now looking forward to a conducive and an appropriate regulatory environment to grow further. Lack of suitable legal and regulatory framework which clearly recognises the role of NGOs in microfinance and enables them to scale up their operations or transform themselves as financial intermediaries is identified as one of the major hurdles being faced by the NGOs. Such a scenario is also leading to many distortions in the sector. In the absence of a suitable regulatory framework, many NGOs are either stagnating in the delivery of microfinance or able to deliver only a fragmented service (Shylendra, 2003).

Without a clear formal recognition, the status of microfinance activity of the NGOs, especially savings mobilisation, has remained vague and even illegal. Since the entry point and other prudential norms are so rigid or high under existing framework, many NGOs, despite good past record, have decided to remain small and local in delivering microfinance. While some have decided to set up non-banking financial companies (NBFC) providing only partial service, others are forced to run two institutions with additional cost. Even formation of a regulated MFI is taking a very long time, given many legal hurdles faced (Fernandez, 2004). Those which are registered as societies or cooperatives have to put up with the problem of interference of politicians or bureaucracy to the detriment of their much needed autonomy. Only a very few states have enacted acts for autonomous or self-reliant cooperatives under which full fledged MFIs could be formed.
It is not difficult for one to see the haphazard way in which the MF sector is growing, being both stifled and fragmented in the process. We feel that the relatively higher rate of interest prevailing in the microfinance sector is partly attributable to the above distortion. Though the Task Force on MF submitted its report more than five years ago, except for minor tinkering no major policy initiatives have so far been taken to end the legal lacunae being faced by the MFIs.

Without a clear legal framework and institutional form no sector can thrive. More so the MF sector, which lacks resources to meet all the prohibitive entry point norms of the existing regulatory framework. Hence it becomes necessary that legally the role of NGOs is clearly recognised and clarified. In order for the NGO programme to attain both outreach and credibility, it is felt that enabling legal provisions should be enacted. There are arguments for a separate legislation on microfinance which would enable NGOs to overcome the existing legal and entry point hurdles, so that they are able to either establish new MFIs or transform themselves into MFIs for a larger outreach and impact.

11.4.3 Lack of capital/funds

Another major constraint identified in the growth of microfinance sector to fill the big gap of unmet need is the availability of funds. Enabling the microfinance sector to reach its potential would require massive funds for institutional development, capacity building and for meeting loanable fund needs. Main constraints at work are in mobilising the required funds to meet the need. Regarding mobilising loanable funds, a major constraint is the inability of unregulated NGOs/MFIs to raise and pool deposits from the members and SHGs. This limitation has not only fragmented the financial intermediation but has also come in the way of MFIs mobilising useful local deposits. Even regulated MFIs like the NBFCs are not able to raise deposits due to prescription of a high level of owned capital (Rs. 20 million). NGOs can neither pool SHG level savings for lending, nor can leverage it for mobilising external funds.

At the same time, though many revolving fund schemes are being operated by the apex agencies (like NABARD, SIDBI, RMK and FWWB), the extent of support received so far has been limited by the MFIs. The apex agencies have been criticised for their rigid approach in extending revolving fund support and failing to come out with suitable products required by the sector (Financial Express, 2004). Even though the entry
of commercial banks recently has eased the situation a little, smaller and newer MFIs continue to face the same difficulties. As identified earlier under the SHG-Bank Linkage Programme, though banks can tap their own huge deposit base for lending to SHGs, the lending has got constrained mainly due to linking of loan limit to the SHG savings base. As a result, even cumulatively in the last one and a half decade the microfinance programmes have been able to disburse about Rs. 41.98 billion till 2003-2004, which account for only a small proportion of total estimated needs. It is identified that absence of guarantee and risk funds is also affecting the smooth flow of loanable funds to the sector.

Mobilising equity to promote MFIs is another major constraint being faced by the NGOs. So far NGO/MFIs have been able to get mainly grant support from donors and apex agencies for their microfinance programmes. NGOs have used these grant funds for initial capacity building as well as for meeting their operational expenses. With the growing number of NGOs taking up microfinance, the availability of grant fund seems to have reduced. However, with many NGOs keen to promote MFIs there is hardly any source from which they can easily mobilise the required equity (Gibbons and Meehan, 2002). With not many venture funds supporting MFIs, mobilising equity has become a major constraint for building MFIs in the country. Even the flow of funds for capacity building seems to be quite limited. It is well known that expanding microfinance needs capacity building at various levels. Training of SHG members, bank staff and NGO staff is considered to be an essential ingredient in capacity building. Though many NGOs have received some support from donor agencies for the purpose, the flow from the apex agencies like SIDBI and NABARD has been of limited nature. As against the Taskforce’s estimation of Rs. 2.57 billion required cumulatively for capacity building till 2003-2004, the two apex agencies have spent about Rs. 289.10 million towards capacity building.

11.5 Some macro conditions and microfinance sector

The direction a sector in an economy takes in its growth and approach depends to a large extent upon the prevailing macro economic conditions and the policy scenario. In order to understand to what extent the emerging macro scenario is likely to support or hinder the microfinance sector in its future growth, it becomes essential to identify some of the macro trends at policy and economy level. Before elaborating our approach and the role of state for scaling up
microfinance, an attempt is made briefly in this section to look at some of the macro trends.

11.5.1 Economic reforms and microfinance

The development of microfinance in its present form in India has incidentally largely coincided with the period which has seen the unfolding of economic reforms, structural adjustment programme and attempts made towards globalisation. The economic reforms being introduced in India since 1992 is mainly aimed at bringing in market based policy initiatives which are expected to lead to higher economic growth through efficient allocation of resources. Under economic reforms the state is expected to reduce its control over the economy through privatisation and liberalisation. At the same time, there is also a push towards integrating the economy with the global economy through liberalised trade in goods and services under GATT and WTO regime. The economic reforms have been subject to major debate over their possible implications for growth and poverty alleviation. While the proponents have argued that economic reforms will bring about poverty alleviation through higher growth and efficiency, a major concern expressed over economic reforms is that market based approach is likely to reverse the achievements of the state led growth leading to adverse impact on poverty and equality in the country (Ghosh, 2002).

Apart from wide range of reforms introduced in trade, industry, agriculture and fiscal policy, the government has also brought in financial and banking sectors under the fold of economic reforms. The major initiatives taken for the financial and banking sector include deregulation of interest rate, more autonomy for banks to decide about deployment of funds, reduction of reserve and liquidity requirements, prescribing prudential norms on international standards for banks, permission to private and foreign investors to promote banking and other financial services. At the same time the government has decided to continue with the priority sector lending policy for banks with some changes in the composition of activities.

The scaling up of microfinance initiative in the form of SHG-Bank Linkage Programme and on-lending to NGOs have coincided with banks being given more autonomy to decide about their functioning, based on market signals rather than on directed lending. Unlike in the past, the banks are being encouraged to adopt initiatives like SHG-
Mainstreaming microfinance for poverty alleviation

Bank linkage more as a viable bankable proposition rather than out of sheer social concern for reaching out to the poor. Given such a scenario where the emphasis is on achieving efficiency and profitability, the major question is, to what extent microfinance initiatives are going to be implemented by banks and other financial institutions with real concern for the poor? With profit being the major concern, will the banks be able to participate wholeheartedly in microfinance, especially if there is a trade-off between outreach of poor and sustainability of their operations? Can the banks really scale up microfinance without any social obligation?

11.5.2 Impact of banking reforms on rural sector

It has been observed that the deregulation of the banking sector has lead to many adverse impacts on the rural sector. Using autonomy, the banks have reduced their rural branches significantly in the last one decade. There is also a major change in the credit-deposit ratio during the post-reform period. The share of small loan accounts (less than Rs. 25,000) has declined very drastically, both in the total number of accounts and in the loan amount outstanding in the post reform period (Shylendra, 2001). The post reform period initially also saw a decline in the share of priority sector lending from the prescribed 40%.

Though the scheduled commercial banks have been able to meet the overall target, it is argued that the increase has come mainly by way of dilution of the original priority sector definition or norm, including allowing the banks to consider parking their shortfall of the target in Rural Infrastructure Development Fund (RIDF) as priority sector advance (Guha and Shylendra, 2004). Though overall the banks have been able to meet their priority sector target, this seems to have happened more by way of dilution of the original mandate than by a proactive involvement of banks. This is also evident by the fact that the banks continue to fall short of meeting the sub-group targets for agriculture (18%) and weaker sections (10%) under priority sector lending.

Another major adverse impact that took place during the period is the transformation of RRBs from weaker section institutions into regular banks, in the process losing their original thrust on microfinance. In other words, under the compulsion of financial sustainability, a formal microfinance institutional structure built for the poor has been allowed to get diluted in terms of its focus on the poor.
It becomes very clear from the above evidence that in the post-reform period the formal banking system as a whole has not been well disposed towards the rural areas and priority sector in general and weaker sections in particular. In a way there is a reversal of social control over banking launched since 1969. It is in this context microfinance by the way of SHG-Bank linkage and on-lending to NGOs is being attempted to be scaled up. Given the adverse trends observed above with regard to weaker section and rural area lending, the attempt to mainstream microfinance with banks appears apparently contradictory. As long as such a contradiction exists, upscaling microfinance in a true sense by formal financial institution would be an uphill task (Shetty, 2001).

11.5.3 Microfinance as a part of global agenda

The year 2005 has been declared as the Year of Microfinance by UN. Incidentally, 2005 was also the target year of the Microcredit Summit Campaign launched in 1997 to reach 100 million households globally. Microfinance has attracted the attention of all major global developmental players like multilateral agencies, bilateral agencies and various private donor organisations. Multilateral agencies like the UN, WB, FAO, IFAD and ADB are trying to support and advocate microfinance through various initiatives. In the UN declaration of Millennium Development Goals, microfinance has come to be recognised as an important tool which could help in combating poverty. Some of the concerns expressed in this regard are:

- Since MF is still a buzzword, the global agencies seem to be focusing their attention on microfinance. Once the euphoria ends, microfinance may lose much of its global support. Funding support may also dry up with the onset of donor fatigue. The national policies might be getting influenced at present by the global focus on microfinance.

- At the same time, the other concern is that the global agencies could be using microfinance as a conduit to push various other agendas like reducing subsidies by developing countries for poverty alleviation, pushing forward cost recovery and market based approaches in poverty alleviation, and increased role for NGOs. Since MF has the potential to contribute in achieving all the goals, it could be serving as an instrument for pushing forward those policy issues. If the concerns expressed are true, then the formation and
implementation of microfinance policies based on global agenda by national governments might suffer from credibility, or may even go against the national interests.

11.5.4 Co-option of microfinance by the state

Microfinance being delivered by using trust, group method and social intermediation is essentially an innovation of the civil society. It is the NGOs which have pioneered the use of group method for delivering savings and credit for the poor. Much of the credit for the success achieved in establishing that ‘poor are bankable’ goes to the efforts made by the NGOs in nurturing and promoting the group concept. What is seen in the efforts being made by agencies like NABARD and SIDBI to promote and scale up microfinance is basically adoption of the model tried out by the NGOs. The state through its agencies has co-opted the idea and concept pioneered by the NGOs. In the Indian context, we see the co-option of the principles of microfinance broadly under two types of programmes, like the SHG-Bank Linkage Programme and the credit based poverty alleviation programmes like SGSY, DPIP and Swashakti (donor sponsored microcredit programme).

Under SHG-Bank Linkage Programme, group method is being used by the formal financial institutions to deliver savings and credit to the poor and women. For this purpose groups are either being promoted by the banks and cooperatives or by the NGOs. In the case of credit based poverty alleviation programmes like SGSY, there is an attempt to integrate groups in the programme design itself. Unlike in the past the BPL households selected are expected from informal groups, which would help them in accessing credit, savings, subsidy and other resources. Here also, the groups are expected to be formed by the government agencies implementing the programme or by the NGOs identified for the purpose. The adoption of informal group methods, including social intermediation, has required the state and formal agencies both to recognise the role of group method as well as relax their norms of dealing with such informal groups.

By co-opting microfinance, as invented by NGOs, the state agencies hope to reap the following advantages. There is scope for eliminating or reducing the limitations of earlier approaches or interventions used for reaching out to the poor. This included ensuring continued access of poor to formal agencies, effective targeting of the poor and reduction of
Towards a Sustainable Microfinance Outreach in India

subsidies in delivering the government programmes. Besides, it is also hoped that the co-option of MF model would help the state and its agencies in scaling up the programme using their vast resource and outreach. However, the concern expressed with the co-option of NGO developed model by the state and its agencies is that because of their top-down and target based approach, the formal agencies may end up defeating the original strengths and purpose of the model. In other words, all the limitations observed in the previous state-led programmes like leakage of resources, exclusion of core poor and inability to ensure programme sustainability may also affect the co-opted model. The promotion and scaling up of microfinance by state agencies is likely to face similar consequences, if necessary safeguards against state failure are not inbuilt into the programme.

11.6 Role of state in promoting and developing microfinance

As identified above, the microfinance sector in the country is faced with number of challenges and constraints which have resulted in a stifled, haphazard, fragmented and distorted growth. Lack of proactive and guiding policy support is one of the major factors for the current status of microfinance. Taking forward the microfinance sector in our view requires a comprehensive approach, which would include proactive and pro-poor policy measures. In all these we assign an active role for the state and its agencies. Before identifying the specific initiatives to be taken by the state we present here the approach or framework which would guide the policy initiatives.

11.6.1 A framework for promoting microfinance sector

There is a need to give further fillip to microfinance. Apart from the reason that there is still a huge gap in the demand and supply of financial services by the poor, microfinance sector needs to be developed as it would help in attaining some of the major goals of development. We advocate the following approach, which should serve as the framework for the development of microfinance sector with the active participation of the state.

- **Microfinance as an instrument of poverty alleviation and empowerment:** As the target group of microfinance is the poor, especially women, we emphasise that the promotion of microfinance
is taken up primarily from the point of view of contributing towards poverty alleviation and empowerment. As it has proved to be a credible tool, development of microfinance could enlarge the basket of policy instruments needed for poverty alleviation. Microfinance, if promoted in a full-fledged and proper way, would enable the poor to participate in the development process by enhancing the availability of capital for economic development (Dreze and Sen, 2002). At the same time promotion of microfinance can be a potential tool for empowerment. Microfinance can help in the empowerment process in many ways. Access to credit and savings and their management by the women can help improve their skill and capacity, economic conditions, as well as their status in the family and society. Moreover promotion of member-based MFIs can help the poor exercise ownership and control over institutions capable of contributing for their livelihood improvement.

While emphasising on the poverty alleviation role of microfinance, we also clarify that the overall goal of poverty eradication has to be taken up in a more integrated way with a multi-pronged strategy, where microfinance goes with interventions like food security, education, health, land reforms and development of infrastructure for the poor.

- **Enlarging formal financial sector for the poor:** Bulk of the poor are outside the preview of formal financial sector both because of rationing and self-exclusion. In certain cases like insurance, the poor are virtually out of the sector. Microfinance sector development has to be taken up to extend the horizon or frontier of the formal sector for the poor. In this process there is institutionalisation of credit and other services for the poor. The poor are enabled to access all services in a full-fledged way and the institutions catering to the poor are able to render and take up full-fledged financial intermediation. Moreover, the MFIs are also able to deliver microfinance at affordable rate of interest for the poor. This requires creating a suitable enabling environment through policies and legal framework wherein the existing as well as newer institutions are able to reach out to the poor for providing financial services. Microfinance institutions and services are able to get integrated with the financial system through promotion and regulation, but retaining their original strengths of trust and informality.
• **State to play a proactive role:** In the promotion of microfinance, the state is visualised to play a very proactive role. Development of microfinance can be considered as a public welfare function aimed at overcoming poverty and deprivation. Given the strong argument that access to microfinance by the poor needs to be considered as a fundamental right (Yunus, 1996), it becomes imminent on the part of the state to ensure that the poor get access to the needed capital easily. A key role for state also becomes essential, as microfinance is an intervention, which has emerged both in response to the state and market failures (Lapenu, 2002; Sriram, 2004). It is the state which has the strength to overcome both such failures. Moreover, much of the microfinance also has emerged in the NGO sector, which has its own limitations of limited outreach and lack of resources. The state can help to promote the microfinance sector at least in three ways. It helps to create necessary policies and legal environment needed for pursuing microfinance activities. It can help mobilise the financial resources from various sources required for developing the sector. Lastly, the state can play an important role in the capacity building of the institutions involved in microfinance delivery through infrastructure development, training and technical support.

• **Multi-pronged institutional strategy:** Given the magnitude and diversity of need, we propose a multi-agency approach for delivering microfinance at grassroots level. Three types of institutions are to be involved in this regard as each can act as a safeguard against the failure of others.

The first set is the **mainstream institutions** consisting of commercial banks, RRB’s, Cooperatives and other financial institutions. These institutions have the required resources, outreach and capacity to deliver microfinance in a full-fledged way. Moreover their involvement is necessary to ensure accountability of mainstream institutions to contribute to poverty alleviation. The mainstream financial institutions need to have a significant share of microfinance in their portfolios in order to rectify their past failures to cater to the needs of the poor. For this, not only the mainstream institutions need to invest resources in microfinance development but also have to fully internalise microfinance in their systems in true letter and spirit.

The second set of institutions would consist of **microfinance institutions** and **banks** promoted exclusively for the purpose of
target groups. Such MFI’s can emerge out of the NGOs involved in microfinance delivery or promoted by financial institutions or government agencies. The reason to promote the MFIs emerges from the point of view of creating an alternative system which is well disposed towards the cause of the poor. The alternative stream can both compete with the mainstream institutions as well as show pathways for dealing with the poor through informal and innovative measures. The alternative stream can also act as a safeguard against the failures of mainstream institutions. The alternative stream can also help towards empowerment by enabling creation of MFI’s owned by members and is able to take up full fledged financial intermediation. Moreover, this stream can help MFIs emerge in their own capacities rather than as agents or as correspondents of the formal institutions, which goes against the spirit of empowerment.

The third stream would consist of NGOs and another informal institution. Since a large number of NGOs are involved in microfinance by mobilising the poor, there is need for allowing them continue as long as such need exists. In a way it is the NGOs which have shown that microfinance works for the poor. This stream can also contribute in providing and sustaining social intermediation needed for delivering microfinance. The stream needs clear recognition to carry out microfinance and also access to adequate resources and capacity building. The NGOs, wherever and whenever possible, could graduate into the MFI stream.

- **Flexible regulation essential for development of MF sector:**
  Regulation of financial institutions is primarily advocated to ensure their safe and sound growth. Regulation of MFIs is also being advocated for a similar purpose. In our view, besides ensuring the protection of depositors and investors, regulation has a role in developing a sector in a desired direction. Absence of regulation can stifle the growth of a sector. As highlighted earlier, this partly seems to be happening for the MF sector. In the absence of regulation, the NGO/MFIs are unable to mature into institutions capable of providing sustainable financial services on a wider scale. Hence, we advocate regulation also from the point of view of development of the sector. In this regard, we further argue that the regulatory framework for the MF sector should be evolved primarily looking at the needs and conditions of the sector.
MF and MFIs have been working on principles which are different from conventional banking norms. Some of these features include substituting trust and social intermediation for conventional collateral targeting poor, illiterate and women members, insistence on saving as a part of their delivery. It is these informal and non-conventional features which have ensured the success of MF that has been achieved so far. Further, promotion of MF through regulation should enable MFIs to work based on these principles which lie at the core of MF delivery. Hence we argue that the regulatory framework for MFIs should be developed which clearly emphasises the basic principles and features of MFIs.

Instead of asking MFIs to adjust or to adapt to the conventional regulatory framework, we visualise a regulatory framework which has been formed keeping the diversity, flexibility and informality of the MFIs in mind. This could be illustrated with the example of RRB’s in India and Grameen Bank in Bangladesh. The RRB’s were promoted in 1976 by the state as microfinance institutions under the existing regulatory framework. The failure of RRB’s to continue as MFI is attributable to the fact that they were evolved mainly under the conventional banking norms (Shylendra, 1996). On the other hand, the Grameen Bank of Bangladesh, which was promoted under a special law suitable for its non-conventional structure, purpose and functioning, could succeed largely because of such a suitable law evolved for the purpose.

11.6.2 Policy initiatives for microfinance

Having identified the framework, we now propose below the specific policy initiatives that are needed to be taken by the state and its agencies in India.

