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MICRO-FINANCE SECTOR: ISSUES AND STRATEGY FOR FUTURE INTERVENTIONS

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The opinions expressed in this report do not necessarily represent the view of IFAD or its member governments.

Acronyms used in the paper

DRDA	District Rural Development Agency
ICT	Information and Communication Technology
IFAD	International Fund for Agriculture Development
IRDP	Integrated Rural Development Program
LAB	Local Area Bank
MACS	Mutually Aided Co-operative Society
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non Banking Finance Company
NGO	Non Government Organisation
NPA	Non Performing Asset
NPL	Non-Performing Loan
OSS	Operational Self-Sufficiency
RCIs	Rural Credit Institutions
RMK	Rashtriya Mahila Kosh
ROA	Return on Average Assets
RRB	Regional Rural Bank
SGSY	Swarnajayanthi Gram Swarozgar Yojana
SHG	Self Help Group
SIDBI	Small Industrial Development Bank of India

I. Introduction

IFAD has a long history of involvement in the development of the micro credit sector in India, beginning in the early 80s with assistance provided to the Tamil Nadu Women's Development Corporation for setting up women's SHGs for thrift and lending. This was followed by the Maharashtra Rural Credit Project in the mid-90s in partnership with NABARD and Government of Maharashtra to link SHGs with the formal banking sector. A third loan was sanctioned to SIDBI in the late 90s to top-up a DFID grant for development of MFIs, with IFAD funds being deployed for on-lending. The interim spanned by these projects has seen rapid and multi-faceted changes in the micro finance scenario in the country.

2. As IFAD plans the next pipeline of projects for India, it is looking to examine the various strategic opportunities for assistance, among others, in the micro finance sector. This paper discusses some strategic issues in the current state of development of the sector in the country. Two riders must be mentioned here. The choice of issues discussed in this paper is deliberately selective, not exhaustive, with the ultimate aim of identifying areas for possible IFAD involvement. Secondly, the paper looks at micro finance as one of the several vehicles to deliver credit to the rural poor, thus necessitating a broader review of developments in the rural credit sector.

Reforms have reduced proportionate access to credit by the poor

3. The 1990s are now acknowledged in India as the decade of significant reforms in the formal financial sector, as part of the overall economic liberalisation process that started in 1991. These reforms have focussed on improving the performance of public sector banks, adoption of prudential lending norms, gradual deregulation of interest rates, reduction of NPAs and raising productivity and profits. It is now possible to discern certain trends in the path of reforms and their impact on the sector, even if firm conclusions are postponed for the present.

4. The thrust of reforms in FFIs was primarily on industrial and trade credit, with limited attention to rural finance and the institutions that service it. The indirect and often unintended effects of the sector wide reforms in the banking industry had a negative impact on the flow of credit to agriculture and allied sectors.

5. Deregulation of interest rates raised the cost of borrowing along with a rise in operating costs, largely owing to ballooning wage bills. The focus on profits and productivity and several voluntary staff separation schemes resulted in the closure of dozens of rural branches. The simmering crises in RRBs burst into the open and rural credit in general began to slip off the priority list of planners. This is not to say that the sector witnessed no action in the 90s: the deregulated interest rate regime, relaxation of service area approach, the setting up of the SGSY by the Government of India and of the RIDF in NABARD, and the growth of the SHG-Bank Linkage Programme were major milestones in the rural credit segment of the industry.

6. There are also signs that the focus on sector wide reforms brought in certain unintended negative consequences as far as the access of the rural poor to institutional credit is concerned, even as certain hopeful new ideas emerged towards the close of the decade. Hard budgets at the central and state level in the early 1990s severely reduced outlays to rural lending programs targeted at the poor and the fiscal crisis in several states from the mid-1990s onwards squeezed spending on social sector schemes in general. The banks which had to take immediate steps to reduce inefficiencies and cope with high NPAs, reduced lending windows that had connected the poor to institutional credit in the 1980s. While institutional credit lines were squeezed, new initiatives to address the credit needs of the poor were inadequate both at the policy and implementation levels. It would appear that after the cooperative movement in the 1950s (the first Big Idea in directing rural credit flows) and IRDP (the second Big Idea that sought to build upon government's control of the banking industry in the 1980s), major fresh initiatives to meet the credit needs of the rural poor were not forthcoming.

7. Among the most positive developments of the decade, as far as the rural poor and credit are concerned, was the emergence of several new models of people-led banking, with links to the formal financial sector. The SHG-bank linkage model of micro-credit has survived almost a decade of testing and appears to be the leading contender for a nation-wide replication to bring institutional credit to the poor. This is not to say that this goal is easily achieved. Replicating what is still a regional success, centred largely in southern India, presupposes overcoming a host of problems, not the least of which is a hazy and evolving regulatory environment, issues regarding the cost of social intermediation and institutional forms.

8. This part of the paper seeks to review the general state of rural credit in India at the beginning of the Tenth Five Year Plan period (2002-2007) with a focus on the rural poor and how they find themselves placed in terms of access to credit. It revisits some of the breakthroughs of the past and examines their current role in meeting credit needs of the rural sector in general and the poor in particular.

9. Before we examine the developments in the microfinance sector, a brief review of the overall situation of advances and loan accounts from scheduled commercial banks to rural and small borrowers, and within that category, to agricultural borrowers, is useful to set the context and to substantiate the trends described above. The table below summarises the trends since 1994, the year when the first Narasimhan Committee Report's recommendations for banking sector reforms started to get implemented.

Table 1

Trends of Rural and Small Loans by Scheduled Commercial Banks (SCBs)

Particulars	1994	1997	2001
Percent of Rural Advances of SCBs	17.5	14.2	12.8
Percent of Agricultural advances of SCBs	11.2	9.6	8.1
No of Agricultural accounts of SCB (in lakhs)	251.0	222.0	195.0
Loan Accounts < Rs 25,000 of SCB (in lakhs)	558.0	500.0	372.0
Percent of small loans (Rs 25000 and below)	18.3	13.2	7.0

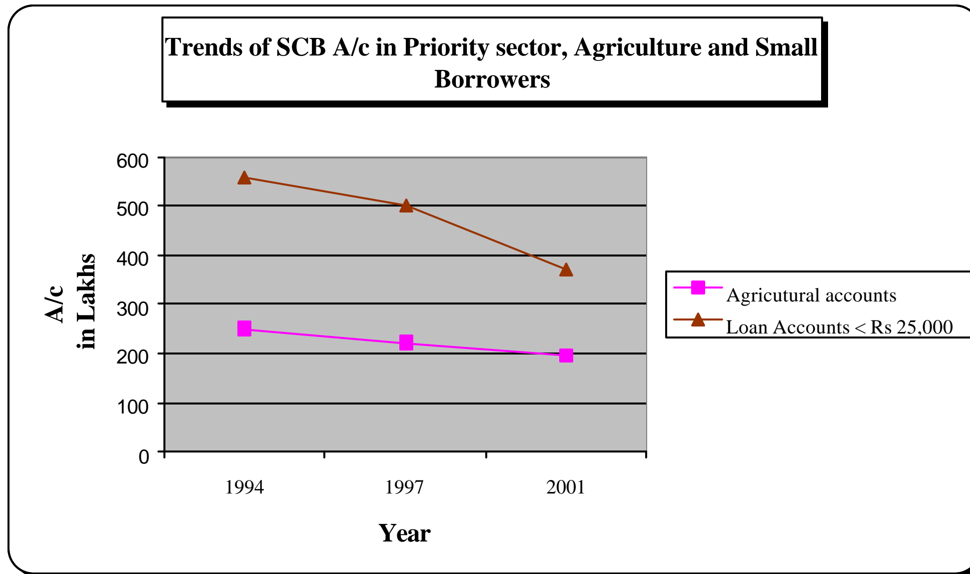
10. The data indicates a clear and consistent declining trend in the percentage of investment in agriculture and rural areas related to total advances of Commercial and Regional Rural Banks. More worrying to the purveyors of micro finance is the declining trend in the number of small loans since it is the general assumption that these loans go to the poor.

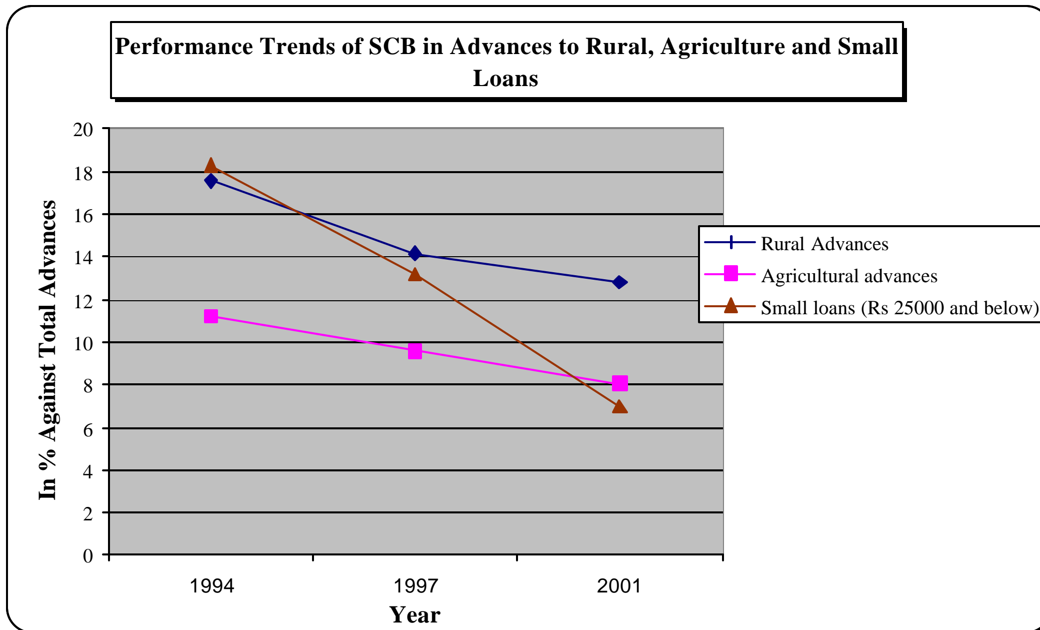
11. Policy makers attempt to explain the declining trend in the percentage of agricultural advances to the sharp decline in government investment in irrigation and infrastructure, particularly in rural roads and markets. Bankers attribute the decline in small loan accounts to the increasing pressure to compete in a liberalised and globalised environment.

12. A number of banks, realising their inability to reach their targets in priority sector lending, opt to park their funds in the RIDF, thereby reducing the number of loan accounts in rural areas as well as the number of small loans. The steady growth of the service sector mainly urban based, has also attracted an increasing flow of funds. Though percentages have dropped, the overall aggregate rural credit flows went up from Rs. 22032 crores in 1995-96 to Rs. 61942 crores in 2001-2002 as the following table indicates. However, what remains a cause of concern and a gap to be filled is the declining trend in small loans, which are generally accessed by the poorer sectors.

Table 2: Rural Credit by Banks in India (Rs Crore)

Agency	1995-96	1996-97	1997-98	1998-99	1999-2000	2001-02 (Provisional)
Co-op. Banks	10479	11944	14085	15957	18429	23533
RRBs	1381	1684	2040	2460	3329	4822
Commercial Banks	10172	12783	15831	18443	22854	33587
Total	**22032**	**26411**	**31956**	**36860**	**44612**	**61942**





The two main micro-credit models were supported by IFAD in early stages

13. IFAD has supported micro-credit initiatives in India through a number of focussed projects. IFAD's first foray in the sector was through the Tamil Nadu Women's Development Programme (TNWDP), which ran from January 1990 through December 1998, including a one-year extension. This was followed by the Maharashtra Rural Credit Project (MRCP) with NABARD and the Government of Maharashtra in 1993. A third project, the National Micro Finance Support Programme (NMFSP) with SIBDI, became effective in 2002. In the interim, IFAD partnered the World Bank to co-finance the Rural Women's Development and Empowerment Project (RWDEP) in 1999. In addition to these focussed support programmes in the micro-credit sector, IFAD's livelihood support and community empowerment programmes in the north-east, Andhra Pradesh, Jharkhand, Chattisgarh and Gujarat, that were designed during the 1990s, also encompassed significant micro-credit components. The total project cost of the directly and co-financed micro credit projects supported by IFAD in India so far is USD 266.47 million, out of which USD 87.41 million comprises of IFAD loans.

