Role of Micro Finance in the Upliftment and Growth of Rural India

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Abstract

Microfinance provides an effective, equitable way of creating the conditions for long-lasting development. Microfinance and its links with community-based education foster conditions for the poor to have long term access to health, education, improved living conditions, development of enterprise and a means for dealing with emergencies or old age. Globally it is becoming a key step in breaking the poverty trap, especially for women, and is working towards providing financial inclusion to the 80% outside the formal financial services. According to Imp-Act, a global action research programme designed to improve the impacts of microfinance on poverty, the growth of microfinance over the last 10 years has demonstrated that poor people can make use of financial services. The paper focuses on the experience, growth, development and transformation of microfinance organisations (MFO) in India. Microfinance and identify its “value attributes”. Having chosen only those MFOs that have microfinance as the core and their experiences. To understands this concept better, Researcher focused on the issues that trigger the growth and development viz: size, diversity of services, financial sustainability, focus and taxation. This paper deals with Indian experiences in India are not large in number. However, there are three forms of organisations that seem to be popular in the microfinance sector – the Non-Banking Finance Companies, the Banks – both Local Area Banks and Urban Co-operative Banks and the Co-operatives. The conclusion is that there is no ideal or easy path for MFOs to mainstream in India. Sustained focus on microfinance as a powerful tool for achieving the Millennium Development Goals, and for enhancing the freedom and dignity of the poor Sustained political will combined with the creativity and dynamism of the microfinance community can make a profound contribution to ending poverty in India.

Keywords: Micro Finance, Poverty, Change, Transformation, Financial sustainability, Growth, Development, Banks

Introduction

Microfinance provides an effective, equitable way of creating the conditions for long-lasting development. Microfinance and its links with community-based education foster conditions for the poor to have long term access to health, education, improved living conditions, development of enterprise and a means for dealing with emergencies or old age. Globally it is becoming a key step in breaking the poverty trap, especially for women, and is working towards providing financial inclusion to the 80% outside the formal financial services. According to Imp-Act, a global action research programme designed to improve the impacts of microfinance on poverty, the growth of microfinance over the last 10 years has demonstrated that poor people can make use of financial services. There are approximately 3 000 MFIs spread across the world and serving more than 70 million people.

Microfinance presents a win-win vision in that it builds financially self-sufficient organisations that are able to provide financial services on a permanent basis to increasing numbers of poor people. It is thereby possible to have a sustained impact on poverty levels and well-being of clients without having to depend on donor subsidy.

From small efforts of starting informal self-help groups (SHG) to access the much-needed savings and credit services in the early 1980s, the microfinance sector has grown significantly today. The fact that national bodies like Small Industries Development Bank of India (SIDBI) and National Bank for Agriculture and Rural Development (NABARD) are devoting significant time, energy and financial resources on microfinance is an indication of the reckoning of the sector. The strength of the Micro Finance Organisations (MFOs) in India is in the diversity of approaches and forms that have evolved over a period of time. While India has its home-grown model of SHGs, and Mutually Aided Co-operative Societies (MACS) there is significant learning from other microfinance experiments across the world, particularly Bangladesh, Indonesia, Thailand and Bolivia.

The fact that microfinance has grown in several forms, and has drawn lessons from several experiments, takes us back to basics. What does microfinance actually mean? It appears that what microfinance means is very well understood, but not clearly articulated. There are some definitions of microfinance offered in past literature. Robinson (2004) for instance says “microfinance refers to small-scale financial services – primarily credit and savings – provided to people who farm, fish or herd.” However, she later admits that the definitions could be narrower and more focused, depending on the typology of lending. She however maintains that it would be good to keep the definition to “refer to all types of financial services provided to low-income households and enterprises.” In India, for instance, if a SHG, gives a loan for kick starting an economic activity; it is immediately seen as microfinance. However, if a commercial bank does a similar loan on similar terms for the same person, as a part of its overall portfolio, this will not be immediately recognised as microfinance. This helps us to define microfinance in softer terms. It is assumed that micro finance has several value attributes loaded on to it. Some of these are elaborated below. Value attributes of Microfinance First, microfinance is something that is done by the alternative sector – not the government, and or the commercial sector.

