

Microfinance Sector in India: Evolution and Current Challenges

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“We got rid of colonialism, we got rid of slavery, and we got rid of apartheid – everyone thought each one of them was impossible. Let’s take the next impossible, do it with joy and get it finished with and create a world free from poverty. Let us create the world of our choice.”

Mohammad Yunus¹

Microfinance refers to small-scale financial services – primarily credit and savings – provided to people who farm or fish or herd; who operate small enterprises or micro enterprises where goods are produced, recycled, repaired, or sold; who provide services; who work for wages or commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at local levels of the developing countries, both rural and urban (Robinson, 2001). Microfinance services can, overall, help low-income people reduce risk, improve management, raise productivity, obtain higher returns on investments, increase their incomes and improve the quality of their lives and of those dependent on them. It plays an important role in

¹ “We Can Create a World of Our Choice,” seventh Nelson Mandela Annual Lecture delivered in Johannesburg on July 11, 2009, on the eve of the 91st birthday of Nelson Mandela. http://www.nelsonmandela.org/images/uploads/Nelson_Mandela_Annual_Lecture_LT.pdf

bringing these poor people into the main stream of the economy and thereby participating in the process of nation building.

Indian Microfinance Sector

The Indian microfinance presents a story of strong growth. Its growth performance was impressively sustained through the recent global liquidity crunch and continued at an increased rate in the second half of 2009. With one of the highest growth rates globally since 2002, the Indian microfinance sector has emerged as the most socially conscious, commercially viable, and financially sustainable worldwide. According to a MIX market study, India has one of the lowest average loan sizes of around \$150 as well as the lowest yield on portfolio of 21.2 per cent.² The small loan size combined with low interest rates testify to the social inclination of Indian MFIs, which seek to genuinely foster financial inclusion among the poor and alleviate poverty. However, the year-on-year growth rate has been declining, illustrating the increasing maturity of the sector. Though decreasing, the growth rate is still high and is reflective of the industry approaching a more sustainable rate of expansion rather than a reversal of the trend observed thus far. As the industry matures, it is also nearing an inflexion point and is considering more sophisticated growth strategies through diversifying product offerings, client targeting, and creative financial and non-financial solutions which will allow the sector to grow at a continuous pace while preserving its solid performance and abiding by its social mission.

Evolution of Microfinance in India

The microfinance sector has covered a long journey from micro savings to micro credit and then to micro enterprises and now micro insurance, micro remittance, micro pension, and micro livelihood. This gradual and evolutionary growth process has given a boost to the rural poor in India to reach reasonable economic, social, and cultural empowerment, leading to better life of participating households.

The development of the microfinance sector in India can be divided into three phases. The first phase started in the pre-independence days. The role prescribed for the financial sector to achieve developmental goals has its origins during that period. The agriculture credit department was set up in 1935 by the Reserve Bank of India to promote rural credit. In its early days, the government sought to promote rural credit by strengthening the cooperative institutions. According to Sa-Dhan (2004), the need to replace costly informal credit with institutional credit was strongly felt as the All India Rural Credit Survey report of 1954 found that informal sources accounted for 70 per cent of rural credit usage, followed by cooperatives (6.4 per cent) and commercial banks (0.9 per cent).

The second phase started in the late 60s. The Lead Bank Scheme was introduced by the Reserve Bank of India in 1969, thereby starting a process of district credit plans and coordination among different financial intermediaries. It was during the same period that the nationalization of fourteen commercial

² "Microfinance Industry in India," <http://www.microfinancegateway.org/gm/document-1.9.43423/05.pdf>

banks took place. According to Sa-Dhan (2004), these initiatives resulted in the share of the formal financial sector in total rural credit usage rising to 30 per cent in 1971. The Regional Rural Banks (RRBs) were conceptualized in 1975 to augment the delivery of financial services in rural areas. This resulted in the creation of a network of banks which is one of the largest in the world even today. The All India Survey Debt and Investment Survey of 1981 found that the share of the formal financial sector in total credit had risen to over 60 per cent.

The government initiated the Integrated Rural Development Programme (IRDP) in 1980-81. The objective was to direct subsidized loans to poor self-employed people through the banking sector. The National Bank for Agriculture and Rural Development (NABARD) was established in 1982. In the same year the government initiated the Development of Women and Children in Rural Areas scheme as a part of IRDP. It was around this time that the first Self Help Groups (SHGs) started emerging in the country mostly as a result of non-government organizations' (NGO) activities. The Mysore Resettlement and Development Authority (MYRADA) was one of the pioneers of the concept of SHGs in India. It was in 1984-85 when MYRADA started linking SHGs to banks. SHGs in turn were also very responsive and flexible to the needs of their members. While MYRADA did not directly intervene in the credit market for the poor, it facilitated banking with micro institutions established and controlled by the poor. SHGs were a step in that direction. This was the beginning of the current microfinance movement.