• **A proactive microfinance policy:** Though the Taskforce had identified the need for a national policy on microfinance, no attempt has been made since then to bring out a policy paper on microfinance. As argued, lack of sustainable policy has been a constraining factor in the growth of microfinance in a desired form and direction. Formulation of a comprehensive and consensus-based microfinance policy would go a long way in helping the growth of the sector. The policy needs to come out clearly with the objectives of microfinance, specify the approach to achieving the goals, define the legal and
regulatory framework, work out ways of mobilising resources and building capacity of the sector. The policy also has to ensure that the poor are able to get microfinance services at affordable cost. Such a policy needs to be brought out as soon as possible. In our view the national policy suggested in the Taskforce report lacked a clear-cut approach and framework for promoting microfinance. The Taskforce’s policy aimed more at fitting microfinance into the existing regulatory framework, rather than preparing a regulatory framework which suits the needs of microfinance.

- **An understanding law for microfinance:** The natural corollary of the above policy framework is formulation of a law which would create a proactive and flexible legal and regulatory system for the promotion, development and sound functioning of MFIs. As identified above, microfinance is an innovation working on an unconventional basis. Microfinance also consists of diverse and informal agencies dealing with target groups like poor who are largely illiterate and women. We need a law which not only ensures safety of deposits and soundness of functioning but also enables diverse and multiple MFIs to come up in the country. The law, as is strongly argued by many, must have a clear provision for promotion and regulation of MFIs on layered basis (Yunus, 2003; WWB, 2002). The NGO/MFIs in the country vary widely in terms of type of activities, jurisdiction and level of business. A clear categorisation of MFIs based on size, area and business needs to be made. The MFIs could be allowed to choose the category they wish. The registration, entry point requirements, prudential norms, supervision and reporting could be specified as per the category of MFIs rather than on a uniform basis.

The thrust and focus of the law should be to recognise the microfinance activity and enable full-fledged financial intermediation, sound growth of diverse MFIs, ownership by members and flexible and innovative regulation. The law must clearly recognise the microfinance activity and remove the confusion and non-legality prevailing with regard to NGO/MFI activity. The law must enable MFIs to mobilise deposits with suitable safeguards. The financial intermediation must be complete with savings mobilisation even if it means mobilising savings only from the members in the lower category of MFIs. Ways of promoting protection through deposit insurance also needs to be highlighted. Moreover, in the creation of MFIs the members could be enabled to buy stakes and own the organisation as a means towards empowerment.
In terms of regulation and supervision, the law must aim towards creating an alternative or independent agency which would rely on multiple ways of regulating MFIs. The law could encourage self-regulation which matches the condition of the MFIs.

- **Adequate funding for development of MF:** Given the need of promoting MF for poverty alleviation, it is worth investing by the state in developing and capacity building of the MFIs. In our view much of the funding is required for the initial promotion and capacity building. While in the case of RRBs, the state and its agencies fully invested funds in their creation, in the case of MFIs the state can afford to invest at least part of the capital. MFIs could mobilise the rest so that they can build their own stakes. Once the MFIs are able to stand on their own, we feel they would be able to leverage their base for raising loanable funds from multiple sources.

The Microfinance Development and Equity Fund needs to be further augmented. Resources could be mobilised for the fund from varied sources like government, multilateral agencies, banks and donor agencies. Funds need to be accepted from these sources without compromising on the pro-poor objectives and thrust to be enunciated in the microfinance policy. The fund could be hived-off into a wholesale agency. The agency could utilise the funds to meet the needs of multiple categories of MFIs with wide range of instruments like equity, quasi-equity, soft loans, commercial loans and guarantees. Given wide variation in the spread of MFIs in the country, the agency could create regional level organisations or funds so that a balanced growth could be attained.

The fund also could be utilised for meeting various capacity building needs of the sector which is highlighted in the next point.

- **Capacity building of MF sector:** Despite the sector having passed the nascent stage, the capacity of the existing MFIs is found to be awfully weak for maturing into stronger institutions. Various constraints identified earlier are also found to be responsible for the weak capacity. The growth of the sector along with the policy measures identified above would require massive capacity building. We visualise capacity building of the sector on the four following lines.
Mainstreaming microfinance for poverty alleviation

- **Strengthening SHGs:** The microfinance movement has started with the group methodology. Its future also to a great extent depends on the health and performance of the groups. Given the fact that the SHGs have grown very fast, their quality also has suffered. We therefore suggest that a major effort is made in building the quality and capacity of the SHGs. This would require investment to be made by government, banks and MFI s. The initiatives like grading and monitoring of SHGs should be continued on a vigorous basis. Training of SHG leaders, members and field staff should be pursued in a focused way. Help of experienced NGOs and capacity building institutions like APMAS should be enlisted for the purpose. Efforts also should be made to create more such SHG capacity building institutions regionally. The progress and performance of SHGs needs to be monitored continuously by these capacity building agencies. Even SHGs created under various government programmes also need to be brought under such capacity building efforts.

- **Training for human resource development:** As the microfinance sector is growing, the need for building the human resource capacity has also increased. There is need for training both the in-service people as well as injecting fresh talent into the sector. The existing training programmes should move from exposure and orientation to specialised training in diverse management areas of microfinance. The target group for specialised in-service training should include managerial staff of NGO/MFIs, banks and financial institutions and specialised functionaries like auditors, regulators and supervisors. There is need to develop training programmes and materials for such needs. There is also need to launch specialised courses or programmes on microfinance in universities and management institutions which could help to develop pool of fresh talents/graduates. These programmes need to focus both on developing managerial skills as well as necessary empathy and values to work in microfinance sector.

- **Information technology for microfinance:** There is need to help develop simple and effective MIS and other IT-based services which would help in better monitoring and reporting of performance and delivery of services on cost effective basis.
– *Research centres:* RBI and NABARD could help to create centres or chairs in different educational institutions to encourage focused research and training in micofinance.

### 11.7 Conclusion

Since poverty alleviation continues to be a major challenge, search for effective and alternative instruments to address the challenge also continues. Microfinance has come to be recognised as a potential tool which could alleviate poverty. The emergence of microfinance could be traced to the problem of market and state failures in ensuring the poor to access capital for development from the formal institutions. Successful experiments with microfinance have shown that microfinance with its unconventional approach of using trust and social intermediation can help the poor access savings and credit on a sustained basis, which can contribute positively in bringing about poverty alleviation and empowerment. In the context of India, microfinance has come to be adopted both by the formal and informal agencies. While the formal agencies like commercial banks, RRBs and cooperatives have adopted largely the SHG-Bank linkage model being promoted by NABARD, the informal agencies like NGOs have largely adopted the on-lending model.

In both the approaches, Self-Help Groups have come to play a crucial role in the delivery of savings and credit for the poor. While there is a good progress in the last one and a half decades, the sector is faced with many constraints and problems which are coming in the way of emergence of the sector in a full-fledged way. Despite the SHG-Bank Linkage Programme, SHGs continue to face difficulties in accessing savings and credit smoothly. There is also the problem of ensuring the quality of SHGs. Moreover, a large number of NGO/MFIs which have played a major role so far are faced with difficulties in taking forward their involvement in microfinance in an organised way. Lack of a conducive legal and regulatory framework is coming in the way of NGOs maturing into microfinance institutions capable of providing full-fledged services to the poor. At the same time, there is also the constraint of mobilising adequate funds both for developing the institutions as well as for meeting huge credit needs.

Simultaneously, one could see certain macro economic conditions like the structural adjustment programme and banking sector reforms which
Mainstreaming microfinance for poverty alleviation

seem to be having certain adverse effects on rural banking and weaker sections lending in the country. There is also the scenario of microfinance being pushed under the global agenda of bringing in market-based developments and state agencies with their own limitations co-opting microfinance for scaling-up under such circumstances.

Given the scenario, the paper advocates a proactive role for the state in up-scaling microfinance to serve as an instrument of poverty alleviation. The role of the state is emphasised: the state only can help address the problem of market and state failures suitably. Based on such a premise, the paper advocates an approach wherein microfinance is promoted as an instrument of poverty alleviation and empowerment under the active guidance of the state. In order to build safeguards against possible failure of the state, market and civil society, a multi-agency approach with three streams of institutions is advocated.

The first stream consists of formal financial institutions following mainly the SHG-Bank Linkage Programme to reach out to the poor. The formal institutions like commercial banks, RRBs and cooperatives are required to fully internalise microfinance so that they are able to utilise their resources and network for providing a sustainable access to the poor. The second stream would consist of mainly MFIs promoted as an alternative to the mainstream institutions. The main reason for promoting an alternate stream of MFIs is both to overcome possibility of continued failure of formal agencies as well as to create institutions capable of providing full-fledged financial services to the poor in a proactive way. The third stream would consist of mainly NGOs which continue to provide both microfinance through on-lending as well as build social intermediation and capacity of the SHGs. The approach also advocates calls for a flexible regulatory framework which is conducive for the needs of microfinance and the diverse players involved in delivering it.

In terms of specific policy initiatives, the paper advocates adoption of a pro-poor microfinance policy which would clearly identify, besides the goal and approach, the enabling conditions and the resources required for mainstreaming microfinance. A natural corollary of the policy is the enactment of a suitable and understanding law for microfinance which would help in promoting and developing the sector. The law must put in place a flexible regulatory framework which fully appreciates the diverse
Towards a Sustainable Microfinance Outreach in India

and unconventional nature of microfinance. A layered regulation suiting diverse category of institutions should be the major feature. Other policy initiatives needed to be taken by the state are ensuring adequate funding of MF sector for meeting equity and loanable fund, and capacity building to enhance the quality of SHGs and to meet the growing human resource development needs for an effective performance.

To conclude, despite the changing developmental paradigm the responsibility of the state for ending poverty continues to be recognised. Hence, in the upscaling of initiatives like microfinance which are capable of contributing to poverty alleviation, the state must play a key and proactive role. What is least expected of the state in India is to come out without any delay with a proactive policy and an understanding law for microfinance so that its full potential for poverty alleviation and empowerment is realised.

References


Mainstreaming microfinance for poverty alleviation


Towards a Sustainable Microfinance Outreach in India


12 Creating an enabling environment for microfinance – the role of Governments – experiences from Thailand

Marie Luise Haberberger

12.1 Introduction

The extent to which governments should engage in the development process remains a subject for discussion. Many pro-government economists believe that the role of governments should be confined to providing the institutional framework within which financial systems can operate but do not support the active involvement of governments. The debate about the role of governments in institutional development has hitherto focused solely on the question, whether, and to what extent governments should intervene. But even if we agree that efficient institutions do not emerge automatically as a result of an evolutionary process and further that governments have to intervene in order to compensate for market deficiencies, there is still no certainty that government intervention will take place at the right time with the right means. However, we all agree that development – economic, social and sustainable – is impossible without an effective government. Let us take a look at Thailand and the well-known BAAC (Bank for Agriculture and Agricultural Cooperatives), a major provider of micro and rural finance services, and the role of the Thai government.

Thailand has a population of about 63 million people occupying an area of some 513,000 square kilometres. The Gross Domestic Product in 2003 was US$ 142.3 billion and the per capita income was US$ 2,241. Over the last five years, the annual inflation rate in Thailand has fluctuated between less than one to 1.5%.

Between 1980 and 1995, the share of agriculture in GDP declined from 23% to 11%. This decline was matched by an increase in the share of industry. These changes had a significant effect on settlement patterns, with the proportion of urban population more than doubling, from 17% in 1980 to 36% in 1995. 50% of the urban population lives in Bangkok.
There has been a drastic reduction in poverty in Thailand in recent years; official estimates suggest that the incidence of poverty has fallen again after the financial crisis to around 12% of the population. However, there is considerable regional variation. A long-term trend towards greater income inequality has been evident since the mid 70s.

### 12.2 The macro economic environment

#### 12.2.1 Favourable growth rates

In the fourth quarter of 2003, the economy expanded by 7.8%, accelerating from the previous quarter. Seasonally adjusted GDP growth increased by 2.7% – an indication of on-going economic expansion. Strong domestic demand, both consumption and investment, were the main driving forces of the economy. Greater domestic consumption and investment have expanded the range of production activities for the grassroots population, providing small entrepreneurs the opportunity to enter the market and earn more income.

#### 12.2.2 Low inflation rates

Over the last five years Thailand has experienced its lowest inflation rates of less than one to 1.5%. These low inflation rates have been conducive to economic stability and growth. Under the inflation targeting system used since 2000, the Monetary Policy Committee of the Bank of Thailand sets short-term interest rates with a goal of sustainable growth while keeping core-inflation within a range of zero to 3.5%. With inflation on the lower side of the target and a relatively strong external position thanks to a good export performance, the monetary policy fully promotes the recovery process.

#### 12.2.3 Poverty reduction through improved export markets for rural products

The Thai government has recognised the importance of local rural production. In order to promote local products, the One Tambon One Product (OTOP) initiative was launched at the beginning of 2001 (a tambon is a group of villages or a sub-district) to enable each community to develop and market its own local products based on traditional indigenous expertise and local know-how. The government is further prepared to provide additional assistance in terms of
appropriate modern technology and new management techniques to promote marketing through domestic and international outlets with a good retail network. The booming Thai tourist industry complements and fosters the sale of rural or locally produced goods. The OTOP initiative aims to channel income into local communities in Thailand, thereby helping to raise standards of living throughout the country.

12.2.4 Infrastructure and bank branch networks

Road infrastructure is fairly well developed in Thailand and road conditions are quite satisfactory. Rural clients reach the nearest branch within 15 to 30 minutes of travelling time. Clients living in remote locations are few. BAAC alone, which has an outreach of 92%\(^1\) throughout its large rural network, is operating in nearly 600 branches and 888 field or service units.

12.2.5 Interest rates

A general ceiling of 15% interest is applied to loans. This ceiling is specified in the Civil and Commercial Code, and applies to all bodies and transactions unless they are specifically excluded. Exceptions are as follows: Since 1992, almost all financial institutions regulated by the Bank of Thailand are free to charge interest rates based on market conditions. However a few Specialised Financial Institutions (SFIs), thrifts and credit cooperatives are excluded and are subject to an interest rate ceiling of 19%, but their interest rates have yet to reach the ceiling.

The interest rate ceilings impact differently on various institutions and could be a constraint to the development of microfinance, particularly when the costs of funds are increasing. Given the higher transaction costs associated with microfinance, the chances of the ceiling acting as an impediment should be closely monitored.\(^2\)

12.2.6 Thailand’s financial sector

The formal financial sector in Thailand consists primarily of commercial banks, non-bank financial institutions, Specialised Financial Institutions established by the government and cooperatives. By 2002, there are 13 Thai commercial banks, 5 credit foncier companies (type of finance company), 18 finance companies and 18 full foreign commercial bank
branches, and 29 BIBFs (Bangkok International Banking Facility). There are 3,632 bank branches throughout the country, all under the supervision of the Bank of Thailand.

There are nine specialised financial institutions (SFIs – four banks and five companies) supervised by the Ministry of Finance (MoF) and inspected by the Bank of Thailand. Most notable among these in regard to micro and rural financial services is the Bank for Agriculture and Agricultural Cooperatives (BAAC) with 588 branches and sub-branches.

12.3 The Bank for Agriculture and Agricultural Cooperatives (BAAC)

12.3.1 General

BAAC is a ‘front rider’ with regard to outreach: 92% of farm households in Thailand have been reached directly or indirectly by BAAC. However outreach is meaningful only if it remains sustainable.

The Bank of Agriculture and Agricultural Cooperatives (BAAC) was established in 1966 as a government-owned agricultural development bank. The mandate of the bank has been to provide agricultural credit to farm households and agricultural cooperatives. Since the expansion of the branch network in 1988, the number of borrowers has doubled. By 2003, more than five million farm households were registered as BAAC’s direct and indirect clients while 2.7 million of them are active BAAC borrowers. This represents about 92%, respectively 46% of the total farm households in Thailand. Savings accounts totalling almost 9.6 million provide significant proof that there is a high demand among rural clients for BAAC’s financial services. BAAC’s pro-active rural savings mobilisation has brought about what is virtually a revolutionary change in the financial resource base. BAAC has become financially self-reliant and has been able to significantly reduce its dependence on and loans from domestic and foreign sources. By 2003, or in just a decade, the deposit-to-loan ratio has reached 100%.

An ongoing process of change is underway at BAAC and reforms are far from complete; important lessons can be learned from BAAC’s experience. BAAC has gone through several evolutionary steps. For many years it tried hard to secure an amendment to the 1966 BAAC Act and to obtain permission to expand its lending operations to non-farm
activities in rural areas. In 1993, a first window was opened when BAAC was allowed to provide loans for farm-related activities and, as a second step in early 1999, the government approved amendment to the BAAC Act. GTZ, as part of its technical cooperation with BAAC, was helping the bank to develop a system for non-farm lending and to conduct testing in selected branches.

BAAC has generated positive returns on assets and equity throughout the 36 years of operations. During this time BAAC has been able to cross-subsidise its lending business with interest income from investments and, more recently, from fee-based income and has managed to maintain its overall profitability. BAAC has benefited from various types of hidden incentives and indirect subsidies, such as an exemption from minimum reserve requirements and income tax.

Since 1998 it has been evident that the financial crisis in Thailand has not left BAAC unaffected and consequently matters concerning prudential regulation by the central bank and diversifying into non-agricultural lending have become serious issues. In 2003, the MoF as supervisor and owner decided that BAAC should implement more realistic provisioning rules to ensure the long-term sustainability of its operations.

12.3.2 Governance, ownership and interventions

BAAC is categorised as a so-called specialised bank providing financial services in rural areas. Ownership has hitherto largely remained with the government. More than 99% of the shares in the Bank are held by the Ministry of Finance, with the balance mainly in the hands of agricultural cooperatives.

BAAC operates under the supervision of the Ministry of Finance, as do all other SFIs, while the commercial banks are supervised by the Bank of Thailand (BoT). The State Audit Office, a government agency, performs the annual external audit. In addition, BAAC’s performance is annually assessed by the Thai Rating and Information Service (TRIS) within a framework designed for state-owned enterprises which focuses on five aspects (operational effectiveness and efficiency, stakeholder issues, management, organisational development, good governance).

BAAC has an internal audit department for the ongoing financial and management audit of its operations. Periodic reports from the provincial
and branch offices are channeled to BAAC’s senior management in order to monitor the sources and uses of funds.

BAAC is governed by a fifteen-member Board of Directors. The Board controls the policies and business operations of the Bank. The composition of the Board is outlined in the BAAC Act of 1966 to include representatives of the Prime Minister's Office, the Ministry of Finance, Ministry of Agriculture and Cooperatives, Cooperative Promotion Department, the Agricultural Land Reform Office, the Bank of Thailand and one representative from the agricultural cooperatives. The president of BAAC is an ex-officio member of the Board. The Finance Minister is officially the chairman of the Board, but the Deputy Finance Minister is assigned to act on his behalf. In general, the Board comprises mainly public officials representing the interests of the government.

The composition of the Board has several important implications. First, it implies a primarily short-term agenda, which may not support the long-term objectives of financial health and sustainability of the institution. Second, major internal policies are based on well-intended and general development considerations, rather than financial business principles. Third, due to its highly emphasised policy status as the major agricultural arm of the government, BAAC has to accommodate the particular interests of ministries and government agencies by implementing a considerable number of ‘special projects’, in addition to its regular lending operations.4

Such ‘development projects/programmes’ have often had a negative impact on the financial viability of the Bank. In response, BAAC has adopted a strategy of ‘interventions against compensations’ through negotiations with the government and members of parliament. The latest and most significant programme implemented through BAAC was debt suspension for all borrowers with an outstanding loan of less than Baht 100,000 (US$ 2,300) with BAAC. Under the programme, borrowers who choose the debt suspension are permitted to suspend loan principle and interest payments for three years. The government compensates BAAC for the interest payments not made. Borrowers under the debt suspension programme cannot borrow from BAAC during the three-year period. The government expects the policy to boost the purchasing power of those given temporary relief from loan repayment. When farmer borrowers join the programme, they
are supervised and helped by the committee to improve and restructure their operations. The programme was launched at the beginning of 2001. About 50% of eligible farmers opted for debt relief and their suspended loans accounted for around 21% of BAAC’s total loan portfolio. Borrowers who opted out of the programme are entitled to a privilege card – a mark of their good credit standing. This is a powerful incentive to keep up the discipline of the credit system, while ensuring that those in real need of debt relief have an option. The debt suspension has definitely been an obstacle on BAAC’s path towards viability and poses a potential threat to its long-term sustainability. An increase in the reserves by BAAC became unavoidable.

In the past, government interventions were mainly confined to policy level, ensuring that the operational level enjoyed a high degree of autonomy. BAAC has managed to resist the pressure from political interest groups as well as interference from local governments with regard to borrower selection and lending decisions. However, the government-directed debt suspension programme in 2001 affects the autonomous nature of BAAC’s operations. BAAC thoroughly monitors the existing status of debt suspension and has established adequate reserves in an effort to prepare its ‘firewall’ for any eventual moral hazard.

