A STUDY OF CHANGING FACE OF MICROFINANCE IN INDIA

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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. In this paper we analyze some of the characteristic of microfinance and compare the performance of a microfinance fund. We try to demonstrate that an investment in microfinance can be profitable both from a social and financial standpoint.

Key Words: Microfinance, Microcredit, Microfinance Institutions, poverty

✦ INTRODUCTION:

The most important finding in the last two decades in the world of finance did not come from the world of the rich or the relatively well-off. More important than the hedge fund or the liquid-yield option note was the finding that the poor can save, can borrow (can indeed decide on loans to fellow poor), and will certainly repay loans. This is the world of microfinance. Microfinance is a form of financing where small sums (so-called microcredits) are lent to microenterprises in developing and newly industrialized countries. The borrowers are mostly women, working for example as vegetable sellers, hairdressers or bakers. The start-up capital enables them to build up more secure means of supporting themselves. Microfinance has, however, come to include more than simply granting small loans – micro entrepreneurs are also being offered insurance services, savings accounts and money and payment transfers. The concept of microfinance thus helps people to help themselves and makes an important contribution to fighting poverty in developing and newly industrialized countries.

✦ 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.

✦ THE MAIN FEATURES OF THE MICRO-FINANCE SERVICES ARE :

1. It is a tool for empowerment of the poorest; the higher the income and better the asset position of the borrower, the lower the incremental benefit from further equal doses of micro-credit is likely to be.
2. Delivery is normally through Self Help Groups (SHGs).
3. It is essentially for promoting self-employment; the opportunities of wage employment are limited in developing countries - micro finance increases the productivity of self-employment in the informal sector of the economy - generally used for (a) direct income generation (b) rearrangement of assets and liabilities for the household to participate in future opportunities and (c) consumption smoothing.
4. It is not just a financing system, but a tool for social change, specially for women - it does not spring from market forces alone - it is potentially welfare enhancing - there is a public interest in promoting the growth of micro finance - this is what makes it acceptable as a valid goal for public policy.
5. Because micro credit is aimed at the poorest, micro-finance lending technology needs to mimic the informal lenders rather than the formal sector lending. It has to : a) provide for seasonality (b) allow repayment flexibility (c) eschew bureaucratic and legal formalities (d) fix a ceiling on loan sizes.

✦ 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 annualized credit usage of all poor families (rural and urban) at over ` 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 (` 6000 and ` 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 globalization and liberalization 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.

(A) 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 pump sets, bore wells and livestock in case of farmers, and equipment (looms, machinery) and work sheds 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 Organization (NSSO), 43rd round, which has revealed that there is a wide 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.

(B) 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 cash flows 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 & dash; 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 savings and credit movement in Andhra Pradesh. Almost all women 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 pump sets, 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.

✦ 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 ` 25,000 and ` 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.

✦ MICRO-FINANCE AND POVERTY ALLEVIATION

Most poor people manage to mobilize resources to develop their enterprises and their dwellings slowly over time. Financial services could enable the poor to leverage their initiative, accelerating the process of building incomes, assets and economic security. However, conventional finance institutions seldom lend down-market to serve the needs of low-income families and women-headed households. They are very often denied access to credit for any purpose, making the discussion of the level of interest rate and other terms of finance irrelevant. Therefore the fundamental problem is not so much of unaffordable terms of loan as the lack of access to credit itself.

The lack of access to credit for the poor is attributable to practical difficulties arising from the discrepancy between the mode of operation followed by financial institutions and the economic characteristics and financing needs of low-income households. For example, commercial lending institutions require that borrowers have a stable source of income out of which principal and interest can be paid back according to the agreed terms. However, the income of many self employed households is not stable, regardless of its size. A large number of small loans are needed to serve the poor, but lenders prefer dealing with large loans in small numbers to minimize administration costs. They also look for collateral with a clear title - which many low-income households do not have. In addition bankers tend to consider low income households a bad risk imposing exceedingly high information monitoring costs on operation.

Microfinance institutions can broaden their resource base by mobilizing savings, accessing capital markets, loan funds and effective institutional development support. A logical way to tap capital market is securitization through a corporation that purchases loans made by microenterprise institutions with the funds raised through the bonds issuance on the capital market. There is atleast one pilot attempt to securitize microfinance portfolio along these lines in Ecuador. As an alternative, BancoSol of Bolivia issued a certificate of deposit which are traded in Bolivian stock exchange. In 1994, it also issued certificates of deposit in the U.S.. The Foundation for Cooperation and Development of Paraguay issued bonds to raise capital for microenterprise lending.

Savings facilities make large scale lending operations possible. On the other hand, studies also show that the poor operating in the informal sector do save, although not in financial assets, and hence value access to client-friendly savings service at least as much access to credit. Savings mobilization also makes financial institutions accountable to local shareholders. Therefore, adequate savings facilities both serve the demand for financial services by the customers and fulfil an important requirement of financial sustainability to the lenders. Microfinance institutions can either provide savings services directly through deposit taking or make arrangements with other financial institutions to provide savings facilities to tap small savings in a flexible manner.

Convenience of location, positive real rate of return, liquidity, and security of savings are essential ingredients of successful savings mobilization Once microfinance institutions are engaged in deposit taking in order to mobilize household savings, they become financial intermediaries. Consequently, prudential financial regulations become necessary to ensure the solvency and financial soundness of the institution and to protect the depositors. However, excessive regulations that do not consider the nature of microfinance institution and their operation can hamper their viability. In view of small loan size, microfinance institutions should be subjected to a minimum capital requirement which is lower than that applicable to commercial banks. On the other hand, a more stringent capital adequacy rate (the ratio between capital and risk assets) should be maintained because microfinance institutions provide uncollateralized loans.

Governments should provide an enabling legal and regulatory framework which encourages the development of a range of institutions and allows them to operate as recognized financial intermediaries subject to simple supervisory and reporting requirements. Usury laws should be repelled or relaxed and microfinance institutions should be given freedom of setting interest rates and fees in order to cover operating and finance costs from interest revenues within a reasonable amount of time. Government could also facilitate the process of transition to a sustainable level of operation by providing support to the lending institutions in their early stage of development through credit enhancement mechanisms or subsidies.

One way of expanding the successful operation of microfinance institutions in the informal sector is through strengthened linkages with their formal sector counterparts. A mutually beneficial partnership should be based on comparative strengths of each sectors. Informal sector microfinance institutions have comparative advantage in terms of small transaction costs achieved through adaptability and flexibility of operations. They are better equipped to deal with credit assessment of the urban poor and hence to absorb the transaction costs associated with loan processing.

On the other hand, formal sector institutions have access to broader resource-base and high leverage through deposit mobilization.

✦ <u>MICROFINANCE AND ITS FUTURE DIRECTIONS</u>

It gives me great pleasure to be here with you all this morning and to participate in this Policy Conference on Microfinance in India. The growth of Microfinance in India has reached a stage when future policy options have to be carefully weighed so that this movement can become truly a strong one. I am happy that this Conference is being attended by senior officials from banks, NGOs, MFls, government and academic institutions. An interaction among this select group should produce the desired result. Microfinance has come to mean the provision of credit and other financial services to the poor so that they can reduce their poverty and raise their living standards. Microfinance has the potential to become an important component of successful and sustainable poverty alleviation programme.

Microfinance has become a worldwide movement. By end-2003, about 80 million clients across the world were being serviced by approximately 2900 microfinance institutions. India's share in this global micro credit market is quite impressive.

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

✦ 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.