IRDP is estimated to have reached over 55 million poor families until 1999. IRDP, in spite of its immense outreach, experienced very low repayment rates and created 40 million defaulters which, coupled with the subsidy component, ruled out long-term sustainability of the programme. Therefore, the government merged several programmes into a new programme - Swarnajayanti Gram Swarojgar Yojna (SGSY). The mandate of SGSY is to continue to provide subsidized credit to the poor through the banking sector to generate self-employment through a self-help group approach. SGSY has been growing at a fast rate. The total number of swarogaris assisted during the year 2009-10 were 13,28,868 out of which approximately 67 per cent were women.³ The formal financial sector has been criticized to be supply driven during this phase (Fisher and Sriram, 2002).

Financial services were viewed as a social obligation. Given the high rates of default, a formal loan waiver was announced by the government in 1989. This had a negative impact on credit discipline, and reinforced the view that lending to the poor was not a profitable business among the mainstream financial institutions.

The third phase marked the modern microfinance movement. The SHG-Bank Linkage Programme was formally launched by NABARD in 1992, with it circulating guidelines to banks for financing SHGs under a pilot project that aimed at financing 500 SHGs across the country through the banking system. While the banks had financed about 600 SHGs by March 1993, they continued to finance even more SHGs in the coming years. This encouraged the Reserve Bank of India (RBI) to include

³ Swarnjayanti Gram Swaroggar Yojana (SGSY) Agenda item for Performance Review Committee Meeting, March 2010; http://rural.nic.in/latest/SGSY_Agenda_15032010.pdf, accessed on January 15, 2010.

financing SHGs as a mainstream activity of banks under their priority sector lending in 1996. The government bestowed national priority to the programme through its recognition of microfinance. The banking system comprising public and private sector commercial banks, regional rural banks, and cooperative banks has joined hands with several organizations in the formal and non-formal sectors to use this delivery mechanism for providing financial services to a large number of the poor.

Table 1: Progress of SHG-Bank Linkage Programme (in lakh)

	No.of SHGs Financed	Cumulative No. of SHGs Financed
2001-2	1.98	4.61
2002-3	2.56	7.17
2003-4	3.62	10.79
2004-5	5.39	16.18
2005-6	6.20	22.38
2006-7	6.87	29.25
2007-8	10.81	N.A.
2008-9	16.09	42.24

Source : *NABARD Annual Reports, 2007-8 and 2009-10*

Concurrently, in 1993, the Rashtriya Mahila Kosh (RMK) was formed to accelerate the flow of funds to self-employed women in the unorganized sector. It is worth mentioning that the SEWA Cooperative Bank has been operating in Gujarat with similar objectives since 1974. The bank has been viable right from its inception and is an ideal example of community-owned sustainable financial service delivery. Microfinance received greater recognition when the Small Industries Development Bank of India (SIDBI) set up a Foundation for Microcredit with an initial capital of Rs100 crore in 1998. The same year also saw the formation of Sa-Dhan as an apex level association of community development finance institutions. The passing of the Mutually Aided Cooperative Societies (MACS) Act by Andhra Pradesh in 1995 and followed by some other states has also acted as a stimulant as many new microfinance initiatives have come up under this legislation. In addition to the success of the NABARD-SHG bank linkage programme, alternative microfinance initiatives following the Grameen and/or SHG methodology or at times individual lending model were also successful.

The year 2004 also saw some very important development in the microfinance sector in India. The banking sector led by ICICI Bank showed interest in microfinance as a viable commercial opportunity. The total disbursement of the banking sector to microfinance was estimated at around Rs1000 crore for the year 2003-4. ICICI Bank took a lead in establishing innovative partnerships with microfinance institutions which allowed for risk sharing between the two.

Current Scenario

As already mentioned, the sector performed creditably in a year (2009) that experienced a widespread liquidity crunch. The SHG – bank linkage programme made remarkable progress during this year; NABARD data indicate that credit to more than 1.716 million SHGs was made available⁴. The outstanding SHG loan accounts were 4.14 million representing an estimated membership of 54 million participants. MFIs too recorded an impressive increase of about 8.5 million clients during the year, registering a growth of 60 per cent over the previous year. The data collected from 230 MFIs by Sa-Dhan reveal that, despite liquidity constraints faced by some MFIs, expansion in client outreach and loan portfolio was vigorous. MFIs reported a total client base of 22.6 millions at the end of March 2009. The overall coverage of the sector as narrowly defined (outstanding accounts of members of SHGs and clients of MFIs) is estimated to have reached 76.6 million against 59 million last year. (Srinivasan, 2009b).

Table 2: Client Outreach : Outstanding Accounts (in million)

Segment	2006-7	2007-8	2008-9	Growth in 2009 over 2008
Banking System	38.02	47.1	54.0	6.9
MFI	10.04	14.1	22.6	8.5
Total	48.06	61.2	76.6	15.4
Total adjusted for overlap	44.97	56.0	70.0	14.0

Source: Srinivasan (2009b).