By 2004, the Ministry of Finance and the Bank of Thailand had implemented new prudential measures on the basis of Basel II for BAAC.

12.3.3 Major restructuring initiated by policy changes lead to remarkable results

One of the core elements of BAAC’s reform process has been the fundamental restructuring of the sources of funds. The restructuring of the liability side progressed over a period of 30 years.

In its early years, BAAC operated almost exclusively with government funds. The major share (about 60%) came as equity contribution and a minor share (about 20%) was in the form of a special credit facility on preferential terms from BoT.

Ten years later (1975-1987), mandatory deposits from commercial banks were the major source of funds (about 40%), following the
agricultural credit policy issued in 1975. At the same time, BAAC started borrowing from international financial agencies, which made this source the second most important (about 30%) in the 1980s. Finally, deposit mobilisation from the general public started to gain importance towards the end of the 80s. In 1987, deposits mobilised by BAAC already accounted for one-fourth of BAAC’s funds.\(^{15}\)

The period from 1988-2001 brought another major change in the funding structure. During this time, BAAC made deposit mobilisation a major activity of its banking operations and, consequently, deposits mainly from the rural areas evolved into the single most important source of funds. The liberalisation of the agricultural credit policy caused commercial banks to reduce their mandatory deposits with BAAC, which led to a substantial stimulation to BAAC’s savings mobilisation efforts. While borrowings fell to a low of 4.6% in 2003, BAAC suffered considerable losses as a result of exchange rate fluctuations associated with foreign loans and adopted a more cautious stance towards borrowings from abroad.

By 2003, BAAC’s source of funds consisted of only 4.6% from borrowings, which is divided into 28% from foreign loans (JBIC) and 72% from local borrowings.

In the last 13 years, BAAC has become increasingly self-reliant in financial terms and has been able to significantly reduce its dependence on government funds, mandatory deposits from commercial banks and loans from domestic and foreign sources. In just a decade, the deposit-to-loan ratio doubled to 100% in 2003.

Since 1995 GTZ has been supporting this major restructuring process at BAAC by jointly planning and implementing a savings mobilisation strategy, savings product development and a savings delivery system.

### 12.3.4 Policy changes lead to innovations in financial service delivery

#### Savings mobilisation

During the first twenty years of operations, BAAC concentrated almost exclusively on credit services while savings – as in many agricultural development banks elsewhere – largely remained the ‘forgotten half’
of rural finance. In the early years, BAAC implemented a compulsory savings scheme for borrowers, requiring each borrower to deposit an amount equivalent to 5% of the loan value in a savings account. The scheme was costly to administer, and was terminated in 1979.

Only since the mid-1980s has BAAC recognised the importance of voluntary savings mobilisation, not only from its own perspective of deposits as a stable and reliable source of funds, but also from the viewpoint of its rural clients, who need safe, liquid and convenient deposit facilities. The Bank realised that there is a strong demand for deposit facilities, especially among farm households that are forced to synchronise income and expenditure in the course of the agricultural production cycle. Furthermore, savings act as a buffer against the uncertainty governing the rural economy. In the wake of unforeseen events and emergencies, financial savings perform a basic insurance function.\(^6\)

Over the past decade, the Bank has campaigned effectively to mobilise rural savings. The branches were instructed to set annual mobilisation targets, and savings mobilisation became one of the major criteria for evaluating branch performance. As a result, BAAC has achieved remarkable success in deposit mobilisation. Deposits from the general public grew at average annual rates of 17% and increased from only Baht seven billion (US$ 280 million) in 1986 to more than Baht 321 billion (US$ 7.3 billion) in March 2004.

**Demand-oriented savings products**

In 1995, BAAC introduced an innovative savings product, called *Om Sap Thawi Choke* or ‘Save and Get a Chance’, primarily targeted at the low-income market. This product was developed by BAAC Savings Promotion Division together with the GTZ-supported Microfinance Linkage Project. The minimum opening deposit is only Baht 50 (US$ 1.15) and, although the interest rate of 0.75% (2002) paid on deposits is one percent below the standard rate, BAAC pays for savings accounts, and the account holder is entitled to participate in semi-annual tombola-drawing parties offering goods popular in rural areas as prizes. After successful pilot testing in selected branches, the product was launched nationwide in early 1996 and, by the end of 2003, had attracted more than 2.5 million depositors with an average deposit of Baht 3,800 per account holder (US$ 87).
The most recent product introduced in 1997, with the objective of attracting medium-term funds is the BAAC Savings Bond (Thawi Sin). The savings bonds have a nominal value of Baht 500 (US$ 11.40) each and a term of three years. The three-year bonds carry an interest rate of only 1.33% per annum (2002) but – as a compensation for the low yield – bond holders participate in a highly publicised prize draw at the national level.

More than 75% of BAAC’s deposits are generated mainly through four core products, which include the two mentioned above. The two other products are Time Deposits and Passbook Savings.

Institutional deposits are made up of a relatively small number of accounts with large amounts. They are held in both savings and fixed deposits on an almost equal balance. Furthermore, institutional deposit accounts are subject to considerable fluctuations, depending on budget allocations and expenditures, which exposes the Bank to a considerable liquidity risk.

Table 1: Change in BAAC’s sources of funds structure, 1967-2001 (%)

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<tbody>
<tr>
<td>Deposits from the public</td>
<td>11</td>
<td>17</td>
<td>12</td>
<td>25</td>
<td>48</td>
<td>62</td>
<td>76</td>
<td>83</td>
</tr>
<tr>
<td>Mandatory deposits from CBs</td>
<td>–</td>
<td>–</td>
<td>39</td>
<td>39</td>
<td>7</td>
<td>1</td>
<td>–</td>
<td>–</td>
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<tr>
<td>Borrowings</td>
<td>19</td>
<td>22</td>
<td>35</td>
<td>29</td>
<td>32</td>
<td>25</td>
<td>13</td>
<td>4.6</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>66</td>
<td>57</td>
<td>12</td>
<td>6</td>
<td>8</td>
<td>7</td>
<td>7</td>
<td>8.4</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>4</td>
<td>4</td>
<td>2</td>
<td>1</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
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<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Deposit-to-loan ratio</td>
<td>14</td>
<td>19</td>
<td>21</td>
<td>38</td>
<td>66</td>
<td>83</td>
<td>98</td>
<td>100</td>
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Source: BAAC
Deposits from individuals have generally been much more stable. More than 90% of deposits from private individuals were held in simple savings accounts including Om Sap Thawi Choke, a pattern typical of rural customers. The number of savings accounts increased from 4.1 million in 1994 to 9.5 million in 2002 – an increase of about one million savings accounts a year.

The size distribution of savings accounts by number and volume reveals a considerable concentration. The vast majority (97%) of the savings accounts have a balance of less than Baht 50,000 (US$ 1,140). This may indicate that the majority of BAAC depositors belong to the lower-income segment. However, these accounts generate 36% of the deposit volume, while a few large depositors (slightly above 10,000 clients or 0.1% in 2002) account for 24% of the volume.

12.3.5 Service-oriented mindset

BAAC pays attention to the quality of its service and continuously stresses the importance of a service-oriented mindset among its work force. This emphasis reaped positive results in the TRIS (Thai Rating and Information Services) annual performance appraisal: 90–95% of BAAC’s clients appreciate the Bank’s services. The annual TRIS evaluation is a tool used by the MoF to control BAAC’s overall quantitative and qualitative performance. Client satisfaction is highly valued and assessed every year. One should bear in mind that the TRIS evaluation result impacts on BAAC staff remuneration. The ‘BAAC Service Culture’ which is an Organisational Development Intervention has become internalised in the entire bank as a permanent subject. It has been progressively developed further. While the initial focus was only on behaviour, it has more recently also encompassed competency such as product and customer knowledge. Although BAAC has hundreds of products, as is the case with the financial products of many other banks in the world, the so-called Pareto rule also applies to BAAC: about 20% of the products and services generate almost 80% of the business. That explains the focus on the products that account for the 20%, as they enhance profitability and efficiency.

BAAC has an outreach (direct and indirect) of 92% (2001) to rural families. The more direct outreach is that 46% of the rural families in Thailand have one active BAAC borrower. In every rural household, there is a BAAC savings account. BAAC holds a market share of 34% of rural deposits (Table 2) and 5.5% on a nationwide basis.
12.3.6 Branches become profit centres

Profitability – expressed by return on assets (ROA) – is becoming an important criterion for measuring branch performance. In 1997, BAAC introduced the transfer price mechanism. Transfer price is the internal interest rate applied on funds transferred between the branches and the head office. When a branch requires funds for its lending operations, it borrows from the head office and is charged the transfer price, and vice versa.
versa: when a branch mobilises savings and deposits, then head office pays, based on the transfer price. In principle, the transfer price is set by the management in accordance with the market cost of funds. It can also be used as an important policy instrument.

BAAC with the support of GTZ and the German Bankakademie has introduced a new Branch Management Information System (BMIS) in all its branches. It provides a complete framework for managing a branch network, based on a decentralised branch-controlling concept. This new BMIS includes monthly provisioning, transfer pricing and realistic cost allocations for the branches. This instrument supports the head office with its central treasury department and the branches in implementing the overall bank strategy.

The fully computerised Branch Management Information System (BMIS) has been operational since early 2003.

12.3.7 Government-secured lending versus viable credit products

Government-secured lending

In addition to its normal lending business, BAAC grants a large number of government-secured loans or so-called ‘special agricultural development projects and policy lending programmes’. There are around 200 ‘special projects and programmes’, some nationwide, some of them regionally concentrated. However, these special projects entail a heavy workload. First results from the decentralised branch controlling (BMIS) indicate that they are loss-making products. Moreover, they divert the attention of credit officers from their mainstream lending activities. Most special lending programmes supported by government departments carry preferential interest rates, which have occasionally caused some confusion among clients. BAAC is compensated by the government in the form of fees and interest compensation. ‘Special loans’ with its old supply-driven approach or ‘old paradigm’ accounted for 7.3% of the total net loans in 2003.

A research study conducted in 1996 by the well-known TDRI (Thai Development Research Institute) confirmed the following:

- Loans under government-secured lending programmes do not reach the poor farmers for whom they were designed, but rather the better off and more informed farmers who know the officers of the Agricultural Extension Service.
• Subsidised loans are not tailored to the needs of poor farmers, because they are designed by agricultural department officials who think they know what is best for poor farmers.

• Most government-secured or subsidised loans create moral hazard or unwillingness to repay the loan. This results in low repayment performance. These subsidised loans also create confusion among other BAAC borrowers.

Shift from wholesale to retail lending

The initial success of direct lending to farmer clients organised in small Joint Liability Groups on the one hand and the problems experienced in lending to agricultural cooperatives on the other caused a shift in the lending policy in the late 70s. BAAC decided to focus mainly on retail lending to farmer clients. From the founding of BAAC until today, the share of wholesale lending through cooperatives dropped from 70% to only six percent in 2003.

Client orientation through credit technology

The development of the Joint Liability Groups concept dates back to the founding of BAAC in 1966. As few Thai farmers had land title documents to use as collateral in the 60s, BAAC adopted joint liability as the principle form of security for small loans. Joint liability has been at the heart of the BAAC’s lending ever since.

Joint Liability Groups are formed by people who know and trust each other. They vary in size from a minimum of five to a maximum of 30 and usually average about 15 members. In general, Joint Liability Groups are primarily client groups and not what is normally understood as Self-Help Groups with organisation and administration. BAAC Joint Liability Groups do not function as financial intermediaries. Individual loans up to Baht 150,000 (US$ 3,400) are granted on the basis of joint liability. Loans above this amount must be secured by tangible collateral, usually through mortgage of land and buildings.

All transactions are conducted between BAAC and the individual members; the group leader has no role in disbursements or recovery of loans and is responsible for distributing repayment notes and reminding the members of their obligations.
Since in the more recent years the majority of the BAAC borrowers earn income from agricultural and non-agricultural activities, the loan assessment has to be in line with the total household cashflow of the borrower and not just follow agricultural harvesting schedules.

**BAAC’s new market segment – cashflow-based lending**

For many years, BAAC has tried hard to secure an amendment to the 1966 Act and to obtain permission to expand its lending operations to non-farm activities in rural areas. While a first window was opened in 1993, when BAAC was allowed to provide loans for farm-related activities, as a second step, in the beginning of 1999, the government approved amendment to the BAAC Act. This allowed the expansion of lending operations into non-farm activities for farmers – up to 20% of the total portfolio. BAAC with the support of GTZ has developed a system and a credit product for cashflow-based lending which is in line with the total household cashflow of the borrower. In 2003, the Thai cabinet decided that BAAC was a Rural Development Bank and no longer restricted to agricultural lending.

**12.4 Conclusions**

Although BAAC is now self-sufficient in its source of funds, and subsidised credit programmes have dwindled, elements of the old and the new paradigm coexist. Two years ago at the Sri Lanka Conference, on “The Challenge of Sustainable Outreach: How can Public Banks Contribute to Outreach in Rural Areas?” there was evidence that the ‘paradigm shift’ in rural and microfinance – in particular after the financial crisis – is becoming increasingly evident in Thailand. BAAC is now focusing on economic viability and sustainability, as well as on the outreach of financial services.

BAAC has managed to resist the pressure exerted by political interest groups as well as interference from local government with regard to borrower selection and lending decisions. The government-directed debt suspension programme in 2001, however, affects the autonomy of BAAC’s operations. BAAC thoroughly monitors the existing status of debt suspension and has established adequate reserves in an effort to prepare its ‘firewall’ for any eventual moral hazard.
In the wake of the financial crisis, an important and positive change was initiated in October 1998 when the government decided in principle to place BAAC under the prudential regulation of the BoT. Prudential regulations and banking standards in line with international standards set out in the Basel Agreement have been developed by the BoT to take effect in the new Thai Banking Law. An on-going dialogue with the Ministry of Finance about the preparation of prudential measures has been concluded and the measures implemented.

The implementation of the decentralised branch controlling system, with its BMIS, is a strong tool to delegate more responsibilities and accountability to branch managers and is a step in the right direction. BAAC knows the financial performance of each of its core products. Moreover, the bank knows that government-secured loans are loss-making for BAAC. This leads to a more appropriate compensation through the government.

Streamlining all BAAC products by identifying the most important ones or core products is a positive step towards accelerating product knowledge and cross-selling among staff.

Reform processes at the BAAC are gradually on-going over a period of 36 years, which is very different from other Agricultural Banks where reforms are implemented quick and massive. At times, the reform processes in the BAAC move slowly, but gain momentum in other periods. In terms of focus and content, reform processes have been directed at the transition from agricultural credit to rural microfinance and at the institutional transformation of BAAC from a specialised credit institution to a diversified rural bank. The gradual diversification of financial services is a clear indication of this evolution.8

The BAAC’s pro-active rural savings mobilisation has caused revolutionary changes to the financial resource base. The BAAC has become financially self-reliant and has significantly reduced its dependence and cut down on loans from domestic and foreign sources. In just a decade, the deposit-to-liability ratio has reached 83%, and the deposit-to-loan ratio 100%. This can be assessed as an outstanding result.

The BAAC has developed a fundamental eagerness for cost effectiveness, productivity and efficiency. BAAC’s management pays
constant attention to branch performance. The delegation of authority and responsibility to managers at all levels and the implementation of profit centres in the branches contribute to this achievement.

12.5 What lessons can be learnt?

Political interventions and government-subsidised loans

Populist political interventions carry a high prize for governments and must be compensated by those who initiate them. A government has to be thoughtful in initiating relevant policies that meet the needs of the lower income groups. The providers of financial services must operate in a sustainable manner and refrain from wasting scarce taxpayers’ money and depleting their own funding base. Governments should not underestimate the risk of moral hazard which some interventions can cause for a very long time.

Of interest in the Indian context could be the finding of the TDRI research, confirming that loans under the government-secured lending programmes do not reach the poor farmers for whom they were designed, but rather the better off and more informed farmers who know the officers of the Agricultural Extension Service. The subsidised loans are not tailored to the needs of the poor farmers, because they are designed by officials who think they know what is best for poor farmers. Most of the subsidised loans create moral hazard or an unwillingness to repay, which is resulting in low repayment performance.

A decentralised branch controlling system or BMIS can become a powerful tool which is essential for a financial institution in its negotiations with governments when it comes to presenting the government with a bill for intervention.

The painful lesson of borrowing from abroad

The experience of borrowing from abroad has been mixed. BAAC was required to take on the foreign exchange risk on most of the loans and, as a consequence, suffered substantial losses due to exchange rate fluctuations. The losses were severe in the wake of the financial crisis and the devaluation of the Thai currency when half of the bank’s equity was wiped out. This was a painful lesson.
Relevance of a favourable macro-economic environment

A stable macro-economic environment, including favourable growth rates, low inflation rates and positive interest rates on (small) savings, poverty reduction strategies, good road infrastructure and bank branch network are of relevance for the growth of sustainable rural finance and microfinance.

BMIS or Branch Controlling System

The new Branch Management Information System (BMIS) in all BAAC branches provides a complete framework for managing a branch network, based on a decentralised branch-controlling concept. This new BMIS includes monthly provisioning, transfer pricing and realistic cost allocations for the branches. This instrument supports the head office with its central treasury department and the branches in implementing the overall bank strategy. The fully computerised BMIS can also be implemented on a manual basis. BMIS could be interesting for the Indian banking sector, as it enables branch managers to manage their branches in a timely and effective manner. Simultaneously it can also be used by the management of a bank’s head office to insert its policies efficiently.

Successful mobilisation of small savings leads to a revolutionary change of the funding structure

Demand-driven approaches to rural financial services offer opportunities for success. There is a large demand for savings facilities in rural areas, so that the self-financing of rural lending is entirely possible. Safety and convenience rather than high interest rates are the main concerns of potential depositors. The success in small savings mobilisation is rooted in BAAC’s ability to provide a balanced combination of what small savers want and need: safety, convenience, liquidity and positive yields. BAAC has successfully addressed these four elements in its savings mobilisation. An accelerated and voluntary savings mobilisation in the rural areas could also be of interest in India, especially in the context of upgrading SHG members or when they require a more flexible liquidity arrangement. Accelerated and voluntary savings mobilisation could also be an important source of funds for a financially healthy credit cooperative structure.
The Joint Liability Group Concept – a low cost credit delivery system

The BAAC experience of more than three decades with the Joint Liability Group concept as the core credit product of the bank deserves attention. In the past, few Thai farmers had land title documents to use as collateral, which is why BAAC adopted joint liability as the principle form of security for small loans. Joint Liability, which has been at the heart of the BAAC’s lending since 1966, is a highly cost-efficient credit delivery model and has contributed substantially to BAAC’s remarkable outreach. The majority of BAAC’s borrowers are served through Joint Liability Groups. The concept of Joint Liability could become a viable alternative to the SHG Linkage Banking in India.

Cashflow-based lending – a new credit delivery system for small borrowers

The cashflow-based lending technology is BAAC’s latest credit delivery system and is geared very much to its future. This credit product corresponds fully with the cashflow of the small enterprise/small farmer combined with his/her household, as 90% of the rural borrowers have income from agriculture and non-agriculture. This relatively new BAAC credit product suits the changes in rural Thai society, which is no longer just agriculture based. Income from non-agricultural sources plays a more significant role while ‘rural’ and ‘urban’ are coming closer. Cashflow-based lending calls for substantial capacity building, as it brings about a change from stereotypical agricultural lending to a more need-oriented cashflow-based lending. In the Indian context, there are important similarities to the Kisan Credit Card. This is where the capacity building of the BAAC cashflow-based lending could be studied.

Connecting qualitative and quantitative performance to remuneration

Total performance-based evaluations like the TRIS in Thailand are impacting on staff remuneration. A possible option could be to build in performance indicators for government-owned banks which have an influence on staff remuneration.
Joint cooperation results in significant leverage

The BAAC-GTZ cooperation in the context of microfinance has served as a laboratory for developing and testing innovative features, products and approaches in selected branches. This cooperation has shown high leverage in supporting BAAC in its savings mobilisation, improving staff competence, developing a decentralised branch controlling system and the system and instruments for cashflow-based lending.

Endnotes

1BAAC has a direct or indirect outreach covering 92% of the farm households in Thailand.


3The Thai-German Microfinance Linkage Project supported BAAC in its savings mobilisation efforts.

4Maurer, Klaus. Rural Finance. Working Paper No. B 6, IFAD.

5Haberberger, Marie-Luise; Wajananawat, Luck; Kuasukul, Nipath. January 2003. The Challenge of Sustainable Outreach (GTZ/BAAC), the Case of the Bank for Agriculture and Agricultural Cooperatives (BAAC), Thailand.