14. The outcome of IFAD's support to micro-credit initiative has been generally positive and contributed to the testing and subsequent mainstreaming of crucial strategies relating to micro-credit. For example, the TNWDP piloted the SHG model of savings on a significant scale, which was later scaled up and replicated with donor support by the state government. Similarly, MRCP helped to establish the viability of the SHG-bank linkage model and partly contributed to the adoption of the concept by the Government of India in its revamped Swarnajayanthi Gram Swarozgar Yojana (SGSY), which replaced the earlier Integrated Rural Development Program (IRDP). Perhaps the biggest contribution of these projects was to convincingly demonstrate the role of micro-credit in empowering rural women and helping to create an image for them as reliable borrowers.

15. IFAD's major lessons from the above initiatives relate to addressing issues of appropriate institutional forms to sustain the achievements of the various projects, removing policy constraints and exploring avenues to meet the costs of social mobilisation and institutional capacity building.

This study is to help IFAD devise an intervention strategy in microfinance

16. It is with this background that the International Fund for Agriculture Development (IFAD) has set up a group of consultants to review the current status of the micro-finance sector in India and draw up a framework and guidelines for a strategy for IFAD's future investment in the micro-finance sector in India. The Terms of References are to:

- Make a comprehensive and critical review of the current state of development in the micro-finance sector in India today including various milestones of achievement, the relative role of different service providers including review of IFAD's involvement and its major outcome.

- Analyse various organisational and institutional models that have evolved in the course of the past two decades in the sector.

- Review legal and policy framework that impacts on the micro-finance sector and suggestions for reform where necessary and

- Draw up suitable guidelines for a strategy for IFAD's future investment in the micro-finance sector in India, outlining institutional models, and financial plans.

II. Micro-Finance in India – An Overview

17. The growth of microfinance initiatives and institutions over the past decade and a half must be placed in the context of overall developments in the rural credit scenario in order to comprehend the reasons for the emergence of micro-finance products and their particular appeal to poor borrowers. One interpretation of the growth of the microfinance movement in India is that it developed as a direct result of and in answer to the failure of official attempts to address the credit needs of the poor; it is thus an articulated civil society response to the policy drift in the rural sector during the 90s.

18. This view must contend with the reality that official policy has pioneered several micro-finance instruments through institutional channels; many of them specifically targeted the rural poor and they did expand the rural credit network and improved access to institutional credit by the poor.

19. It must also be noted that the most widely prevalent model in the sector, i.e. the SHG-bank linkage model, seeks to leverage the impressive network of banks and financial institutions in the country, which are products of earlier efforts to push rural credit. The major change in policy that supported the model to take off was the RBI's decision allowing banks to lend to groups – not just to individuals in groups – even if they were not registered, but provided they functioned according to the norms required of registered bodies.

20. Micro finance has emerged as the latest instrument of poverty alleviation. The last two national budgets highlighted its role, while international financial institutions have supported it for several years. Though this recognition by the Government has given the micro finance sector a recognised status, it has not changed the content of the main anti-poverty programmes of the Government. In other words the Government has not incorporated any lessons from the micro finance experience into its anti-poverty programmes.

21. The SGSY, which had the praise worthy intention of integrating all rural anti-poverty programmes, still continues to subsidise the asset and to exclude loans for consumption or purchase of assets like land. Though some provision for capacity building has been made, the focus on the ground continues to be restricted only to the provision of credit. There is pressure to disburse in order to meet targets, even if this pressure weakens the people's institutions in the process.

22. A fair conclusion, thus, would be that microfinance initiatives and institutions emerged in the gaps that had been created for tiny borrowers in the formal rural financial sector. Its current popularity with small borrowers and the FFIs alike proves that it has filled a niche, not just for borrowers, but also for lenders, who saw an answer to their dilemma of containing transaction costs and covering the risks of lending to the poor by advancing loans to groups rather than to individuals.

The demand for micro-credit is large, and largely unmet

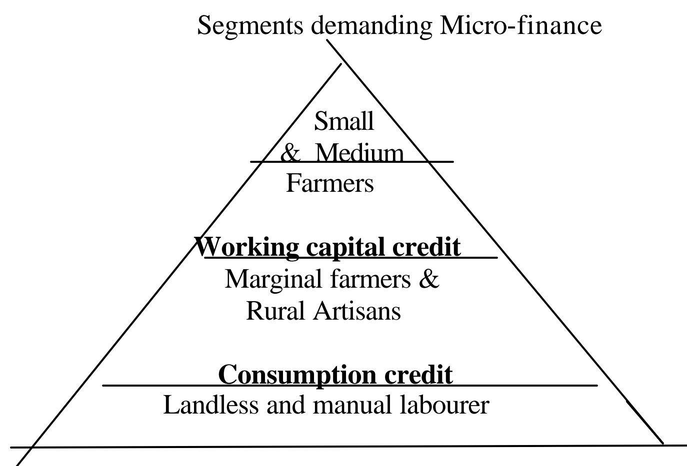
23. Sa-Dhan, an association of major microfinance institutions in India, estimated the credit use of families below the poverty line at Rs 495 billion in 1998 based on annual needs of Rs 6,000 for rural families and Rs 9,000 for urban families.[1] Of this, Rs 240 billion (49 percent) was for rural consumption, Rs 120 billion (24 percent) was for rural production, Rs 74 billion (15 percent) was for urban consumption, and Rs 61 billion (12 percent) was for urban production.

24. Other estimates confirm that consumption accounts for about two-thirds of the credit used by the poor (Task Force, 1999; Mahajan and Gupta Ramola, 1996). The NABARD task force also noted that

[1] These two estimates were extrapolated by multiplying the numbers of poor rural and urban households (using government figures) by their estimated average annual credit use. The figures do not include the demand for housing credit by the poor, estimated at an additional Rs 100 billion a year (Task Force, 1999).

nearly three-quarters of the demand for consumption credit is for short-term credit to deal with emergencies such as illnesses and household expenses during the lean season. [2]

25. Poor people have various demands for micro-loans. Practitioners have identified three groups, each of which has specific needs for financial services (Mahajan, 2000):



26. 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 employment, and for contingencies such as illness.

27. The experience of various MFIs and NGOs in microfinance indicates clearly that while the poor initially want loans that are comparatively small, they often graduate after 6 months to credit for trading, animal husbandry and agriculture (on leased land). Marginal farmers and rural artisans too take loans for consumption and not just for working capital.

28. 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. This category 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 the case of non-farm workers. This group largely comprises the poor but not the poorest.

29. 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, teashops, and various service enterprises. These persons are not always poor.

30. One market segment which is of great importance to micro-finance is women. The Census 2001 figures reveal that out of a total of 54.1 million marginal workers, 47.1 million were women. According to the 43rd round of the National Sample Survey, 53.6 % of rural female workers expressed the need for initial finance, and 22% for working capital facilities to undertake income-

[2] Information taken from the World Bank Report No: 22531-IN

generation activities. It appears that the interest rate ceiling by banks only limits the availability of capital to the poor, who might be willing to borrow at higher rates of interest.[3]

31. Some questions that arise from the above are:

- How do we understand consumption credit? In the strict (and popular) sense credit for any asset which does not produce income is called consumption credit. Therefore, loans cannot be given for food, clothes, health, education, etc. because this investment does not generate repayable income. Hence unit costs are worked out at the altar of "viability". In 1990, MYRADA in Dharmapuri, Tamil Nadu analysed the sources of repayments on asset loans where the repayment rates were over 75 percent. The conclusion was that 65 percent of the repayment on these asset loans (based on unit costs) came from income from other sources and not from the asset. So MYRADA concluded that it would not spend time on working out the viability of each investment. What about health and education? MYRADA does not consider these to be consumption. Perhaps we should restrict consumption only to food and clothes. Several people think that even credit for food is not consumption since it ensures productive occupation, especially during farming seasons.

- Should micro finance endeavour to meet the entire demand for credit or would it be enough if it met a critical percentage which would have an impact on the interest rates of private money lenders? A recent study of Sanghamitra's programme in peri-urban areas of Bangalore indicates that where Sanghamitra met of about 40% of credit needs of the poor (organised in SAGs), the prevailing interest rates levied by private money lenders fell by half. Should our strategy focus on introducing competition which brings down interest rates as a major objective? Can MFIs ever hope to provide the entire credit requirements of the poor?

Informal channels continue to be the main source of credit for the poor

32. The availability of data for rural credit is better than for the urban informal sector. RBI data shows that informal sources provide a significant part of the total credit needs of the rural population.

33. The magnitude of the dependence of the rural poor on informal sources of credit can be seen from the findings of the successive All India Debt and Investment Surveys (AIDIS) [4]. These show that the share of the non-institutional agencies (informal sector) in the outstanding cash dues of the rural households has been reduced from 83.7 % in 1961 to 36 % in 1991. This is shown below.

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[3] Sanjay Sinha, 2000

[4] Government of India (1997): *All India Debt and Investment Survey, 1991-92 – Indebtedness of Rural Households. National Sample Survey, 48th Round,* Delhi: NSS Organisation

Outstandings from Informal Sources as a percentage of Total Dues of Rural Households

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

34. As per the latest AIDIS, 1991, formal institutional sources, banks and co-operatives provided credit support to almost 64 percent of the rural households, while money lenders were providing credit to almost one fifth of the rural households.

Sources of Credit for Rural Households, 1991

Credit Agency	% of Rural Households
Government etc	6.1
Cooperative Societies	21.6
Commercial Banks and RRBs	33.7
Insurance	0.3
Provident Fund	0.7
Other institutional Sources	1.6
All Institutional Agencies	**64.0**
Landlords	4.0
Agricultural Money-lenders	7.0
Professional Money-lenders	10.5
Relatives and Friends	5.5
Others	9.0
All Non-institutional Agencies	**36.0**
All Agencies	100.0

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

Share of Debt from Various Sources, by Asset Holdings of Households

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

100-150	61	39
150-250	68	32
250 and above	81	19
All Classes	64	36

35. The AIDIS data seems to indicate a more favourable picture than various micro studies, such as the World Bank study cited above. This study showed that of the total annual credit usage, only 22 % came from formal sources, viz. banks and co-operatives and the remaining 78 % was from informal sources, significant among these being the money lender, commission agents and friends and relatives. Credit usage by the poor from formal sources is lower than the others, even for productive usage, as below.

Credit Usage by Source, for different category of households, by income

Income Category	Formal to Total (Overall)	Formal to Total (Productive)
< Rs 10,000	7%	15%
Rs. 10,000 – Rs 20,000	8%	16%
Rs 20,000 – Rs 40,000	23%	39%
Rs 40,000 – Rs. 80,000	17%	22%
Rs 80,000 – Rs 1,20,000	25%	31%
> Rs 1,20,000	32%	39%
Total	22%	32%

36. The reason for this difference can be that the AIDIS data measured debt, which is a stock variable, while the other study measured credit usage, which is a flow variable. Since there is a tendency among households to repay institutional loans more slowly than informal loans, the share of debt from institutional sources would be higher than share of credit usage from them.

37. What are the reasons for the quantum of credit usage from institutional sources not being high? While banks have been engaged in financing small borrowers, the manner in which this is being done can hardly be called satisfactory. The procedures are cumbersome, the staff unfriendly and the transaction costs high. Repeat loans, except for crop production, are rare, even for borrowers who have repaid fully. Furthermore, even though many of the loans extended to the poor by the public sector financial institutions are subsidized, their ultimate cost to the borrowers is high: factoring in out-of-pocket costs, payments to middle men, wage and business loss due to time spent in getting the loan approved. The World Bank study cited above showed that effectively, the total cost of funds to the borrower ranges between 22–33 percent, as against the 12-14 percent nominal lending rates specified for commercial bank loans below Rs 200,000. All this results in low repayment rates, leading to a vicious cycle of non-availability and non-repayment.

Even though formal credit institutions have a wider network

38. The network of formal credit institutions in India is very extensive. The rural and semi urban areas of the country are served today by more than 1,50,000 retail credit outlets comprising over 92,000 cooperative societies, 12,128 branches of DCCBs, 14,142 branches of RRBs, and 20,571 rural and 12,283 semi-urban branches of commercial banks. In other words, there is at least one retail credit outlet for every three to four villages. The total credit outstanding of the scheduled commercial banks was over Rs. 450,000 crore in March 2002. The credit support extended, however, has not been uniform. Wide variation has been observed in credit support between urban and rural areas and between regions. In terms of size wise distribution, we find that 81.7 % of accounts were less than Rs.