Banks typically will have to be classified as promoters, rather than providers. Microfinance grows out of developmental roots. This is what can be termed as “alternative commercial sector.” This encompasses the first two points – the organisations are promoted by the alternative sector, and targeting the poor. However, the new organizations growing out of these roots need not necessarily be “developmental” in the form of incorporation. There are MFOs that have been offshoots of NGOs run on commercial lines. There are also instances where new MFOs are promoted on commercial lines. People who have worked with NGOs in the past and have “developmental” credentials usually promote such MFOs. The lending and related activities done by such MFOs are usually understood to be microfinance. Very rarely do we find commercial organisations setting up “microfinance businesses”. It is important to understand this before we look at the development and growth NGOs to commercial MFOs. Lastly, the Reserve Bank of India (RBI) has defined microfinance by specifying criteria for MFOs to seek exemption from registration under the Non-Banking Finance Company (NBFC) guidelines. This definition is limited to not-for-profit companies and as of date only two MFOs in India – Sanghamithra Rural Financial Services (SRFS), and Indian Association of Savings and Credit (IASC) – qualify to be classified as microfinance companies.

Microfinance can play an important part in achieving the growth and development as a sustainable approach to development, helping families to create enterprises and take the first steps out of poverty, a ‘hand up rather than a hand out’. It covers some of the innovations in the public and private sectors for scaling up microfinance as it currently serves only 1% of the poor. The effectiveness of microfinance in achieving the development and growth, the Consultative Group for the Alleviation of Poverty, points out the 'multi-tasking' role of microfinance by providing the means for poor people to have sustained access to employment, health and education: Access to financial services forms a fundamental basis on which many of the other essential interventions depend. Financial services thus reduce poverty and its effects in multiple, concrete ways. In addition, the beauty of microfinance is that, as programs approach financial sustainability, they can reach far beyond the limits of scarce donor resources.

1. Eradicating Poverty Microfinance allows poor people to: Protect, diversify, and increase their sources of income, the essential path out of poverty and hunger, Use a safe, convenient savings account to accumulate enough cash to buy assets for a small business enterprise, pay for health, home improvements, and school fees, Safeguard against the extreme vulnerability of their everyday existence with loans, savings, and insurance to take them over lean periods, emergencies or deaths in the family.

2. Promoting Children's Education: One of the first things poor people all over the world do with new income from micro enterprise is invest in their children's education. Children of microfinance clients are more likely to go to school. An impact study of a microfinance program in India, conducted for the various project, showed that client households invest more in education than non-client households

3. Improving Health Outcomes for Women and Children: Households of microfinance clients appear to have better nutrition, health practices, and health outcomes than comparable non-client households. Along with financial services, some microfinance institutions also provide health education; others provide credit products for water, sanitation, and housing and a growing number are working with insurance providers to offer health insurance

4. Empowering Women: Microfinance programs have generally targeted women as clients as they tend to be more financially responsible and reliable, with many microfinance institutions reporting repayment rates from 80 to 95%. Appropriate program design can have a strong, positive effect on women's empowerment, resulting in women owning more assets, having a more active role in family decisions, and increasing investment in family welfare.

Some Major Issues

It is evident that NGOs have existed for a long time and never in the history has this issue come in under such a detailed scrutiny. While examine these issues, we will be confronted with some generic issues – the ones that affect MFOs across the world and some specific issues – these are pertaining to the local laws.

Size

The most significant issue that triggers the growth is both promoters and providers of microfinance encounter this – though at different stages of growth. Invariably the promoters of microfinance find that the existing institutions are unwilling to provide finance at the same pace at which the providers expect them to provide finance. Working with the attitudes of these organisations is not an easy task. For instance, MYRADA in India was working hard on linking SHGs to the local banks and often found that the mainstream organisations have their limitations. In several cases, the initiative was individual driven – and depended on the manager. In such a situation impatience creeps in and the NGO would get into action to either start lending on their own (they need not necessarily transform, but open a division for microfinance), or set up a MFO. The story appears familiar with several Indian MFOs, if one looks at their genesis carefully.

