Microfinance in India: A critique
by Rajarshi Ghosh

Abstract: The article traces the evolution of the Microfinance revolution in India as a powerful tool for poverty alleviation and women empowerment. Where institutional finance failed Microfinance delivered, but the outreach is too small. There is a question mark on the viability of the Microfinance Institutions. There is a need for an all round effort to help develop the fledgling Microfinance Industry while tackling the tradeoff between outreach and sustainability.

This article is based on secondary data sources (duly acknowledged in the article) and a Field Survey carried out by the Author in the villages of Duttapulia, Gola ,Haridanga, Beladanga, Khushberia, Balia, Baranberia and Shindrani.(Villages in Nadia district of West Bengal)

Section I: Introduction

'Microfinance refers to small scale financial services for both credits and deposits- that are provided to people who farm or fish or herd; operate small or micro enterprise 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; and to other individuals and local groups in developing countries in both rural and urban areas'- Marguerite S. Robinson.

The Indian state put stress on providing financial services to the poor and underprivileged since independence. The commercial banks were nationalized in 1969 and were directed to lend 40% of their loan able funds, at a concessional rate, to the priority sector. The priority sector included agriculture and other rural activities and the weaker strata of society in general. The aim was to provide resources to help the poor to attain self sufficiency. They had neither resources nor employment opportunities to be financially independent, let alone meet the minimal consumption needs.

To supplement these efforts, the credit scheme Integrated Rural Development Programme (IRDP) was launched in 1980. But these supply side programs (ignoring the demand side of the economy) aided by corruption and leakages, achieved little. Further, 'The share of the formal financial sector in total rural credit was 56.6%, compared to informal finance at 39.6% and unspecified sources at 3.8%. [RBI 1992]. Not only had formal credit flow been less but also uneven. The collateral and paperwork based system shied away from the poor. The vacuum continued to be filled by the village moneylender who charged interest rates of 2 to 30% per month (Rural Credit and Self Help Groups- Microfinance needs and Concepts in India- K.G.Karmakar 1999). 70% of landless/marginal farmers did not have a bank account and 87% had no access to credit from a formal source.(World Bank NCAER, Rural Financial Access Survey 2003)

It was in this cheerless background that the Microfinance Revolution occurred worldwide. In India it began in the 1980s with the formation of pockets of informal Self

Help Groups (SHG) engaging in micro activities financed by Microfinance. But India's first Microfinance Institution 'Shri Mahila SEWA Sahkari Bank was set up as an urban co-operative bank, by the Self Employed Women's Association (SEWA) soon after the group (founder Ms. Ela Bhatt)was formed in 1974.

The first official effort materialized under the direction of NABARD.(National Bank For Agriculture And Rural Development).The Mysore Resettlement and Development Agency (MYRADA) sponsored project on "Savings and Credit Management of SHGs was partially financed by NABARD during 1986-87.['Mainstreaming of Indian Microfinance'- P.Satish, 2005]

Section II: MFIs, Self Help Groups , Income Generation and Women Empowerment

Under the microfinance programme, loans are extended to the 'Self Help Groups (SHG)' who pool a part of their income into a common fund from which they can borrow. The members of the group decide on the minimum amount of deposit which ranges from Rs 20 to Rs 100 per month depending upon the size of the group. The group funds are deposited with a Micro Finance Institution (MFI) against which they usually lend (The deposits are usually placed with a bank by the MFI) at a credit deposit ratio of 4:1 but the ratio improves with account performance record i.e. prompt repayment of loans. The group funds is the way 'micro savings' are enforced ,though it may seem like a collateral .The loan ticket sizes are usually Rs 2000/- to Rs 15,000/-(Source: Field Survey by Author and Impact Assessment of Microfinance in India- Frances Sinha and the impact assessment team: EDA Rural Systems Pvt. Ltd, Gurgaon, 2003),

The MFIs stress on asset creation by the SHGs and extend loans for production and provides training for the same. If any member needs credit beyond the stipulated limits they are allowed to draw from group funds and the amount is settled in the periodic (monthly) group meetings. SHGs consisting of poor members with identical socio-economic backgrounds are usually more sensitive to the credit needs of the poor.

Though loan repayment is a joint liability of the group but, in reality, individual liability. is stressed upon. Maintaining group reputation leads to the application of tremendous peer pressure.