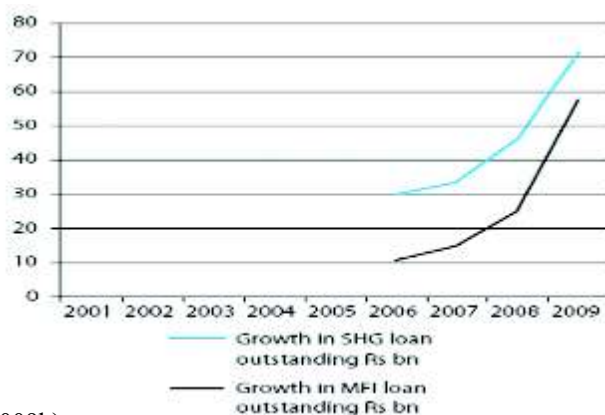
Figure 1: Trend of Incremental Clients of SBLP and MFIs



Source: Srinivasan (2009b).

⁴ This includes repeat loans to existing groups. Data on repeat finance to groups is not given separately in NABARD data sets.

Figure 2: Growth in Outstanding Microfinance Loans



Source: Srinivasan (2009b).

The World Bank has estimated the demand for micro-credit in the country in the region of Rs. 50,000 crore. RBI estimates that in 256 of India's 626 districts the credit gap is at least 95 per cent or more. According to CRISIL estimates, 120 million households in India continue to face financial exclusion and this translates into a credit demand of Rs.1,200 crore.

Structure of Microfinance Industry in India

Specifically, National Bank for Agriculture and Rural Development (NABARD) is the apex agency for the microfinance sector, taking care of the regulatory framework and providing refinance facility. Other government agencies are Small Industries Development Bank of India Ltd (SIDBI) and Rashtriya Mahila Kosh. The entire network of scheduled commercial banks (public sector, private sector, foreign banks), regional rural banks, and cooperative banks either reaches out to the poor client directly or through NGOs or microfinance institutions network. At the last level there are several microfinance institutions which are continuously working with poor clients for their various requirements.

National Bank for Agriculture Development

NABARD has been set up as an apex development bank with a mandate for facilitating credit flow for promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts, and other rural crafts. It also has the mandate to support all other allied economic activities in rural areas, promote integrated and sustainable rural development, and secure prosperity of rural areas.

NABARD has been instrumental in facilitating various activities under the microfinance sector, involving all possible partners in the arena. It has been encouraging voluntary agencies, bankers, socially spirited individuals, other formal and informal entities, and government functionaries to promote and nurture SHGs. The focus has been on training and capacity building of partners, promotional grant assistance to self-help promoting institutions (SHPIs), revolving fund assistance to

MFIs, equity/ capital support to MFIs to supplement their financial resources, and provision of 100 per cent refinance against bank loans provided by banks for microfinance activities. According to NABARD (2009), total refinance disbursed to banks against banks' loans to SHGs during 2008-9 was Rs. 2620.03 crore as against Rs. 1615.50 crore during 2007-8 registering a growth of 62.2 per cent. Further, the cumulative refinance disbursed under the SHG-bank linkage programme by NABARD to banks till March 31, 2009, stood at Rs. 9688.09 crore.

Small Industries Development Bank of India

The SIDBI Foundation for Micro Credit (SFMC) was launched by SIDBI in January 1999 for channelizing funds to the poor in line with the success of the pilot phase of the micro credit scheme. SFMC's mission is to create a national network of strong, viable, and sustainable microfinance institutions from the informal and formal financial sectors to provide microfinance services to the poor, especially women.

SFMC is the apex wholesaler for microfinance in India providing a complete range of financial and non-financial services such as loan funds, grant support, equity, and institution building support to retailing MFI including two-tier MFIs so as to facilitate their development into financially sustainable entities, besides developing a network of service providers for the sector. Capacity assessment rating was introduced by SFMC as a supplementary tool to assess risk perception. On SFMC's initiative, four rating agencies have started rating MFIs.

Rashtriya Mahila Kosh

The National Credit Fund for Women or the Rashtriya Mahila Kosh (RMK) was set up in March 1993 as an independent registered society by the Department of Women and Child Development in the Ministry of Human Resource Development with an initial corpus of Rs. 310,000,000. The objective was not to replace the banking sector but to fill the gap between what the banking sector offers and what the poor need. RMK's objectives are:

- to provide or promote the provision of micro-credit to poor women for income generation activities or for asset creation
- to adopt a quasi-informal delivery system, which is client friendly, uses simple and minimal procedures, disburses quickly and repeatedly, has flexibility of approach, links thrift and savings with credit, and has low transaction costs for both borrower and lender
- to demonstrate and replicate participatory approaches in the organization of women's groups for thrift and savings and effective utilization of credit
- to use the group concept and provision of credit as an instrument of women's empowerment, socio-economic change, and development
- to cooperate with government, state governments, union territory administrations, credit institutions, industrial and commercial organizations, NGOs, and others in promoting the objectives of the Kosh

- to receive grants, donations, loans, etc. for the furtherance of the aims and objectives of the Kosh.

Microfinance Programmes in India

The microfinance programmes in India can be divided into three categories; SHG-Bank Linkage Programme, MFI-Bank Linkage Programme, and various microfinance programmes provided by MFIs.

SHG-Bank Linkage Programme

The SHG – bank linkage programme started as an action research project in 1989. This model involves banks directly financing SHGs. In 1992, the findings from the project led to the setting up of a pilot project. The pilot project was designed as a partnership model between three agencies, viz. SHGs, banks, and NGOs.