Diversity of Services

While in most cases credit is the trigger to start microfinance activities, MFOs soon realise the need to provide other support services. One service is risk mitigation. How does one ensure that the loan given does not turn bad? Microfinance sector has evolved good systems to address the issue of willful default through the mechanism of group guarantees. However, the issue is also of non-willful default. This is to be addressed to a combination of self-insurance, group insurance and re-insurance. Savings is one mechanism of self-insurance. However when MFOs get into savings services, it is seen that the NGO format is not suited and they have to look at this options.

Financial Sustainability

This issue is closely linked to the growth. Beyond a level of operations, the MFOs will have to seek external funds. Donor money can only start up a microfinance activity. Donors cannot be a sustainable source of funding. Then, the only alternatives left for the MFO would be to seek either investments or loans. When MFOs seek investments or loans from the mainstream organisations, questions will be asked on the ownership structure and capital adequacy. For a MFO to survive in the long run, it has to transform itself into a financial institution that is accountable. For instance in the Bolivian context the main constraint the MFOs faced was that they were dealing with "other people's money." NGOs have clear-cut ownership structure and making people liable under the NGO format is a problem. If one were to be sustainable and grow, there is no option but to deal with mainstream institutions.

Focus

In several NGOs, there is a need to maintain focus of the original mandate. Carrying out microfinance related activities is transaction intensive and requires a different orientation and skill sets. There is always a conflict between microfinance stream – which earns returns, and therefore could be called "commercial" and other activities that are promotional in nature. The NGO might trigger a spin off because of this. Obviously, when the spin-off is with the clear mandate of working in the arena of microfinance, the form of incorporation would have to be in the arena where the mainstream financial institutions operate.

Taxation

In the Indian context, significant issues pertaining to taxation are raised. The argument is simple. If a NGO – that usually tax-exempt entity, carries out commercial activities (microfinance) on a large scale, then it would attract the attention of the taxation authorities. It is possible that in the process of building up microfinance NGO, we might jeopardise the tax status of the other activities, making even grants taxable. This is one of the concerns of NGOMFOs. This triggers a search for an alternative where microfinance could be kept isolated.

Experiences: The Indian Experiences

The issues grappling the microfinance sector worldwide are usually the same. We have reviewed the literature pertaining to the experiences in the world to highlight the alternate approaches that have been adopted to get an identity for microfinance. The Indian MFOs are a Diaspora of various approaches. Surprisingly in spite of different orientation and focus, some change efforts look very similar on the surface. We examine the types of Change that has taken place in the country in this context and highlight the implications for growth of the sector. Experiences of the Indian microfinance sector from two viewpoints.

Challenges Posed by the Issues

Much of the microfinance practice is developed by NGOs. However there are some questions about NGOs on aspects of effectiveness, management and efficiency. This includes the scale of the delivery. Some drawbacks of the NGOs in microfinance include:

Difficulty in growing beyond a size: There are reasons why growth and development gets triggered off due to the size of the operation. Typically, NGOs have multiple developmental objectives and microfinance addresses a sub-set of the overall concerns. But microfinance activity is very visible and has scope to grow. However, the form of incorporation of an NGO is not suited for financial activities. To the extent that the microfinance activity is small, it would be possible to carry on within the framework of an NGO, but growth means documentation, regulation, follow-up and money management (Sriram, 2002). To ensure that there is a clear demarcation between the charitable activities of the organisation and the activities that involve commercial aspects, it might be necessary to spin off microfinance to a separate unit.

• Growth needs infusion of funds for microfinance operations. The organisational form of an NGO does not allow it to scale-up borrowings or attract investments from outsiders.

