Micro Finance: Problems and Prospects

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Abstract:

Microfinance has been recognized world over as one of the new development paradigms for alleviating poverty through social and economic empowerment of the poor, particularly women. Experiences of different antipoverty and other welfare programmes worldwide have shown that the key to success lies in the evolution and participation of community based organizations at the grassroots level. Linking of formal credit institutions to borrowers through group approach have been recognized as a supplementary mechanism for providing credit support to the rural poor.

Microfinance refers to small scale financial services for both credit and deposits that are provided to people who farm or fish or herd; operate small or micro enterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools in both rural and urban areas. It is now recognized that providing efficient micro finance services to poor and low income households is important for a variety of reasons.

(i) Microfinance can be a critical element of an effective poverty reduction strategy by enabling the poor to smooth their consumption, manage risks better, build their assets gradually, develop their micro enterprises, enhanced their income earning capacity, and enjoy an improved quality of life.
(ii) Micro finance can provide an effective way to assist and empower poor women.
(iii) Micro finance can contribute to the development of the overall financial system through integration of financial markets.

Hence, we can say that micro finance acts as a catalyst in the lives of the poor. It has helped them achieve a reasonable rise in their income level and improve their standards of living. Thus, micro finance is expected to play an important role in

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promoting financial inclusion and inclusive growth. However, there is a large gap in the demand and supply of credit to the poor. As per some estimates, the credit support for poor households in India has been assessed at about Rs. 4, 50,000crore. Some of the micro level studies indicate that the poor still continue to depend on informal sources of credit, accounting for 40 % to 60 % of the household demand. There are, however, several challenges faced by the micro finance system, some of them are:

(i) Regional disparities of growth
(ii) Problem of quality of SHGs
(iii) Imparting training on banks, SHGs Members
(iv) Capacity building of Mfis.

Introduction:

Microfinance refers to the provision of financial services on a small scale to the rural and urban poor, including the self-employed. Financial services generally include savings and credit; however some microfinance institutions also provide additional services like technical assistance. Microfinance activities usually involve small loans typically for working capital; informal appraisal of borrowers and investment; collateral substitutes such as group guarantees or compulsory saving; access to repeat and larger loans based repayment performance; and securing savings products. Microfinance is not simply banking, it is a development tool.

The microfinance industry in India emerged in the 1970’s to provide poor people with access to credit without resorting to the usurious interest rates fixed by informal moneylenders. Because of their weak asset base, poor people are generally unable to fulfill loan guarantees requested by traditional banks and remain trapped in a vicious circle of low income, low investment and low revenue.

Micro finance – concept and evolution:

The concept of microfinance is not new. Savings and credit groups that have operated for centuries include the "susus" of ghana, "chit funds" in India, "tandas" in mexico, "arisan" in indonesia, "cheetu" in sri lanka, "tontines" in west africa, and "pasanaku" in bolivia, as well as numerous savings clubs and burial societies found all over the world.

In bangladesh, professor muhammad yunus addressed the banking problem faced by the poor through a programme of action-research. With his graduate students in chittagong university in 1976, he designed an experimental credit programme to serve them. It spread rapidly to hundreds of villages. Through a special relationship with rural banks, he disbursed and recovered thousands of loans, but the bankers refused to take over the project at the end of the pilot phase. They feared it was too expensive and risky in spite of his success. Eventually, through the support of donors, the grameen bank was founded in 1983 and now serves more than 4 million borrowers.

In India, however, financial services especially for the rural poor also had a parallel evolution, starting from the earliest cooperative societies in 1890 to the burgeoning microfinance sector of today, dominated by self help groups (shgs), which have emerged as micro level financial intermediaries.

The shg – bank linkage programme was formally launched by the nabard in the year 1992, with it circulating guidelines to banks for financing self help groups (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 more and more shgs in the coming years. This encouraged the reserve bank of India (rbi) to include financing to shgs as a mainstream activity of banks under their priority sector lending in 1996. The government of India bestowed national priority to the programme through its recognition of microfinance and it found a mention in the union budget of 1999. 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 poor.