In India and other Asian countries the majority of SHGs consist of women because, in these countries, Self Employment through Microfinance was perceived as a powerful tool for emancipation of women. It has been observed that gender equality is a necessary condition for economic development. The World Bank reports that societies that discriminate on the basis of gender are in greater poverty, have slower economic growth, weaker governance, and lower living standards. (World Bank. Engendering Development: Through Gender Equality in Rights, Resources, and Voice—Summary. (Washington: World Bank, 2001) www.worldbank.org/gender/prr/engendersummary.pdf.)

And the results are encouraging. Loans obtained from MFIs are utilized in agriculture and small businesses. Independent incomes and modest savings have made women self confident and helped them to fight poverty and exploitation. [Sampark (2003) 'Mid-Term Impact Assessment Study of CASHE Project in Orissa].

"Previously we had to cringe before our husbands to ask for one rupee. We do not have to wear tattered sarees anymore and, today, we have the confidence to come and talk to you without seeking permission from our husbands"-As told to the author in the Field Survey.

Women's indicators of empowerment through microfinance

- Ability to save and access loans
- Opportunity to undertake an economic activity
- Mobility-Opportunity to visit nearby towns
- Awareness- local issues, MFI procedures, banking transactions
- Skills for income generation
- Decision making within the household
- Group mobilization in support of individual clients- action on social issues
- Role in community development activities

Source: Impact Assessment, Frances Sinha (2003)

Women, the world over, tend to spend increasing proportion of their income on the welfare of the family . The same phenomenon is observed among women made self sufficient by micro finance. These findings get corroborated in the field survey of the author. "We can now put our children in school" (Field Survey) .Though instances of husbands of women being the real beneficiaries and women taking a back seat after the loan is sanctioned is also there. [K.G.Karmakar]. However, the author, during the survey, witnessed a novel way the issue had been tackled by Sreema Mahila Samity, a very active NGO engaged in providing Microfinance in West Bengal. They simply created Self Help Groups for men and enabled them to borrow and engage in micro activities on their own. This way, the family's income improved without disturbing the inner harmony.

Section III: Financing the SHGs

The financial needs of the SHGs are catered to by various financial institutions: the Commercial Banks, Co-operative Banks, Co-operative Credit Societies and Regional Rural Banks (RRB). There are around 94000 Co-operative outlets, 14000 branches of the RRBs and 33,000 suburban branches of the commercial banks. (Financial Services for Low Income Families: An Appraisal, by Sanjay Sinha 2003) They finance the SHGs directly or route their funds through a Microfinance Institution set up by an NGO (NGO-MFI) or Non-Banking Financial Companies (NBFC).

The NGO-MFIs (the major source of MFIs in India) disburse loans from the line of credit which is provided to them by a Financial Institution. The advantages of intermediation of funds through NGOs are manifold: It leads to reduction in time of identification of creditworthy people, documentation and recovery. The fall in transaction costs is not less than 40 %.(K.G.Karmakar).

Along with developing saving and credit facilities, the NGOs engage in:
(1)Providing Basic Education
(2) Developing a sense of Health and Hygiene
(3) Encourage family planning.
(4) Creating Awareness about environment protection
(5)Most important, nurturing an environment of gender equality.

These activities are the rudiments of sustained economic development.

Basically, the MFIs in India are of three categories: (i) Not for profit MFI, which include the NGOs (ii) Mutual Benefit MFIs, which include mutually-aided co-operative credit and (iii) for Profit MFIs, which include the Non-Banking Financial Companies (NBFC).

Legal Forms of MFIs in India

Types of MFIs	Estimated number *	Legal Acts under which registered
1. Not for Profit MFIs a. NGO-MFIs	400 to 500	Societies Registration Act, 1860 or similar Provincial Acts. Indian Trust Act, 1882.
b. Non-profit companies	10	Section 25 of the Companies Act, 1956
2.Mutual Benefit MFIs: Mutually Aided Co-operative Societies(MACs)and similarly set up institutions	200 to 250	Mutually Aided Co-operative Societies Act enacted by State Government.
3. For Profit MFIs	6	Indian Companies Act, 1956. Reserve Bank of India Act, 1934.
Total	700 to 800	

* The estimated number is of those MFIs actually engaged in credit disbursement
[*Source: Adapted from the Report of the Task Force on Supportive Policy and Regulatory Framework for Microfinance (NABARD 1999) and updated]*

NABARD refinances the Financial Institutions engaged in micro finance, to the extent of actual disbursement. NABARD, SIDBI are 'bulk financiers', who cleverly leverage resources obtained from a variety of sources (donors, government, market) for rural finance including microfinance. If one carefully analyses the Financial Institutions (FIs) refinanced by NABARD (as shown in the next table) one can have an idea of the relative roles played by each in the financing of SHGs.