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 organize the poor, build their capacities, and facilitate the process of empowering them.

More than 1.6 million SHGs have been linked with 35,294 bank branches of 560 banks in 563 districts across various states. Cumulatively, they have so far accessed credit of Rs.6.86 billion. About 24 million poor households have gained access to the formal banking system through the programme.⁵ Table 3 provides details.

Table 3 : Bank Loans Disbursed to SHGs (Rs crore)

	During the Year	Loans disbursed by Banks to SHGs during the Year				Per SHG loan disbursed (Rupees)	Out of Total: Bank loan disbursed to SHGs under SGSY	
		No. Of SHGs	% Share	Amount	% Share		No. of SHGs	Amount
Commercial Banks (Public & Private Sector)	2007-08	735119	59.9	5403.90	61.1	73511	160674	1103.70
	2008-09	1004587	62.4	8060.53	65.8	80237	133117	1102.38
	% growth	36.7		49.2		9.2	-17.2	-0.1
Regional Rural banks	2007-08	327650	26.7	2651.84	30.0	80935	64678	597.71
	2008-09	405569	25.2	3193.49	26.1	78741	81662	655.27
	% growth	23.8		20.4		-2.7	26.3	9.6
Cooperative Banks	2007-08	165001	13.4	793.52	9.0	48092	21297	156.33
	2008-09	199430	12.4	999.49	8.2	50117	49874	257.57
	% growth	20.9		26.0		4.2	134.2	64.8
Total	2007-08	1227770	100.00	8849.26	100.00	72076	246649	1857.74
	2008-09	1609586	100.00	12253.51	100.00	76128	264653	2015.22
	% growth	31.1		38.5		5.6	7.3	8.5

Source: NABARD, Status of Microfinance in India 2008-9.

⁵ "Rural Credit in India: Issues and Concerns," http://www.nabard.org/fileupload/DataBank/Speeches/MD_speech_Shri_Y.S.P.Thorat_241105.pdf; accessed in December 25, 2010.

Promotional Support by NABARD to SHG-Bank Linkage Programme

NABARD offers support to the promotion of the SHG-bank linkage programme through a number of measures.

Microfinance Development and Equity Fund (MFDEF): The Microfinance Development Fund (MFDF) was formed in 2000-1, with an initial contribution of Rs.100 crore to be funded by RBI and NABARD (Rs.40 crore each). The balance of Rs.20 crore was to be contributed by commercial banks. In the union budget for 2005-6, the government decided to redesignate the existing MFDF as the microfinance development and equity fund (MFDEF) and raised its corpus from Rs.100 crore to Rs.200 crore while maintaining the same ratio of contribution from the original promoters. MFDEF is managed and administered by NABARD. The objective is to facilitate and support the orderly growth of the microfinance sector.

Training: NABARD organizes / sponsors training programmes and exposure visits for the benefit of officials of banks, NGOs, SHGs, and government agencies to enhance their effectiveness in the field of microfinance. Training supplements and materials are supplied to banks and other agencies.

Microenterprise Development Programme for Skill Development: The programme was launched in March 2006 to enhance the capacities of members of matured SHGs to take up micro enterprises through appropriate skill upgradation/development in the existing or new livelihood activities, both in farm and non-farm sectors, by way of enriching knowledge of participants on enterprise management, business dynamics, and rural markets. It is tailor-made and focuses on skill building.

Grant Support to Partner Agencies for Promotion and Nurturing of SHGs : NABARD has been instrumental in the formation and nurturing of quality SHGs by means of promotional grant support to NGOs, RRBs, DCCBs, farmers' clubs, and individual rural volunteers, and by facilitating capacity building of various partners.

Pilot Project on SHG-Post Office Linkage Programme : The pilot project for the SHG-Post Office Linkage programme was initially launched in five districts of Tamil Nadu, viz. Sivaganga, Pudukottai, Tiruvannamalai, Thanjavur, and Tiruvarur, with the objective of examining the feasibility of utilizing the vast network of post offices in rural areas in disbursement of credit to rural poor, through SHGs, on agency basis.

The progress has been encouraging. As on March 31, 2009, 2,835 SHGs have opened zero- interest savings accounts with select post offices in Tamil Nadu and 889 SHGs have been credit linked with loan amounting to Rs.213.11 lakh. In addition to Revolving Fund Assistance (RFA) of Rs.3 crore sanctioned to the Department of Posts, NABARD has sanctioned RFA of Rs.5 lakh to post offices in Meghalaya for on-lending to 50 SHGs in East Khasi Hills.

Support to Activity-Based Groups : During 2008-9, NABARD introduced a scheme for supporting small-scale activity-based groups wherein capacity building, production, and investment credit and

market-related support would be extended. The scheme focuses on forming and nurturing groups engaged in similar economic activities such as farmers, handloom weavers, craftsmen, fishermen, etc. to improve production efficiency and realize better terms from the market through economies of aggregation and scale.