Some recent developments

The year 2004 has seen some very important development in the microfinance sector in India. The banking sector led by ICICI bank has shown interest in microfinance as a viable commercial opportunity. The total disbursement of the banking sector to microfinance is put at around rs1000 crores for the year 2003-04. ICICI bank plans to build a microfinance portfolio in excess of rs1000 crores. It has taken a lead in establishing innovative partnerships with microfinance institutions which will allow for risk sharing between the two. ICICI bank has also securitized the microfinance portfolio of share and basic, and has potentially opened the doors of capital markets for the microfinance sector. Microfinance sector in India is set to enter a new growth phase in its evolutionary course.

Micro finance models:

In the post-nationalization era, the banking system in India witnessed unprecedented growth and achieved phenomenal outreach. However, empirical studies in the 1980's revealed that a very large number of poorest of the poor continue to remain outside the reach of the formal banking system. It was realized that the existing banking policies, systems and procedures and deposits and loan products were not well suited to meet the credit needs of the poor. Apart from the existing banking network, with a view to developing supplementary credit delivery system that is cost-effective and user friendly for both banks and the poor, micro finance initiatives were encouraged in India.

Microfinance initiatives are now recognized as a cost effective and sustainable way of expanding outreach of the banking system to the rural poor.

There are two major models under microfinance i.e., self help group (shg) – bank linkages and microfinance institutions (mfi) - bank linkages being operated in the country.

Self-help group (shg) - bank linkage program (model- i)

The shg – bank linkage programme was started as an action research project in 1989 which was the offshoot of a nabard initiative during 1987 through sanctioning Rs 10 lakh to myrada as seed money assistance for experimenting credit management groups. In the same year the ministry of rural development provided pradan with support to establish self-help groups in Rajasthan. The experiences of these early efforts led to the approval of a pilot project by nabard in 1992. The pilot project was designed as a partnership model between three agencies, viz., the shgs, banks and ngos. This was reviewed by a working group in 1995 that led to the evolution of a streamlined set of rbi approved guidelines to banks to enable shgs to open bank accounts, based on a simple "inters" agreement. This was coupled with a commitment by nabard to provide refinance and promotional support to banks for the shg - bank linkage programme. Initially there was a slow progress in the programme up to 1999 as only 32,995 groups were credit linked during the period 1992 to 1999. Since then the programme has been growing rapidly and the number of shgs financed increased from 81,780 in 1999-2000 to more than 6.20 lakh in 2005-06 and 6.87 lakh in 2006- 07.

year	no. Of shgs financed during the year (in lakh)	Cumulative no. Of shgs financed (in lakh)
2001-02	1.98	4.61
2002-03	2.56	7.17
2003-04	3.62	10.79
2004-05	5.39	16.18
2005-06	6.20	22.38
2006-07	6.87	29.25

Nabard, in association with gtz, conducted a study, in 2005, on the comparative performance of shg – bank linkage programme vis-à-vis other priority sector credit. The findings are based on the data received from 27 commercial banks, 192 rrbs and 114 cooperative banks participating in the programme. One of the important observations of the study was that 1.44 million shgs had loans outstanding of Rs. 4,200 crore with the banking system. 2.63 million shgs had saving accounts with the banks and the savings outstanding was Rs. 2,391 crore.

To cover all the 50 million odd poor households in India, the existing number of shgs will have to be more than doubled and the extent of credit to the members of each shg will have to be increased substantially.

Positive features of the shg - bank linkage programme:

The financial inclusion attained through shgs is sustainable and scalable on account of its various positive features. The programme confronts many challenges and for further scaling up, these challenges need to be addressed.

Financial inclusion of poor women:

The committee noted that more than 90% of the members of shgs are women and most of them are poor and asset less. The shg movement has been instrumental in mainstreaming women by-passed by the banking system.

Loan repayments:

One of the distinctive features of the shg - bank linkage programme has been very high on-time recovery. As on june 2005, the on-time recovery under shg - bank linkage programme was 90% in commercial banks, 87% in rrbs and 86% in cooperative banks.