25,000 in size but constituted only 10 % of the outstanding amount. Similar is the story regarding support extended to women, who got less than 4 % of credit.

39. With over 116 lakh poor households accessing banking services through their 7.7.lakh SHGs, the SHG-Bank Linkage program is now perhaps the largest micro finance program of the world in terms of its outreach. More significantly, the growth during 2002-2003 has been phenomenal. During the year, the credit flow to SHGs nearly equalled the cumulative bank loans given to SHGs from 1992 up to March 2003. While Rs 1026.3 crore had been disbursed up to March 2002, a total of Rs 1022.3 crore was disbursed during 2002-2003.[5]

40. These numbers indicate that outreach is tiny relative to the number of poor people in India (about 300 million) and their potential demand for micro-finance services. The recent growth of India's largest microfinance program - NABARD's self-help group program- suggests that outreach may have grown faster in recent years. Still, the absolute number of microfinance clients and the volume of loans disbursed remain limited relative to the estimated demand. [6]In terms of coverage, distribution is not uniform across the country. For instance, in the case of NABARD's self-help group program, the largest micro-finance provider in India, coverage varied across regions. The southern states had about 69 % SHGs linked, while the figure is 13 % for central India, 8 % for the eastern states, 7 % for western India and 3 % for the northern and north eastern states. Except for the Southern India, the other regions experience the poorest financial services in India because of predominantly hilly and sparsely populated terrain where providing financial infrastructure become very expensive.

The poor need savings and insurance even more than credit

41. One of the fundamental flaws with the micro-credit orthodoxy is to ignore the role of other financial services. In fact due to risk and vulnerability, the poor need savings and insurance services more than credit. In case the contingency is more serious, such as long-term illness, accident, a natural calamity leading to loss of house or productive assets, or death of an earning member of the family, insurance is a more appropriate way, instead of credit to answer the needs of the situation. We thus look at some estimates of the demand for savings and savings and insurance services by the poor.

Demand for Savings Services:

42. Savings by households are and can be a major source of funds for themselves. A study[7] by the National Council for Applied Economic Research (NCAER), based on a large sample survey in 1994-95, showed that the average income of rural households was Rs.27,411 per annum (as against Rs.57,675 for urban households). The annual savings were Rs.5,056 or 18.5 percent of the income (as against Rs.13,080 or 22.7 percent for urban households). However, in the study, "savings" are defined to include savings in the form of physical assets as well financial assets. The annual financial savings of rural households were Rs.1,804 or 6.6 percent of the income (as against Rs. 6,994 or 12.1 percent for urban households). The (modalities –as used in table below – or instruments) of financial savings for households were deposits, provident funds, life insurance, chit funds shares and securities and others.

43. The annual aggregate financial savings in the unorganised sector comes to over Rs.38,702 crore based on approximate extrapolations from the NCAER study data as follows:

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[5] NABARD & Microfinance, 2001-2002

[6] Information taken from the World Bank Report No: 22531-IN

[7] Pradhan, Basant K., PK Roy and MR Saluja, 1999: National Council for Applied Economic Research (NCAER), New Delhi: *Informal Sector in India: A Study of the Household Savings Behaviour*

Savings Modality	Annual Estimated Savings by Unorganised Sector Households, Rs. Crore in 2001
Deposits	25580.3 (66.1 percent of all financial savings)
Provident Funds	518.2 (1.3 percent)
Chit Funds	3017.9 (7.8 percent)
Shares and Securities	2632.7 (6.8 percent)
Life Insurance	2327.6 (6.0 percent)
Others	4625.6 (12.0 percent)
Total	38702.3

There are certain attributes of the lower income savers, which are important to note. These attributes include:

- Small amounts saved at any one time
- Frequent/regular savin gs rather than lumpy saving
- Many periods when savings are negative, during this period they draw out of savings for consumption
- Concern for safety
- Ease of transaction, preferably at the doorstep or walking distance
- Rate of interest is not important, in fac t they are willing to pay for basic intermediation[8]

These attributes are generally missing from the savings facilities offered by banks. Yet if savings from the poor have to be mopped up as a source of funds for the sector, then savings services would have to be offered with these attributes.

44. In a recent study [9]carried out by the Indian Market Research Bureau (IMRB) in Andhra Pradesh and Karnataka for BASIX, it was found that as many as 35 % of rural households were saving with private credit agencies – finance companies, chit funds, traders and so on.

Agency with which savings were made	Value of savings (Rs.)	% households saving with that agency
Private credit agencies	305	33
Commercial Banks	450	19
Post Office Certificates	440	30
Gramin Banks	350	7

45. The study reflected that most of the respondents considered security and ease of transactions as the two key factors while selecting the source of savings. They laid the most emphasis on 'high level of safety' extended by the source. The other attributes that played an important role while selecting a source were credibility established by 'age old' tried and tested institutions, and profitability through the transactions.

Demand for Insurance Services:

46. The demand for insurance services, though not very well articulated, is also substantial. The Ramola and Mahajan study cited above tried to identify the need for insurance based on major adverse events in the previous 10 years of rural households. The percentage of households of those surveyed, which reported adverse events were flood/heavy rain (44%), drought (39%) and pest attack (27%). Death of an earning member was 3 percent. The survey found that 64 percent of the respondents wanted some form of insurance – of them, 50 percent wanted life cover, 30 percent livestock, while 20 percent crop and other asset insurance. Only 15 percent had any insurance at all.

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[8] Rutherford, Stuart and Sukhwinder Singh Arora, 1997: Urban Poverty Office, DFID, New Delhi: *City Savers*

[9] Indian Market Research Bureau, Mumbai: Impact Assessment for BASIX, 2002.

In the IMRB study cited above, most respondents expressed the view that the concept of insurance can be adopted 'to cover oneself from risks/deaths". About 30% said they would consider taking insurance for the purpose of savings /investment. They perceived insurance as a source of saving wherein they could extend protection to their children and ensure overall future occupational security. Financial constraints were the key reasons for not being willing to invest in insurance.

47. About 25% were inclined towards buying insurance as a risk cover. They preferred investing in life insurance, crop and animal insurance and were willing to pay for each type of insurance. The table below indicates the amount they were willing to pay for each.

Type of insurance	% willing to pay	Average annual premium amount in Rs.
Life Insurance	55	12508
Crop Insurance	21	1183
Animal Insurance	3	5000

In another study on health insurance[10], it has been found that there is a willingness to pay for unforeseen health care expenditure in the form of an insurance premium among rural households, provided they feel that the service provider is reliable. The above studies show that there is a huge untapped market for insurance services in rural areas.

Credit alone is not going to generate livelihoods for the poor.

48. As per the X Five Year Plan, India needs to generate livelihoods for nearly 10 million new persons entering the workforce every year in the coming five years and to enhance the incomes of over 40 million rural poor households. It is therefore essential that self-employment programs be effectively implemented. While there are initiatives to promote the credit side of self-employment programs, the weak link so far is livelihood promotion services. Unfortunately, micro-credit initiatives have also not given much thought to this.

49. We give below a case study of complex livelihood promotion needs for very poor communities in economically backward regions and the small part micro-credit plays in the whole effort. In other words, even if there was a highly effective micro-credit institution, the chances of the poor households, who are not yet integrated into the market economy, benefiting from it, are minimal.

Promoting Tasar Sericulture in Jharkhand: The Case of PRADAN[11]

PRADAN is an NGO working in a number of states including Jharkhand, to promote livelihoods for poor people. Tasar sericulture is a traditional activity in Jharkhand, parts of Orissa and eastern Madhya Pradesh, carried out by tribal people to supplement their livelihoods. Tasar silk rearers are forest dwellers and often tribal, an estimated 1.25 lakh across India, 45% in Jharkhand (Source: Central Silk Board). A traditional activity, the entire family spends 80-90 days to rear silkworms to produce cocoons to sell in the market. Production of tasar cocoons has a large untapped potential to generate livelihoods.

Traditional Tasar sericulture is risk prone, and characterized by low yielding traditional rearing practices. Lack of availability of good quality Tasar eggs, or disease free layings (DFLs) further reduces productivity. Only 5% of the total requirement for good quality DFLs is currently met by the sericulture establishment, seriously affecting production. Lack of formal credit mechanisms and open markets ensure that rearers are financially exploited in a closed system operated by the moneylender, traders and order fillers.

Incomes of tribal people and women who produce and process tasar, respectively, can be enhanced substantially by introducing new technologies and modern production organisation, and by opening up new

[10] BASIX: Community Based Health Financing by Youth for Action in Mahaboobnagar district of AP, 2003

[11] Based on www.pradan.net Section on Forests/Tasar

markets. Thus PRADAN's work in this sub-sector has focused on promotion of plantations of tasar host trees to be used to produce seed crops and for controlled rearing, modern rearing techniques and a network of rearing inputs providers, promoting processing of yarn from tasar and opening up markets for cocoons, yarn and fabric.

Coverage & achievements: PRADAN raised 1250 acres of plantations of Tasar host plant Terminalia arjuna in the wastelands owned by 542 families. The average income from 1 acre of plantation is Rs. 5200 in two months. It pioneered private seed production units and grainages in the Tasar sector. PRADAN trains young people from the rearer community and helps them to set up grainages in their villages. Grainages function as home based service enterprise to produce high quality disease free layings (DFLs).

PRADAN has promoted 132 grainages, which produced 4,00,000 units of DFLs to cater to the needs of 1,600 rearers in 2001-02. It helped rearers market cocoons competitively by linking them to institutional buyers, groups of women spinners and reelers and by organising buyer-seller haats. 1,029 rearers have earned average incomes of Rs 12,200 per crop, and grainage earners Rs 10,000. They fed the raw material to 133 women spinners and reelers.

Future scope and need for micro-finance: In Jharkhand alone 2.3 million ha of forest area is under tasar host flora, of which 1.5 million ha has potential for intensive rearing. New plantations can be raised on large tracts of privately owned wasteland. Over 2 lakh families can rear tasar using the existing flora against an estimated 60,000 who presently do so. Some 120 lakh disease free layings (DFLs) would be required to serve even the existing 60,000 rearers. About 3,500 grainages would be needed to produce the DFLs. Cocoon production would then increase by 480 million pieces to yield an additional 450 tons of raw silk.

PRADAN has raised some funds from the State Bank of India and the ICICI Bank as part of the SHG-Bank linkage program. It has also raised funds in collaboration with the Central Silk Board from the GOI's SGSY program to develop additional grainage infrastructure.

III. Delivery Methods and Institutional Models for Micro-Finance in India

50. Micro-finance encompasses financial services other than credit. In India there are three major models of delivery of micro-credit. The SHG Bank Linkage Programme, within which there are three variations primarily the Grameen Bank model and Individual lending. A much smaller initiative, which was earlier part of official banking strategy but did not really take off, is lending to individuals with joint liability. The SHG-Bank linkage programme, especially where the SHGs meet weekly, also provides effective savings services. In addition, there are some models for delivery of savings and insurance services to the poor. Some emerging models aim at providing financial services in an integrated manner. Finally, a few organisations have evolved models for integrating micro-finance with livelihood promotion services.

Models for delivery of credit services to the poor

The Grameen Bank Model

51. The Grameen Model which was pioneered by Prof. Muhammad Yunus of Grameen Bank is perhaps the most well known, admired and practised model in the world. The model involves the following elements.

- Homogeneous group of five women members
- Eight groups form a Centre
- Centre meets every week
- Regular savings by all members (which was introduced a few years after GB started)
- Loan proposals approved at Centre meeting
- Loan disbursed directly to individuals
- All loans repaid in 50 instalments

52. The Grameen model follows a fairly regimented routine. The group members tend to be selected or at least strongly vetted by the bank. It is cost intensive. One of the reasons for the high cost is that staff members can conduct only two meetings a day and are thus occupied for only a few hours in field work, usually early morning or late in the evening. They were used additionally for accounting work, but this is now done more cost-effectively using computers. The model is also rather meeting intensive, and members can cope as long as they have no alternative use for their time but can be a problem as they go up the income ladder.

53. The strength of the Grameen model is in the simplicity of the design of its products and delivery, which makes it widely replicable. However, the Grameen model works only under certain assumptions. As the loans are for enterprise promotion only, it assumes that all the members want to be self-employed. However, women do not borrow for enterprise purposes only. They may borrow 'officially' for enterprise purposes, particularly to support their husbands' businesses, and 'unofficially' use the credit for marriage, food, health care, etc. The repayment of loans starts the week after the loan is disbursed – the inherent assumption being that the borrowers can service their loan from ex-ante income. Both assumptions can be questioned.