Support to SHGs' Federations: Recognizing the emerging role of the SHGs' federations in nurturing of SHGs, enhancing the bargaining powers of group members and livelihood promotion, NABARD introduced a flexible scheme in 2007-8 to support such federations on a model neutral basis. Support to the federations is extended by way of grant for training, capacity building, and exposure visits of SHG members, etc. as also under all of NABARD's existing promotional schemes.

MFI-Bank Linkage Programme: This model covers financing of MFIs by banking agencies for on-lending to SHGs and other small borrowers covered under the microfinance sector. This model has also been initiated by NABARD.

Table 4: Overall Progress under NABARD's Microfinance Programme

(Rs. crore)

Particulars	2006-07		2007-08		%Growth (2007-08)		2008-09		% Growth (2008-09)		
	No of SHGs '000s	Amt	No of SHGs '000s	Amt	No of SHGs	Amt	No of SHGs '000s	Amt	No of SHGs	Amt	
A. SHG Linkage Model											
Savings of SHGs with Banks as on 31 March	Total SHGs	416 0	3512.71	5010	3785.39	20.4	7.8	6121	5545.62	22.2	46.5
	Out of which SGSY	956	757.50	1203	809.51	25.8	6.9	1506	1563.38	25.1	93.1
Bank Loan disbursed to SHGs during the Year	Total SHGs	110 6	6570.39	1228	8849.26	11.0	34.7	1610	12253.5 1	31.1	38.5
	Out of which SGSY	189	1411.02	247	1857.74	30.5	31.7	265	2015.2	7.3	8.5
Bank Loan outstanding with SHGs as on 31 March	Total SHGs	289 5	12366.4 9	3626	16999.9 1	25.3	37.5	4224	22679.8 4	16.5	33.4
	Out of which SGSY	687	3273.03	917	4816.87	33.4	47.2	977	5861.72	6.5	21.8
B. MFI Linkage Model											
Bank Loan disbursed to SHGs during the Year	0.334	1151.56	0.518	1970.15	55.1	71.1	0.581	37.32	12.2	89.4	
Bank Loan outstanding with SHGs as on 31 March	0.550	1584.48	1.109	2748.84	101.6	73.5	1.915	5009.09	72.7	82.2	

Source: NABARD, Status of Microfinance in India-2008-9.

NABARD's Promotional Support to MFI-Bank Linkage

Just as NABARD offers promotional support to the SHG-Bank Linkage Programme, it also offers a variety of promotional support to the MFI-bank linkage programme. Some of its support activities are described below.

Rating of Microfinance Institutions : In order to identify, classify, and rate MFIs and empower them to function as intermediaries between lending banks and clients, NABARD has introduced a scheme for providing financial assistance to avail the services of accredited rating agencies for rating MFIs. Banks can avail the services of CRISIL, M-CRIL, ICRA, CARE, and Planet Finance for rating MFIs and avail financial assistance, subject to a maximum of Rs.1 lakh. The facility is available for the first rating of a MFI.

During 2008-9, a new scheme was introduced under which 100 per cent of the professional fees of the credit rating agency, subject to a ceiling of Rs.3 lakh, will be borne by NABARD in respect of only those MFIs approaching NABARD directly for capital/ equity support and/or Revolving Fund Assistance (RFA) from the Micro Finance Development and Equity Fund (MEDEF). Criterion for eligibility for MFIs is minimum loan outstanding of Rs.50 lakh.

Capital / Equity Support to Microfinance Institutions : A scheme to support MFIs was introduced in 2007-8 under which capital/ equity support to various types of MFIs would be provided by NABARD to enable them to leverage commercial and other funds from banks. During 2008-9, capital support amounting to Rs.11.75 crore had been sanctioned to 13 agencies taking the cumulative support to Rs. 21 crore covering 24 agencies under the scheme and an amount of Rs.17 crore has been released so far. NABARD introduced a new scheme for capital support to start-up MFIs having potential to scale-up their activities but lacking in capital, infrastructure, and managerial skills.

Revolving Fund Assistance to Microfinance Institutions : NABARD provides revolving fund assistance (RFA) on a selective basis to MFIs. RFA is necessarily to be used for on-lending to SHGs or individuals and the amount is to be repaid along with the service charge between 6.5 per cent and 9.5 per cent within 3 to 7 years. This enables MFIs to build a 'history', which would help them access credit facilities through regular banking channels. During 2008-9, RFA of Rs.6.25 crore was sanctioned. Cumulatively, RFA of Rs. 42.98 crore has been sanctioned to 38 agencies and an amount of Rs. 33.94 crore has so far been released against which an amount of Rs.13.62 crore was outstanding as on March 31, 2009.

Microfinance Programmes from MFIs: MFIs play a vital role in the process of financial inclusion in the country. Some of them operate in small geographical areas and therefore are at an advantage because of their understanding of the requirements of the people in that region. They differ from each other in terms of lending method, calculation of interest, portfolio of lending, legal structure, and products.