Mfis- bank linkages (Model II)

The Mfis model has gained significant momentum in India in recent years and continues to grow as the viable alternative to shgs. In contrast to an shg, an mfi is a separate legal organization that provides financial services directly to borroweRs. Mfis have their own employees, record keeping and accounting systems and are often subject to regulatory oversight. Mfis require borrowers from a village to organize themselves in small groups, typically of five women, that have joint decision making responsibility for the approval of member loans. The groups meet weekly to conduct transactions. Mfi staff travel to the villages to attend the weekly group meetings to disburse loans and collect repayments. Unlike shgs, loans are issued by Mfis without collateral or prior savings. Mfis now exist in a variety of legal forms, including trusts, societies, cooperatives, non-profit nbfcs registered under section 25 of the companies act, 1956, or section 25 companies, and nbfcs registered with the rbi. Trusts, cooperatives and section 25 companies are regulated by the specific act under which they are registered and not by the rbi.. Attempts have been made by some of the associations of Mfis like sa-dhan to capture the business volume of the Mfi sector. As per the bharat micro finance report of sa-dhan, in march 2009, the 233 member Mfis of sa-dhan had an outreach of 22.6 million clients with an outstanding microfinance portfolio of INR 117 billion ($ 2.5 billion).

ICICI bank began to experiment with the micro finance institution (Mfi) as a substitute for the more granular self help group. The Mfis were willing to take on the risk of the financial performance of the groups/ individuals that were being lent to. Therefore the stake in good quality group formation was also built in. Also, this channel was better for leveraging large amounts of funds without necessarily having a grassroots level presence of the bank staff. The mfi would undertake the processes and operationalization in terms of group formation, cash management, disbursal and recovery, and also record keeping. The bank would lend to the mfi on the basis of its balance sheet and portfolio performance and the mfi would repay the bank.

The Mfi-bank linkage model paved the way for taking a wider range of services to the financially underserved populace. These financial services include provision of micro insurance tailored to the cash flows and insurance needs of the low-income clients. The micro insurance ensured the end client a support in case of accidents/ disablement as well as loan insurance in case of death. This was a significant step towards reducing household vulnerabilities.

The intermediation model at first looked scalable, but there seemed to be constraints in this model as well. For instance there was a double charge on capital created, once at the level of the bank lending to the mfi and secondly at the level of the mfi on lending to the client. This seemed to be a sub optimal lending structure due to the double counting that also, because the small balance sheet size, unduly affected the risk perceived about the Mfi, even if it had very robust systems and processes. Other key challenges to performance were that the Mfis could not grow and scale as fast as their capabilities would permit, because of severe capital constraints. Most Mfis had potential access to large debt funds, but because of their small size balance sheet (which would represent the very limited initial capital of the promoters); they were constrained to operate with limited debt funding. In the complete absence of equity investors in the microfinance institutions, there was hardly any scope for the mfi to scale up rapidly.

Microfinance future movement in India: issues challenges and strategy:

Although the importance of microfinance in the process of poverty eradication is realized, it faces multiple problems. This is because offering credit to the poor is a complicated process and the sector is still in its experimental stage.

Perceived high risk of micro entrepreneurship and small businesses:

Micro entrepreneurs usually have no collateral to offer to microfinance providers against loans, they usually lack an alternate source of income, and have little, if any, formal education or training in the area of their business. As a result, commercial banks attribute a high credit risk to micro entrepreneurs and steer clear of this sector.

High costs involved in small transactions/micro lending:

The small size of micro enterprises increases the transaction cost for Mfis because they cannot process loans in bulk (unless good management information systems are in place). This denies Mfis the benefit of economies of scale; hence, they are forced to cover their costs through high interest rates on loans.

According to a study conducted by Asian development bank, microfinance providers in the asia-pacific region charge interest rates on micro-sized loans ranging from 30 to 70% a year, which is much higher than rates offered by commercial banks (fernando, 2006). However, there are instances where the interest rates charged were too low for the Mfis' sustainability.

Lack of debt and equity funds for Mfis to pass on to the poor:

Capital availability for microfinance is hardly a problem owing to the rapid growth in the microfinance sector, which has been fueled by attention from the media and development agencies. Even though there are plenty of financing options available for Mfis, there is an emerging shortage of money because of the current financial crisis across the globe. Another reason for this shortfall is the lack of awareness of funding sources by mfi managers.