54. Some of the major Grameen replicators in India are SHARE Microfin Ltd. and Swayam Krishi Sangha (SKS) in Andhra Pradesh, Bharat Seva Samsthe and Grameen Koota in Karnataka, ASA in Tamil Nadu, Cashpor Financial and Technical Services in Uttar Pradesh and the Rashtriya Gramin Vikas Nidhi in Assam and Orissa.

55. The Grameen Bank and some of its 'replicators' outside and within India have introduced more flexible products for farming, housing (a long standing Grameen product) and other purposes. While the Grameen method is time consuming for members, it is also quite easy for them; the only decision they have to make as a group is whether or not to accept their fellow members' loan proposals, which is usually somewhat of a formality, since loans are at least initially disbursed on a strict rotational basis.

56. There is enough literature to question whether the Grameen model is best suited for the poorest – particularly when their risk taking ability with new enterprises may be inadequate. There is a lot of evidence from Bangladesh to suggest that the Grameen model benefits the poorest the least, and that it actually harms many people. Its simplicity leads staff to focus exclusively on recoveries, and hence to mobilise fierce group pressure, which has led in one case to seizure of roofing material as security, hence houses being torn down, and even suicides. (Malcolm Harper, 2003, in Micro-finance Roundtable, IIM-Ahmedabad)

<u>The Self-help Group Model</u>

57. The SHG model is a home-grown model. The model is quite popular with bankers who see a long term potential in micro-finance, as is evident from the phenomenal growth of the SHG - Bank Linkage during 2002-2003. The essential design elements of the SHG model are:

- Homogenous members of similar economic status
- Affinity- trust and mutual support among members; this tends to restrict the group to 15-20 members
- Regular meetings – studies indicate that SHG's which meet weekly are most likely to evolve as sound institutions providing both savings and credit services as well as taking initiatives for change.
- Regular savings – the group begins by savings which are placed in a group common fund; the stress is on regularity in order to create the savings habit
- Lending decisions are taken by the group
- Groups select their leaders which are rotated
- The group as a institution accesses external funds

58. The groups tend to be dependent on the intervening agency (NGOs) for a long time to help them not only maintain accounts and conduct meetings, but also to manage the external interface with bankers and others. Wherever the NGO has invested in institutional capacity building of SHGs this is not the case. The rate of growth of SHGs is not as fast as the Grameen groups, since the design allows for flexibility and focuses on internal capability development, it may take a long time for penetration. SHGs tend to work better in areas where the credit culture is not severely damaged – particularly in the southern part of India. The Grameen model – which is more structured - seems to work in areas where the credit culture is severely impaired – particularly in the north and eastern parts.

Individual lending with joint liability groups (JLGs)

59. Under this model, while the MFI lends to individual borrowers, they are asked to form "joint liability groups" of 5-7 self-selected members, who agree to guarantee repayment on behalf of each other. This is a mechanism for providing social collateral to the lending institution. The possibility of repayment improves due to the application of peer pressure in case of wilful default by a member, or through mutual help in case one has a genuine setback in the activity and has a temporary shortfall to repay. The JLG also improves repayment because in the first place members eliminate those whom they think are likely to be wilful defaulters or will not be able to use the loan properly.

Individual lending models

60. This is appropriate for borrowers who have graduated from the SHGs or JLGs after a number of cycles and may need loans of Rs. 25,000 or more. They either carry out enterprise work on their own, or hire others as labour. The reason why this works with larger clients is because the transaction size is large enough for the lending institution to justify the transaction costs of dealing with one borrower at a time. The history of borrowing in groups, or of smaller individual loans, helps the MFI assess the creditworthiness of the borrower and thus eliminates the need for collateral security.

Summary of attributes of various lending models

Lending Model	**Borrower profile**	**Transaction Costs**	**Repayment Levels**
Grameen Bank[12]	Poor, women	High	99%+
Self-Help Group	Poor, mainly women	Medium-low	97%+
Individual in Joint Liability Groups	Slightly above poverty line	Medium -High	95%+
Individual[13]	Above poverty line	High	95%+

Models for delivery of savings services to the poor

61. The models which are used for savings services can be classified as follows:

- **Informal:**
  - Cash kept with self or neighbours/relatives
  - Regular (weekly) savings kept in the SHG's group common fund
  - Small hand loans given to neighbours and relatives
  - Committees/Bishis/Chits run in the village/neigbourhood
  - Daily/weekly savings collectors of unregistered and unauthorised finance companies

- **Formal:**
  - Savings collected by MFIs, even though not legally permitted by RBI
  - Daily/weekly savings collection by RBI approved "residuary non-bank finance companies (RNBCs) such as Sahara and Peerless

[12] Based on data from SHARE and Cashpor

[13] Both this and the joint liability groups data is from BASIX

- Post office savings
- Savings in banks

62. Given the attributes that the poor require for savings, namely flexibility, frequency, safety, liquidity and doorstep transactions, there is nothing to beat the "savings collector" and this accounts for the popularity of companies like Sahara and Peerless with millions of depositors. This is in spite of the fact that savings are hard to withdraw or even to take a loan from (see box on Sahara). However, this model works best in highly populated areas, particularly in cities and towns where the distances to be covered between depositors is short.

63. In more remote areas, SHGs provide a major savings service with all the attributes mentioned above including ready access for withdrawals. For example the 7332 SHGs currently in the MYRADA programme area have a total common fund of Rs.60.7 crores of which Rs.24.3 crores is savings and Rs.12.5 crores is the interest earned on loans.

Saving Collection: The Sahara Model [14]

Sahara collects savings from 39 million depositors ("1 out of every 25 Indians") through 1,379 branch offices and has 600,000 staff and agents for the purpose. Sahara invests its asset base of Rs.160 billion ($3.3 billion) on the Mumbai money market as well as in lucrative real estate projects. It has even invested in an airline – the third largest airline providing domestic air services in India. Any savings instalment missed by a Sahara depositor has to be paid later along with 9% interest and the withdrawal of savings before the completion of the term of the deposit is virtually impossible. The only means depositors have of leveraging their savings with Sahara is the possibility of taking a loan against the balance in the deposit account; Sahara lends back 75% of the depositors' savings at an interest rate of 15% per annum compounded monthly. However, the company is reluctant to make such loans and agents generally discourage clients from using the facility. Only 10% of the Sahara clients in the block have been able to utilise the service.

64. However, a number of fly-by night finance companies also provide the same service and decamp with the savings of the poor. By not permitting MFIs to take savings from their client group, the RBI is in fact unwittingly driving the poor into the hands of far less reliable and unscrupulous operators. Under the Provisions of the RBI Act, 1934, as per the amended Section 45 S of the Act, "No person being an individual, or a firm or an unincorporated association of individuals shall accept any deposit if his or its business wholly or partly includes any of the activities specified in clause (c) of Sec. 45-I (i.e. the business of a financial institution such as financing activities of other institutions, acquisition of shares, bonds, debentures, etc., letting or delivering of any goods under hire purchase agreements, insurance business, managing chits and kurkis and collecting money by issue of units), or his or its principal business is that of receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner".

65. In spite of this provision, a number of MFIs continue to collect savings. Some do it on their own books, thereby risking the charge of conducting an activity, which is illegal. Others have established artifices such as "mutual benefit savings trusts" whose legal status vis-à-vis is uncertain. Yet others, particularly in AP, have taken recourse to the AP Mutually Aided Cooperative Societies Act, 1995, which permits mobilising savings from members. In summary, the logic of the legal framework for savings is driven by RBI's rightful concern for depositor safety, but neglects the fact that the poor are unable to access most of the regulated institutions that offer it.

Models for delivery of insurance services to the poor

66. The Life Insurance Corporation of India (LIC) has had a monopoly in the life insurance business for nearly 50 years. As a result of its public ownership, it was obligated to provide life cover to rural areas and to the vulnerable segments of the population. As for the former, what the LIC did is

[14] Sinha Sanjay and Meenal Patole, op. cit.

obvious from the following excerpt from the IRDA's Annual Report[15]. *"Though in the past the LIC has indicated that more than 52% of its new business used to come from the rural sector, the performance has to be judged in the background of the regulations that have been made by the Authority defining the rural sector. On the basis of the revised yardsticks and the definition of rural sector, LIC's business from that area is around 18%. The Authority hopes that in the years to come LIC will improve its performance in the rural and social sectors".* The LIC, nevertheless continues to offer the largest number of covers for the poor, mostly through group policies, such as the ones linked to government programs such as SGSY. Likewise, the four public sector non-life insurance companies under the General Insurance Corporation (GIC) also offer a number of useful schemes.[16] The insurance sector has opened up to private participation only three years ago and already a number of innovative delivery models have emerged. These have arisen in response to obligations imposed by the IRDA on new private insurance companies (see box). These obligations have spurred private sector agencies to seek partnerships with NGOs, MFIs and in some cases dairy cooperatives. These models work as follows: in the case of social sector policies, an insurance company appoints an NGO as a "nodal agency", which originates insurance proposals from the target group of poor communities it may be working with. These are then offered life insurance, usually of small amounts, varying from Rs 5000 to 25,000 in case of death. The insurance policies can be individual or for a group, which has to be defined.

67. In the case of group insurance, the paper work is minimal and the premium is sometimes paid by the NGO. In matured variations of this model, the front-end administration, premium collection and claim settlement is done by the NGO, and the accounts are settled periodically between the NGO and the insurance company. This has been done for years by SEWA with the LIC and now with private insurers.

68. In the case of non-life insurance, the ones most important for the poor are related to health, crop and livestock. However, health insurance has yet to take off in India. Crop insurance though now "universal" under the Rashtriya Krishi Bima Yojana, is not easily available to small and marginal farmers. Livestock insurance is mandatory when the poor get bank loans to buy animals, but is not widely used by other livestock farmers.

69. In summary, the need for insurance among the poor to protect their lives and livelihoods is high and perhaps should be addressed before credit. There are a number of insurance products being offered by both public and private sector insurance companies to address the poor and what is required is to build collaborative models of delivery between MFIs and insurance companies.

Micro Finance Institutions have emerged as the alternative serving the poor

NGOs in Micro-finance

70. NGOs discovered micro-finance because they were engaged in empowerment and economic development of the poor. Most institutions under this category are multipurpose NGOs, which are involved in other development activities. It is estimated that there are about 1000 NGOs in India (NABARD, 2000; Mahajan, 2000) involved in micro finance.

71. They operate on a non-profit basis and have social welfare objectives. Examples include Activists for Social Alternatives (ASA) in Tamil Nadu, Adithi in Bihar, and the Cooperative for Assistance and Relief Everywhere (CARE) in Maharastra, Madhya Pradesh, Andhra Pradesh, Orissa, Bihar, and West Bengal. NGOs that are involved in the promotion of self-help groups but without financial intermediation activities, are not considered microfinance institutions. They include MYRADA,

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[15] Insurance Regulatory and Development Authority (IRDA), First Annual Report 2001-01.

[16] Friends of Women's World Banking, Ahmedabad: Compilation of insurance schemes available with the four nationalized insurance companies in India, suitable to poor families. 2002

DHAN Foundation, ASSEFA and PRADAN. They are, however, instrumental in linking SHGs to banks and other micro-finance institutions.

Specialized MFIs

72. The number and size of NGO MFIs is increasing to the point where they now collectively account for perhaps nearly one million borrowers and over Rs.300 crore in outstanding loans. Together they span three main categories:

73. The first kind are microfinance NGOs, of which there are only a handful in India. Examples include Spandana in Andhra Pradesh, the Rural Development Organization (RDO) in Manipur, and Nari-Nidhi in Bihar, established by Adithi.

74. The next category is co-operative societies such as the Indian Co-operative Network for Women (ICNW) of the Working Women's Forum (WWF), the Self-Employed Women's Association (SEWA) Bank in Gujarat, and the thrift and credit co-operative societies promoted by the Co-operative Development Foundation (CDF) in Andhra Pradesh. Some mutually aided co-operative societies (MACS) also specialise in micro-finance -such as Mahila Vikasa in Andhra Pradesh.

