Micro Finance in India

1. Definition

Micro-finance refers to small savings, credit and insurance services extended to socially and economically disadvantaged segments of society. In the Indian context terms like "small and marginal farmers", " rural artisans" and "economically weaker sections" have been used to broadly define micro-finance customers. The recent Task Force on Micro Finance has defined it as "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban or urban areas, for enabling them to raise their income levels and improve living standards". At present, a large part of micro finance activity is confined to credit only. Women constitute a vast majority of users of micro-credit and savings services.

2.Demand of Micro Finance Services in India

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

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

Credit on reasonable terms to the poor can bring about a significant reduction in poverty. It is with this hypothesis, micro credit assumes significance in the Indian context. With about 60 million households below or just above the austerely defined poverty line and with more than 80 percent unable to access credit at reasonable rates, it is obvious that there are certain issues and problems, which have prevented the reach of micro finance to the needy.

With globalisation and liberalisation of the economy, opportunities for the unskilled and the illiterate are not increasing fast enough, as compared to the rest of the economy. This is leading to a lopsided growth in the economy thus increasing the gap between the haves and have-nots. It is in this context, the institutions involved in micro finance have a significant role to play to reduce this disparity and lead to more equitable growth.

2.1 Demand for Credit:

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

At the very bottom in terms of income and assets, and most numerous, are those who are landless and are engaged in agricultural work on a seasonal basis, and manual labourers in forestry, mining, household industries, construction and transport. This segment requires, first and foremost, consumption credit during those months when they do not get labour work, and for contingencies such as illness. They also need credit for acquiring small productive assets, such as livestock, using which they can generate additional income.

The next market segment is small and marginal farmers and rural artisans, weavers and those self-employed in the urban informal sector as hawkers, vendors, and workers in household micro-enterprises. This segment mainly needs credit for working capital, a small part of which also serves consumption needs. In rural areas, one of the main uses of working capital is for crop production. This segment also needs term credit for acquiring additional productive assets, such as irrigation pumpsets, borewells and livestock in case of farmers, and equipment (looms, machinery) and worksheds in case of non-farm workers. This market segment also largely comprises the poor but not the poorest.

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

One market segment, which is of great importance to micro-credit is women. The 1991 Census figures reveal that out of total 2.81 million marginal workers, 2.54 million were women and their further break-up shows that out of a total of 2.67 million rural marginal workers, 2.44 million were females. Further, many more women were willing to work. This has been corroborated by the results of a survey done by the National Sample Survey Organisation (NSSO), 43rd round, which has revealed that there is a vide variety of work which rural women combine with household work.

In the NSSO survey it has also been estimated that a large percentage of rural women in the age group of 15 years and above, who are usually engaged in household work, are willing to accept work at household premises (29.3 percent), in activities such as dairy (9.5 percent), poultry (3 percent), cattle rearing, spinning and weaving (3.4 percent), tailoring (6.1 percent) and manufacturing of wood and cane products etc. Amongst the women surveyed, 27.5 percent rural women were seeking regular full-time work, and 65.3 percent were seeking part-time work. To start or to carry on such work, 53.6 percent women wanted initial finance on easy terms, and 22.2 percent wanted working capital facilities, as can be seen from the table below:

Assistance Required (by women marginal workers seeking or available for work at their household premises).	Percent of Women Seeking Assistance
No assistance	2.1
Initial finance on easy terms	53.6
Working capital facilities	22.2
Raw materials availability	4.6
Marketing	1.7
Training	10.5
Accommodation	0.4
Other assistance	4.9
Total	100

2. Demand for Savings and Insurance Services:

The demand for savings services is ever higher than for credit. Studies of rural households in various states in India show that the poor, particularly women, are looking for a way to save small amounts whenever they can. The irregularity of cashflows and the small amounts available for savings at one time, deter them from using formal channels such as banks. In urban areas also this is true, in spite of better banking facilities, as shown by the experience of the SEWA Bank, Ahmedabad. The poor want to save for various reasons – as a cushion against contingencies like illness, calamities, death in the family, etc; as a source of equity or margin to take loans; and finally, as a liquid asset. The safety of savings is of higher concern than interest rates. The demand for savings services is high in rural areas as well, as can be seen from a recent study of women's savings and credit movement in Andhra Pradesh. Almost all women's groups in their early years begin with regular savings and their savings exceed the loans they give from their funds. Of course, part of this lower demand for credit is the inadequate absorption capacity of women, which comes from long years of exclusion from the economic sphere outside their homes.