6Maurer, Klaus. Rural Finance. Working Paper No. B 6, IFAD.

7Haberberger, Marie-Luise; Wajananawat, Luck; Kuasukul, Nipath. January 2003. The Challenge of Sustainable Outreach (GTZ/BAAC), the Case of the Bank for Agriculture and Agricultural Cooperatives (BAAC), Thailand.

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13 Financing microfinance: The ICICI Bank partnership model

Bindu Ananth

13.1 Introduction

Microfinance in India has witnessed a recent impetus with a growing number of commercially oriented microfinance institutions (MFIs) emerging and banks increasing their exposure to this sector considerably. Despite this, a large gap between estimated demand and total supply persists. Countries encounter varying challenges in the pursuit of universalisation of access to basic financial services. In India, several enabling factors exist – a vibrant commercial banking sector, presence of operationally sound MFIs and a regulatory environment that permits multiple models of building access in the case of credit. This paper seeks to focus on one particular aspect that is impeding scale in India – that of access to the capital required for building a scaled microfinance industry. Some of the insights may be useful for other countries as well. One of the key assumptions of this paper is that the route to universalisation of microfinance, certainly in the case of India, is to work with high quality, autonomous (both for-profit and not-for-profit) local financial institutions, broadly referred to as Microfinance Institutions. Commercial banks directly building outreach to microfinance clients is not a model that has been kept in mind, for the purpose of this discussion.

Debates on challenges in scaling up microfinance have curiously not dwelled on the capital constraint that the sector faces. In India, we have witnessed high-performing MFIs growing at sub-optimal rates owing merely to a capital constraint. Often, wholesale funds for on-lending and equity are not distinguished when debating availability. Owing to priority sector targets for banks which requires banks to lend at least 40% of their net bank credit in any given year to agriculture and weaker sections that includes lending to historically disadvantaged
communities and microcredit, there has been a logic for the flow of wholesale funds to this sector, however limited it may be. However, there are no ‘natural providers’ of risk capital for microfinance and that has constrained scale for several MFIs. (In fact, risk capital/equity is a constraint, not just for microfinance in India, but also for the small scale enterprise and infrastructure sectors.)

Further, a discussion on risk capital would need to distinguish between explicit and implicit capital (Mor and Sehrawat, 2003) to precisely understand where the gap arises. Explicit capital is the capital committed by the promoter of a project and implicit capital is that committed by the lender to a project usually in the form of economic capital or Tier 1/2 capital adequacy. In the Indian microfinance context, it must be noted that the scarcity has been of explicit capital that the promoter (in this case the MFI) would bring in. Banks, on the other hand have an ability to contribute the implicit capital – at least in the volumes necessitated by microfinance. The paper discusses a model that overcomes this particular challenge.

Recommendations to set up ‘equity funds’ by the Government for this sector do not adequately address key issues such as rules governing allocation of these funds among competing MFIs, moral hazard/incentive of MFI to use these funds parsimoniously and a business model for the fund itself.

Models of microfinance that have prevailed tend to use risk capital inefficiently. The few MFIs in India who have raised commercial equity have delivered return on equity figures of less than five percent primarily because of low levels of leverage. The fact that several MFIs have chosen to establish themselves legally as non-banking finance companies (NBFCs) also imposes a demand for regulatory capital. (In order to register as an NBFC, an MFI would need entry level capital of Rs. 20 million, approximately US$ 500,000 at an exchange rate of Rs. 40 = US$ 1.00). The preference for an NBFC format may be largely explained by the desire of MFIs to provide savings facilities for its clients. In a later section, the paper briefly discusses how savings may be facilitated without the MFI adopting an NBFC format.

This paper analyses the models of financing prevalent for microfinance in India and goes on to suggest a new approach developed by ICICI Bank, that has the potential for overcoming challenges inherent in traditional models.
13.2 A comparison of three financing models for microfinance

In order to examine the merits of the partnership model, it would be pertinent to understand traditional financing approaches for microfinance in India and compare them along the two key dimensions of efficient use of capital and incentive alignment. These dimensions are vital for evaluating potential for scale and provide the context to understanding why microfinance outreach in India has not grown rapidly enough despite underlying demand being high.

13.2.1 The SHG-Bank Linkage model

The predominant model in the Indian microfinance context continues to be the SHG-Bank Linkage model that accounts for nearly 20 million clients. Under this model, the Self-Help Promoting Institution (SHPI), usually a non-government organisation (NGO) promotes groups (of 15 to 20 individuals) which, after a certain incubation period, are linked to banks. The process of bank linkage involves the bank lending to groups after the incubation period. This linkage may be single or multi-period. The SHPI typically receives no, or below cost, consideration either from the bank or the clients for the function of group promotion. They meet this expense out of external grant sources. The cost estimates for this vary from Rs. 1,500 to Rs. 10,000 per group. Once the groups have been linked to the bank, the SHPI may supervise the loan portfolio out of an implicit understanding with the bank as is the common case. However, there is no specific incentive for the SHPI to play this ongoing role which has associated expenses in terms of employee time. Pricing to the clients under this model is not based on full costing as the costs of promotion and those of transactions handled by the SHPI do not get included.

Capital allocation

Since the SHPI in this case does not play the role of a financial intermediary, it does not have to allocate capital against the lending under this programme. In most cases, the SHPIs in this programme are Trusts or Societies and hence have no desire to take credit risk. Capital needs to be allocated only by the bank which bears the entire credit risk.
Towards a Sustainable Microfinance Outreach in India

Incentive alignment

In this model, the bank bears 100% of the credit risk. It has no recourse to the SHPI which has originated the groups, in the event of default on loans. Therefore, at least in theory, the incentive of the SHPI to consistently originate high quality groups and supervise existing portfolio is weak. One of the reasons why this might not be reflected in repayment rates under the SHG-Bank Linkage Programme (which are reported to be high) could be that portfolio sizes per SHPI are small and not quite comparable to that of MFIs. Also, for several of the larger NGOs, repayment is seen to reflect on ‘reputation’ and hence they ensure that supervision levels remain high even if it means raising resources from donors and other agencies for this purpose. Repayment rates might alter with a significant scaling up of portfolio per SHPI and bank branch.

13.2.2 Financial intermediation by the microfinance institution

In this model, the MFI borrows from commercial sources and on-lends to clients (groups/individuals). This is a recent shift that has been facilitated in part by the participation of commercial banks in the microfinance sector and in part by the lack of resource options for growing MFIs, given that they cannot take deposits and face limited availability of grant funds. Most MFIs in India started operations with grants and concessional loans and gradually made the transition to commercial funding. For instance Bharatiya Samruddhi Finance Ltd. (BSFL), one of India’s leading MFIs, financed much of the growth in the initial years with concessional loans from funding agencies. This was followed by a phase (2001 onwards) in which BSFL raised equity from various domestic as well as international agencies.

Capital allocation

Here, capital allocation happens at two stages for the same portfolio that is financed. An illustration will make this clearer. If an MFI estimates a loan requirement of say Rs. 10 million for its clients, it approaches a bank for that amount. The bank views it as a lending ‘to the MFI’ (organisation-based lending), not finance for the underlying pool of borrowers (asset-based lending). Accordingly, pricing is a function of the rating of the MFI which in most cases is likely to be poor due to low levels of equity capital (contrast this with the rating on the loans pool which is derived from historical loss rates).
The bank allocates capital as relevant to the rating obtained by the MFI. Now, when the MFI on-lends the Rs. 10 million to its clients, it further allocates capital against this portfolio to take care of unexpected losses on this portfolio and to satisfy capital adequacy norms that may govern it. This, in effect, results in a double counting of capital requirement as far as that particular portfolio of micro-loans (of Rs. 10 million) is concerned – once by the bank and again by the MFI. The final pricing will therefore include capital charges at both these levels.

**Incentive alignment**

The incentives of the MFI to maintain supervision levels and collection ratios are high in this case as it bears 100% credit risk on the portfolio. The banks’ incentive is directed to ensure MFI solvency.

**13.2.3 The Partnership Model: MFI as the servicer**

In 2002, an internal analysis by ICICI Bank revealed that despite consistent evidence of viable demand from clients, exposure to MFIs was constrained due to the organisation-based financing model adopted until then. Due to the limited number of rural branches, the SHG-Bank Linkage model was not considered a scaleable route for ICICI Bank. The partnership model pioneered by ICICI Bank attempted to address the following key gaps:

- Separating the risk of the MFI from the risk inherent in the microfinance portfolio.
- Providing a mechanism for banks to continuously incentivise partner MFIs, especially in a scenario where the borrower entered into a contract directly with the bank and the role of the MFI was closer to that of an agent.
- Inability of MFIs to provide risk capital in large quantum, which limited the advances from banks despite a greater ability of the latter to provide implicit capital.
The model has been conceptualised and executed with the following key characteristics:

**Loan contracts directly between bank and borrower**

The loans are contracted directly between the bank and the underlying borrower, i.e., it does not reflect on the balance sheet of the MFI (this feature is similar to the SHG-Bank Linkage model). The MFI continues to service the loans until maturity. In other words, the bank relies on the MFI's field operations for collection and supervision. The key difference then, between this and the financial intermediation model does not lie in the operating methodology (it is in fact identical), but in the manner in which the financing structure has been designed.

This structure primarily attempts to separate the risk of the MFI from the risk of the underlying portfolio. Why is this important? Because when the bank lends to the MFI, it has no recourse to the underlying borrowers. On the other hand, if the bank lends directly to the borrowers without the funds entering the MFI's balance sheet, it has recourse to the borrowers. So, at least in theory, if the particular MFI goes bankrupt or closes down for any other reason, the Bank can appoint another agency to recover the dues from borrowers. In addition, since the loans are not reflected on the balance sheet of the MFI, its own requirement for regulatory capital ceases to exist. Therefore, the lending paradigm shifts from being organisation-based to being asset-based. This shift has crucial implications for rating, pricing and consequent marketability.

**Alignment of incentives with a first loss guarantee structure**

In order to preserve MFI incentives for portfolio quality in the new scenario where its role is closer to that of an ‘agent’, the structure requires the MFI to provide a guarantee (typically a first loss default guarantee) through which it shares the risk of the portfolio with the Bank up to a certain defined limit. A first loss default guarantee (FLDG) makes the provider of the guarantee liable to bear losses up to a certain specified limit, say the first 10% or 20% of loss on the portfolio. It is different from partial guarantees where the guarantor is liable for a fraction of losses on the portfolio, say 50% of all losses. In terms of incentive compatibility, an FLDG forces the guarantor to prevent any losses at all as it is affected adversely right from the start. The quantum
and pricing of the FLDG will reflect the operating capability and maturity of the MFI.

In this model, the MFI collects a ‘service charge’ from the borrowers to cover its transaction costs and margins. The lower the defaults, the better the earnings of the MFI as it will not incur any penal charges vis-à-vis the guarantee it provides. Over a longer period of time, returns from the partnership model can thus permit the MFI to build its Tier I capital through retained earnings. The Bank receives a fixed amount as interest on its loan. It must be noted that the Bank accepts a fixed pay-off while passing on the dynamic benefits/losses of ‘higher than expected recovery’ and ‘lower than expected recovery’ (losses limited to the band defined by the FLDG) to the MFI. The asset that the Bank has thus acquired has a risk-return profile that is now similar to an AAA asset for which secondary markets are easier to access.

**Transfer of implicit capital from the bank to the MFI through an overdraft facility**

Executing the partnership model at scale begs one question – how will MFIs provide the risk capital implied in the First Loss Default Guarantee (FLDG) in large amounts? In other words, how does it resolve the capital issue for the MFI? ICICI Bank has evolved a very innovative structure that combines the provision of both debt as well as mezzanine finance in response to this challenge. Along with advancing the credit to meet the demand of the clients, ICICI Bank provides an overdraft (OD) facility to the MFI. The OD facility is equivalent to the amount which the MFI is liable to provide as the FLDG. The OD represents funds committed, but not utilised. The OD is drawn only in the event of default. On default, the MFI is liable to pay a penal rate of interest on the amount drawn down from the OD facility.

The OD facility, in effect, assumes the character of mezzanine equity permitting the MFI to leverage it for wholesale funding. In this manner, through the OD facility, the bank enables the MFI to provide explicit capital. The bank’s own implicit capital allocation alters only to the extent that it has to now allocate capital against the OD limit advanced to the MFI separate from the capital that it will allocate against the microfinance portfolio. Given that the FLDG is a fraction varying between five to twenty percent of the loan portfolio, the leverage that the MFI is able to achieve improves tremendously. This has implications
for MFI profitability and therefore, return on equity without any real difference in operating methodology.

With this structure that combines the provision of both wholesale funding and mezzanine equity, the limits to MFI growth are purely posed by its capability to grow field operations in a sustainable manner. Financing ceases to be the binding constraint. This can be a key driver of scale for mature MFIs operating in an environment of high client demand.

Given this structure, it is interesting to note that an MFI that expects to have very low rates of default can grow operations even being a ‘shell company’ with no equity. All it needs is a robust operating methodology and long-term funds to finance the field operation until it breaks even.

This model may prove critical in ‘unleashing’ the wholesale funds that banks in India have available to deploy in a viable manner. This excess of wholesale funds may be seen in a very high proportion of savings deposits being held by banks as investments in Government of India securities. Against a regulatory requirement of 25% of net demand and time liabilities, the average for the banking system as a whole is about 40%. It may be argued that this unleashing can happen even with direct equity investment in the MFI. However, as discussed earlier, direct equity infusion suffers from the chances of co-mingling of funds at the MFI level, lack of transparency about which assets are being guaranteed and therefore impacts liquidity and marketability of the underlying assets.

As the partnership model scales up, there will be several aspects to analyse. For instance, by working with several MFIs in different geographical regions, can the bank derive diversification benefits and therefore reduce the capital allocation against the OD as well? How does providing insurance cover against systemic risks such as rainfall affect the OD/FLDG requirement? Going forward, if indeed banks are successful in this model that provides significant leverage on the OD/FLDG, the returns to the provider of the OD/FLDG could be very high and potentially of interest to mainstream equity investors. These are issues to research and track.

With the partnership structure, ICICI Bank is working with more than 30 MFIs in India, accounting for loans outstanding of approximately
US$ 55 million in December 2004. With the traditional financing structure (second model), ICICI Bank’s lending to MFIs did not exceed US$ 5 million in 2001-02. The vision is to work with 200 MFIs in the country, each serving half a million clients each with average loan sizes of Rs. 3,000 (US$ 60).

13.3. The partnership model and securitisation: Paving the way for capital markets access

Microfinance assets originated under the partnership model facilitate participation of a wider investor base. This is achieved through the process of securitisation. This may involve sale of portfolio by the originating bank to another bank in the initial phases. When the microfinance pools become larger in size, issuance of securities that are backed by microfinance assets become conceivable.

Securitisation is a process through which homogenous illiquid financial assets are pooled and repackaged into marketable securities. Securitisation involves isolation of specific risks, evaluation of the same, allocating the risks to various participants in the transaction (based on who is best equipped to mitigate the respective risks), mitigating the risks through appropriate credit enhancement structures and pricing the residual risk borne by the originator.

The intent of securitisation typically is to ensure that repayment of the securities issued to investors is dependent upon the securitised assets and therefore will not be affected by the insolvency of any other party, including the entity securitising the assets. This reveals why a partnership model financing that separates risk of the MFI from risk of the microfinance loans is a pre-cursor for securitising microfinance loans.

An analysis of microfinance portfolios against desired attributes for securitisation reveals a reasonably good fit. Some of the pertinent characteristics are described below:

- Microfinance assets represent weekly steady cash flows from clearly identifiable borrowers.
- An analysis of the past portfolio details of the top MFIs in India reveals portfolio losses to be consistently under five percent.
Towards a Sustainable Microfinance Outreach in India

This can be explained by various factors – most significantly, joint liability models preventing adverse selection and moral hazard issues, high levels of supervision by MFIs and alternative sources of finance for the poor being non-existent or very expensive.

- Microfinance portfolios comprise of several small loans made to individuals for diversified purposes, including livestock, small businesses and consumption. Loan sizes per individual client typically range from Rs. 1,000 to Rs. 20,000. Recent initiatives in bundling insurance products with the loan contract, that result in the insurer bearing loan liability when specified events (critical illness, death, accident and rainfall failure) occur, further contribute to de-risking the portfolio against systemic and large idiosyncratic shocks that might impair the individual’s ability to pay.

- Ideally for securitisation, receivables that are being securitised must be periodic. With most MFIs following weekly repayment schedules, this criterion is easily satisfied.

- Most MFIs advance loans that are fairly similar in terms of maturity, interest rates and risk profiles. For example, almost no MFI in India directly finances crop farming, which presents a significantly different profile (often adverse) from lending small amounts for livestock.

### 13.4 Credit enhancement for microfinance portfolios

For several banks and investors, microfinance represents an unfamiliar asset class. While microfinance practitioners have evolved a methodology over several years based on client and household level insights, several of these are not obvious. For example, when ICICI Bank was in dialogue with rating agencies for the rating of its microfinance portfolio, some of the questions that were raised included: “Do poor households have any surplus to repay loans in the first place? What happens if the business for which the money is borrowed fails or the cow financed by the loan dies? What if there is a serious rainfall failure?”

Therefore, in order to facilitate securitisation and the participation of ‘mainstream investors’, it may be necessary to provide additional ‘comfort’ to these investors through various forms of credit enhancement. Over a period of time, with sufficient familiarity and experience of investing in microfinance portfolios, the levels of credit enhancements can be tapered.
Credit enhancements could be:

- **Originator provided**: Here, the originator (MFI or the bank) provides a guarantee or cash collateral either in part or full.

- **Structural**: Structural credit enhancement is achieved by distribution of risks among investors with different risk appetites and through tranched securitisation. Tranching is possible with issuance of multiple tranches of securities with a pre-determined priority in their servicing, whereby first losses are borne by the holders of the subordinated tranches. In certain structures, the originator retains a subordinate tranche. In this case, the subordinate tranche could be retained by the originating MFI or bank.

- **Third party provided**: There could be specialised third-party entities that provide credit enhancement. In the USA, there are examples of third party agencies contributing significantly to catalysing new asset classes. For mortgage financing, the relevant examples are the Federal Housing Administration and the Federal Home Loan Mortgage Corporation. The objective was to develop a secondary market in mortgage financing. The Small Business Administration (SBA) similarly issues guarantees, pools loans given to small businesses and securitises them for sale to investors.

An effort to create a specialised entity that will provide credit enhancement for microfinance portfolios is underway in India. Modeled along the lines of the agencies described in the previous paragraph, Grameen Capital India is a joint initiative of ICICI Bank and the Grameen Foundation, USA. Over time, this agency could facilitate capital markets access directly for MFIs. It would then compete with banks in providing access to funding for MFIs. This is likely to favorably impact cost of funds. It might even be possible for large diversified MFIs to access capital markets directly, if they can produce the credit enhancement on their own.

There is scope for the participation of equity investors as well as multilaterals to catalyse this effort.

### 13.5 The opportunity for MFIs

A model of financing that starts with the partnership model and culminates in securitisation significantly relaxes the capital constraint that was outlined in the introductory paragraph.
Firstly, it permits the MFI to build outreach much more rapidly. This is facilitated by certain aspects of the model. One, the OD facility overcomes the problem of explicit capital shortfall. Secondly, the MFI is able to achieve more leverage for a given amount of risk capital because of the structure, where the lending bypasses the balance sheet of the MFI.

The process of securitisation releases capital for the origination of fresh assets at a frequency that is more than what would be possible if MFIs held assets on their own balance sheet to maturity.

The MFI also experiences ‘rating arbitrage’, in that it is conceivable through structuring and credit enhancement for the asset pool to obtain a rating that is higher than what a generic organisation rating would have yielded. The improved rating results in lower cost of financing for the asset pool than would have been possible otherwise. If we just examine ICICI Bank’s own experience, the lending rate has fallen from an average of 12% to 8.5% (without including the commitment fee on the OD facility) with the transition in financing structure.

**Microfinance Securitisation**

Share, a Grameen Bank replicator, has been one of the leading MFIs in India with a good track record, growth rate and scale of operation.

In two transactions with Share having a premium structure, ICICI Bank has securitised the receivables of microfinance loans from Share amounting to Rs. 215 million, which consists of loans made by Share to microfinance clients.

**Deal structure:**

ICICI Bank bought this microfinance loan portfolio against:

- A consideration calculated by computing the NPV of receivables amounting to Rs. 215 million at an agreed discount rate;

- partial credit protection provided by Share to ICICI Bank in the form of a first loss default guarantee amounting to eight percent of the receivables under the portfolio.