75. The third category is NBFCs specializing in micro-finance, such as those established by BASIX (Bhartiya Samruddi Finance) and SHARE Micro Finance Ltd in Andhra Pradesh, Sanghamithra, a not-for-profit Company promoted by MYRADA and working in Karnataka, Tamil Nadu, and Andhra Pradesh, Sarvodaya Nano Finance Ltd. and CASHPOR Financial and Technical Services (CFTS) in Uttar Pradesh in Tamil Nadu - are part of this group.

76. MFIs in India had an outstanding of around Rs.45 crore from bulk lending institutions,[17] roughly the same amount from donors, and another Rs.50–60 crore in member savings, leading to a total of Rs.140–150 crore in outstanding capital[18] in 2000. This number is likely to be close to Rs. 350 crore by March 2003. Such evidence as is available, on the other hand, suggests that effective demand is overwhelmingly in excess of this.

Emerging institutional models for composite micro-finance services

77. As seen by the poor, the specialisation developed by the financial sector is perhaps dysfunctional. What they need is a composite service which provides them at least the three main components, savings, credit and insurance, and perhaps adds on a few services such as money transfer, which is increasingly needed by the poor as part of the family migrates in search of a livelihood. There are only a few examples of composite financial services, mostly to be found among MFIs. For example,

- SEWA Ahmedabad provides a combination of savings and credit through its Sri Mahila SEWA Urban Co-operative Bank and insurance services managed through its Vimo SEWA affiliate, which front ends for the LIC and a number of general insurance companies. Vimo SEWA is perhaps the nation's largest MFI insurer, covering over 100,000 women, for life as well as risks related to houses and assets used in earning their livelihoods. It also is a leader in designing and offering health insurance products covering maternity as well.

- SHARE in Andhra Pradesh provides savings services to its members through the Sneha Mutually Aided Co-operative Society (MACS), in the same weekly meeting where they gather to repay loan instalments and seek fresh loans from Share Micro-fin Ltd, the NBFC. The members are also insured against death.

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[17] Refer annexure for details

[18] Sanjay Sinha, 2000

- Sanghamitra – promoted by MYRADA, has entered into an agreement with ICICI Prudential Life Insurance for marketing a specially packaged life insurance policy to its members.

- BASIX group's Krishna Bhima Samruddhi Local Area Bank, however, is able to provide all the services–savings, including daily deposits collected from the doorstep of its borrowers, credit for a range of purposes from crop loans to non-farm activities and to SHGs; and crop insurance to farmers under the Kisan Credit Card / Rashtriya Krishi Bima Yojana. BASIX has also developed a new product offered jointly with AVIVA Life Insurance Company which ensures that in case of a borrower's death, the entire amount outstanding in his name is repaid by the insurance company and in addition the family gets a certain amount. Separately, with Royal Sundaram General Insurance Company, BASIX provides livestock insurance to its borrowers.

78. What is the logic for such composite services? As far as the poor are concerned, it reduces their problem of having to deal with a number of agencies and thus reduces the transaction costs involved. Moreover, their credit record with one agency is not considered by another offering a different service. But if the agency is a composite one and has a good internal MIS, it can use the savings history as a "collateral" for loans. Similarly, if the same agency provides insurance for life or livelihoods, it will be more willing to give a loan. From the MFIs' point of view, transaction costs come down as the same delivery system can be used, with some inputs of training, software and staff. There is thus a need for regulators to look at the poor as customers for composite services.

IV. Issues in Micro-Finance

79. There is currently considerable activity and excitement, in official, donor and civil society circles alike, about the prospects and potential of micro-finance as an instrument to address the critical savings and credit needs of the poor. This is also where the convergence of perspectives ends. A commonly agreed upon agenda for action has yet to emerge, even as there are signs that most major players (except the borrowers or any institution that could represent their point of view) are engaged in dialogue at various levels to arrive at a broad consensus for further action. While the range of issues that requires urgent attention is daunting, we discuss below a few core issues.

SHGs and NGOs have compromised their social role because of microfinance

80. The SHG movement was started by NGOs, not only as a means of ensuring that the poor get access to credit, but more importantly, to organise them and give them a sense of solidarity. The earliest groups have their origin in Mahila Mandals and other such women's groups which were brought together for the purpose of giving extension education in the fields of family planning, nutrition, child care, preventive health care and so on. The emphasis was on interaction and not on financial transactions.

81. In contrast, as many NGOs started getting more seriously involved in savings and credit related activities, they had to sharpen their financial skills. They had to maintain account books, and a large part of the group meeting time now gets taken up by transactions, even just counting cash, rather than interactions. This brings down the sense of cohesion among the members and they begin to see SHGs as mere savings and credit groups. The wider agenda of awareness building and solidarity, let alone empowerment, gets side-lined. This transformation at the SHG level is mirrored at the level of NGOs also, as they become more and more "business like" and eventually, some even transform themselves into MFIs.

82. The focus on financial functions can be justified on the grounds of effectiveness and maintaining credit discipline. However, the social role of SHGs gets eroded. As group members move from obvious first-time uses of credit such as livestock rearing and petty trading, they find that they hit a

plateau because anything more complex requires cooperation. This may be in the form of collective purchase of inputs, sharing of production infrastructure and equipment, or common marketing of products. Similarly, in the field of natural resource management, such as land, water and forests, co-operation of a high order is required, which is well beyond the level of savings and credit groups. A large number of SHGs thus find it difficult to go beyond the mutual lending stage.

83. This situation has been aggravated by the target approach imposed by various state governments for the formation of SHGs particularly under the SGSY. There is a lot of competition among officials for forming SHGs, whether they have the necessary cohesion or not. The next stage of this process sets targets for linking groups with banks. Here, fortunately, bankers apply their discretion and only the better groups get linked. Thus in AP, while a study showed that only 19 percent of all sample SHGs were of good enough quality to be bank linked, another study showed that of those SHGs which were linked with banks, only about 60 percent were of good quality.

84. The situation can be remedied only when the target approach is removed and NGOs revert to their social intermediation role rather than taking up financial roles of lending and collecting repayments from SHGs.

Reaching the poorest and the poorer regions is still a challenge

85. A study conducted by NABARD showed that providing loans to SHGs increased their assets (livestock and consumer durables), employment (especially non-farm), consumption, household income, and decreased the incidence of poverty (Puhazhendi and Satyasai, 2000).

SIDBI also sponsored two studies to assess its micro-credit scheme. Both concluded that credit support reached the most deserving poor, reduced their debt to local moneylenders, and increased incomes and savings.

86. The evidence from the most successful models of micro-finance intervention in the past decade brings out three major conclusions:

- that it is the relatively not-so-poor in rural areas that have been the most successful beneficiaries of micro-finance loans,
- that the group strategy (lending to SHGs based on affinity or to individuals in groups as in the Grameen Bank) tends to be a more appropriate instrument to reach the poorer households than individual loans,
- in the first year micro-finance has primarily played a role in consumption smoothening and exigency gap filling for the household, but the focus shifts to loans for trading and assets from the second year; there is also a significant increase in the size of these loans from the third year onwards. For example, Sanghamitra now gives loans to SHGs ranging between Rs.2 to Rs.3 lakhs – this has encouraged RRBs to follow suit.
- it is only where repeated loans have been accessed that there is any visible impact on livelihoods.

87. The logical corollary of these conclusions is that micro-finance has failed to reach the poorest households, that other sources of rural credit, especially informal sources, continue to play a vital role in this arena and that institutions engaged in micro-finance delivery have tended to largely undersupply their clients. The questions, however, remain: Do all the poor want to be self-employed? Who are the poorest? Are they not the sick, old? Do these people need microfinance? Who identifies the poorest, the local people or outsiders?

88. Besides the obvious vulnerability to hunger and ill health, the poor household is at risk in natural calamities like droughts, floods, cyclones etc., in addition to social risks such as discrimination, exclusion and lack of participation in representative institutions. These risks are mostly ignored in devising risk mitigation or credit strategies. To this list may be added physical violence, forcible

eviction from habitat and livelihood spaces and involvement in social and political conflict. Evolving a strategy to target micro-finance at such households will mean that several questions, such as who meets the costs of social mobilisation, what kind of institutions are necessary to perform a mentoring role to SHGs of the poor and how is micro insurance to be packaged with micro-finance, will have to be answered.

89. For micro-finance to play a significant role in rural livelihoods, especially those of the poorest households, a more varied institution building and support strategy will have to be developed. If the intention is to target the poorest rural households, the issue of vulnerability and risk will have to be centrally addressed before there is even an attempt to mobilise savings and link up with credit lines.

The SHG Bank linkage model is both promising and problematic

Growth in volumes of SHG-Bank Linkage

By Mar 31	Cumulative bank loans (Rs. million)
1999	571
2000	1,930
2001	4,809
2002	10,263
2003	20,487

90. As can be seen from the table above, banks have greatly increased their exposure to SHGs over the last three years. Though the profitability of SHG lending is not yet fully established, indications are that banks are able to do this business without losses even when interest rates are capped at 12.5 percent. Indeed, the State Bank of India has recently announced its intention to lend at lower rates to SHGs. This is spurred by the fact that due to a cut in deposit rates, the cost of funds for banks is going down and at least so far the level of defaults in the SHG portfolio is small. About transaction costs, the banks feel that since they have a rural branch network with all the fixed costs anyway, there are few incremental costs for SHG lending.

91. A few studies examined the economies of lending to SHGs by some commercial banks and RRBs and have found it to be profitable. For instance, Bank of Baroda, one of the largest public banks involved in lending to SHGs, had a regular repayment rate of nearly 100 percent and reasonable transaction costs, so the total cost of this lending activity was not higher than that for large loans. Oriental Bank of Commerce, a small public bank, has also developed profitable lending to SHGs (Shete, 1999).[19]

92. Bank of Madura, an old private commercial bank, has found the SHG programme so satisfactory that it has made it part of a strategy for achieving viability in 104 rural branches (Sinha, 2000). Bank of Madura, now part of the private ICICI Bank, highlights the importance of finding innovative solutions to cut the costs associated with the programme and confirms the pioneering role played by the private sector in innovating. Bank of Madura expects its SHG lending to become profitable even without using NABARD refinancing. (However, the poor are not the major beneficiaries of this programme.)

93. These success stories could be circulated to encourage commercial banks to include SHG lending in their business strategies, and innovative methods to cut the costs of the program could be shared with other practitioners. In addition, the Bank of Madura example shows that financially healthy and well-managed institutions with low-cost funding do not need NABARD's subsidized refinancing.

[19] Information taken from the World Bank Report No: 22531-IN

94. This suggests a new responsibility for NABARD, focused on selecting experienced and well-managed institutions to participate in the program, imposing clear profitability objectives and sharing best practice in the market. This will ensure the long-term sustainability of SHG lending activities. NABARD has taken a first step towards commercial principles by liberalizing the programme's interest rates in 1999. However, incentives remain biased toward growth of the programme without attention to its overall sustainability.

95. NABARD's subsidized refinancing could be offered only to institutions with a proven track record or a strong commitment to micro-finance and focusing on financial discipline, transparency and viability. These requirements are already required of its MFI borrowers by SIDBI. Subsidies could be eliminated once participating institutions have profitable SHG portfolios. Such a policy would encourage participating institutions to look for ways to make their SHG activities profitable. This in turn will ensure the long-term sustainability of micro-finance in the country.

96. A recent study[20] by Sanjay Sinha on RRBs indicates that there are a number of problems with profitability of SHG lending and RRBs may actually be losing money by under-pricing these loans. The data analysed by the study shows that all bank branches, irrespective of SHG promotion mechanisms, are making substantial losses in lending to SHGs due to pricing of SHG loans below cost. These loans carry the lowest interest rates of all products in all the sample banks (12.5-13 percent per annum), and this does not allow the banks to earn a spread even with the most efficient operating system. The five RRBs studied in the sample showed that the cost of SHG lending varied from 22- 30 percent (even if one excluded an RRB where it cost over 48 percent, as an outlier). Thus, unless banks increase their interest rates on SHG lending to the range of 24 percent, it is unlikely that they will make any profits. However, efficiency improvement in operations of RRBs as also economies of scale with more SHG lending may also reduce the breakeven pricing to perhaps 21 percent. Of course, they can cross-subsidise this product from their other business. It also returns us to the issue of packaging savings, credit and other financial services by service providers to make lending to the poor a viable proposition.