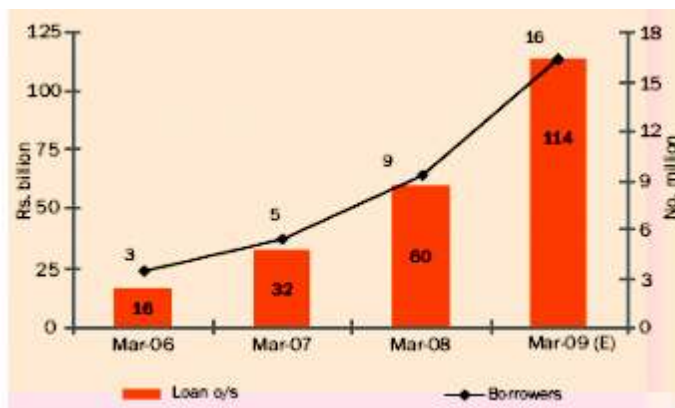
Various legal forms of microfinance institutions are given below:

- **Not-for-profit MFIs:** societies, public trusts and non-profit organizations
- **Mutual Benefit MFIs:** cooperatives registered under state or national acts and mutually – aided cooperative societies
- **For profit MFIs:** non-banking financial companies, producer companies, and local area banks

MFIs are estimated to have total outstanding loans of Rs. 11,000 – 12,000 crore as on March 31, 2009. The microfinance sector in India is fragmented – there are more than 3000 MFIs, NGOs, and NGO-MFIs of which about 400 have active lending programmes. The top 10 MFIs are estimated to account for around 74 per cent of total loans outstanding for MFIs; around 17 MFIs had outstanding loans of more than Rs.100 crore as on March 31, 2009, with the top three MFIs crossing Rs. 1000 crore in terms of outstanding loan portfolio.⁶

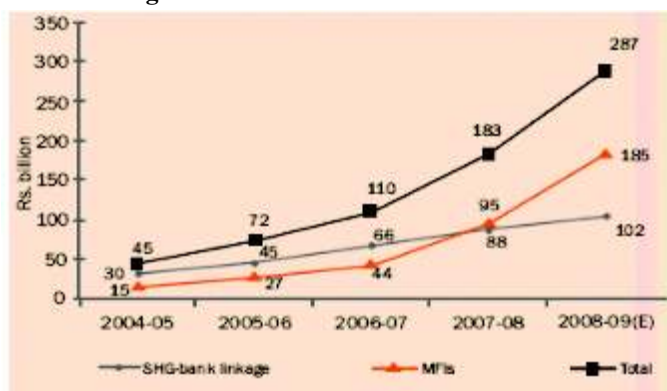
The trends in growth of and disbursements by microfinance institutions are shown in Figures 3 and 4.

Figure 3: Growth Trends in Microfinance



Source: CRISIL, India Top 50 Microfinance Institutions.

Figure 4: Microfinance Disbursements



Source: CRISIL, India Top 50 Microfinance Institutions.

⁶ CRISIL, India Top 50 Microfinance Institutions, A Financial Awareness Initiative, October 2009.

Developmental Challenges with Delivery Models

Issues and challenges faced by the microfinance sector and the institutions therein are discussed below.

SHG-Bank Linkage Programme

Regional Imbalances : The first challenge is the skewed distribution of SHGs across states. About 44 per cent of the total SHG credit linkage in the country is concentrated in the southern states of India. However, in states which have a larger share of the poor, the coverage is comparatively low. The skewed distribution is attributed to:

the overzealous support extended by some of the state governments to the programme

skewed distribution of NGOs

local culture and practice

Quality of SHGs : Ensuring the quality of SHGs in an environment of exponential growth is one of the major challenges. Owing 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 poor maintenance of books and accounts. 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

diminishing skill sets of SHG members in managing their groups

Impact of SGSY : The success of the programme has motivated the government to borrow its design features and incorporate them in its 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 causes migration generally for the wrong reasons. Also, micro level studies have raised concerns regarding the process through which groups are formed under SGSY. It is said that in many cases members are induced to come together not for self-help but for subsidy.

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 fora 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.

MFI Delivery Model

MFIs are an extremely heterogeneous group comprising NBFCs, societies, trusts, and cooperatives. They are provided financial support by 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 onlending 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 in recent times. While there is no published data on private MFIs operating in the country, the number of MFIs is estimated to be around 800. Out of this not more than a dozen MFIs have an outreach of 1,00,000 microfinance clients. A large majority of them operate on a much smaller scale with clients ranging between 500 and 1,500 per MFI. It is estimated that the MFIs' share of the total institution-based micro-credit portfolio is about 8 per cent. MFIs can play a vital role in bridging the gap between demand and supply of financial services if the following critical challenges confronting them are addressed:

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 and Sharma (2001) shows that 89 per cent of the MFIs in the sample were subsidy-dependent and only 9 were able to cover more than 80 per cent 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 are 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 financial services.

Lack of Capital : The second area of concern is paucity of owned funds. Many of the MFIs are socially oriented institutions and do not have access to 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. The Micro Finance Development Fund (MFDF) redesignated as the Micro Finance Development Equity Fund (MFDEF), is expected to play a vital role in meeting the equity needs of MFIs. Amarnani and Amarnani (2009) recommend the suitability of venture capital for funding microfinance institutions.