Subsequently, ICICI Bank sold the securitised portfolio to a private sector bank in India.
13.6 Implications for the financial system

Beyond the benefits to the MFIs outlined above, pursuing capital markets access for microfinance also has implications for the larger financial system. In the Indian context, it creates a sustainable model to originate ‘priority sector assets’ which are in short supply. The Reserve Bank of India’s report on Advances to Agriculture and Weaker Sections (2004) reveals that only four out of thirty private sector banks and seven of twenty seven public sector banks met the target for lending to ‘weaker sections’.

It catalyses development of a secondary market for microfinance where some entities specialise as originators and others emerge as buyers. Therefore, those with unique competencies to originate assets can potentially earn a premium for that function. On the other hand, banks with no originating capability, instead of building branch networks from scratch, can rely on existing originators.

Microfinance securitisation also results in the creation of new asset classes for investors. This refers not only to the underlying microfinance loans, but also potentially the pool of OD facilities that represent MFI risk.

13.7 Creating a conducive environment for capital markets access

• Servicer risk and capabilities: Servicer risk is the risk of the MFI defaulting on its commitment to monitor the programme and collect receivables. This might arise from a variety of factors, including bankruptcy. The separation between portfolio risk and MFI risk has not been considered possible among analysts of microfinance in the past, because the quality of the loan is as much a function of the organisation as of the borrower, such that it has been assumed that you could not transfer the loan servicing from one organisation to another in the case of failure of the originating organisation. However, there have been no studies to look at the contribution of various MFI supervision aspects (separate from joint liability effects, for instance) on portfolio performance. This is an aspect that will have to be studied in greater detail.
The servicer risk debate does raise serious challenges for the MFI in terms of operating capabilities. The systems and procedures of the MFI are critical in determining on-going servicing ability. Emerging MFIs need to invest sufficient time and energy in ensuring that their MIS systems are able to provide detailed portfolio data with minimum time lags.

Training continues to be an important factor for MFIs. As they gradually move into a phase of rapid expansion with standard operating models, it becomes critical to seamlessly add to the field workforce without too much lag.

- **Legal format**: The legal format chosen by the MFI must be one that permits it to assign loans, provide guarantees and retain earnings, for the model to be executed smoothly. It appears that a Trust or Society format is less suited, given this objective.

- **Rating agency participation**: Most securitisation issues are rated by an accredited credit rating agency. The existence of professional rating provides comfort to investors. The rating applies to the securities that are issued to investors and indicates the likelihood of payment of interest and payment of principal in full and on time. Rating agencies need to engage with the microfinance sector from a wholly commercial perspective in order to give investors sufficient comfort.

- **Pre-operating expenditure for new MFIs**: The partnership model tries to solve the problem of wholesale funds. However, it does not solve the problem of working capital finance for MFIs – to expand into new geographies, to cover branch costs when portfolio sizes are small. While it is possible to conceive of long-term loans to finance expansion of mature MFIs into new geographical areas, there remains an issue for early stage financing of emerging MFIs. There may be a role for venture capital companies and other investors who are willing to take MFI risk initially and consequently exit through arrangements with the banks interested in financing these MFIs or with MFIs directly.

- **Regulatory support**: This is necessary in order to take the partnership model to scale. This could involve recognising the MFI engaged in a partnership model as playing a facilitative role and exempting it from needing an NBFC license. The regulator has taken an important step in the development of a secondary market by
giving securitised paper the same recognition as directly originated assets vis-à-vis priority sector requirements. This will eventually lead to specialisation of a few players (with comparative advantage in origination capabilities) as net originators.

Similar to the partnership approach for credit, the Regulator may explore supporting agenting models for increasing access to other financial services as well, specifically savings and insurance. This has the advantage of leveraging the risk management capabilities of mainstream providers (like banks, mutual funds and insurance companies), while relying on the operational strengths of MFIs. Widening the range of services facilitated by the MFI also has positive implications for its operational self-sufficiency. For instance, Prudential ICICI Mutual Fund is exploring a product that will replicate the features of a savings bank account through a money market mutual fund which is then offered to microfinance clients through the MFI. Individual accounts are maintained by the company for reconciliations and the MFI plays a purely facilitative role in terms of cash handling and data capture.

With the emergence of the partnership and similar models, it becomes conceivable to think of MFIs emerging as thinly capitalised profitable local financial institutions playing a vital role in distribution of financial services to the poor and interacting with multiple providers in the back-end. The entry and growth barriers cease to be that of capital, but those of operating capabilities. This is then, a challenge that can be addressed with the support of training and donor agencies.

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14 Designing innovative products, processes and channels for the promotion of microfinance

Graham A.N. Wright

14.1 Introduction: The diverse needs for financial services amongst the low income segment

The microfinance industry has traditionally seen poor people’s needs for financial services simply as ‘credit for enterprise’. Today however, it is generally accepted that poor people also need access to lump sums of money to send their children to school, to buy medicines, to respond to other shocks and emergencies that beset their households, for social and religious festivals, to save up for old age, etc. Thus it is increasingly clear that poor people need a range of ‘financial services’, not just the traditional mono-product working capital loan.

Figure 1: Diverse services driven by diverse needs

![Diagram showing diverse services driven by diverse needs]

Source: Monique Cohen  
C = credit  S = savings  I = insurance
Figure 1 outlines the diverse needs of not just the poor, but of all of us. The most typical offerings of microfinance institutions (working capital and productive asset loans) are simply not adequate – and omit the other services such as savings and insurance that might help poor households meet these needs.

Furthermore, even the typical four to twelve month working capital loan repayable in equal, immutable, weekly instalments does not adequately reflect the changing realities of poor households – whose income and expenditure flows can change significantly according to the season, the advent of festivals or with shocks to the household economy. Low-income households need prompt access to emergency loans (a role played by family/friends or the informal sector moneylenders in most countries) or to increased flexibility in the repayment schedules set by financial institutions seeking to serve them.

As a result, growing numbers of financial institutions have started thinking about developing and delivering a range of financial products tailored to meet these needs.

However, before proceeding, a word of caution about ‘product proliferation’ is appropriate.

14.1.1 Product proliferation

Product proliferation is increasingly common amongst many financial institutions that try to tailor products to respond to individual market segments with specific needs. These institutions can find themselves offering many slightly different products. At one extreme MicroSave once worked on product costing with one bank that discovered that it was offering 89 different products – some with only a handful of customers using them! A multitude of products often results in:

- Confusion amongst front-line staff and clients;
- complex delivery systems;
- complicated management information systems; and
- cannibalisation among products.

When evaluating the diverse needs of clients, the financial institution should recognise that it cannot design a product to respond to each
Designing innovative products, processes and channels for MF promotion

and every individual-specific need. The financial institution should group the most common and prevalent needs of its target market segment and then develop products in response to them. One product can be marketed in many different ways to meet a variety of clients’ needs. Thus an emergency loan (an immensely valuable and popular product for poor people) can be developed with flexible repayment schedules/terms to allow it to meet a wide variety of short-term needs – from education to accident, from ill-health to death, as well as to seize opportunities as they arise.

14.1.2 The market-led revolution

This paper examines some of the products designed (many in collaboration with MicroSave) to respond to these needs, as well as some of the innovative delivery processes currently under testing, and finally reviews the MicroSave approach to product design. It closes with a few comments on NABARD’s Kisan Credit Card and the implications of the changing face of microfinance for the ‘massification’ of financial services for the low-income market in India.

Here it is important to note that a ‘product’ comprises not just the basic terms, conditions and price as is often thought, but all ‘8Ps’ of marketing.

The products, delivery processes and channels outlined below highlight the revolution underway in microfinance. As different financial institutions (from commercial banks to insurance companies, from mobile phone operators to health management organisations) become increasingly interested and involved in the low-income segment of the market, so the products and options for delivering them are expanding rapidly. The days of an inflexible working capital loan as the only product available to the poor customer are over as microfinance moves onto a market-led basis. Market-led microfinance puts the customer at the centre of the business. In the context of product development, this means understanding the customer and his/her needs in order to develop client-responsive and flexible financial services.
The ‘8 Ps’ of marketing

<table>
<thead>
<tr>
<th>The ‘P’</th>
<th>Details of the ‘P’</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Product</strong></td>
<td>Includes specific product features, opening/minimum savings balances, liquidity/withdrawal terms, loan terms, ancillary services such as loan review and disbursement times, collateral or guarantees, amortization schedules, repayment structures (e.g. balloon payments or interest-free grace periods, etc.).</td>
</tr>
<tr>
<td><strong>Price</strong></td>
<td>Includes the interest rate, withdrawals costs, statement/ledger fees, loan fees, prepayment penalties, prompt payment incentives, transaction costs and other discounts.</td>
</tr>
<tr>
<td><strong>Promotion</strong></td>
<td>Includes advertising, public relations, direct marketing, publicity, and all aspects of sales communication.</td>
</tr>
<tr>
<td><strong>Place</strong></td>
<td>Refers to distribution and making sure that the product/service is available where and when it is wanted. This includes such options as outreach workers or agents, mobile bankers, ATMs, working with the informal sector financial services, etc.</td>
</tr>
<tr>
<td><strong>Positioning</strong></td>
<td>Is the effort by the microfinance institutions (MFI) to occupy a distinct competitive position in the mind of the target customer. This could be in terms of low transaction cost, low price, high quality, security of savings, quick turnaround time, professional service, etc. It is a perception.</td>
</tr>
<tr>
<td><strong>Physical</strong></td>
<td>Includes the presentation of the product: How the branch physically looks, whether it is tidy or dirty, newly painted or decaying, the appearance of the brochures, posters and passbooks, etc.</td>
</tr>
<tr>
<td><strong>evidence</strong></td>
<td></td>
</tr>
<tr>
<td><strong>People</strong></td>
<td>Includes how the clients are treated by the people involved with delivering the product – in other words the staff of the MFI. It also includes recruitment, internal communications, performance monitoring and training. To get the best performance from staff, MFIs need to recruit the right staff, then invest in training on customer service and in products, the MFIs' processes and procedures.</td>
</tr>
<tr>
<td><strong>Process</strong></td>
<td>Includes the way or system in which or through which the product is delivered: How the transaction is processed and documented, the queues/waiting involved, the forms to be filled, etc.</td>
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Towards a Sustainable Microfinance Outreach in India
14.2 New generation products

14.2.1 BURO, Tangail’s ‘contractual savings agreement’

BURO, Tangail’s contractual savings agreement was designed to meet the expressed demand for a disciplined savings mechanism that would allow its clients to save up for predictable life-events – particularly their daughters’ marriages. Other clients use the product to save up to buy small parcels of land or to add/renovate housing.

The contractual savings agreement was initially pilot-tested in one form: A five-year contractual savings agreement with weekly instalments of Tk. 5 to Tk. 100 (US$ 0.10 to US$ 2). The effective rate of interest was 15% per annum, compounded yearly. On maturity at the end of five years, the accumulated deposit with profit is immediately cashable. To open a contractual savings account members are required to visit the branch office, discuss the scheme with branch staff, and pay a fee of Tk. 10 (US$ 0.20) to initiate the account. Failure to make a weekly deposit results in a fine of Tk. 1 (US$ 0.02) per Tk. 5 (US$ 0.10) payable and this fine must be paid along with the arrears the following week. Failure to pay more than three consecutive weekly deposits anytime during the five years terminates the scheme, and the accumulated deposit amount is transferred to the member’s general savings account, where it will earn the normal rate of interest on savings from the inception date of the scheme.

BURO, Tangail’s pilot-testing system also provides for an extensive series of interviews with clients who have used the products and those in the groups who have not used the new products in order to understand how and why (or why not) clients are using them. The on-going informal market research during the pilot-testing process also resulted in BURO, Tangail understanding the even more latent demand for contractual savings products of other (primarily shorter) durations and thus the demand for 3 and 10-year agreements. This in turn led to another round of informal costing and pricing, and the introduction of the multiple duration contractual saving products into the organisation. The costing of the product also indicated a need to re-price it, and so as the product was rolled out, the compound interest rate was dropped to 10% - 12.5% (according to the length of the contract).
The contractual savings product proved extremely popular, with demand far outstripping the rationed supply offered during the pilot-test, but it necessitated substantial changes in BURO, Tangail’s systems. The clients’ passbooks and front-line programme officers’ collection sheets were re-designed. The ledgers in the branch offices were changed and extended to allow analysis of the up-take of the product and a provisional assessment of its implications for liquidity management. While the programme officers’ workload was not significantly increased, the product (taken in conjunction with the other products introduced) necessitated the recruitment and training of new assistant cashiers to manage it. Additional training was designed for the staff charged with selling contractual savings agreements and those responsible for managing the resulting cash flows.

The results have been phenomenal, as can be seen from Figure 2. The contractual savings product has grown faster than any other savings product and now represents 65.5% of the total savings deposited with the institution. At the beginning of 2004 there were 135,091 contractual savings accounts. During the year 48,238 of these matured and were paid and another 89,541 accounts were opened,
giving 176,394 accounts (with an average balance of US$ 18.45) as of 31st December, 2004. Together these 176,394 contractual savings accounts provided US$ 3,254,672 in deposits as of 31st December 2004. In the eight years since the contractual savings accounts were first pilot-tested in 1997, a total of 305,860 accounts have been opened and 129,466 have matured. At the end of 2004 BURO, Tangail had 221,366 customers and (given that some members have multiple accounts) around 70% of customers held a contractual savings account. These savings provide a longer-term, stable source of capital that BURO, Tangail can use to lend, generates a good flow of fee-based income, and also (despite their entirely voluntary nature) provide an important security for the institution’s lending activities.

14.2.2 Equity Bank’s *Jijenge* contractual loan product – with emergency loan

Equity Bank has developed the *Jijenge* savings account to assist their clients ‘Realise Your Dreams’. *Jijenge* is a contractual savings product similar to that of BURO, Tangail, but with an emergency loan facility attached. The client defines the length of the contract and the periodicity of the deposits (weekly, fortnightly or monthly). A premium interest rate is offered to those who take out longer-term contracts but there are quite significant penalties for premature withdrawals from the account. Finally, all *Jijenge* savings account holders have guaranteed, immediate access to an emergency loan of 90% of the value of the amount in their *Jijenge* savings account on demand.

As well as providing a disciplined way to save (in the same way that many informal sector mechanisms do), this product allows its clients to meet their ‘illiquidity’ preference and protect their savings against the demands of petty spending or marauding relatives. The account is already proving extremely popular with existing and new clients alike.

The *Jijenge* savings account provides Equity Bank’s clients a financial product that helps them with their financial planning objectives. As a product of extensive market research and constant customer interaction, the *Jijenge* savings account is clearly meeting customer needs. *Jijenge* accountholders are particularly pleased with the:

- Disciplined saving,
- freedom to set terms,
• automatic access to loans, and
• no operational charges.

The *Jijenge* savings account has provided customers with the opportunity to actively involve Equity Bank in their financial planning, thus building on its “Listening, Caring Financial Partner” image and position in the market. The first contractual savings product in the lower-income market segment, the *Jijenge* savings account is a strong starting point for future cross-selling opportunities.

For Equity Bank, the *Jijenge* savings account offers a stable deposit base from which to lend as well as supplementary income from the emergency loans and premature withdrawal fees. In addition, the product is allowing Equity Bank to attract new clients into its banking halls and also to assess their monthly cash flows to inform future lending decisions.

All the above said, the pilot-test of the product clearly identified the need for careful, intense marketing of this relatively complex product to the low-income market, in order to ensure that they understand the product’s benefits and features. The rollout of *Jijenge* coincided with the massive and explosive growth of Equity Bank and has therefore not been as successful as the pilot-test had promised – since the customer service staff have had to focus more on basic savings account opening rather than the lengthy process of selling the *Jijenge* product. Despite this, Equity Bank management continue to see *Jijenge* as a key strategic product for the bank in the medium and long term. As of end of February 2005 there were 4,756 *Jijenge* account holders – with a total of US$ 512,226 (average US$ 107.70) deposited in their accounts.

**14.2.3 The revised ‘Grameen II’ products**

Under its Grameen II programme, Grameen Bank has completely re-invented its product offering. As Stuart Rutherford notes, “Grameen II consolidates many of the lessons from (the bank’s) experience, but goes beyond that by making some fundamental changes”.

Among the more important are:

• **Public deposit services**: The bank has become a true intermediary by mobilising deposits from the general public (and not just from its members).
• **Extended member deposit services:** There is a wider range of savings opportunities for members, including a commitment-saving account known as ‘Grameen Pension Savings’ (GPS). Personal savings accounts have been made far more flexible, and group savings accounts have largely gone.

• **Improved loan contracts:** There is a wider range of loan contracts with variable terms and repayment schedules. Larger loans for business use are available. Loans may be ‘topped up’ mid-term, or paid off early. There is no obligation to borrow. Borrowers in repayment difficulties have their loans rescheduled (into ‘flexi’ loans). Joint financial liability is formally banned (though members still undertake to help each other in other ways).” (Rutherford, 2004)

In an innovation similar to BURO, Tangail’s ‘supplementary loan’ that was developed to maintain working capital within customers’ businesses, Grameen II offers loan ‘top-ups’. In the words of Stuart Rutherford, “for loans of 12 months duration or more, you may ‘top up’ the loan after six months (twenty-six weeks). That is, you may re-borrow the amount you have repaid during the first six months of your loan term, adding that amount to your loan outstanding balance. In that case, the term of the loan is extended by a further period (usually six months) so that in most cases weekly repayment amounts do not rise – and may even fall – as a result of a top-up. In some cases you may extend the loan term – without topping up the loan amount...  

Kendra (groups of 40 to 50 members) managers quickly identify members with repayment problems, and under Grameen II they can take advantage of the six month (twenty-six week) ‘top-up’ rule: they coax such members through to the twenty-sixth week, when they can borrow again an amount equal to half the original loan, enough to pay down any debts still outstanding to fellow-members and to provide some helpful liquidity to manage the remainder of the loan. We have also witnessed – though such cases are still uncommon as far as we know – another inventive use of the top-up rule. I call it the – ‘empty top-up’. At twenty-six weeks a member in repayment problems may be given an extension of term without any cash top-up. The effect of this is to halve the weekly repayment amount due. This achieves much (though not all) of what the flexi-loan was meant to achieve.” (Rutherford, 2004)
These loan top-ups are proving very popular indeed. Rutherford notes in MicroSave Briefing Note No. 3, “Members quickly understood the loan ‘top-up’ system. At first there were mixed feelings, some members believing it slowed the growth of credit limits, but by 2004 we found very few who dislike the system, none who didn’t know it, and many who value and use it.” But even more popular is the ‘Grameen Pension Savings’ (GPS). Rutherford notes in MicroSave Briefing Note No. 2, “The GPS offers another entirely new, but quite different, form of saving service to Grameen members. It allows members to save up steadily over the long haul for large expenditures: marriage for daughters, careers for sons, and future business investments were the three uses most often quoted by our respondents. It features growing balances, and it already dominates the savings portfolios of our three sample branches, with shares of 35%, 38% and 43%, rising rapidly, and typically twice the share held by personal savings and by special savings.”

The results of these more client-responsive products have been extraordinary and re-emphasise the importance of market-led approach to designing and delivering products for the low-income market:

The Bank’s audited accounts for 2003 show a six-fold increase in net profits over 2002 – from Tk. 60 million to Tk. 358 million (US$ 6 million). 2003 was the first full year of ‘Grameen II’, so this surge in profit looks like a good return on the decision to launch Grameen II.

Profits came from growing interest income on loans outstripping even faster growing interest expense on the new range of savings accounts, from containing costs, and from a fall in loan loss provision. Yet only three years ago the Bank admitted to falling repayment rates, and Muhammad Yunus, its managing director, noted that ‘Grameen II’ was needed to improve performance through more flexible product design, including the use of quick loan rescheduling using the new ‘flexi’ loans. He also promised stringent provisioning policies for more transparent accounting of the quality of the loan portfolio.

Membership growth involves not only new members but also past members who had left but returned after Grameen II started. This is evidenced by the remarkable rise since 2002 in recovery of bad debts – loans that had been written off but subsequently recovered.
Not all who repaid old debt returned to membership, but our field-level investigation show that the majority of such payments are made by members seeking to return to Grameen and to borrow again. It seems, therefore, that Grameen II loan products have managed to both satisfy new members and attract back old ones, and satisfied clients tend to repay loans well...