Sustainability of most MFIs is yet to be established

97. The World Bank[21] study on micro-finance had the following conclusions on MFI sustainability:

- Cumulative lending by MFIs in the country is approximately between Rs.300-350 crore. It may be useful to look at MFIs in a disaggregated manner to understand the diversity among them. This, in turn, would shape policy initiatives for MFIs in the country.

- Operational self-sufficiency ranges from 40 per cent for 'early MFIs' to greater than 100 per cent for mature MFIs such as BASIX, SHARE and SEWA Bank.
- Only one MFI, Bhartiya Samruddhi Finance Limited, has been able to raise capital from mainstream markets. Return on equity for 2002-03 was 3 per cent.

98. Case studies [22]carried out by BASIX for IFAD in 1999 on select MFIs revealed that most of the MFIs were making losses from their micro finance operations. This was attributed to the fact that lending rates, cost of funds, operating costs and loan losses were not following a financially consistent model in the MFI operating structure.

[20] "The Outreach/viability Conundrum " Can India's Regional Rural Banks really serve low income clients?" p. 42-46 by MCRIL, Gurgaon

[21] World Bank 2001. "India – Microfinance in India: Issues, Constraints and Potential for Sustainable Growth." South Asia Region. Finance and Private Sector Development Unit, Washington. D.C

[22] BASIX (2000), 'Case Studies on Select Micro-Finance Institutions in India'

99. It appears that most of the MFIs are under capitalised due to their legal form – most are Societies/ Trusts, which do not have any concept of equity.[23] This will restrict these MFIs' ability to seek adequate debt in the long run. Moreover, there is no cushion to absorb loan losses, though some have built reserve funds at various levels. In fact most lending schemes to MFIs, such as by the RMK and FWWB, are structured to suit only NGOs registered as Societies/Trusts. Low levels of equity make it difficult for MFIs to leverage commercial loan funds. Analysis of costs[24] indicate that interest rates of 27 per cent are needed for sustainable operations of MFIs who are lending directly to individuals and 24 per cent to those who are lending to SHGs. These figures are based on cost of funds, lending rates and loan losses. Currently MFIs are either making up for operating deficits with grants or using low or no-cost funds to increase spread. This situation is not sustainable. The restriction of on-lending rates imposed by the bulk lenders like RMK compounds matters further. Cost of funds for MFIs has been high because of the inability to mobilise savings and reliance on commercial funding.

100. A recent study[25] by MCRIL of 69 leading MFIs showed that they had an outreach of over 1.4 million members (not all of whom were borrowers), with loans outstanding of Rs.164 crore and an average loan of Rs.3600 per borrower and savings of Rs.650 per member. However, the MFIs were far from operationally self-sufficient, with the sample being able to earn only 80.2 percent of their operating costs from their revenues, the rest being subsidised. The financial self-sufficiency ratio, which also takes into account any below-market price lending funds, apart from operating subsidies, was only 68.3 percent for the sample MFIs. Thus the MFI sector has a long way to go before it can claim to financially sustainable.

Inadequate institutional capacity is a problem

101. Inadequate investment in institutional capacity building is perhaps the single most important constraint at present in the growth of the micro-finance sector in India. The issue of institutional capacity building was discussed in detail in the Working Group on Enhancing Financial Flows to the Unorganised Sector, set up by the Prime Minister's Office in 2001. The sub-group on Capacity Building, convened by DHAN Foundation made the following detailed analysis and recommendations on the matter. Capacity Building is required at three levels: This includes the

- *Demand Stream* (SHGs, SHG Federation, Sub-sectoral Federations, Confederations and movements of unorganised sectors),
- *Supply Stream (*bulk lending institutions, Commercial banks, RRBs, Co-operatives, Financial Institutions and MFIs) and
- E*nabling Stream (*Promotional Institutions, NGOs, Regulatory Institutions).

102. The critical importance of providing institutional capacity building training for the SHGs cannot be over-stressed. The strength of the superstructure including the federations and sub-sectoral federations depends on the strength of the SHGs. Unfortunately the degree of importance given to this investment differs widely. Further, in many cases, only the representatives of leaders of the SHGs are trained and not the entire SHG. One indicator of this difference is the amount budgeted in various programmes based on SHG strategy.

103. For example, Sthree Shakti (a Karnataka Government Programme) budgets Rs. 600 per group; NABARD around Rs.1500 per group while Swa Shakti (a World Bank-IFAD sponsored programme) budgets Rs.16,000 per group. MYRADA which has been involved in training SHGs since mid-eighties, estimates that the cost per group ranges between Rs.7,000 to Rs.10,000. Based on its field experience of conducting 12,369 trainings for SHGs between April 1999 and March 2002 (an average of about 4,100 programmes a year), MYRADA brought out a Training Manual with 24

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[23] World Bank, op. cit.
[24] World Bank, op.cit.

[25] Sinha, Sanajy: "Financial Services for Low Income Families: An Appraisal" in *Management Review*, IIM , Bangalore, June 2003

modules to promote institutional capacity building of SHGs, which is widely used and translated into Hindi and Bahasa Indonesia in the context of IFAD promoted projects. Training individual members to upgrade existing and adopting new livelihood options, and building confidence is another critical area where investment of time and money is required. It is also imperative to provide support to build appropriate linkages with the private sector for design, quality and marketing and to provide access to local markets. On the whole, the good news is that capacity building institutions are emerging. There is an increasing number of institutions which have become active in the field of research, consultancy and training in the field of micro finance.

104. The foremost among these are the Bankers Institute of Rural Development (BIRD) Lucknow, mainly focusing on bankers, and the Institute for Rural Management, Anand (IRMA), focusing on MFI staff. In addition, a few faculty members at the Centre for Management of Agriculture at the Indian Institute of Management, Ahmedabad are active in micro finance research. In addition, the National Institute of Bank Management (NIBM), Pune and the College of Agricultural Banking (CAB), Pune have also started training programs and research in this field. All these institutions are also offering consultancy services to donors and funding institutions, as well as to individual MFIs. Among specialist consultancy agencies are EDA Rural Systems and BASIX. Sa-Dhan offers an annual micro finance Education Program (MEP) for mid level practitioners.

105. While we have referred to training institutions above, most of these focus on training of staff of formal or micro finance institutions. However, in view of the fact that there are now close to a million Self Help Groups (SHGs) in India, about half of them in Andhra Pradesh alone, there is a huge need for training and capacity building at the grass roots level. Among the leading NGOs in capacity building are Friends of Women's World Banking (FWWB), Ahmedabad, CDF and APMAS (see box below) in Andhra Pradesh. Indian Grameen Services of the BASIX group is active in AP, MP and Jharkhand. Sanghamitra established by MYRADA in Karnataka acts as both a lending and capacity building agency for SHGs. CARE, through its CASHE project working in the states of West Bengal, Orissa and Andhra Pradesh provides similar services.

Capacity Building of SHGs by the thousands – The Case of APMAS and MYRADA

Andhra Pradesh has been at the forefront of the micro-finance movement in India. There are a variety of microfinance models in the state such as SHGs, Grameen, cooperative and individual lending. Hyderabad, the state capital of Andhra Pradesh, prides itself as the *mecca* of micro-finance in India. Currently there are more than 400000 SHGs with over 5.3 million women as members. Andhra Pradesh is home to the development of several interesting models of micro finance.

As a result of increasing concern in various forums to bring quality to the SHG movement in Andhra Pradesh, the Mahila Abhivruddhi Society, Andhra Pradesh (APMAS) was registered as a public society and started functioning from July 2001. APMAS is a state level institution, which supports the women's self help movement and promotes sustainable livelihoods.

The vision of APMAS is the emergence of high quality and financially viable member-managed & member-owned savings and credit institutions (SMFI) for women in Andhra Pradesh. The intended purpose of APMAS is to improve the quality of SMFIs and to strengthen their effective access to resources. It seeks to address the key felt needs of the sector: Quality enhancement, Quality Assessment and Research & Advocacy.

APMAS represents a public-private partnership institution, with active participation of the Government of Andhra Pradesh, Banks, representatives of Civil Society Organizations and SHG/ MACS. APMAS had supported NABARD in developing a Critical Rating Index for SHGs and has developing "GRADES" assessment tool for SHG federations. It has trained over 300 resource persons in SHG assessment and another 200 more in SHG capacity building. All these persons are based in the districts and each in turn works with 50-100 SHGs and a number of SHG Federations.

As per its five year business plan, APMAS would have enabled the assessment of over 86,000 SHGs and training of 132,000 SHGs, through a network of authorised quality assessment and capacity building agencies.

V. The Policy And Regulatory Framework

Poverty alleviation programs impinge on the environment for microcredit

106. While the micro-credit movement in the country is growing steadily, both through the SHG-Bank Linkage program and through direct lending by MFIs, there are a number of government poverty alleviation programs, which impinge on the environment for micro-credit. The SGSY is the pre-eminent national self-employment programme for the poor, launched in 1999, with an objective to establish a large number of micro-enterprises in rural areas that build on the potential of the rural poor. It replaced the individual assistance approach of the earlier IRDP with a group lending one. This involves formation of SHGs, particularly of women, capacity building and supporting them with both credit and subsidy components for the identified potential cluster activities. An SHG under SGSY can get a maximum subsidy of Rs. 1.25 lakhs.[26]

107. As on February 2003, 1,262,786 SHGs have been formed all over the country since the launch of the programme. Of these only 8 percent received support for economic activities. The cumulative credit target as on February 2003, was Rs.12130 crore; however, the utilization was only Rs.4627 crore (38 percent). Within this, the credit disbursed to individuals was Rs.3597 crore, which was much higher than Rs.1030 crore credit extended to SGSY SHGs. This indicates that the program objective of promoting SHGs is still needs to be strengthened.

108. Apart from the nationwide SGSY, the other big programme run is the DPIP. It is a joint initiative of the World Bank and the Government, aimed at addressing the issue of poverty. There are three states under the DPIP - Andhra Pradesh, Madhya Pradesh and Rajasthan. The three are amongst the poorest states in India and were targeted by the Bank's Country Assistance Strategy (CAS) for India. The project approach was to form grassroots organisations and build up there capacity for project sustainability.

109. DPIP is a major source of grant funds to communities and its ability to distort the market for micro-credit is enormous. It is difficult for a poor household to distinguish between grant funds that flow to them through their SHGs and loan funds that come to them from banks or MFIs through the same SHGs. The repayment rates of micro-credit are likely to suffer and that will reduce greatly the appeal that the "new" methodologies of micro-credit have for banks. This will eventually reduce the flow of credit to the poor.

Banks/Insurance Cos. are debilitated by public ownership and pricing curbs

110. Policymakers in India have traditionally held the view that farmers and poor people need low interest and subsidized credit and low-premium insurance, particularly crop insurance. Thus, there is a regulated interest regime for the loans up to Rs 25,000 and Rs 2,00,000/- with an interest cap of 12 percent and 13.5 percent respectively. It is assumed that the poor cannot save, they are unwilling to repay loans and the administrative costs of reaching financial services to the poor are high.

- Small loans have also been used as a tool to disburse political patronage through occasional mass waivers, undermining the principle 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 the RRBs, and none of the Co-operative Acts of the states permit district level co-operative banks to be set up by anyone except the state government. The result of these two laws put together is that rural credit has been a monopoly of state owned institutions.

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[26] Ministry of Rural Development: Agenda papers for Central Level Coordination Committee on SGSY, May 2003

- The NABARD Act does not permit it to refinance any private sector financial institutions or undertake direct financing (NABARD's direct lending to micro-finance NGOs so far has been out of donor funds). Similarly the SIDBI Act restricts it from extending loans to agriculture and allied sectors, whereas many of the members of the SHGs are engaged in such activities.

111. In contrast, the private sector ICICI Bank has shown a great amount of dynamism in building expertise in micro-finance and expanding its portfolio. The same is true of the HDFC. In addition, among the new generation private sector banks, UTI Bank, and the HDFC Bank are aggressively seeking micro-finance business through MFIs.

112. The public sector ownership of LIC and GIC also came in the way of their ever looking at the poor as a profitable market. The social fund in the LIC was earmarked as a subsidy to the poor. The large number of schemes devised for the poor were mainly offered through group master policies, with the insured rarely even being aware that they were insured. As a result, for example, there were hardly any claims from the group insurance policies covering millions of poor people under the IRDP and later the SGSY.