• Since there is no capital base in an NGO, leveraging becomes complex. There are concerns on the nature of taxability of its operations if microfinance activities form the biggest chunk of the surplus earning activities of an NGO. Share Microfin Limited demonstrates from an NGO to an NBFC due to growth in size and focus on financial services.

Diversity of Services: But need not necessarily be dependent on size. Apart from loans, MFOs would want to offer services of savings for the clients. This is useful, as it is an essential service for the clients. It also forms an important source to help the loaning services grow. Some MFOs would also want to offer insurance and other services. For instance, when SEWA wanted to work with poor women a few decades ago, one important gap that was perceived by them was that the women did not have an instrumentality to save. There were issues pertaining to social security. When we examine Sewa Bank, we realise that it was necessary for them to open a specialised institution for this activity rather than carry it out in the parent institution. In fact it might be more apt to indicate that more than diversity of service; the trigger usually is the need to start savings services. Unlike micro-credit (where only loans are given), which is not as closely regulated, savings is very closely regulated and monitored

Financial Sustainability: The trigger for sustainability could come from within, and from outside. For instance several donor agencies might be prime movers for an NGO, by granting seed money. However, they would want the activity to continue sustainably. A good example is BASIX. The Ratan Tata Trust was willing to extend a returnable grant for BASIX for a period of one year to carry out pilot operations in microfinance. However, it was clearly understood that the grant would not be renewed or enhanced. BASIX started its operations in a not-for-profit company, but they had to get the rest of the act in place so that transactions could be carried out in a sustainable manner. Several donor agencies grant revolving funds for microfinance activity to start off. However, if the activities were to continue, on a sustainable basis, then change is necessary.

Focus: Some NGOs might spin-off an entity to manage microfinance exclusively. It might be because the NGO wants to continue its other developmental activities and sees microfinance diffusing its focus. We have two instances of spin-off in the Indian context. The first is that of Sewa Bank – which was set up as a separate organisation by SEWA. As the activities of Sewa Bank grew, it not only focussed on financial services, but also provided a diverse range of financial services – savings, risk management and credit. Now that Sewa Bank itself has recognised that Insurance is a specialised function, they have decided to address the issue of providing risk products through a new organisation - Vimo-Sewa. SRFS was set up by MYRADA to address the specific needs of the self-help groups promoted by MYRADA and other organisations. MYRADA has been donning the role of a "promoter" of microfinance. However, when they realised that the embedding of the groups with the mainstream was not happening at the planned pace, they decided to also assume the role of a "provider". This involved specialised systems and procedures and a change in the thought process. It was appropriate for them to build an arm's length relationship between the developmental work of promotion and the commercial work of provision of services. Therefore, it can be seen that one of the sub-processes of Change includes spin-off of new institutions.

Implications for Regulation

The microfinance industry represented by Sa-Dhan has been advocating easing of entry point capitalisation norms for microfinance "companies". This means that there would be a new company defined as a microfinance company with lower capitalisation norms, which would be allowed to offer financial services on par with other NBFCs. While this would help a large number of NGOs to hive off their commercial operations and help operations to grow organically, it does not prevent other individuals or institutions masquerading as MFOs. The recent experiences of a series of urban co-operative bank failures in Gujarat and Andhra Pradesh are an indication of what would happen when the easier entry norm is misused. For instance, the easier entry norm for co-operative banks must have been introduced because these were democratic institutions, member owned and member-driven. However, over a period of time, all these banks started transacting heavily with non-members. The institutions lost the "co-operative" nature for which the entry norms were eased, but turned out to be in the hands of a handful of "investors". When we are proposing regulatory reform, we need to be wary of the potential misuse of the easing of entry hurdles. We also have a good number of residuary NBFCs that collect savings from the poor and the un-organised. While these are closely regulated, their leeway in providing credit is cramped. Therefore, MFOs have not seen RNBFCs as a viable option. In any case, the microfinance sector does not treat them as MFOs (offering savings service) for obvious reasons of "value attributes" discussed earlier. When regulation of entry norms is eased, and several other institutions come in claiming to be MFOs, the microfinance sector will encounter similar credibility crisis. Bolivian experiences, the FFPs were seen as an intermediary step for the NGOs to get into mainstream. The entry norms were steep, but the norms allowed an NGO to invest in a bank. In this scenario, it is possible for an NGO to convert the donor money received for pump priming as equity in a new and proper banking entity. In case of K-Rep, the NGO is registered as a company limited by guarantee, and resources are held in a charitable trust that has invested in the Bank. It is obvious that in both the cases that while some norms were relaxed; all these new institutions were treated as proper financial institutions.