We conclude that the improvement in the bank’s financial performance is real, and is related to the greater attractiveness of Grameen II’s wider range of more user-friendly loan products, and to its decision to attract deposits in much greater volume, which has allowed it to expand its loan portfolio and serve many new borrowers.” (Hossain, 2005)

### 14.2.4 Health Care Financing Scheme

The Health Care Financing Project brings together a diverse consortium comprised of AAR Health Services, AAR Credit, K-Rep Bank and K-Rep Development Agency to develop and test an innovative, private sector-driven, commercially viable and replicable health financing scheme to reach low-income groups. Through the project and its consortium partners, a range of health care financing products have been developed and are being pilot tested. These products will contribute towards quality, accessible and affordable health care financing services for the low-income groups. This is achieved through the establishment of franchised health centres in the low-income areas of Nairobi city that offer both fee-for-service and also provide health care to families covered by the AAR Afya health care financing plans.

- **AAR Franchised Health Centres**: AAR successfully established three urban-based franchise health centres in Nairobi – specifically in Kawangware, Buruburu and Kasarani areas in the close proximity of low-income communities. These franchised health centres are crucial for the marketing of Afya products because these serve as ‘home clinics’ for the Afya members. Between January 2003 and March 2005 these three franchised health care centres have received total

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<tr>
<td></td>
<td>10</td>
<td>47</td>
<td>105</td>
<td>132</td>
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</table>

Table 1: Recovered loan debt, Grameen Bank, million Tk. (Tk. 60: US$ 1)
of around 40,000 patient visits (from both fee-for-service and Afya members) and currently receive an average of around 1,000 patient visits per clinic per month.

- **‘Afya card’ products**: The product concepts were the result of extensive market research conducted by KDA. Coverage components and pricing have been determined through actuaries who have been working with the HCF consortium since February 2002. The pilot test ran from January 2003 to April 2004 and was used to assess options for the product. However, the process of fine-tuning the product still continues as the project’s understanding of customers’ needs and health-seeking behaviour grows through the pilot test/rollout process. Three products are currently under rollout:
  - **Afya 1**: In-patient only cover.
  - **Afya 2**: Comprehensive in and out-patient cover.
  - **Afya Maisha**: An in-patient only cover targeted for the corporate members.

The intention with these product options is to create a range of opportunities to satisfy the needs and abilities of the target market of low income, self and otherwise employed and their families.

The target clientele for the Afya card products are as follows:

- **K-Rep group** (in particular K-Rep Bank) clients, who are typically drawn from the informal ‘jua kali’ sector.

- **Support staff** of the existent pool of AAR corporate members – since employers of low-income workers have also expressed significant demand for a low-end health care financing product. This has proved to be a significant source of clients from the target market.

- **Other small-scale businesses** such as taxi associations, small hotels, security companies, petrol stations and supermarkets, Formal and informal organisations and individual families.

**Afya Loan** – Afya loan is a flexible credit facility offered by the K-Rep Bank and AAR Credit to low-income clients to allow them to finance their annual membership fees for the Afya products. The size of the loan amount depends on the family size and is the equivalent to the Afya card annual membership fees. The Afya loan provides credit for a maximum of 10 months credit – so that the clients must put a down
Designing innovative products, processes and channels for MF promotion

payment of two months premium at the beginning of the loan. The loan repayment is on weekly or monthly basis, as this model has worked for the business loans in many microfinance institutions. Around 80% of all clients are using the Afya loan to finance their premiums.

The project has faced several challenges that have resulted in its slow start. These are broadly as follows:

• **Political:** In January 2003, as the Afya card was launched, the Health Minister and Ministry of Planning repeatedly promised to provide “free health care for all.” These promises to the public had a huge impact among the low-income communities – Afya card’s market. People wanted to believe that soon they would receive free health care – and in the resulting uncertain environment few wanted to participate in a health financing scheme and commit themselves for a year. Nearly two and half years later, the Government of Kenya is still assessing how to deliver on this promise.

• **Marketing issues:** To date the appropriate marketing of Afya card remains one of the biggest challenges. The low-income market for health care financing products is brand new to all parties involved in the consortium. It has been difficult to achieve clarity and congruence of vision and effort on the marketing of the Afya card amongst the consortium members. The project continues to test innovative ways to market Afya card to the low income community.

• **Product restrictions:** Under the Afya card clients are tied into using specific ‘home clinic’ franchised health care facilities, and to a maximum number of visits per year (for example a family of five is limited to 20 out-patient visits in a year). These restrictions are essential to keep the annual membership fees low. This has caused some problems in take-up since the product is seen to be subject to too many restrictions. Work is underway to re-balance costs and restrictions while protecting the quality of the services provided.

• **Balancing services offered and price:** The project has faced a dilemma not uncommon in insurance – those who can afford the premium want access to higher-grade hospitals and those that are happy just to get access to the lower-grade hospitals often struggle to afford the annual membership fees. This remains a challenge and the project continues to track and analyse the annual membership fees to claims ratios in order to try to respond to this.
Despite these challenges, the results of the *Afya* products are promising, as shown in Figure 3. The *Afya* card products have shown a steady increase in take-up and while corporate renewal/lapses drive the fluctuations in the cumulative membership of *Afya Maisha*, it also shows an overall upward trend. This positive trend is now expected to accelerate after the media reported that the Kenyan government has announced that it is unable to afford the health-for-all (through the National Social Health Insurance Fund) as originally promised by the Minister of Health.

**Figure 3: Cumulative membership of Afya products**

![Cumulative membership of Afya products](image)

Overall, the findings from the project provide reassuring indications that the health care product(s) tailored for low-income groups do indeed have a huge market in Kenya. Indeed AAR is looking at replicating the product in Uganda and the re-insurer seems set to replicate the product in Tanzania. So it is clear that the commercial case has been broadly accepted by those involved. However, such products need a dedicated, active and focused marketing team, as well as broader based outlets (for example the Kenya Post Office Savings Bank has expressed interest in marketing the product), to achieve the target for marketing and sales.
It will take time to penetrate this market and gain understanding, trust and confidence from people. In addition, because health insurance is less tangible, many people take a long time to understand the concept and decide to take up membership. Many potential/interested clients in the community are watching closely their peers who have enrolled. As a result, it is very important to build a good rapport with the current members, since they are likely to play the role of a catalyst or ambassador in their community – and to drive the all-important word-of-mouth marketing.

14.2.5 FINCA, Tanzania’s *Uvibiashara* micro-leasing product

FINCA, Tanzania provides access to microcredit to economically disadvantaged people, using the village banking methodology. Client numbers have grown from 39,455 active clients end of September 2004 to 41,680 end of February 2005 and the total outstanding portfolio stands at US$ 4.89 million.

FINCA, Tanzania began pilot testing its new micro-leasing product – *Uvibiashara* – in October 2003. The product had been developed to respond to the demand expressed by FINCA’s existing clients for a lease product to buy assets to start or expand their business. *Uvibiashara* was pilot-tested for 10 months – and an evaluation of the pilot test was conducted in July 2004. This evaluation confirmed that the product was successful and had even performed beyond set targets. FINCA Tanzania therefore chose to rollout *Uvibiashara* in all its areas of operation – subject to it composing a maximum of 20% of the organisation’s total portfolio.

*Uvibiashara* is a microlease product designed to enable low-income people to acquire productive assets. The product has the following features:

- The loan term varies proportionately with the loan size as follows:
  - Four months (Tsh. 0.1 to 1 million or US$ 100 to1,000),
  - six months (Tsh. 1 to 2 million or US$ 1,000 to 2,000),
  - twelve months (Tsh. 2 to 10 million or US$ 2,000 to 10,000).
- The lease is priced at the base interest rate of between 25% to 30% inclusive of insurance upon client’s death.
Customers’ down payment is 20% based on total value of the asset leased; ownership documents are retained by FINCA Tanzania; group guarantee for assets below Tsh. 1 million (US$ 1,000) and individual guarantee above one million.

No grace period is provided as the assets are assumed to be productive as soon as they are delivered.

Bimonthly repayments.

Late payment is penalised by 10% of the missed instalment, and none-repayment by 20% of the amount required.

Table 2 summarises the performances of Uvibiashara during the pilot test period. The product reached higher targets than those set. The targets on monthly repayments were not met because of the delayed take off of the product and an increased repayment period for the larger loans.

Table 2: Uvibiashara pilot test period performance November 2003 to June 2004

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<thead>
<tr>
<th></th>
<th>Actual</th>
<th>Target</th>
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<tr>
<td>Number of disbursements</td>
<td>97</td>
<td>70</td>
</tr>
<tr>
<td>Number of active leases</td>
<td>77</td>
<td>70</td>
</tr>
<tr>
<td>Lease disbursements</td>
<td>US$ 198,121</td>
<td>US$ 86,201</td>
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<tr>
<td>Total monthly repayments</td>
<td>US$ 28,191</td>
<td>US$ 34,350</td>
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<td>Gross outstanding portfolio</td>
<td>US$ 148,526</td>
<td>US$ 51,852</td>
</tr>
<tr>
<td>Average outstanding lease balance</td>
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<tr>
<td>Average lease disbursement size</td>
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<tr>
<td>Total income microlease</td>
<td>US$ 8,652</td>
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</table>

Uvibiashara is the only product of its kind on the market and the product is expected to enhance the image of FINCA Tanzania in the low-income market. Since the product has successfully passed through all the stages of market research and pilot testing, Uvibiashara is client oriented and this has made a substantial contribution to its successful performance. The rollout of Uvibiashara has given FINCA an opportunity to capitalise on the product and build on its already existent competitive edge.
The results of the rollout have been good, with demand consistently outstripping supply. Despite the success and profitability of the product, FINCA lacks the capital to further expand its *Uvibiashara* portfolio at any significant pace.

**Table 3: Uvibiashara results over the months December 2004 – February 2005**

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<thead>
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<td>223</td>
</tr>
<tr>
<td>Disbursements</td>
<td>51,436,200</td>
<td>44,451,900</td>
<td>51,355,000</td>
</tr>
<tr>
<td>Loan portfolio (US$)</td>
<td>620,617</td>
<td>629,035</td>
<td>636,965</td>
</tr>
</tbody>
</table>

### 14.3 New generation delivery channels/products

#### 14.3.1 Equity Banks’ mobile banking service

Equity’s mobile banking service is now over six years old and is motivated by the desire to ‘take banking services closer to the people’. The service was initiated to increase outreach and offer commercial banking services in rural areas that are poorly served by formal financial institutions or where formal financial institutions withdrew their services. Each mobile unit centre serves a radius of 20 to 60 kilometres from the branch and takes services into areas that have poor accessibility and high levels of insecurity. The target clientele for Equity’s mobile banking units are small and micro business entrepreneurs and smallholder farming households in rural centres lacking in infrastructure such as accessible road networks, telephone and electricity and cost-efficient transport services.

Coetzee *et al.* note (2003): “Each mobile banking unit is attached to an Equity branch. A village satellite is established in a simple rented structure that is served once or twice per week by a mobile banking unit. Equity has networked its mobile units using VSAT communication and adding VHF radios to provide voice based communication. DFID has also financed fully equipped units designed as complete banking units with cash-dispensing outlets, using solar panels, inverters and rechargeable batteries which can power laptops, printers, etc. Equity’s experience
suggests that technology can be used to deliver a significant range of services in rural areas and that donor support can accelerate the process. Convenience, accessibility and liquidity are clearly valued by clients.

As of July 31st, 2003 10,028 clients were served through mobile banking units, of which approximately 65% held loans. Seven branches serviced 28 locations. A branch costing showed that three out of seven branches had profitable mobile banking units. Although the overall mobile banking programme is profitable, the programme is clearly in its growth phase and the current infrastructure can accommodate many new locations. Profitability is clearly related to volume of business, whether this is reflected in portfolio size, savings balances or client numbers.”

As can be seen by the graph below, by March 2005, 30,843 clients were being served through the mobile branches (up 33.7% from September 30, 2004 alone). These clients made 69,173 transactions through the 48 mobile locations (administered from 12 different branches) in March 2005.

Figure 4: Equity Bank Mobile Branches 2001-2005
and the average deposit was US$ 63.03 (raised significantly by a minority of 1,630 (5.3%) of account holders who hold balances > Tsh. 20,000 (US$ 263) which hold 75.3% of the total US$ 1,945,278 net deposits.

14.3.2 Teba Bank’s A-Card

The A-Card is a completely real time debit card using Global System for Mobile Communications (GSM) and Unstructured Supplementary Services Data (USSD) mobile phone technology to communicate with the server. It holds significant additional potential to include many other features including cell phone air time top up, distribution of government and other mass transactions, ATM access, fuel payments, medical savings, specific savings pool options. The use of cell phone technology allows for placement of cell phone based POS machines in rural and urban areas, dramatically enhancing access and convenience for A-Card clients. A full range of traditional banking (liability side) transactions (including deposits, withdrawals, balance inquiries and statement production) will become accessible at local shops and other locations. Because of network and switch access, traditional POS and ATM withdrawals will be available at all non-A-Card sites, increasing possible locations for transacting with the A-Card.

Initially the bank developed its systems through a joint venture agreement with its solution providers. As Cracknell notes, “The joint venture agreement appears to have encouraged:

• **Cost control:** A small, focused development team has kept development costs low. The focus on cost control has included purchasing and reconditioning several high-end servers, which enable one or more servers to be offline at any time and provide disaster recovery at a very low cost.

• **The development of a feature rich product:** Teba Bank’s A-Card is a fully featured solution offering functionality equivalent to a bank account with additional functions not available through a normal bank account, including airtime top up and card-to-card transfer.” (Cracknell, 2003)

This range of features has meant that Teba Bank in South Africa also had to design and test communications materials based on photographs, with minimal text aimed at explaining the operation of the card to semi-literate customers.
As of February 2005, Teba Bank is running four pilot tests with a total of around 6,585 users on the A-Card. The first pilot test is with Community C (for airtime top-up), the second is introducing an A-Card based salary account, the third is with the Unemployment Insurance Fund (as a payments system for the Government of South Africa) and the fourth is with Beehive – a South African NGO.

The telephone company Cell C has teamed up with Teba Bank to enable Cell C community kiosk operators to manage their prepaid accounts. Kiosk operators can deposit funds in their Teba Bank A-Card accounts in post offices, Teba Bank branches and major supermarket chains and can top up their airtime at any time.

The Community C pilot test provides a mechanism for phone kiosk operators to manage cash payments to Cell C. The test continues to perform well, with hundreds of thousands of transactions being made during the one year the test has been in operation. Transactions volumes for corporate users are likely to be significantly higher than transaction volumes for individual users – and in this way corporate business channels can support the huge cost of developing e-banking solutions for individual users.

**14.3.3 Safaricom/Vodafone – Commercial Bank of Africa-Faulu: Mobile Phone Banking**

Funded by the DFID Financial Deepening Challenge Fund (matched by Vodafone) with extensive contributions from Safaricom, Commercial Bank of Africa, Faulu-Kenya (NGO-MFI) and MicroSave the partners are to develop a mobile phone-based payments system. This is outlined in Figure 5.

This project is designed to provide a robust and easy to use microfinance system that can be used to extend the reach and efficiency of microfinance institutions. The system will be subjected to a systems test before extending into a live pilot-test shortly afterwards. Since the account manager is dealing with real money, it is essential that Safaricom (Vodafone’s associate company in Kenya) installs and operates it in a secure manner, including physical and electronic security.

For the system to be sustainable, the pilot-test must demonstrate significant potential. This would then prompt the stakeholders to invest
Designing innovative products, processes and channels for MF promotion

Figure 5: Mobile phone-based payments system

further to build the user base to the levels capable of sustaining a commercial system. If the system is to be commercially viable, the transaction costs must be kept to an absolute minimum, and it must be accessible to a wide range of users often in rural communities. Clearly, massification of outreach is the key to generating the economies of scale necessary to make the system sustainable. Safaricom’s existing client base of over 2.5 million will clearly assist with this.

In order to achieve this, the project aims to be:

- **Accessible** – reach a large proportion of the population (including remote areas) and in a way that can include as many potential users as possible;
- **experimental, innovative and flexible** throughout the project to alter its behaviour in the light of lessons learned and add extended functionality;
- **pragmatic, appropriate and sensitive** to the communities using and supporting the system;
- **scalable** – a system appropriate for a pilot, which can scale up (either directly or by design) to very large numbers of accounts and transactions, with potential for multiple operators and international services;
• secure, safe and reliable for each of the key stakeholders; and
• economic – low transaction, roll out and operation costs maximising the opportunity for commercial success.

The project will operate through a dedicated payment platform, the account manager. The account manager manages clients’ accounts and supports the basic transactions of Faulu’s microcredit programme.

Similar ‘disruptive technology’ product/delivery systems are under development in South Africa and India too and could lead to a significantly different way of ‘doing business’ with the mass market for financial services.

14.4 And in India ...

In India, while the MFIs replicating the old ‘classic’ Grameen are making some reasonably good progress, the ‘stars’ that are showing rapid growth such as Spandana and Share-MicroFin are already diversifying their product range in response to the needs of their customers. With the diverse markets and operating challenges in India, this tailoring of products to the expressed needs of the clients will have to continue, and indeed be set at the heart of the operating methods of any truly successful financial institution. In addition, there is growing evidence that the banks are probably making losses on lending to the SHGs linked to them (see for example Sinha et al., 2003 and CARE, 2005). Given the importance of the SHGs in Indian microfinance, it is clearly time to:

• Focus either on improving the cost-efficiency of the delivery processes, including rationalisation of process of group formation and maintenance, records and their maintenance etc.; and/or

• on diversifying the product range/offerings to spread the bank’s operating costs further; and/or

• re-visit the products pricing to ensure ‘sustainable access’ to financial services, in order to remove the disincentives to banks to provide services to the poor, and thus to maximise access to all.
NABARD’s Kisan Credit Card

One of NABARD’s more recent innovations to improve the flow of credit to the agricultural sector is the Kisan Credit Card (KCC). Introduced in 1998-1999, by the end of March 2003 some 31.6 million KCCs had been issued (Basu, 2004). Basu goes on to note, “Though these are not truly credit cards, the KCCs present a number of advantages for the borrowers and lenders. Borrowers appear to have found this scheme quite useful because of the ease with which they can access credit and renew loans on a yearly basis, once the initial screening has been done, the reduction in number of visits required to branches, the choice/freedom of purchase of inputs and operation of accounts at the designated branches. KCCs have substantially reduced the paperwork and delays associated with renewal of crop loans. Branch staff also appear to have found the scheme helpful, as it has reduced transactions costs.” (Basu, 2004)

However, concerns remain about the distribution of KCC cards – in the World Bank’s 2003 Rural Finance Access Study (RFAS, 2003) found that of households from AP and UP only six percent reported having a KCC. Furthermore, the RFAS, 2003 also indicated that access to a KCC appeared to be higher for the larger farmers – noting that while around 20% of large farmers had a KCC, only two percent of marginal farmers did so. Basu concludes that “The success of the KCC, and other similar facilities that could be introduced in the future, would depend critically on the following factors: (i) extending the facility to rural non-farm activities; (ii) efforts to update land records in a timely manner; (iii) a relaxation by the RBI in the rules so as to accommodate for oral lessees and sharecroppers; (iv) greater flexibility to branch managers to be innovative in the use of the KCC facility to meet the totality of the credit requirements of farm households; (v) greater flexibility to cardholders to make deposits and withdrawals; (vi) uniformity in service charges (and) interest rates among various banks; (vii) a reduction in documentation charges; and (viii) efforts to better publicise the scheme.” (Basu, 2004)

Furthermore, Mr. Dalbir Singh, CMD of a commercial bank in India highlighted another key issue at the June 18, 2004 joint meeting of the Indian Banker’s Association and the Smart Card Forum of India. Mr. Singh noted that while the banks had taken various initiatives such as the KCC, there was inadequate infrastructure to allow their effective use. He challenged the hardware developers in India to develop an indigenous, low-cost point of sale device to overcome this barrier to using smart card technology.
NABARD is currently pilot-testing a smart card in four RRB branches in coastal Andhra Pradesh and in Karnataka. One cannot help but speculate that this might be the beginning of the next generation of the ‘smart’ KCC that will not only hold the holder’s personal data (perhaps linked to the nascent national identity system and thus to a credit reference bureau) but also his/her savings and loan account history as well as details of land-holding, previous sales through registered agents etc. This would then allow the banks to make significantly better-informed lending decisions, thus reducing their transaction costs. Such a smart KCC would also allow the Government of India to channel agricultural subsidies directly to the end user in preference to driving them through (and thus distorting the market for) the banking system.