There is a no specialised legal framework for MFIs in India

113. Most of India's small micro-finance institutions are constrained from achieving financial sustainability by legal restrictions on their operations (mainly limiting their ability to mobilize sufficient resources), insufficient institutional capacity, and welfare concerns. Small micro-finance institutions with the required institutional capacity have managed to be profitable and have changed their legal structure to avoid legal restrictions and enable their operations to grow. The legal form of MFIs range from:

- Not-for-profit MFIs (Societies, Public Trusts and Section 25 companies)
- Mutual benefit MFIs (State credit co-operatives, National Credit Co-operatives and Mutually Aided Co-operative societies)
- For-profit MFIs (NBFCs). More than 76 per cent of the disbursements are by three of the leading MFIs in the country (SHARE, BASIX. and CFTS).

114. Many NGOs, either registered under Trust or Society's Acts, which entered the micro-finance sector with the objective of filling the gap between the demand and supply of such services, are constrained by the legal and policy framework. Though mainstream financial institutions such as NABARD, SIDBI, RMK and FWWB support these NGOs with funding, they face the following problems:

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

115. The other alternative for an MFI is to become a co-operative or a company. In the long run the primary source of lending funds for MFIs is deposits but till that stage the MFI has to rely on borrowings. To be able to attract borrowings, the MFI has to have equity capital. Thus, it is only possible to establish a financially sustainable MFI either as a co-operative or as a company. In most states, with the exception of Andhra Pradesh, Maharashtra, and Gujarat, co-operatives are politicised and state controlled and are thus not an appropriate form of incorporation for an MFI. The concept of the Local Area Bank, with a lower start up capital of Rs 5 crore, has not picked up momentum from the government. That leaves an MFI with the choice to be incorporated as a company and then become an NBFC or a Bank. The latter requires a license and a minimum start up equity of Rs.00

crore, which is very difficult for an MFI to mobilise. If an MFI opts to become an NBFC, it has the following problems

- The minimum entry-level capital requirement is Rs.2 Crore, w.e.f April 1999.
- It is difficult to mobilise any borrowings from Indian financial institutions due to the negative image of NBFCs in general. Further, even deposit mobilisation is not possible at least for the first three years, till a satisfactory credit rating is obtained.
- That leaves the option of borrowing from foreign institutions, which is difficult in the first place, due to RBI's requirement of at least two credit ratings. Further, very few foreign institutions are willing to give rupee denominated loans. Thus, it leaves the MFI to take foreign currency loans, which are subject to exchange risks and obviously out of reach.

The existing policy framework continues to be non-supportive

115. Among all the factors affecting the rapid growth, expansion and deepening of micro-finance initiatives in the country, the absence of a clearly enunciated policy framework to nurture the sector is the most significant. Till about a decade ago this policy vacuum was actually an advantage, as experimentation and innovation in the sector continued unhindered by the boundaries and rules of play any official policy necessarily prescribes. The very concept of a SHG with no statutory recognition and formal structure being able to access a credit line from the formal financial sector was a small revolution of sorts.

116. However, this was part of the exploration with new institutional forms and the numbers were too small to require regulation. With the SHG-bank linkage model increasingly emerging as the preferred route for channelling credit by commercial banks to poor rural households, and social intermediation roles being almost exclusively assumed by civil society institutions, a host of issues have arisen. The potential for growth and scaling-up in the present grey areas and policy gaps has been exhausted and future expansion depends upon a conducive policy framework. The specific constraints due to an unsupportive policy framework, faced by both mainstream and alternative micro-financial institutions, are explained in the next section.

117. Though there is significant dialogue and thinking on policy issues, the output in terms of official policy initiative is meagre. RBI has provided enough flexibility and comfort in terms of guidelines to enable banks to create and nurture micro finance portfolios. NABARD hosted two major policy review groups on micro-finance and produced reports for policy planners. Most recently the Prime Minister's Office (PMO) has acted to provide a platform to bring together formal and civil society institutions in an attempt to define a core agenda of policy action.

118. As a result of the initiative taken up by the PMO, seven working groups comprising of government, NGO and banking sector representatives were constituted to submit detailed working papers on the following subjects during 2002:

1. Validated credit delivery models in the unorganized sector.
2. Capacity building for enhancing availability of institutional finance for unorganized sector.
3. Enhancing resource flows to unorganized sector.
4. Women and microfinance.
5. Identification of new technologies for delivery of financial services.
6. Addressing of legal and regulatory challenge for non-formal financial intermediaries.
7. Provision of non-financial services and their integration with credit delivery structure.

119. Six of the seven groups submitted their reports to the PMO in December 2002, while the last report was dropped. An action plan was adopted after a detailed discussion of the working group reports and handed over to the Dept. of Banking in the Ministry of Finance for follow-up. News of progress since then is not available but it is understood that this is among the 110 odd items put on

fast-track monitoring by the Cabinet Committee on Economic Affairs (CCEA) and the PMO will be making periodic reviews. In parallel, RBI is also processing the recommendations of several informal groups it had set up to make recommendations on micro finance. It can only be hoped that some of the good ideas brought to light as a result of the deliberations of the working groups will find their way into official policy.

120. Interest rate restrictions continue to be a problem not just for banks but also for MFIs. For example, in June 2003, the Government of Tamil Nadu issued an Ordinance in which it has decreed that "no person" can give a secured loan at more than 9 percent per annum and an unsecured loan at more than 12 percent per annum. Breach is punishable by imprisonment. This has led to widespread consternation among NGO-MFIs in the state and some of them have been visited by local authorities and are being questioned about interest rates. This type of politically motivated interference in the sector leads to setbacks.

121. It would be wrong to say, however, that no progress has been made on the policy framework. The table below lists some of the major milestones of policy reform in the recent past and outstanding issues awaiting attention.

Policy Measures for Micro-Finance: Some Accepted and Some Yet to Be…

The Task Force on Micro Finance constituted by the RBI Governor under the Chairmanship of NABARD in 1999 made recommendations in the four broad areas of mainstreaming of MFIs and other MF structures, regulation and supervision of MFIs, organisational aspects relating to MFIs and capacity building of MFIs, banks and Self-help Groups (SHGs). To process the report, RBI set up a Micro Credit Special Cell in April 1999. As a result, RBI issued guidelines in February 2000 which stated that micro credit extended by banks (directly or through intermediaries) would be reckoned as part of priority sector lending. It allowed banks to choose their own models and intermediaries in micro credit and permitted banks to prescribe their own lending norms in respect of micro credit. RBI also deregulated interest rates on loans to micro credit organisations and by the micro credit organisations to Self Help Groups (SHGs)/ member beneficiaries. The interest rate ceiling is currently applicable only to direct small loans given by banks to individual borrowers.

Companies registered under Section 25 of the Companies Act engaged in micro finance activities and which are not accepting public deposits have been exempted from registration as NBFCs and other related regulations.

RBI contributed Rs. 40 crore as per the Task Force recommendation to a Rs.100 crore Micro Finance Development Fund that was established with NABARD. The rest of the contributions came from NABARD and commercial banks. However, disbursements from it are meagre.

Separately, the GOI has permitted foreign equity investment in micro-finance NBFCs with a minimum amount of investment being $0.5 million and not exceeding 51 percent share.

Still pending:

There is a long-standing demand to lower the capital threshold to form a NBFC exclusively for micro-finance to Rs. 25 lakh instead of Rs. 2 crore. This will enable a large number of NGO MFIs to transfer their micro-finance activities to properly constituted MFIs, which can then be properly regulated by the RBI.

The matter of allowing MFIs to accept savings from their members/clients/borrowers has not been addressed squarely. As a result, a number of MFIs are operating in the grey zone. More importantly, in the absence of having a reliable agency for collecting their savings, the poor often park their money with fly-by-night operators and suffer losses.

Easing the restrictions on external commercial borrowings, particularly if the loans are repayable in Rupees. Similarly, lowering the minimum limit of investment of foreign equity from $0.5 million to $50,000 in micro-finance NBFCs so as to attract equity from socially minded individual investors.

Extending a similar status under the Income Tax Act to micro-finance NBFCs as is available housing finance and infrastructure finance companies and allowing NGOs to invest in the equity of micro-finance NBFCs that they may establish as their programmes mature.

VI. Some Ways Forward for IFAD

What criteria can IFAD use for its intervention?

119. As we stated in the opening chapter of this paper, IFAD has a substantial history of involvement in this sector and can legitimately take pride in the fact that over the last 15 odd years, it has supported two of the main institutional models for delivery of micro-finance in India – the SHG Bank Linkage model and the MFI model. Going forward, the strategy which IFAD adopts for supporting micro-finance in India should also fit with its global Strategic Framework 2002-2006[27]. The Framework talks about three strategic objectives:

1. Strengthening the capacity of the rural poor and their organisations
2. Improving equitable access to productive natural resources and technology.
3. Increasing access to financial services and markets.

120. We give below a framework which can help IFAD make strategic choices for intervention in micro-finance in India, recognising the fact that all the three objectives above are mutually supportive, even though only objective 3 seems to be directly linked to micro-finance. In reality, credit plays a critical role in strategies to achieve all three objectives.

Strengthening the capacity of the poor and rural their organisations: It is now accepted that the formation of people's institutions and their capacity building is best achieved by NGOs. IFAD should therefore continue its policy of involving NGOs to provide this service in all its programmes. The implications of this approach can be derived from a study of several on-going IFAD projects in Chattisgarh-Jharkhand, North East, etc. Capacity building should include not only financial and organisational management skills but also building confidence to take risks and build linkages required to access larger loans for livelihoods; the confidence that a group acquires to get involved in society to initiate change is the beginning of the ability to take risk. People's institutions should include SHGs, Watershed Management Associations, Joint Forest Committees, Village Water and Sanitation Committees, Parent Teacher Associations, etc. Training modules and participatory mechanisms and methodologies for self-assessment should be evolved and adapted to each situation. MYRADA's experience indicates that it is not so much the provision of credit to these institutions that is empowering, but their ability to develop systems, practices and a culture to mobilise and manage credit. Therefore these institutions need to be trained to manage credit.

Strengthening the capacity of individual members of these institutions as well as of their family members, especially youth dropouts (young men and women who are dropouts and cannot get admission into recognised training institutions) and women. Examples are: a) Technical training for dropouts (boys and girls) and for women b) Basic Health care training. MYRADA has managed a Technical Training Institute for dropouts over the past 5 years with a yearly intake of 60. Since last year there has been campus recruitment. All the trainees are employed or self employed. Sanghamitra is now prepared to advance loans to cover the entire training cost. Twenty young women, mainly tribals, took a six-month health care training course, have all been employed by private medical institutions in rural areas. This course will now be a regular feature and will also be financed through loans. IFAD should consider supporting NGOs to set up Technical Training Institutes for school dropouts and women to offer basic health care and functional literacy courses particularly in tribal and remote areas.

Strengthen community based MFIs and alternative delivery models

121. Building on its work so far, under this strategic alternative, IFAD could consider a three-pronged approach. The first would be providing all the support possible to various stakeholders to

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[27] IFAD Strategic Framework, 2002-2006

maintain quality of SHGs and community based micro-finance institutions such as SHG Federations and MACS before and after they are linked with banks. For this, the work of Sanghamitra and APMAS are the precursors from which a number of lessons can be drawn. IFAD can therefore consider the promotion of entities such as Sanghamitra and APMAS in other states, particularly the central and eastern states which are prone to political interference in development programs and have weak institutional capacity.

122. The second thrust could be developing and nurturing micro finance delivery models other than the dominant SHG bank linkage model. In this context, the lessons from the success of Grameen bank replicators such as SHARE in Andhra Pradesh and Cashpor in Uttar Pradesh need to be analysed. The other successful model is based on lending to joint liability groups of individuals borrowers by BASIX in Andhra Pradesh, Orissa and Jharkhand. Any future IFAD intervention in microfinance in India should explore these alternative models.

123. The third step would be support to "sector building institutions" which engage in research, training, consultancy and policy advocacy, such as APMAS and IRMA. These institutions can not only provide the leadership in times of change but also engage effectively in policy dialogue and influence design.