Difficulty in measuring the social performance of Mfis:

Microfinance is delivering the economic returns its proponents promised, but there are only a handful of tools available that measure the social return of loan programs for the poor. To add to the problem, the tools use proxies to estimate the amount of poverty and social change surrounding micro entrepreneuRs. This makes the gathering of funds a challenge because donors may question the actual impact made my microfinance.

Mixing charity with business:

Since credit without strict discipline is nothing but charity (professor yunus), if microfinance providers fail to protect themselves against loan delinquency, they will, in effect, prioritize social objectives at the expense of financial sustainability.

Improper delinquency management is a result of inadequate implementation of corporate governance principles, and formal as well as semi-formal microfinance providers often suffer from this. As a result, looser controls over microfinance deals will lead to higher default rates. Read more about the difficulty in mixing charity with business.

Lack of customized solutions for the poor:

Inappropriate targeting of poor households by microfinance programs is a common problem because Mfis fail to understand the varied needs of micro entrepreneuRs. Mfis must spend time in the field with their clients and his/her business, and then use this research to develop customized microfinance tools for each micro entrepreneur.

Lack of microfinance training for human resource in microfinance institutions

Working in the microfinance sector is a different ball game compared to the traditional financial sector. For instance, microfinance officers and volunteers need to talk a different language, build lasting relationships with individual micro entrepreneurs, understand the unique needs of the poor, evaluate the borrower's sustainability, and grasp the cultural nuances of the borrower's communities.

Poor distribution system of microfinance institutions and lack of information about microfinance investment opportunities:

There are over 10,000 Mfis across the world, but their reach is only 4% of the potential market. The reasons are; firstly, microfinance providers may be complacent with their client base in certain cities and feel no economic need (ignoring the social need to eradicate poverty) to spread out their distribution system to cater to the poorest of households. Secondly, micro entrepreneurs are sprawled over large geographical areas, often in remote places, which often make them inaccessible to Mfis. This is a slight problem because even though there are over 10,000 Mfis around the world, they may not know about the existence and needs of certain micro entrepreneurs.

Dual mission of microfinance institutions to be financially sustainable as well as development oriented:

Microfinance providers tend to forget their main objective is social development and not profit creation. The principle of 'one micro entrepreneur – one micro loan' is overlooked by profit-hungry Mfis who end up targeting the same individual for many loans and cause multiple borrowing (also known as credit pollution). This is a major problem because at the end of the day, that individual gets burdened by mounting interest payments and is pushed deeper into the folds of poverty. Poor governance on the side of Mfis as well as the micro entrepreneur is to blame for this.

All these problems can broadly fall into either financial or operational in nature and we can therefore see that they should not be impossible to solve as the microfinance sector moves towards it optimal performance level in the next several years. In other words, despite these problems, the prospects of microfinance are quite bright. In the coming weeks, we will look at potential solutions to all these problems, which aren't difficult to adopt (a couple have been already been mentioned above).

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 a larger share of the poor, the coverage is comparatively low. The skewed distribution is attributed to

- The overzealous support extended by some the state governments to the programme;
- Skewed distribution of ngos and;
- Local cultures & practices. 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 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.

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 program, 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 the assessment, significant financial investment and technical support is required for meeting this challenge.

Mfis: critical issues:

Mfis can play a vital role in bridging the gap between demand & supply of financial services if the 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 & 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 we know that, the micro finance development fund (mfdf), set up with nabard, has been augmented and re-designated as the micro finance development equity fund (mfdef). This fund is expected to play a 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. We 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 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 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 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.