Contribution of Different segments of FIs in the SHG movement

Bank	Cumulative No of SHGs provided with bank loan upto March 2001	Cumulative No of SHGs provided with bank loan upto March 2004
Total public sector bank	118855	516697
Total private sector bank	5391	21725
Regional Rural Bank	84775	405998
Co-operatives	12773	134671
Total	221794	1079091
SHARE(per cent)		
Total public sector bank	53.6	47.9
Total private sector bank	2.4	2.0
Regional Rural Bank	38.2	37.6
Co-operatives	5.8	12.5

Source: NABARD

"The program of linking Self Help Groups with the banking system has emerged as the major microfinance programme in the country. 560 banks including 48 commercial banks, 196 Regional Rural Banks and 316 co-operative banks are now actively involved in the programme."- India's Finance Minister in his Budget speech (February 2005) for the year 2005-06.

Section 4: Outreach and Sustainability of Microfinance

In spite of the optimism generated by the expansion of SHG credit and the high recovery rate (According to NABARD 2003-04 report on SHG bank linkage it was more than 95 %.) there is a gap between actual per capita credit provided to the poor and the demand.
The out standings of the SHG programme in March 2003 were around Rs 10 billion which met only 2.2% to 6.6% of the projected demand.[Mahajan Vijay and Bharti Gupta Ramola (2003); 'Microfinance in India –Banyan Tree and Bonsai']. The total disbursement of bank loans to SHGs were Rs 2049 crore as on 31st March 2003 with an average loan of Rs 28,559 per SHG and Rs 1766 per family [RBI(2003): Report on Trend and Progress of Banking in India, 2002-03]. The share of micro credit in total credit of the Indian banking system was less than 1 %(The Transforming World of Indian Microfinance-Tara S.Nair, 2005). Further, the distribution of Micro finance in India was highly skewed, with 65% of the SHGs being in Southern India and these SHGs were enjoying 75% of the credit disbursed. (Exploring Possibilities – Microfinance and Rural Credit Access for the poor in India- Priya Basu and Pradeep Srivastava, 2005).

Though there is limited data on the accessibility of the poor in India to Microfinance programmes, available evidence suggests that 80% of the poor do not have any savings and 91% are without any formal credit. [EDA (2004): The Maturing Indian Microfinance: A Longitudinal Study; EDA Rural System]. In fact the 'poorest of the poor' are excluded and this was felt by the author also during the field survey. The logic of the author is simple; the effective rates of interest charged by the MF institutions are in the range of 14 to 36% p.a. (Frances Sinha (2003), Author's Field Survey). In fact, the author observed a monthly interest rate of 1.5%, the annual compounding rate can be calculated by the reader.

In a country of one billion, where 25% of the population (As on 1st January, 2004 as per the CIA World Fact book) are below the national poverty line, and even among those above the poverty line , very few can afford to pay these kinds of interest rates. They may be able to only at a great cost and upto a limited time. One reason why high interest rates prevail is because timely availability of credit is more important than cost of credit per se.[A popular notion is that the poor constitute a huge market for FMCG products. While surveying the author observed that it is the upper crust of the poor, the beneficiaries of Microfinance and the bearers of these interest rates, who are the real consumers of FMCG goods. But whether this constitutes a huge market is a debatable issue and beyond the scope of this paper.]

Poverty Line

As per the Government of India, poverty line for the urban areas is Rs. 296 per month and for rural areas Rs. 276 per month, i.e. people in India who earn less than Rs. 10 per day. As per GOI, this amount will buy food equivalent to 2200 calories per day, medically enough, to prevent death.
(http://www.wakeupcall.org/administration_in_india/poverty_line.php)

The World Bank's definition of the poverty line, for emerging economies, like India, is US$ 1/day/person or US $365 per year.