14.5 The need for systematic product development

The above examples provide clear proof of the effectiveness of a systematic approach to product development. But it is not always thus. Under the prevalent top-down model that characterises many financial institutions’ approach to product development, there is little or no market research, inadequate costing/pricing of the new product, no attempt to describe the product in clear, concise client-language, no pilot-testing and no attempt at a planned roll-out of the new product. A top-down approach to product development can have expensive consequences – as many financial institutions that have introduced products without following a systematic process have discovered. Problems have arisen in such diverse areas as:

- Limited demand for the new product (in some extreme cases, additional client drop-outs);
- poor profitability of (or more specifically losses generated by) the new product;
- management information systems unable to monitor/report on the new product; and
- staff inadequately trained to market and deliver the new product¹.

Experience has repeatedly shown that investing small amounts up front in a systematic process of product development can save large amounts and/or generate larger amounts of business in the future. One step of the product development process leads to and informs the next and provides a disaster/reality check that insulates the financial
A proper process also provides the financial institution an opportunity to correct problems or respond to issues while they are limited by the confines of each step.

### 14.6 A systematic process to product development

*MicroSave* promotes a systematic approach to product development designed to minimise the risks associated with what is a complex task. The approach looks to maximise the information the financial institution can gain at each step before proceeding to the next one – thus optimising the product for the clients in the market, and the institution offering it. The approach is shown in Figure 6.

**Figure 6: Market research, prototype development and pilot-test preparation process overview**

![Process Diagram]

- **Research issue**
- **Qualitative research plan**
- **Qualitative research FGD/PRA**
- **Understanding clients’ needs**
- **Concept development**
- **Product ready for pilot test**
- **Qualitative research: prototype testing**
- **Refine the concept into a prototype**
- **Costing & pricing of concept**
- **Refining/testing the prototype**
- **Process mapping procedures**
- **New product risk analysis**
**Research issue:** A clear, focused objective should drive any market research. A precisely defined research objective will allow the financial institution to derive credible, actionable results cost-effectively. Poorly defined, or unfocused, research objectives are likely to require more time and effort to conduct the research, and often leave the financial institution with a mass of confusing data.

The research objective often is best driven by an on-going monitoring system that tracks key performance indicators. These indicators are usually linked to the strategic goals or institutional/product risk drivers of the organisation – for example portfolio at risk. These indicators should be built into the Management Information System (MIS) and routinely tracked to enable the organisation to assess when *ad hoc* research is required.

**Market research and concept/prototype development:** Using MicroSave’s ‘Market Research MicroFinance Toolkit’, the financial institution is able to understand its clients’ perceptions, needs and opportunities using Focus Group Discussions (FGDs) and Participatory Rapid Appraisal (PRA) tools. The techniques are used to develop initial product ideas into concepts, and subsequently to refine the product concepts into prototypes for testing. The market research tools are also used to evaluate the progress of pilot-tests from the clients’ perspectives as well as to test marketing materials and develop/assess customer service standards.

“This assessment confirms the very positive value and effectiveness of MicroSave Market Research for MicroFinance toolkit. The PRA tools are well conceived, useful and effective; the training is excellent; and both have received extremely positive reviews by almost all users. The tools have had a significant outreach to MFIs in East Africa and beyond. They have had positive impacts on MFI thinking about and approach to clients and market research. They are unique in the microfinance field and have brought many MFIs to a point where they “can’t go back” to their old supply led ways. This has led to the development of a wide range of new and improved products and services that have improved the competitive position of many MFIs. The change in approach is profound.” (Anyango et al., 2002)

**Product costing and pricing:** To enable financial institutions develop profitable products and credible financial projections, it is essential to
implement a product costing system. MicroSave’s ‘Costing and Pricing Financial Services Toolkit’ outlines how Allocation Based Costing can assist financial institutions with this process. CGAP has also developed an Activity Based Costing manual. Product costing is an essential tool in developing profitable and efficient financial services through identifying inefficiencies and loss making products. For MFIs focused on achieving the bottom-line with outreach it is indispensable.

“Allocation based costing allowed Equity Building Society to obtain a range of ‘quick wins’…(it) enabled us to identify some of the factors that are driving costs within the institution… Product Costing has already become an indispensable tool… after only three months costing it is impacting on many of the strategic decisions being made within the institution.” (James Mwangi, CEO, Equity Bank)

While marketing texts typically offer a bewildering variety of complex pricing strategies such as loss leading, penetration pricing etc., these are rarely practical for most financial institutions serving the low-income market. MicroSave also assists its action research partners with the pricing of their products, using a simple “cost-competition-demand” approach. In the words of David Cracknell, “To price products first assess the cost of providing financial services; second examine the prices charged by the competition for similar products and third examine whether customer perceptions of the product justify premium pricing. When this approach is combined with transparent communication of pricing, the results can be significant. When Equity Bank re-priced its services in 2002, after performing market research it communicated these changes carefully. Deposit account sales increased ten-fold.” (Cracknell et al., 2005)

Risk analysis: As part of the preparation for pilot-testing, MicroSave conducts risk analysis and process-mapping. Introducing a new product inevitably increases the strategic and operational risk of the institution. MicroSave has worked with ShoreBank to develop an ‘Institutional and New Product Development Risk Analysis Toolkit’ to assist financial institutions assess and manage these risks.

“Risk management is at the core of the Basel II guidelines and essential to optimising the performance of microfinance institutions (MFIs)...The risk management tools developed are dynamic, and change as the MFI cycles through the steps of the feedback loop. The MicroSave ‘Toolkit
### The product development process

1. **Evaluation and preparation**
   1.1 Analyse the institutional capacity and ‘readiness’ to undertake product development
   1.2 Assemble the multi-disciplinary product development team, including a ‘product champion’

2. **Market research**
   2.1 Define the research objective or issue
   2.2 Extract and analyse secondary market data
   2.3 Analyse institution-based information, financial information/client results from consultative groups, feedback from frontline staff, competition analysis, etc.
   2.4 Plan and undertake primary market research

3. **Concept/prototype design**
   3.1 Define initial product concept
   3.2 Map out operational logistics and processes (including MIS and personnel functions)
   3.3 Undertake cost analysis and revenue projections to complete initial financial analysis of product
   3.4 Verify legal and regulatory compliance
   3.5 Assess risks of new products and define strategies/tactics for responding to them
   3.6 On the basis of the above plus client feedback sessions, refine the product concept into a product prototype in clear, concise, client language
   3.7 Finalise prototype for final quantitative prototype testing or pilot testing, according to the risk/cost nature of the product

4. **Pilot testing**
   4.1 Define objectives to be measured and monitored during pilot test, primarily based on financial projections
   4.2 Establish parameters of pilot test through the pilot test protocol, including sample size, location, duration, periodic evaluation dates, etc.
   4.3 Prepare for pilot test, install and test systems, draft procedures manuals, develop marketing materials, train staff, etc.
4.4 Monitor and evaluate pilot test results

4.5 Complete recommendation letter documenting the results of the pilot test, comparison with projections, lessons learned, finalised systems/procedures manuals, etc. and the initial plans for the roll out

5. **Product launch and rollout**

   5.1 Manage transfer of product prototype into mainstream operations

   5.2 Define objectives to be measured and monitored during roll out based on financial projections

   5.3 Establish parameters of rollout through the rollout protocol including schedule, location, tracking, budget, process

   5.4 Prepare for rollout, install and test systems, finalise procedures manuals, develop marketing materials, train staff, etc.

   5.5 Monitor and evaluate rollout process and results

for Institutional and Product Development Risk Analysis’ helps guide an MFI through the risk identification process, management, and measurement of their risks. Early indications based on the pilot test reveal that the tools, if rigorously applied, will help in the early detection and management of risks, especially in the development of new products.” (Pikholz and Champagne, 2004)

**Process mapping:** *MicroSave* uses process mapping as part of the risk analysis and management methodology and to make the workflows visible (since the latter greatly assists with the development of policies and procedures and, subsequently, staff training). A process map is a flowchart that shows who is doing what, with whom, when and for how long. It shows how operational decisions are made and the sequence of events. Process maps are good for streamlining work activities and in explaining processes.

“Process mapping is a powerful management tool that looks beyond an organisation’s functional boundaries in order to reveal its core processes and how the different parts work together to serve customers. Process Maps are visual representations of a process, that use symbols, arrows, and concise wording to show inputs, outputs, tasks performed, and task sequence.” (Champagne, 2004)
MicroSave goes further than drawing a flowchart – it adopts a four-tier approach:

- The flowchart,
- a description of the process,
- an assessment of the potential risks in the process, and
- documentation of the controls to manage the risks identified.

This approach enables efficiency and internal controls to be carefully balanced, to the benefit of the institution and its customers. MicroSave has also developed a toolkit on ‘Process Mapping’.

“Action Research Partners have reported extremely positive results from process mapping. In many institutions this may reflect the prior absence of a mechanism to review processes holistically combined with the organic growth of processes over time. This suggests that significant benefits can be derived from a first round of process mapping. Benefits reported operate at strategic, managerial and operational levels.” (Sempangi et al., 2005)

**Pilot testing**: MicroSave assists financial institutions to plan and establish a pilot test to analyse the product that they have developed. The pilot testing process has ten steps detailed in MicroSave’s ‘Planning, Implementing and Monitoring Pilot Tests Toolkit’. Pilot-tests are essential for the successful development and rollout of new products.

### The ten steps of pilot testing

1. Composing the pilot test team
2. Developing the testing protocol
3. Defining the objectives
4. Preparing all systems
5. Modelling the financial projections
6. Documenting the product definitions and procedures
7. Training the relevant staff
8. Developing product marketing plans and materials
9. Commencing the product test
10. Monitoring and evaluating the test
“There are many good reasons for pilot testing new products in terms of reducing risks, controlling costs and in carefully developing products in a controlled environment. A few of the most commonly quoted reasons are provided below:

- To reduce the risk of developing inappropriate new products;
- to reduce the cost of making mistakes;
- to grow business volumes and profits through better meeting the needs of prospective customers;
- to perfect the product whilst changes can be made quickly and easily and without risk to reputation;
- to develop innovative new products – to be a product leader not a follower;
- to develop a competitive advantage;
- to experiment in a new sector; and
- to understand/optimise marketing of the new product.”

Source: Cracknell et al., 2003a

“Launching new products without a pilot test is another mistake that MFIs in Latin America often make”, says Luis Echarte, founding partner of Paraguay’s Servicios Internacionales de Consultoría para el Desarrollo (SIC). “The need for growth (of MFIs) causes them to imitate local competitors or successful organizations in other countries without conducting an appropriate analysis of the implications of the innovations they introduce,” he explains. Micro-lenders can be blinded by illusions. “Rapid growth is one such common illusion that can prove costly to microcredit institutions. In fact, according to experts, it’s a situation that may conceal a number of dangerous traps.” (Microenterprise Americas Magazine, 2003)

A well-designed, implemented and evaluated pilot-test can save the financial institution significant strategic and operational problems and financial/non-financial losses.

**Product marketing:** The successful introduction of new products often depends on the ability of the product development team to market the product to customers and to staff. Adapting its ‘Market Research for MicroFinance’ tools, MicroSave helps financial institutions to define product benefits to customers and in communicating the product to
staff. *MicroSave* has formalised this experience into a ‘Product Marketing Strategy Toolkit’. Key outputs of this process are field-based research leading to taglines, benefit and positioning statements, competition analysis, publicity material and a marketing plan.

“... a product marketing strategy must accomplish several objectives to be successful:

- It must define who the MFI wants to serve and which markets it can serve most effectively.
- It must identify the characteristics, needs, desires, preferences, values and priorities of the market(s) it wants to serve.
- It must develop a product that meets market needs better than the competition.
- It must price the product competitively.
- It must craft a message that clearly and concisely conveys the product’s benefits and positions it in line with the corporate brand strategy.
- It must design and implement a sales strategy that effectively communicates the product’s value and encourages purchase.
- It must monitor and manage product performance, learning from the feedback gathered to improve product design, delivery, promotion and sales.”

(Frankiewicz *et al*., 2004)

**Rollout:** Once again, with a view to ensuring a systematic and controlled rollout, *MicroSave* uses a carefully planned, comprehensive approach to the rollout process using its Product Rollout: A Toolkit for Expanding a Tested Product Throughout the Market. The toolkit provides practical tips and checklists to assist financial institutions with all aspects of the rollout process: recommendation letters, handover, finances, human resources, systems and marketing, as well as assessment of the rollout process.
“Once a financial service has been piloted, how you introduce the product to each new location has a significant impact upon the success or failure of the product. In each new location as a minimum, staff training, marketing the product to clients and staff and customisation of systems and procedures will be required.” (Cracknell et al., 2003)

14.7 Conclusion

For many years microfinance organisations throughout the world have operated on the basis of replicating a basic working capital loan originally developed by Grameen Bank in Bangladesh or FINCA in Central America. In the past few years, it has become very clear that simply replicating products and systems into very different socio-economic conditions will not work. Furthermore, there is a growing recognition that the low-income market has many and diverse needs for financial services, many of which can indeed be met on a profitable basis.

Worldwide the increasing competition among institutions is resulting in greater efficiency as well as a broader range of products, to the benefit of the clients. Advances in technology are already leading to reduced transaction costs, thus overcoming the long-standing barriers to the expansion of services. E-banking offers a huge opportunity to leap-frog bankers’ traditional concerns about “high volumes of low value transactions” and “investing bricks in bricks and mortar”, and will increase volumes while driving down marginal costs. New technologies can also improve information about clients, reducing risk and thus costs. These factors have resulted in a growing number of commercial financial institutions initiating efforts to serve the low-income market.

As the microfinance industry matures and moves towards a market-led basis, financial institutions and other players entering the market are beginning to look for new opportunities and approaches to offering a diverse range of financial services to the low-income market. This has encouraged them to revisit many of the basic questions posed in Stuart Rutherford’s “Basis for Designing Quality Financial Services”.

Product development is an essential activity for market-responsive financial institutions. As clients and their needs change, so the market-led, demand-driven financial institutions must refine their existing products or develop new ones. But product development is a complex, resource-consuming activity that should not be entered into lightly.
Recognising all of the above, those financial institutions committed to being market leaders, and to responding to their clients, must indeed conduct product development. Effectively conducted, systematic product development will result in products that are popular with clients (even in very competitive environments) and more cost-effective operations for financial institutions. More client-responsive products will reduce dropouts, attract increasing numbers of new clients and contribute substantially to the long-term sustainability of the financial institution.

### The basis for designing quality financial services

An organisation wishing to get involved in financial services for the poor might ask the following questions during its surveys of its proposed area of operation.

- **How do poor people manage their savings deposits?** Are there savings banks, or deposit takers, or insurance salesmen, or savings clubs? Do the poor have access to them? If not, how do they save, and how convenient do the poor find the available forms of savings?
- **Can poor temporarily realise the value of assets they hold?** Are there pawnbrokers or are there schemes that allow them to mortgage land or other major assets safely? If such devices exist, are they exploitative or enabling?
- **Can poor people get access to the current value of future savings?** Are there moneylenders willing to advance small loans against future savings? Are there rotating savings and credit associations (ROSCAs) or managed or commercial chits, or cooperative banks or NGOs that offer loans against small regular repayment instalments? Do the very poor have access to them?
- **Can poor people make provision for known life-cycle expenses?** Can they provide for daughters’ marriages, their own old age and funeral, and for their heirs? Are there clubs that satisfy these needs, or general savings services or insurance companies that will do as well? Are there government or employer-run schemes?
- **Can poor people secure themselves against emergencies?** What happens when the breadwinner is ill, or when a flood or drought occurs? Does the government have schemes that reach the poor in these circumstances? If not, what local provision can people make?
- **Can poor entrepreneurs get access to business finance?** If so, in what amounts and at what cost?

Source: Rutherford, 1996b
India has the world’s most extensive banking infrastructure – indeed it is the envy of the world in this context. Today, there are about 60,000 retail credit outlets of the formal banking sector comprising 12,000 branches of district level Cooperative Banks, over 14,000 branches of the Regional Rural Banks (RRBs) and over 30,000 rural and semi-urban branches of commercial banks; in addition to 112,000 Cooperative Credit Societies at the village level. There is at least one retail credit outlet on average for about 5,000 rural people or every 1,000 households. This is clearly a remarkable and extensive network capable of meeting the financial needs of the entire rural population. And yet, a very conservative estimate suggests that, at most, just 20% of all the eligible low-income people have access to financial services from formal financial institutions, MFIs and other such stakeholders. More client-responsive products and cost-effective delivery systems may well also allow India to realise the full potential of this extraordinary banking infrastructure and bring financial services to the millions currently without access to basic, reliable savings and loan facilities. This is the challenge before us...

Endnote

1 A recent MicroSave virtual conference on pilot testing financial services re-emphasised these issues and the need for systematic pilot-testing. For a report on the virtual conference, see www.MicroSave.org.

References


Towards a Sustainable Microfinance Outreach in India


15  Expanding secular growth: The role for innovations in microfinance

Mathew Titus

15.1  Introduction

Secular growth is the development of a market segment, for any goods and/or service which is not particularly contingent on the provision of such a service by one company or one large intervention, but grows across a wide variety of institutions and places. In essence, growth is the result of a robust market.

This paper argues that the secular growth of microfinance and more particularly the provision of financial services to the excluded are dependent on the introduction of innovation by a range of institutions.

15.1.1  Why innovations?

The market for financial services for the poor today has too much evidence of exclusion, and non-participation. Further, it is littered with almost forty years of interventions, dominated by the perspective of forcing credit into particular markets. In addition, as it involves the poor, there are fundamental distortions that arise from the debate being influenced by ‘political’ concerns. Hence movement away from these fixed positions will require all the spirit and attention of an innovative institution.

Such a departure will entail many kinds of changes. It involves among others, broadly, three sets: first is the refinement of existing positions and interventions of organisations – to be more effective in the markets they operate in. Second is the refinement of process and products that can bear the rigour of competitive-management of costs and risks. And third is the development of public goods and knowledge that will reduce the transaction costs of management of the service, and lead to scaling this opportunity.
Towards a Sustainable Microfinance Outreach in India

In particularly contextualising the debate to microfinance there are distinct elements that we must mention. Microfinance, unlike any other market, has two fundamental constraints: First of being a ‘credit’ market contract/product, and hence operating in market conditions that make it differ fundamentally from all other markets for goods and services\(^1\) (Bhatt, ’87). Secondly, the cost of servicing or delivering any product in this market is constrained by relatively high (given the nature of problems in credit markets, which have now been spelt out – information, incentives to repay and continue to participate, enforcement and others, it is likely that a percentage of borrowing will come from informal sources – Hoff and Stiglitz 1990.) costs as opposed to credit market transactions for larger transactions.

Consequently, we believe, the overall impact of these interventions will be to enable or overcome constraints either of credit markets or of small ticket transactions and thus contribute in the overall reduction of costs for all entities providing financial services, making the market inherently more efficient.

### 15.1.2 What are the innovations?

Innovation, hence if examined across all the stakeholders, would therefore entail any intervention, the design and approach of which fundamentally contributes to reducing the transaction costs of the contract; together with reducing the overall risk of the service to the institution and the market.

### 15.1.3 Innovations and stakeholders

In microfinance, there are typically two sets of ‘costs’ in an operation: one which is made up of a public good, and the other set of costs which can be priced into their operation and recovered by the service providing institutions. The public goods costs are those which have been identified broadly in the debate as promotional and relate to the building of infrastructure for the industry, and/or the cost of overcoming asymmetries of information or the strengthening of institutions that enhance enforcement. The second sets of costs relate to provision of the service itself, most of which can be captured in the pricing of the service. In addressing hence the subject of ‘innovation’ and the expansion of the credit market, in this paper I attend to both kinds of interventions.
It is important to state first that most of the dialogue and debate on microfinance takes place in either the context of retailers, or what they should do; apex banks and what they should not do; or central banks and government and why they cannot do or do, what they most desire and are mandated for. The challenge is that we need to step away and remind ourselves that any secular growth of the market will require each of the stakeholders to be active and hold a market-enhancing position and intervention.

The second point to appreciate is that in developing country economies, as in many others, we suffer from historical-distortions. These are essentially distortions and limitations that arise from the overwhelming presence of institutions and organisations – especially development financial institutions – which tend to perform a diverse set of functions, many times in contradiction to each other. Any attempt at making the market more efficient will require a fundamental attention to redesigning organisation/schemes/programmes.

15.2 Innovations and the microfinance market

For purposes of this article, I identify the following key stakeholders: Government, Central Banks, Development Banks and Apex institutions, Retail Banks, Community Development Finance Institutions and third party institutions such as auditors, rating agencies and other similar bodies. While in an earlier article (Titus, 2002) I had spelled out their initial role in being either distorting or constructive in their interventions in these markets, in this piece I call attention to their potential or promise of being innovative.