Group loans to shgs and shg loans to members:

The average loan provided to shgs by the banks for the last three years is

Presented in the following table:

Year	No. Of shgs financed		Bank loan (Rs. Crore)		Per group loan (Rs.)	
	New	existing	New	existing	New	existing
2003-04	361731	171669	1157.74	697.74	32005	40644
2004-05	539365	258092	1726.60	1267.60	32012	49114
2005-06	620109	344052	2330.45	2168.63	37581	62949

During the year 2005-06, the average loan provided to new shgs was Rs. 37,581. On an average, per member loans work out to less than Rs. 4,000. Many believe that such loan amounts are grossly inadequate for pursuing any meaningful livelihood activity. Per capita loans in mature shgs are increasing very gradually. It has also to be kept in view that members take very short term loans of 3 to 6 months on many occasions and there can be more than one cycle of borrowing/ repayment in one year.

Cost recovery and sustainability:

It is important for banks to carefully work out their actual costs for shg lending. While the shg portfolio is often only a small part of the total bank lending, and since the portfolio quality is good, it may be possible to reduce interest rates while ensuring recovery of costs.

In the initial phase of the shg movement, the groups were formed by ngos and hence start-up costs were low for banks. However, over the years, banks have also evolved as shpis. In the process, the start-up costs of group formation, etc. Have devolved on the banks, impacting their pricing policies.

It is an accepted fact that banks will base their lending rate decisions on three important criteria – their cost of funds, transaction costs and the required spreads. While the sources of funds will determine the cost of funds, the transaction costs will depend mostly on the efficiency with which the transfer of funds is enabled.

At present, banks do not incur incremental costs for lending to shgs, as it is done through the existing branch network. Shg lending to members has been reportedly at interest rates ranging between 15% and 24%. While this has been considered high, it is also reported that members borrow for short periods and do not feel the annualized burden of interest rates. Further, the interest income of shgs is ploughed back into the corpus for lending and is beneficial to all members.

Regional imbalances:

The spread of the shg - bank linkage programme in different regions has been uneven on account of various factors like pro-active role of state governments, presence of well performing ngos, socio-cultural factors, better performance of shgs, etc. In March, 2001, 71% of the linked shgs were from southern region consisting of andhra pradesh, karnataka, kerala and tamil nadu. The share of southern region has come down progressively over the years but it is still at 44%. Many states such as uttar pradesh and bihar with high incidence of poverty have shown poor performance under the programme.

One of the major concerns was the slow progress of the shg bank linkage movement in the north-eastern and central parts of the country. It was even argued in some quarters that the shg strategy was not suitable to the social configurations that prevailed in the north-east. As a result of the special efforts made by nabard, progress in the regions / states where imbalances and low performance had been observed has picked up considerably, as detailed in the following table:

Region/state	Development of cumulative nos. Of shgs financed					
	March 2001	March 2002	March 2003	March 2004	March 2005	March 2006
North east	477	1490	4069	12278	34238	62517
Kalahandi	4192	9869	18934	31372	45976	64550
Orissa	8888	20553	42272	77588	123256	180896
West bengal	8739	17143	32647	51685	92698	136251
Bihar	4592	3957	8161	16246	28015	48138
Jharkhand	0 *	4198	7765	12647	21531	28902
Uttar pradesh	23152	33114	53696	79210	119648	163439
Uttaranchal	0 *	3323	5853	10908	14043	16060
Rajasthan	5616	12564	22742	33846	60006	98171
Himachal pradesh	2545	5069	8875	13228	17798	22920
Madhya pradesh	5699	7981	15271	27095	45105	58912
Chattisgarh	0 *	3763	6763	9796	18569	29504
Maharashtra	10468	19619	28065	38535	71146	131470
Gujarat	4929	9496	13875	15974	24712	34160
All India	263825	461478	717360	1079091	1618456	2238565

- Included in the undivided state

Conclusion:

It has now recognized that micro finance is much more than micro credit, and the emergence of Mfis served as a mechanism for achieving the task of provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi- urban and or urban areas for enabling them to raise their income levels and improving living standards. Further, some critical issues have to be resolved in the context of growing demand for micro finance services in a country like India. The foremost issue still finds a place is are poorest included in shgs? Secondly, has the shg experiments been spread throughout the country? Thirdly, should shg movement be gender sensitive in the sense more women are actively joining this new recent movement on large scale and why? And finally, what should be the ideal criteria, i.e., should homogeneity be the criteria of group formation in future also?

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