Borrowings : In comparison with earlier years, MFIs are now finding it relatively easier to raise loan funds from banks. This change came after 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.

Capacity of MFIs : It is now recognized 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 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 centered 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.

Some Delivery Innovations

One of the major successful innovations in India has been the SHG-bank linkage programme. However, over the years there have been a number of innovations as far as delivery modes are concerned for financial inclusion.

Bank Partnership Model : This is an innovative way of financing MFIs. The bank is the lender and MFI acts as an agent for handling items of work relating to credit monitoring, supervision, and recovery. In other words, 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 variation of this model is where MFI, as an NBFC, holds the individual loans on its books for a while before securitizing them and selling them to the bank. Such refinancing through securitization enables MFI increased funding access. If an MFI fulfils the ‘true sale’ criterion the exposure of the bank 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 securitization structure.

Banking Correspondents : Bank correspondents (BCs) are technology partners with the bank and carry on all banking activities for the bank. A business correspondent can be an individual or a local grocery shop doing financial transactions with banks on behalf of people. For banks, they ensure significant savings in terms of not having to open and run branches in far-flung areas while allowing a wide reach. For the unbanked, they offer a degree of comfort and trust in how their finances are handled. According to RBI data, out of the 600,000 villages with a population of 2,000 or more, only 30,000 have access to banking services.

Service Company Model : The service company model developed by Accion and used in some of the Latin American countries is worth noting. It 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 works hand in hand with that MFI to extend loan and other services. On paper, the model is similar to the partnership model: MFI originates the loan and the bank books it. This model has two very different and interesting operational features:

1. 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 standalone MFI. In the case of banks which have a large branch network, it also allows rapid scaling up. In the partnership model, MFIs may enter into

contracts with many banks in an arms length relationship. In the service company model, MFI works specifically for the bank and develops an intensive operational cooperation between them to their mutual advantage.

2. The partnership model uses 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 operations off the management of the bank and put it in the hands of MFI managers who are focused on microfinance to introduce additional products.

Issues and Challenges in Indian Microfinance Sector

While the Indian microfinance sector has made significant progress in the last two decades, there are issues and challenges which it needs to address to make further progress.

Quality of Growth

As already mentioned earlier, the Indian microfinance sector has been growing at a very fast rate. The outreach has improved and the quality of processes adopted by the sector has also improved over the period. However, there still remain some concerns for the sector.

Intense Competition and Borrower Fatigue: The aftermath of entrenched default in some parts of Karnataka seems set for a protracted reconstruction process. It must be added that the problems are small, constituting a portfolio share of less than 0.5 per cent and confined to a few geographical locations. But the possibility of a virulent spread to other regions and among other institutions is worrisome.

Skewed Growth: The regional skew is continuing to be addressed by both the banking sector and MFIs. Northern states have turned in a better performance as also the southern region. The Eastern and North-eastern regions have recorded moderate growth rates while the Central and Western regions have shown a decline in the number of groups with loans.

‘Andhra Pradesh Issue’: In the case of Andhra Pradesh (AP), lending and outreach have reached extraordinary levels. More than two crore microfinance clients have been financed to the tune of Rs.123,000 crore in AP. The number of households in AP is about 1.6 crore. Statistically more than 125 per cent of all households in AP are covered by microfinance loans. If only poor families had been targeted, then each family had been financed eight times (the number of poor households is about 0.252 crore) under microfinance. The average debt outstanding is estimated at Rs 49,000 per household, which is about eight times the national average MFI loan outstanding and about 11 times the average member-level loan outstanding in the case of SHGs. There is a clear indication of fierce competition and multiple lending in three states – Andhra Pradesh, Tamil Nadu, and Karnataka. The concentration risk in developed geographies is growing and is an area of major concern.

Loan Size: The average loan size has increased significantly especially in the case of MFIs and the proportion of clients that is offered lower size of loans has come down significantly. This is a welcome development as it improves the chances of clients getting viable size of loans to pursue livelihood activity and moderates the temptation for multiple borrowing. It also improves the profitability and the revenue to cost ratio per client in the case of MFIs and banks. However, the average loan sizes are still quite low compared with the requirements of livelihood activities that can produce a poverty-mitigating income for households.

Microinsurance: Insurance coverage has been increasing, but not in the explosive manner of credit. The insurance sector has not been able to come up with dedicated microinsurance institutions that focus on small clients and their risk mitigation needs. The Insurance Regulatory and Development Authority (IRDA) has indicated that the insurance density at 46 (though an improvement from 38 in 2006) still has a long way to go. The penetration ratio estimated for India in 2007 was 4.7 per cent which was lower than the level achieved in 2006 at 4.8 per cent. Moreover, poor claim settlement processes plague microinsurance.

Policy Environment

Currently, there are many legal forms (mainly not-for profits, mutual benefits, and for-profits) through which microfinance is delivered in India. The multiplicity of legal forms itself indicates that different acts and laws will govern the sector and, thus, give rise to several issues and challenges.