15.2.1 Innovative government policy

As in any democratic process, governments confront competing sets of pressures arising from the demands of its citizens. The provision of financial services to the poor, marginalised and excluded remains one of the abiding pressures that governments in India have confronted, as they have sought to alleviate and enhance the process of making this market more effective. To that end, from the early days of enacting legislation on giving a legal form to cooperatives, to the nationalisation of banks and the formation of the Regional Rural Banks, the process has been sustained. The results have however been skewed. Every significant survey and data sets continue to highlight the exclusion of
large parts of the population from this very important service. It is therefore no surprise that governments have seized any opportunity or idea that seems to offer possible solutions to what seems an intractable problem.

While it can be argued that the role of government as promoter of these financial institutions has been crucial in developing the market for financial services in India, its role in management has affected the poor the worst. Markets for financial services to the poor can never be uniform, or be approached in a manner that constraints the ability of a firm or an organisation to be innovative, especially in a matter of cutting costs of transaction. Directed by process and products that have been centrally designed and rolled out in a uniform manner, these firms failed to capture the challenge that presented itself in an effort to expand these markets⁴ (Von Pischke, 1983). Simplistically put, if the government continues towards decreasing management engagement and allows these organisations to becoming competitive firms that can be responsive to some of the most extreme diverse conditions that the poor entrepreneur in India confronts, it will have the effect of driving innovation, resulting in financial deepening of the market.

Further, in expressing its concern in expanding financial services markets, the government can and should use its different instruments for spelling out its priorities and the resources necessary in translating them into tangible benefits for the poor. To that extent, it is important that the government not only nudge institutions to examine how to make the service work in this market but, in addition, ensure that the management of ‘public good’ resources too is efficient – by ensuring that the most effective manager of those funds has control of it. In refining hence its position, the government will find it useful to even spell out measures which will help capture its measure of the performance of such grant-based resources to ensure that its objectives are being met. These steps then became innovative when they depart and break away from their existing method of functions and lead to interventions which result in the enhancement of both the poor and the institutions that seek to service, resulting in an efficient environment that leads to the expansion of the market.
15.2.2 Innovative Central Banks

In many ways, regulators by their very nature and analytical functions, respond only when the contours of a sector are well defined – either due to growth or due to failure of an entity. Such delays however lay the foundation for the emergence of an ingenious-period, when attention is called to new opportunities that exist in markets.

Regulators, hence have two approaches in such an instance to respond. First, to identify the nature of the market opportunity and appreciate its different dimensions, both on the demand and on the supply side; and secondly, to understand constraints that emerge within the firm that has led to either a failure or success of the intervention. Shaping regulatory policy that takes cognisance of the nature of the contracts and the constraints is the ground where, in all possibility, we will find solutions which will lead to the expansion of the market.

Achieving such an approach will require fundamentally changing the method of identifying solutions. While there have been two working groups or committees that have identified directions in which solutions can be found, progress has been limited. The problem is that much of the discussion is directed at defining who could be possibly responsible for carrying out the task of regulation, or the type of regulation that might best fit the conditions that seem to dominate microfinance in the country. While both these discussions might be useful, they do not constitute the primary basis of what might lead to identifying a unique and distinct solution to what the Indian context might require. If therefore we have to move towards a solution that is unique to the constraints of both buyers and suppliers of such a service in India, it will be necessary to work with the ‘constraints’ that exist and identify processes and mechanisms that will lead to overcoming them.

Examples of this kind of an approach abound across the world. For example, in recognising the crucial role that community-based and owned organisations play in these markets, Indonesian regulators have simply extended the function of the local bank functionaries of State-owned local banks. These functionaries, on a monthly basis, visit such community-based institutions and file the aggregate details of their portfolio with the Central Bank. The cost of the operation is borne by the equivalent of the SGSY – a Rural Development Programme – and reimbursed to the bank, based on the regularity in filing and quality of
the data. While local in nature, the rural manager brings to the oversight of the portfolio familiarity and information which can be very useful. While this example is useful to illustrate the discussion, the question truly is what can be done to supervise such portfolios at low cost and effectively, rather than who or which organisations can or cannot do the task – which is essentially a function of management, core-competence and the deployment of skill rather than a question of building market efficiencies.

Similarly, in providing sanction to the provision of the different service providers, the hybrid regulator in South Africa, the Microfinance Regulatory Council, provides simplistic registration framework for all service providers who provide loans less than R10,000 irrespective of legal form. Consequently, it is not only community-based organisations who report, but in addition, banks and moneylenders. The assumption being that all portfolios belonging to a particular market-segment will possess similar characteristics of what is optimal, irrespective of legal form. In managing the data and overseeing its supervision, it will be possible to suggest that knowledge thus gained on either of the portfolios originating in any of the institutions, will be useful in calling attention to any regulatory problems that might emerge.

The focus consequently, of any emerging attention, must recognise either the cost or risk related features of transactions and then design and agree on a possible intervention. Locating it in a particular institution and building the necessary skills then becomes a secondary aspect of the debate, rather than a primary focus that does nothing to enhance efficiencies.

15.2.3 Innovative Apexes

Apex organisations serve an important function of undertaking to demystify the risk that new market-segments potentially carry. Given that the risk-perceptions in financial markets are both subjective of the assessor and an objective component based on the data, it is important that apex organisations focus on reducing risk related views on these operations. Such interventions can be of many kinds, some of them innovative, which will assist in taking on the burden of the microfinance sector, the specific gains of which can be captured by individual organisations.
One very crucial bit of work, especially in early market development, is the use of data to popularise the asset quality that underlies a portfolio. Such data, while difficult to get in the early stages, assists in making markets, especially between lenders and borrowers, more robust. Sa-Dhan is now putting out a biannual data set on its members’ operations. Other activities that can be undertaken are those that result in signalling stability of operations, by the taking of equity positions, providing linkages to a wider variety of lenders, etc. In addition to taking on this risk and these functions, apex organisations are better able to direct funding for ‘public good functions’ into avenues that result in the deepening and integration of the market. By investing in market infrastructure such as the quality enhancement of auditors, the apex brings to the table the necessary weight that can attract a lot of other investors. That is why the equity or other non-financial investments by an apex are not in the nature of plain venture capitalist, but more in the manner of signalling intent to the market of an important experiment, and that can result in multiple experiments taking place.

In designing the future, the question is, can we bring a necessary resilience to the intervention of these institutions? Or can we ask the question, what can we do to overcome the fundamental problem of small credit transactions-high administrative costs? To that extent there are a whole series of experiments that can result in large-scale innovation happening; possibly the one which is the most complex but with the largest upside, is the use and application of technology. While the regulator, for example, will work on understanding the nuances of the delivery models, the apex in the field can make it possible for a stabilisation of these operating models. In putting forward a few of such suggestions, the article calls attention to the important function not only of developing innovative ideas, but the application of innovation in refining old ideas.

15.2.4 Innovative banks

With the growth in the economy, there is going to be an increasing demand by the poor family for financial services – either for capitalising on an economic opportunity or the need to use one of other services of savings, insurance and money-remittance. Ignoring this constituency will mean overlooking not only a large segment of the population, but in addition, a very economically-active set of borrowers who will possibly drive the growth in the economy past the eight percent mark. Hence expanding
services to this segment will require banks to make a clear call on if they would like to directly operate in this market or do it through other institutions. In either case, there will be opportunities to be innovative.

While the larger banks will possibly move towards using intermediaries, there will be a strong case for working closely with these intermediaries in undertaking product design (as Pradan is doing with their silk-rearing entrepreneurs), examining opportunities of enhancing treasury related functions, specially in reducing costs, (such as the benefits of introducing securitisation and bringing down costs) and providing other support that can lead to innovatively deepening the market for services (such as the delivery of insurance, especially in rain-fed agricultural areas). Such an expansion needs to be more broad-based across all financial institutions, rather than limited to one or two entities.

Smaller banks, especially the Regional Rural Banks and other scheduled cooperative banks on the other hand, can stir the market directly with MFIs. They can either introduce competitive products, lower-prices, segment the market and/or generally work on refining and meeting the demand of entrepreneurs in the region. There is interesting anecdotal evidence emerging of how this competition is taking place in a few of the areas where the microfinance institutions are active. A few RRBs have taken to identifying long-term microfinance borrowers and offering them longer tenure lower priced products of much larger sums. In this instance clearly, the ladder approach will work effectively; microfinance institutions nurturing borrowers who then graduate to borrow from RRBs. Clearly, the complexity of this rural and micro-lending market is just beginning to emerge and there are large possibilities that need attention if opportunity is to be capitalised.

15.2.5 Innovative donors

Donors too can have a wholesome impact on sectors. While such bodies have funded public good functions, their interventions attempt to cover all the ground in any market. Such attempts lead to the development of institutions that possess within themselves multiple functions, sometimes in contradiction to each other. This is best illustrated by the problems of concentrating both loan and development functions within the same institution. Such aggregation of functions leads to the distortion of the effectiveness of a possible lending or grant funding decision being compromised.
It is important then for donors to work on two kinds of features: first is to help support innovative and long-term institutional building ideas. These are long-term slower processes that require patience, time and large amounts of capital. Typically, this work is evolutionary and slow, but work which requires sustained and systematic attention. Examples of such work relate to, for example, the skills in working through the pricing of products, development of Management Information Systems and/or reporting skills to supervisors and regulators. However, blending this with decisions on loan-portfolios can lead to compromises in the tight management of possible delinquency that might emerge.

This is of course in contradiction to most of the donors who require large amounts of capital to be sewn into the design of pre-conceived ideas, which are in essence complete check-lists of what needs to be done in markets; not what needs to be done to make markets more effective, leading to the enhancements of contracts and exchanges that take place.

Moving institutions and their interventions and/or products towards being market-efficient is an extremely important support function. While this exercise of withdrawal and/or refinement by existing market institutions may seem long-term and high cost, they are central to the development of these market mechanisms. Encouraging such a reform process should seek to become a priority as it will lead to the reduction of distortions, or will enable the building up of such institutions which can have a positive impact on the development of the market.

15.2.6 Innovative practitioners

For the last few years, we have been witnessing a great set of innovations in the field of retail lending. Broadly, there are two types. The first are the ones that result in the retailer arriving at price-efficiencies that are passed on to the customer; the second are those that move towards de-risking the loan portfolio and diminishing the high risk bias that characterises agricultural lending. Consequently, we are witnessing a growing expansion in lending through MFIs and Self-Help Group federations to the sector. From Rs. 350 million of outstanding in 1999, Sa-Dhan members in 2004 had an outstanding of Rs. 4.34 billion and a cumulative lending of Rs. 12 billion, which by any measure is substantial.
Price efficiencies now encompass a set of measures that these intermediaries have introduced, covering a range of small but significant steps. Starting from finding methods that reduce the costs of training and promoting groups, to the effective use of technology in managing product attributes to the reduction of management layers, advanced microfinance intermediaries have moved effectively towards reducing prices. From the early days of their evolution, these advanced-intermediaries have moved towards reducing their interest rates by as much as seven to ten percent points. While these are early days of such innovations, we are yet to witness the advantages that can possibly arise from the competition between such service providers.

De-risking the cyclical nature of this portfolio though has received less attention, but is certainly part of microfinance strategy in this country. Early evidence of this has been in the nature of support that organisations such as PRADAN have provided their client base: lift-irrigation system in rain-fed agriculture, enhanced facilities and methods to sort out high yielding silk cocoons, etc. SEWA bank has constantly sought to enhance the productive capabilities of its women borrowers by financing their workplace or tools.

BASIX has done commendable work in limiting the downsides cycles of dairy producers among their borrowers, by ensuring linkages with both veterinary service providers and/or the milk chilling and transporting plants. Further, both BASIX and SHARE have moved towards ensuring the transfer price-benefits to the consumption pattern of its borrowers by setting up super-bazaars that source material at wholesale prices\(^7\). Such work clearly has not only served to fortify the portfolio but in addition developed large-scale demonstration effects that enable its appreciation by both borrowers and lenders to the sector, especially banks.

Clearly, there is merit in the categorisation of these innovations and appreciating the short-term and the long-term impact of this in the provision of financial services.

15.2.7 Innovative third party service providers

It is important to recognise that, as in all markets, institutions, especially those who are involved in the validation of data – such as rating agencies, auditors, certifying agencies – develop as response to the
demand from the market. However, such a skill in understanding microfinance portfolios and the consequent validation of the data that describes these portfolios is an important function – more in the nature of a public good in the early years – that needs support. To enable such development, banks, apexes and regulators should seek to use increasingly such tools. In so doing, there is significant expansion by an instrument that defines and weighs risks that are inherent in loan portfolios and such institutions, making its pricing more efficient over time.

However, to reach such a situation, the ideal condition would be to move towards enhancing the ‘reputation-capital’ and its benefits for such firms. To enable such a condition to emerge, the ‘demand-agents’ would need to move away from accepting only data that is coming out of government owned and run institutions to those firms who can more effectively process and validate data that is coming from the field. While it will be some time that private organisations can match the skills-of-scale of government organisations, it is important that the ‘incentives’ set reward quality.

Fundamentally hence, it is important to recognise that the firm and its recommendations are driven by the competency of such audit, rating or any third-party organisations which critically process and validate data. These are early days, and it demands innovative organisations with innovative tools to be recognised. Such data and its validation and examination by non-interested third parties will play a crucial role in enhancing the confidence of service providers, bankers and investors in the market.

But lenders, by themselves, will not be able to create a sufficient skill and knowledge set to enhance such a development. It will need, in addition, the active support of both apex organisations and regulators to signal the engagement with such tools.

15.3 Conclusion

In looking to the future, it is clear that there are distinct roles that different kinds of organisations have in these markets. Focusing on these roles and refining the interventions of the different organisations is an important function, as it significantly contributes to either reducing the costs in such transactions or the risk inherent in the portfolio.
Construction of the environment for financial services in general, and microfinance in particular, in the field of policy cannot afford to ignore any stakeholder organisations’ ineffectiveness. Hence assisting in the refinement of organisations’ role is an important agenda for an innovative intervention.

Therefore in designing for the growth of the microfinance sector, it is important that as the policy environment seeks to broaden the sector, it should seek to encourage the specialisation and functional efficiency of each of the actors. Second, given the wide range of constraints that affect the market, it is important to appreciate that deficiencies can be overcome by only a few organisations. It will be important to ensure that for the market to develop, the right product or instrument to enhance the market rests with the right kind of institution. It is only then that agents will participate in the market, with fear of distortions or apprehensions of perverse incentives. One of the key emerging questions is what is the nature of effort which can lead to accelerating the staid nature of government organisations? It is only when they are able to effectively evaluate the effectiveness of their interventions, and refine it to enhance overall efficiencies in the market, will we see the overall impact of expanding financial services to the poor.

Thirdly, there has been little discussion and appreciation of the roles of different organisations and funds; both on the debt side and those for the building of ‘public goods’. Today there is enough insight and experience to suggest that the management of organisations are complex; further the ability to manage the debt portfolio and the grants portfolio too have both a different character. Given what has to be achieved in the field in terms of outreach and development of the sector, it is important that efforts are made to specialise and develop core-competencies around the different functions; and each have different contributions to make to the expansion of the microfinance field. Hence it is important that each of these organisations and funds are managed separately and distinctly to ensure that they do not lead to the compromise of the development of the sector, but rather, lead to the development of competitive products and pricing. It is important that just as in the case of the financial market field, this sector witnesses the cleaning up of the provision of services.

Finally, as this is a growing and nascent field: the expansion which we are witnessing, it is urgent that efforts are made to document and learn
Expanding secular growth: The role for innovations in microfinance

from policy initiatives. This should include the development of policy clearly and must have built-in incentives to experimentation and growth.

Endnotes


3SIDBI and EDA impact study, unpublished document, 2004. EDA.


7www.basixindia.com
Your excellencies, ladies and gentlemen,

Having heard the excellent presentations on the conclusions reached by the groups on the SHG-Bank linkage, MFIs and innovations in microfinance, it now remains for me to formally tie these up and discern the roadmap which has been so ably suggested to us for the future.

1. Firstly how do we see the emerging role of NABARD in this new context? Weaving together the suggestions received and the introspections that we have had, there is a case for putting in position a model neutral, sector friendly NABARD partnership framework. This will include among others, NABARD partnering the players in the sector in a variety of ways such as innovations, product development and piloting, capacity building and extending resource support. In many of these areas active support, expertise and wisdom of the sector players will be required. I call upon you to pledge this. Emerging from this active collaboration of all players in the sector would be the policy and strategy issues for advocacy. NABARD would be happy to provide the platform for advocacy and a space for such activism as may be necessary to operationalise it. The details of this framework will be jointly worked out.

2. Your excellencies, the microfinance sector is on the verge of becoming an industry in this country. This is being taken forward by the multi-agency approach. This emerging framework includes the extant SHG model, the rapidly growing MFI models and other innovations.

3. In regard to the SHG-Bank Linkage model the aspects that we need to address are a better distribution of group formation and linkage efforts especially in the northern, central, eastern and northeastern
states. This is important in the context of the fact that these states have a higher concentration of poor.

- We also need to identify ways and means of improving and sustaining the quality of SHGs consistent with rapid growth and balancing sustainability with access.

- The problem of promoting livelihood among SHG members is becoming increasingly important because of the need to create livelihood and employment opportunities for higher incomes in the rural areas. We believe that the problem of rural migration which is a cause of concern could among others be addressed through this intervention.

- In light of the widely recognised quality and integrity of the groups formed under the SHG-Bank Linkage Programme there is an urgent need for evolving a method for bringing about a convergence between government sponsored programmes and the SHG-Bank Linkage Programme to ensure uniform quality and cost effectiveness.

- With a view to improve the information base and introduce data based monitoring at the group level we need to draw up a time bound programme for upgrading quality of bookkeeping and introducing an MIS which provides timely and accurate record of transactions.

- Within this model we seriously need to look at introduction of micro-insurance products and NABARD would be happy to collate the available information, bring together the players in the sector and support pilots in composite products.

- Lastly we need to evaluate the programme in a rigorous way so that the contribution of NABARD can find its rightful place in the sun.

4. In the MFI model, for growing MFIs there is a need to find access to capital funds. In this context we invite MFIs and all players to access the microfinance Development and Equity Fund, which will be operationalised shortly.

- In regard to enterprise financing by MFIs, they may like to explore setting up RUDISETI type institutions on a micro scale, for which NABARD support could be counted on.
• Introduction of transparent management practices, founded on accepted principles of good governance also need to be focused on. This entire initiative could be leveraged if interfaced with a suitable technology platform which would provide information to both the management and others forming a credible basis for decisions as well as oversight.

• Taking cognisance of the debate between no-regulation and self-regulation, NABARD would be happy to provide the space and expertise for examination of the issues by a group, on a no-commitment basis. In this context the development of a decentralised and distributed, self-monitoring model has been suggested. We hope the group would seriously consider this suggestion.

• Capacity building has been identified as a critical need of the entire sector. NABARD would take up this challenge and build on the immense expertise existing within the sector and deliver critical external inputs so as to comprehensively address the needs. Our bilateral partners would no doubt have a strong supportive role to play in this effort.

5. Yesterday it was mentioned that the rural financial services market is indeed a large one. All of us are cognisant of the fact that the unfinished agenda of taking financial services to the unreached is vast. We must therefore focus on designing suitable products, refining processes and identifying new delivery channels as the future agenda for action.

6. Speaking on a personal note I have gained immensely from this workshop. This appears to be the experience of those to whom I have spoken. The remarkable feature has been a free and open dialogue, sometimes with no holds barred, but always without malice and with courtesy towards all. We have come closer and bonded in a special way.

7. In the end, when we test the workshop against its objectives we all have sufficient reason to be proud. The quality of contributions made by all, the active listening, interacting and the willingness to learn have made the workshop a rich experience. We have no hesitation in making this an annual event. As I say au revoir, may I have the pleasure of having your company some time next year.
Towards a Sustainable Microfinance Outreach in India
Experiences and Perspectives

Access to financial services by the rural poor has been a complex issue in the agenda of social banking legislation. Measures adopted for massive expansion of retail banking network to rural areas and mandated lending to the priority sector did not, however, ensure outreach of financial services to the real poor. Financial exclusion is mainly featured among the large segment of rural poor.

NABARD with the support of GTZ and SDC organised a Policy Conference in New Delhi in May 2005 with the active participation of microfinance practitioners from India and abroad to share their best practice experiences in microfinance. Academics, policy makers and practitioners made invaluable contributions during the Conference leading towards a Sustainable Microfinance Outreach in India. The various presentations made by microfinance practitioners, bankers, NGOs and MFI representatives, academics and research institutions have been compiled in this book.

The publishers are confident that practitioners and policy makers of microfinance will find this publication useful.

Cover Photograph: Martin Egbert