The demand for insurance services, though not very well articulated, is also substantial. This comes from the fact that not only incomes of microfinance customers low, but are also highly variable. Insurance by the poor is needed for assets such as livestock and pumpsets, for shelter. Crop insurance could be very useful to the rural poor. Finally, insurance against illness, disability and death would also reduce the shocks caused by such contingencies, which lead the poor into taking loans at such times at high interest.

3.Supply of Micro-Finance Services

RBI data shows that informal sources provide a significant part of the total credit needs of the rural population. The magnitude of the dependence of the rural poor on informal sources of credit can be observed from the findings of the All India Debt and Investment Survey, 1992, which shows that the share of the non-institutional agencies (informal sector) in the outstanding cash dues of the rural households was 36 percent. However, the dependence of rural households on such informal sources had reduced of their total outstanding dues steadily from 83.7 percent in 1961 to 36 percent in 1991. This is shown in the table below.

Outstandings from Informal Sources as a Percentage of Total Dues,

for Various Occupational Categories of Rural Households

Year	Cultivators	Non-Cultivators	All
1961	81.6	89.5	83.7
1971	60.3	89.2	70.8
1981	36.8	63.3	38.8
1991	33.7	44.7	36.0

Among formal institutional sources, banks and co-operatives provided credit support to almost 56 percent of the rural households, while professional and agricultural money lenders were providing credit to almost one sixth of the rural households. The details by source are given below:

Sources of Credit for Rural Households, 1991

Credit Agency	% of Rural Households
Government etc	6.1
Cooperative Societies	21.6
Commercial Banks and RRBs	33.7

Insurance	0.3
Provident Fund	0.7
Other institutional Sources	1.6
All Institutional Agencies	64.0
Landlord	4.0
Agricultural Money-lenders	7.0
Professional Money-lenders	10.5
Relatives and Friends	5.5
Others	9.0
All Non-institutional Agencies	36.0
All Agencies	100.0

Though the overall share of institutional credit for rural households has gone up steadily, households in the lower asset groups were more dependent on the non-institutional credit agencies. The share of debt from the non-institutional credit agencies was 58 percent in the case of lowest asset group of "less than Rs 5,000" as against a low of 19 percent in the highest asset group of " Rs 2.5 lakh and above".

Share of Debt from Institutional and Non-institutional Sources,

by Asset Holdings of Households

Household Assets (Rs 000)	Institutional Agency Share as %	Non-institutional Agency Share as %	All
Less than 5	42	58	100
5-10	47	53	100
10-20	44	56	100
20-30	68	32	100
30-50	55	45	100
50-70	53	47	100
70-100	61	39	100
100-150	61	39	100

150-250	68	32	100
250 and above	81	19	100
All Classes	64	36	100

Over the decades following India's independence in 1947, Government of India (GOI) has made concerted efforts to provide micro-finance to the rural poor through the formal financial sector namely the co-operatives. However, the limited success of the co-operatives in the mid fifties to the sixties forged the need for nationalisation of commercial banks (CB) in 1971 and the establishment of a large network to reach every village, and every segment of the population. In the mid-1970s, Regional Rural Banks (RRB) were also established to continue further the outreach of the banking sector in reaching the rural poor. All these programs were supported by a policy of mandated credit programs for the low-income households that were supported by the Integrated Rural Development Program (IRDP), launched in 1980. The IRDP was designed to provide a mix of subsidy from the government and credit from the banking system to enable the asset acquisition of the poor.

As a result of these programs, India has one of the largest banking networks in the world with close to 50,000 CB outlets; 14,420 RRBs; and 90,000 primary agricultural co-operative societies. Close to 43 percent of the CB, and RRB branches are located in the rural areas. Even more impressive is the fact that, there is a financial intermediary branch for every 15,000 households, and a co-operative in every village.

Due to the extensive expansion of the banking network and emphasis on lending to small borrowers, there have been a lot of small loans by banks. In terms of amount, this was 13.2 percent of the total credit outstanding from commercial banks and RRBs. As per RBI data for March 1994, the number of accounts below Rs 25,000 was 5.6 million, or 93.6 percent of total loan accounts, with 18.6 percent of the outstanding amount. Of these, accounts with outstanding below Rs 7500 comprised 80.5 percent of the number of accounts and 49.5 percent of amount outstanding. In terms of purpose, 45.8 percent of amount was for small agricultural loans, 20.2 percent for industry and 18.8 percent for trade and services.

By March 1997, the number of small borrowal accounts with a credit limit below Rs 25,000, had come down by as many 0.6 million accounts to 5.0 million, or 90.1 percent of the outstanding loan accounts. This decline in number of accounts clearly shows the post liberalisation trend, with banks concentrating their efforts on larger loans and becoming ever more reluctant to extend credit to small borrowers.