Proposed Microfinance Development and Regulation Bill, 2010: The bill was first placed in the Lok Sabha in March 2007 but it expired with the lapse of the 14th Lok Sabha. The purpose was to provide for the promotion, development, and regulation of micro finance organizations in rural and urban areas and thereby for securing easy access to credit, thrift, and other financial facilities of women and certain disadvantaged sections of the people, and for matters connected therewith or incidental there to. It is expected that a revised bill will soon be placed in the Lok Sabha.

The highlights of the bill are:⁷

Constitution of Microfinance Development Council: an advisory body

Micro Finance Development and Equity Fund (MFDEF)

Redressal Mechanism - Microfinance Ombudsman

Regulatory and development powers to NABARD for microfinance organizations; regulation to be framed by it

Powers to the government to make rules to implement provisions of the act and decide the penalties for offences.

⁷ Mohanty, B., "Microfinance Sector in India – Developing a Support Policy and Regulatory Framework and Environment – Position and Perspectives," paper presented at the international conference on Microfinance Regulation, Dhaka, March 2010.

Malegam Sub-Committee Report:⁸ RBI set up a sub-committee in October 2010 to study the issues and concerns in the microfinance sector under the chairmanship of Shri Y. H. Malegam. The committee has recommended creation of a separate category of NBFCs operating in the microfinance sector to be designated as NBFC-MFIs. To qualify as a NBFC-MFI, NBFC should be “a company which provides financial services predominantly to low-income borrowers, with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks” and which further satisfies the regulations specified in that behalf.

The committee has recommended that banks lending to NBFCs which qualify as NBFC-MFIs will be entitled to priority lending status. With regard to the interest chargeable to the borrower, it has recommended an average margin cap of 10 per cent for MFIs having a loan portfolio of Rs. 100 crore and 12 per cent for smaller MFIs and a cap of 24 per cent for interest on individual loans. It has also proposed that, in the interest of transparency, an MFI can levy only three charges: processing fee, interest, and insurance charge.

The committee has made a number of recommendations to mitigate the problems of multiple-lending, overborrowing, ghost borrowers, and coercive methods of recovery. These include :

A borrower can be a member of only one SHG or a joint liability group (JLG)

Not more than two MFIs can lend to a single borrower

There should be a minimum period of moratorium between the disbursement of loan and the commencement of recovery

The tenure of the loan must vary with its amount

A credit information bureau has to be established

The primary responsibility for avoidance of coercive methods of recovery must lie with MFI and its management

RBI must prepare a draft customer protection code to be adopted by all MFIs

There must be grievance redressal procedures and establishment of ombudsmen

All MFIs must observe a specified code of corporate governance

The committee has recommended that entities governed by the proposed act should not be allowed to do the business of providing thrift services. It has also suggested that NBFC-MFIs should be exempted from the state money lending acts.

⁸ Mohanty B. <http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=608>; accessed on January 20, 2011.

Changing Landscape

The entire microfinance ecosystem is undergoing a transformation. The major changes are described below:

Urban Microfinance : Urban microfinance has become a magnet for several large and small MFIs. However, the growth posted in urban locations during 2009 has been moderate compared to rural business.

Professional Management : Some of the new institutions that entered the sector have professional promoters and a clear vision backed by sound business models. These institutions are able to find both equity and bank funding. Comparatively, MFIs with NGO parentage find it difficult to expand; access to banks' funds is a limitation which they need to overcome. Banks are not too comfortable with their past record as a socially oriented institution.

Increased Competition : Eight million accounts have been opened by banks using the banking correspondents so far (which is about 50 per cent of the new customers acquired by the microfinance sector). If this gathers momentum, competition for microfinance customers is bound to be severe. The guidelines issued on mobile banking have not led to the kind of explosive activity expected by sector watchers.

Funding Trends in the Sector

Both NABARD and SIDBI had reported significant increase in their exposure to microfinance in 2009. Another bulk funder, Friends of Women's World Banking (FWWB), is also an important source of finance for the microfinance sector. RMK is also in the process of restructuring, its corpus is to increase from Rs. 100 crore to Rs. 500 crore over a period of three years. Funds are also coming from international organizations such as the World Bank, Kreditanstalt für Wiederaufbau (KfW), Department for International Development (DFID), and others.

Technology

The use of smart cards, biometrics, and mobile-based transaction devices for financial inclusion is being experimented with varying degrees of success. However, the comfort level of MFIs with different technologies is at best mixed. Failure of cards, card terminals, and software has been reported. The manual override of procedures adopted in the case of technology failure is fraught with risks of misuse and fraud. Further, some of the technologies that offer smart card-based financial inclusion have been found to be expensive.

Conclusion

The microfinance sector in India has developed significantly to reach its current stature. We conclude that there exists a gap in terms of outreach or quality of growth. By outreach we mean penetration

within the poor states in the country and outreach in terms of the very poor people covered by the programme. There also exists a gap as far as a stable policy framework for the sector is concerned. Numerous vacillations have seen the private sector alternate between microfinance purveyor to exploiter and even victims of politically supported willful default. The passing of the microfinance bill with changes recommended by the Malegam committee is imperative at this stage of growth for the sector. A major gap also exists in terms of funds available to the sector. Only with an improved availability of funds will the sector be able to adopt better technologies to improve its efficiency and outreach.

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