Scaling Up Microfinance in India

The Indian microfinance sector requires training and funding for capacity building along with increased involvement by the private sector. Here are a few examples of measures to increase the outreach and sustainability of microfinance:

1. Support Indian Governments to define precisely their role and strategy in microfinance to improve the regulatory framework of the sector in India

2. Involve banks and the private sector to support microfinance development. Some current examples include:

ICICI Bank, the second largest in India, has developed a low cost structure in the field, working with voluntary organisations to reach nearly 200,000 rural poor households.

They are working on innovative ideas and are seeking partners to take up large-scale implementation and identifying sources of low cost funds for providing working capital assistance to partners.

Citigroup has partnered with MFIs in the Phillipines for delivery of training. PlaNet Finance and Citigroup have proposed working together in Ghana with the bank providing mentors for MFIs on a long-term training scheme for capacity building.

Barclays is supporting Opportunity International's work by transferring knowledge and expertise to Opportunity's overseas partners. Through its Community Placement Scheme, Barclays bank makes a donation to contribute towards the salaries of Barclays employees leaving the bank due to retirement or redundancy, when they take up employment with approved charity posts through Barclays preferred outsourcing agencies. Over the past two years, donations from Barclays have supported the positions of a number of Opportunity International staff in this way.

Conclusion and Recommendations

In case of the Indian legislation, the steps of graduating from an NGO to an NBFC to a LAB to a Commercial Bank appear impossible. It is impossible because the law does not provide for change. It is also not possible because the steps between these stages are really steep. The current legislation for instance does not easily provide for a co-operative society or urban cooperative bank to gradually increase its area of operation. A LAB can never hope to go beyond its area of operation of three districts. It would be useful if the microfinance sector can argue for a legislation that allows MFOs to graduate to bigger institutions – one on co-operative lines and another on corporate lines.

Another route that the microfinance sector can advocate is to adhere to the current norms of entry and capitalisation for NBFCs, and LABs – but seek permission for NGOs to invest in such for-profit entities, without prejudice to the tax status of the NGOs. This would mean that only NGOs that can raise enough funds from various sources could actually set up a mainstream-type NBFC. This gives no short cuts for the entrants from the non-NGO sector, since if they have to bring in substantial capital, for them, it does not makes matters simpler if they can adopt the non-profit entity route. After all, they will have to find somebody to put in money into the nonprofit entity in the first place.

Microfinance is not a panacea, but it is a crucial component in breaking the cycle of poverty and aid dependence. Microfinance supports developments in health, education, housing, enterprise and agriculture. Peter Drucker, the management guru has stated, 'Enabling people to buy in installments can transform economies, regardless of their condition.' The inclusion of the poor in financial services is a fundamental condition for economic and social growth. This was recognized at the 2004 G8 Sea Island Summit. We request and urge the Commission for India to use its influence to support sharply increased funding for capacity building in microfinance, and substantial expansion and strengthening of existing centers of expertise on microfinance. Collaboration and knowledge transfer between Indian MFIs, and between the Indian microfinance community and more mature institutions in other parts of the world. Integration of microfinance with mainstream financial institutions and financial markets creates or support of Indian funding facilities. Sustained focus on microfinance as a powerful tool for achieving the Millennium Development Goals, and for enhancing the freedom and dignity of the poor Sustained political will combined with the creativity and dynamism of the microfinance community can make a profound contribution to ending poverty in India.

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