While banks have been engaged in financing small borrowers, the manner in which this is being done can hardly be called micro-finance. The procedures are cumbersome, the staff unfriendly and the transaction costs high. Repeat loans, except for crop production, are rare, even for borrowers who have repaid fully. Furthermore, even though the many of the loans extended to the poor by the public sector financial institutions are subsidized, their ultimate cost to the borrowers is high: factoring in out-of-pocket costs, payments to middle men, wage and business loss due to time spent in getting the loan approved. Effectively, the total cost of funds to the borrower ranges between 22–30 percent as against the 12-14 percent nominal lending rates specified for commercial bank loans below Rs 200,000. All this results in low repayment rates, leading to a vicious cycle of non-availability and non-repayment.

Supply of Savings and Insurance Services:

In the case of savings services, again while banks have provided access to a large number of small depositors, the demand is nowhere near being met, particularly for small , frequent "recurring" deposits. Hence the poor turn to other means such as chits, bishis and savings mobilisation companies like Peerless and Sahara. Many such companies are fly-by night and as a result, the poor lose their money. The RBI has tightened up deposit taking activity since 1997, but this has, perversely, also led to legitimate MFIs being not allowed to take deposits and thus provide savings services to the poor. Transaction costs of savings in formal institutions were as high as 10 percent for the rural poor, because of small average transaction size and distance of the bank from villages.

The supply of insurance services to the poor has been increased substantially over the 1990s, and there are a large number of low premium schemes covering them against death, accidents, natural calamities, and loss of assets due to fire, theft, etc. However, the usage is limited by low awareness among the poor. Crop and livestock insurance, however, are quite expensive and their reach to the poor is negligible. Livestock and asset insurance was extended top the poor along with the IRDP subsidised loans, and thus remained scheme driven, with little awareness among the customers.

4. Micro-Finance Institutional Structure:

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

4.1 Mainstream Micro Finance Institutions

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

4.2 Alternative Micro Finance Institutions

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

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

Some of the leading alternative microfinance institutions in this segment are SEWA Bank in Gujarat, which also runs federations of SHGs in nine districts; ASSEFA and its Sarva Jana Seva Kosh Ltd, the and ASA in Tamil Nadu: SHARE, BASIX, CARE and MACTs in AP promoted among others by the Cooperative Development Foundation (CDF); MYRADA in Karnataka, which has promoted Sanghamitra, a company of its village savings and credit sanghas; PRADAN which has established a large number of SHGs and federated them under Damodar in Bihar, Sakhi Samiti in Rajasthan and the Kalanjiams in Tamil Nadu (the last now run by DHAN Foundation); ADITHI in Bihar has established Nari Nidhi, a federation of women’s groups; PREM in Orissa has done the same through the Utkal Mahila Sanchay O Bikas; the Rashtriya Gramin Vikas Nidhi which runs credit and savings programs in Assam and Orissa, on the lines of the Grameen Bank, Bangladesh, as does SHARE in AP, ASA in Tamil Nadu and RDO in Manipur.

5. The Problems Associated with Mainstream MFIs

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

The mainstream financial institutions are flush with funds and have access to enormous amounts of low cost savings deposits. Indeed, the poorer the region, the lower the credit deposit ratio – most of the eastern UP, Bihar, Orissa and the North-East have Credit Deposit ratios of 20-30 percent. Thus while banks are physically present in rural areas and offer concessional interest rates, rural producers are not able to access, with the result that the rest of the deposits are finding their way into the financial sector. Some of the main reasons for the above are:

5.1 Borrower Unfriendly Products and Procedures

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

5.2 Inflexibility and Delay

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

5.3 High Transaction Costs, both Legitimate and Illegal

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

5.4 Social Obligation and not a Business Opportunity

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

5.5 Financing to Alternative MFIs

NABARD Act does not permit them to refinance any private sector FI and do any direct financing (NABARD's direct lending to micro-finance NGOs so far has been out of donor funds), similarly SIDBI Act restricts it from extending loans to the agricultural and allied sectors, whereas many of the members of the self help groups are engaged in such activities.

5.6 Legal and Regulatory Framework

- The policymakers feel that farmers and poor people need low interest and subsidized credit. Thereby we have regulated interest regime for the loans up to Rs 25,000 and Rs 2,00,000/- with an interest cap of 12 percent and 13.5 percent respectively. They believe that poor cannot save, they are unwilling to repay the loans, and the administrative costs of servicing them are high.

- Also small loans have been used as a tool for disbursing political patronage, undermining the norm that loans must be repaid. Thus the mainstream institutions feel that these loans are risky, difficult to serve and have a low or negative net spread.

- The Regional Rural Banks Act does not permit any private share holding in any RRBs, and the Cooperative Act of all states do not permit district level co-operative banks to be set up except by the state government. The result of these two laws together is that rural credit has been a monopoly of state owned institutions.