Morduch Jonathan(1999) :The Microfinance Promise pp 1569-1614 in Journal Of Economic Literature, 37 (December) defines 'Microfinance schism' meaning that the majority of the poorest cannot pay high interest rates regularly, in which case it is a choice between self sufficiency and targeting the poor.

The flip side to this argument is that the interest rates charged by the Microfinance Institutions has had a tremendous beneficial effect in bringing down the interest rates charged by the moneylenders from 2 to 30% (K.G.Karmakar)per month to an uniform level of 3 to 5% per month. (Field Survey)The rates came down because with the appearance of the Microfinance Institution all the villagers migrated to it en-masse and the village money lender, sitting with idle money had no choice but to bring down the lending rate. (MFI can be called a much benign moneylender.) It has been reported that some researchers analyzing other pockets of SHG movement across India have come to identical conclusions.

Even after charging high rates of interest the 'financial spread being earned by the average MFI in India is barely 11% leaving a 7.5% gap between it and the operating expense level of 18.5% of average portfolio'(Sanjay Sinha: Financial Services for Low

Income Families: An Appraisal, 2003). Naturally, they have to look upon donors for assistance. It was observed that 28% of the funds of MFIs are soft loans provided by development banks and dedicated microfinance wholesalers [Fisher, Thomas and M.S. Sriram (2002): Beyond Micro-Credit: Putting Development Back into Microfinance} .It was estimated that not even 10% of the MFIs in the Asia-Pacific region had achieved break even, let alone generate surplus. [Goodwin-Groen, Ruth (1998): 'The Role of Commercial Banks in Microfinance in the Asia-Pacific Region.']

Section 5: The Need To Go Ahead

A way out is expansion of scale of operations which can bring down the average operating expenses. The major factor holding up scaling of operations is cited to be lack of funds.

Majority of MFIs would like to be converted to NBFCs which would enable them to raise public deposits for on lending. A big deterrent is the startup capital of Rs 20 million required to register as an NBFC which is beyond the reach of many MFIs. But this requirement is part of the regulatory apparatus of RBI to ensure the issue of safety of public money. But MFIs need liquidity also. Hence, they should be allowed to borrow public money with adequate safeguards like deposit insurance with banks. MFIs also want to have more freedom in raising equity capital .They face difficulties in raising equity, because NGOs are not allowed to invest in MFI equity, because of the charitable status of NGOs under the Sections 11 and 12 of the Income Tax Act. (Priya Basu et.al)One good measure of late is NGO-MFIs have been allowed to raise External Commercial Borrowings, where the interest costs are relatively lower, from April 2005. {Reserve Bank of India release April 2005} The stipulations are (1) funds are to be routed through normal banking channels (2) funds to be earmarked for microfinance only and (3)the borrowed amount must be hedged.

Another area of concern is the activities financed by microfinance tend to remain 'micro'. With a loan of Rs 2000/- to Rs 15,000/- and monthly /quarterly installment payments, there is not much scope for expansion of activities. The activities of selling cow milk, goat milk, chicken, fireweed, agriculture on leased land, only provide the poor with the bare minimum. (Field Survey)One way it makes a difference is that when the income generated is added on to the present income of the upper crust of the poor it helps them to transcend the income line, but does not help to develop an asset base. The only solution is to enhance the volume of credit in line with the growth of the productive activities i.e. 'Macro' and not 'Micro' finance is needed for a larger scale of operations. A policy direction may be helpful here.

Further, if for some reason the micro activity does not fetch any return say crop failure due to bad monsoons, the beneficiaries of Microfinance suffer tremendously. In such instances 'Micro insurance' helps in providing a buffer and it is heartening to note that national and private insurance companies are talking steps here.

All said and done, Microfinance remains a powerful tool for development. It may be a drop in the ocean, but it has made people self sufficient. Our task is to spread Microfinance and bring down the cost of capital and the operating costs and strengthen the bonding between Microfinance and the Formal Financial System. However, for sustainable development of the poor and rural economy, we have to focus on development of rural infrastructure and the rural economy, otherwise there will be few activities requiring finance.

Further Readings:

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