6. Problems for Alternative Micro-Finance Institutions

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

- Financial problems leading to setting up of inappropriate legal structures
- Lack of commercial orientation
- Lack of proper governance and accountability
- Isolated and scattered

6.1 Inappropriate Legal Forms

NGOs invented micro-finance but NGOs are not the best type of agencies to carry out

micro-finance on a long-term sustainable basis. If an MFI opts to become an NGO, it has the following problems:

- The major source of funds of NGOs are grants, which are very limited.
- If the NGOs earn a substantial part of their income from lending activity, they violate section 11 (4) of the Income Tax Act and can lose their charitable status under Section-12.
- Moreover, NGOs do not have the appropriate financial structure for carrying out micro finance activities. NGOs being registered as societies or trusts, do not have any equity capital and can never be "capital adequate".

The other alternative for an MFI is to become a cooperative or a company. As in the long run, the primary source of lending funds for MFIs is deposits, till that stage, the MFI has to rely on borrowings. To be able to attract borrowings, the MFI has to have equity capital. Thus, it is only possible to establish a financially sustainable MFI either as a cooperative or as a company.

In most states, with exception of Andhra Pradesh, Maharashtra, and Gujarat, cooperatives are politicized and state controlled and thus not an appropriate form of incorporation for an MFI. That leaves an MFI with the choice to be incorporated as a company and then become an NBFC or a Bank. The latter requires a license and a minimum start up equity of Rs100 crores, which is very difficult for an MFI to mobilise. The concept of Local Area Bank, with a lower start up capital of Rs 5 crores, has not yet been operationalised by the government. If an MFI opts to become an NBFC, it has the following problems

- The minimum entry-level capital requirements is Rs 2 Crores, wef April 1999.
- It is difficult to mobilise any borrowings from Indian Financial Institutions due to the negative image of NBFCs in general. Further, even deposit mobilisation is not possible at least for the first three years, till a satisfactory credit rating is obtained.
- That leaves the option of borrowing from foreign institutions, which is difficult in the first place, due to RBI’s requirement of at least two credit ratings. Further, very few foreign institutions are willing to give rupee denominated loans. Thus the MFI taking foreign currency loans are subject

to exchange risks, which they cannot handle.

6.2 Lack of Commercial Orientation

Striving to make the customers credit available at low cost with subsidies and grants, most of the alternate MFIs achieve a lot of success in their programs in the initial period, but they fail to maintain the same record in the long run because of lack of commercial orientation thus making it unsustainable.

6.3 Lack of Proper Governance and Accountability

Governance and accountability are limited in case of non-profits and need to be improved. Their boards must be made aware of their financial liabilities in case of failure. The lenders should be more stringent and insist on nominating a few directors.

6.4 Isolated and Scattered

The alternate MFIs are isolated and scattered. There is no proper coordination among them and also there is lack of information dissemination.

7. Moving Forward

Most of the issues stated above are being tackled at various levels and the initiatives if successful, could substantially remove these hurdles. Over the last few years, the Government of India has been encouraging micro-finance as an alternative to IRDP type of poverty alleviation programs because of the sustainability of micro-finance activities. In the last two Budget Speeches, the Finance Ministers have talked about the need to enhance the reach of the MFIs. The RBI also made a special mention of micro-finance in its credit policy announced in April 1999. The RBI has established a micro-credit cell; NABARD has set up a Micro-credit Innovations Department, while HUDCO is also formulating a similar plan. The issue of inappropriate legal form for MFIs is being addressed by a Task Force setup by the Reserve Bank of India, which among other things is looking into the regulatory and legal issues concerning microfinance in India.

An increasing number of MFIs have begun to address the issue of financial sustainability of their programs and have started taking effective steps towards achieving sustainability. Many of them have increased their interest rates, at least to cover their costs. Some of them have taken steps to convert themselves into for-profit corporations and have sought commercial investors to invest in them. These will not only make microfinance more commercially oriented but will also increase the quality of governance.

Another welcome development in the Indian micro-finance sector in recent years has been the establishment of networks of micro finance practitioners. These networks not only help in creating awareness but also help in formation, experience sharing etc. These could also develop into a Self Regulatory Organisation of microfinance institutions.

8. Conclusion

After the pioneering efforts of the last ten years, the microfinance scene in India has reached a take-off point. With some effort substantial progress can be made in taking MFIs to the next orbit of significance and sustainability. This needs innovative and forward-looking policies, based on the ground realities of successful MFIs. This, combined with a commercial approach from the MFIs in making microfinance financially sustainable, will make this sector vibrant and help achieve its single-minded mission of providing financial services to the poor.

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