124. A good framework for this three level capacity building agenda was developed by the DHAN Foundation led sub-group on capacity building in the Working Group on Enhancing Resource Flows to the Unorganised Sector, established by the Prime Minister's Office in 2001. This is summarised below:

<u>Suggestions for Capacity Building for the Microfinance Sector</u>

<u>Demand Stream</u>: There are three major areas, where these institutions need to focus on.

a) *Support for credit absorption*: To sustain the credit linkages, the support to poor should go beyond the initial loaning of consumption and redemption of old debts to asset creation and enterprise promotion. The success of it depends upon allocation of resources and providing a facilitating environment.
b) *Building Demonstration Centres:* The process of building social capital would be enhanced by exposure to role model SHGs and its federations who have demonstrated good governance, efficiency in functioning and best practices.
c) *Institution Building for Sustainability:* The SHG model has proved to be effective in organizing the poor into institutions and building their social capital. However, the issue of sustainability has still to be addressed. NGOs have formed SHGs Federation, in some cases Resource Centres to provide financial and other associated supports to its member's body. For program sustainability, these federated bodies need to be strengthened.

<u>Supply Stream:</u> Building positive attitude of the bankers is extremely important towards lending to poor and orient them to see lending to poor as a viable proposition and not a social obligation. Other factors, which should focus on are:

a) *Experimentation for field banking:* Many of the formal financial institutions do not have the experience of non-subsidized lending with the poor. As part of building the capacity of these institutions, 10 experimental projects can be initiated for next five years, where each bank will open exclusive micro-finance branches and operate profitably.
b) *Building MFIs:* A cadre of new generation micro-finance leaders needs to be promoted to strengthen the emergence of micro-finance institutions and contribute towards the growth of the sector. Senior executives of the emerging micro-finance institutions need to be provided with varied opportunities to attend the short and long term courses at national and international level in management training institutes of repute.

Enabling Stream:

a) *Reallocate subsidies as promotional costs*: There is a need to involve NGOs for social mobilization for promotion and building of quality groups. Government should recognize the role of NGOs and collaborate with them in programmes like SGSY as an equal partner. The credit subsidy allocation of SGSY can be reduced and reallocated for promotional costs of NGOs and MFIs.
b) *Government to shift from implementation to facilitation*: Government departments and agencies are not equipped for undertaking social mobilization processes. In order to encourage promotion of quality SHGs and ensure greater participation of banks the government should play enabling role and not direct implementation role.
c) *Collaboration for capacity building*: The existing training institutions like SIRD, NIRD and NIPCID need to be equipped to train the government official involved in implementing the SGSY and other developmental programmes. These institutions need to develop collaborations with various strong NGOs and MFIs for field orientation and demonstration for the learners who act as resource institutions.
d) *Networking*: Promotion of networks of NGOs and MFIs need to be encouraged to set standards and provide capacity building support, organize policy workshop, seminars and conferences for dissemination of learning and best practices. Promotion of strong network would facilitate co-learning and promotion self-regulation.

Focus on less-developed states and support NGO-MFIs with a Trust Fund

125. Though the micro-finance movement in India has acquired both volume and depth, there is a substantial regional skew. This is recognised by NABARD as well as SIDBI. Most of the bank – linked SHGs are from the southern states of AP, Tamil Nadu, Karnataka and Kerala, followed by the western states. In contrast, MP, Chattisgarh, Jharkhand, Orissa, Bihar, West Bengal and the north-eastern states have relatively few SHGs and also few dynamic MFIs. This is also reflected in the overall bank credit in the regions. Yet this is the region where India's poor is concentrated. In terms of regional distribution of the outstanding credit:

- Western and Southern regions account for 32 % and 28 % respectively.
- Northern region accounts for another 21.3 %.
- Eastern region accounted for only 9.3 %, while
- Central region for another 8.5 %.
- The north-eastern region accounted for only 0.8 %.

In view of the above, IFAD's next phase of work must be focussed on the central, eastern and north-eastern states. In case this is too large an expanse, specific states may be selected, such as Orissa, Jharkhand and Chattisgarh, where IFAD has ongoing programs. Contiguous states such as Bihar and Madhya Pradesh could be included in such interventions.

126. The central, eastern and north-eastern states have a large need for investment in processes and institutions of social intermediation. Credit-deposit ratios are generally very low, which means that the savings mopped up by the banking sector are not being reinvested. However, while banks have substantial liquidity and high credit targets, they are unwilling to invest directly in creating or funding appropriate institutions of social intermediation that could channel credit to the poor. Banks generally do not consider this to be legitimate market development activity worthy of investment.

127. On the other hand, NGOs working these under-served regions have largely tended to concentrate on the social sector through a welfare-oriented approach to literacy, health and advocacy issues. Most NGOs do not possess the skill or competence in the micro credit, small enterprise and other income generating sectors impinging on livelihood issues. These NGOs are largely functioning through grant-based projects. The efforts of the state governments are limited to implementing

poverty alleviation programmes funded by the central government, with little in the form of support services or resources to improve credit absorption among the poor.

128. Given the social milieu of the underserved states it is unrealistic to expect quality MFIs of a scale to emerge in the medium term to lead the micro finance movement. The strategy here should be to leverage the strength of strong NGOs that have a presence on the ground and credibility with the community, irrespective of their area of work. Thus, if an NGO has developed a relationship of trust with the community through its work on health etc. issues it is that much easier to introduce savings and lending services after suitable training inputs to the field staff and community workers.

129. Though separation of social and financial services is a good idea when micro-finance activity matures, in the early stages, in the under-served areas, a mixed social plus financial intermediation approach may be needed. Once there is a larger and critical mass of SHGs, with increased bank linkages, independent MFIs will slowly emerge with the most successful organisations professionalising their micro finance services.

130. It must also be recognised that any breakthrough in the currently under-served areas will not be feasible without the strong backing and commitment of the concerned state governments. What is required is a strong state-NGO partnership, encouraged by IFAD assistance to create local institutions, which would identify "demand" for micro credit and support structures of training and capacity building that would sustain it.

131. There is, therefore, an institutional vacuum that needs to be filled. It is here that IFAD should think strategically and innovatively and create a pool of funds towards meeting the cost of supporting social intermediation in the underserved areas. A Trust Fund can be created with a seed contribution by IFAD, but with the bulk of its corpus coming from other donors, multilateral institutions, financial institutions, and, most importantly, the central government. It must be ensured that the governance of this Trust Fund learns to avoid all the negative lessons from the RMK and in contrast, adopt the positive lessons from APMAS. It is imperative that the governance structure is widely representative of all the stakeholders in the sector and become a genuine public-private partnership, like APMAS.

Promote livelihoods through access to natural resources and technology

132. While micro-finance, in its narrow or augmented form, is a helpful input for improving the livelihoods of the poor, there are major changes in the "real" economy that need to be made to ensure that the poor have the wherewithal for employment and income.

133. IFAD needs to incorporate a sharp focus in its strategy to promote policy and implementation for land reform as well as to establish land security. The latter is critical in areas like the north-east where no cadastral mapping has been done as well as in the tribal and upland areas where the boundaries between community-owned land, forest land and private land are blurred. The growing problem of unrecognised tenancy and leased land (often arising from the inability to repay loans and thus losing ownership of land which is given back on lease) must also be addressed. Though there are laws governing crop sharing, they are not observed with the landlord appropriating a much larger share than legitimately allowed. This results in lack of investment in maintaining the quality of soil and in increasing productivity. Once land titles are secure, credit can flow both for land development as well as for agricultural inputs. Thus, some tied lending to support policy reform in securing access to productive assets, especially for women, should be attempted.

134. The watershed management strategy which is based on people's participation and on well functioning institutions like Watershed Management Associations and SHGs of the poorer families has proved to be appropriate to promote equitable access to productive natural resources like grazing lands, water bodies and community forests. IFAD's strategy so far has incorporated this approach; the results and impact have to be analysed and feedback incorporated for improvement. As far as credit in concerned, MYRADA's experience in over 80 micro watersheds indicates that people are willing and

able to take credit for treatment measures on their private lands in the context of micro watershed management. The strategy for incorporating a credit component in watershed programmes needs to be gradually introduced in IFAD's programme strategy.

135. Joint Forestry management has become accepted in the country but the policy still gives a central role to the forester in managing the affairs of the Committee. This needs to be changed. Management and control of forest produce by people's institutions is critical for credit to play a role in raising the value of non-timber forest products and liberating the poor from the clutches of middlemen who are also money lenders. The Panchayat Raj Act gives control to the local bodies over tanks and ponds; however, the strategy to implement this has still to be developed. Once this is achieved the potential for credit increases. Similarly water users' associations in irrigated areas have emerged after the necessary supporting legislation has been enacted and have proved to be successful in some parts of the country. The lessons drawn from such experiences, particularly where proper management has ensured that water is distributed equitably can be incorporated in future IFAD programmes. This will ensure that the risk involved in agriculture by the tail-enders is lowered, thereby increasing their potential for credit and repayment.

136. Building on the above argument, an even more ambitious strategy to support livelihood promotion organisations is suggested below and it requires some explanation as to why it is being suggested. Though widely known, two facts are often forgotten in the design of strategies for poverty alleviation:

137. ***Not all the poor wish to be or are capable of being self-employed:*** What they want is regular wage-employment, on-farm or off-farm. This employment is often generated by micro- and small entrepreneurs and commercial farmers who are themselves not poor, although they also suffer from lack of access to credit. Thus, any realistic strategy for poverty alleviation should also aim at a robust level of growth in rural areas and small towns, so that the poor can get wage employment near their place of living. This should be a major thrust in Government policy and a priority in public investment. Genuine decentralisation of resources as well as power to the Panchayat Raj Institutions could help to push this strategy forward

138. ***Credit is a necessary but not sufficient condition for becoming self-employed.*** There are a number of other things needed, such as the existence of demand for a product or service that the self-employed can produce, the availability of raw materials and infrastructure, training in technical and business aspects and so on. A number of these cannot be provided on a full cost-recovery basis and thus need ongoing subsidies. However, the focus needs to shift from subsidising the asset to investing resources in building the necessary supporting infrastructure. For example, rather than subsidise the animals provided under SGSY, the resources saved should be invested in maintaining and equipping veterinary clinics wherever the milk route is established and much animals are being provided under various schemes. Establishing rural market centres with adequate road and communication facilities is another sector which needs urgent and major investment. A major focus on providing basic technical education of high quality even to school dropouts who cannot find a place in Government Technical Institutes is also an urgent need.

139. The key to providing livelihood promotion services is committed and competent human resources at the district and lower levels as well as adequate and appropriate infrastructure like village roads, storage, markets, transport, linkages, veterinary support services, technical support services in agriculture and small scale enterprises. Given the constraints on improving these components within the government system, this paper proposes a strategy of augmenting human resources, establishing micro infrastructure and linkages and supporting experimentation for the promotion of self-employment, from outside the government system.

140. It has been widely accepted, after the experience of IRDP, that credit is a necessary but not sufficient condition for the promotion of self-employment. There are numerous other requirements to ensure sustainable self-employment for the rural poor. These include:

- Micro-planning for identification of livelihood opportunities for promoting self-employment and constraints thereon.
- Proper identification of the self-employed poor to ensure that vested interest do not corner the benefits meant for BPL families and more positively, to ensure that SC, ST, minority, disabled and women-headed households are included.
- Social mobilization, which begins with forming self-help groups (SHGs), but is thereafter an ongoing process, in terms of capacity building of SHGs and later of higher-level formations such as SHG Federations and co-operatives of the poor.
- Skill and entrepreneurial training, since the poor often are unskilled and do not have the self-confidence and exposure to the world of market transactions.
- Micro-infrastructure, which varies from activity to activity, to ensure that local value addition takes place. For example, in dairy, a preferred livelihood by the poor, even dairy cans for milk collection, fat-testing machines, constitute "micro-infrastructure".
- Market linkages are the most important to ensure that the value added in any economic activity is reasonably retained by the poor. To continue with the dairy example above, if there is no adequate facility for milk marketing, then the actual benefit of the dairy loans passes on to the milk vendors
- Experimentation with new livelihoods is important to ensure that diversification in agriculture and off farm enterprises takes place. However, the poor may not have the resources or the risk taking ability to carry out such experiments. Thus these need to be carried out by selected NGOs in conjunction with ICAR/CSIR laboratories and the private sector
- Finally, monitoring and evaluation of self-employment programs on an ongoing basis is very important, to improve the program design constantly.

141. Thus, as a third alternative, if IFAD decides to be really path-breaking, it could support a whole new set of institutions, which we term as "livelihood promotion organisations" or LPOs. LPOs would be specialised entities, initially NGO promoted and later community based, registered as cooperatives or "producer companies", under the recent amendment to the Companies Act. LPOs would be located at the state level in the poorer states, with extensive presence in the backward districts of these states. LPOs would be able to perform a number of critical roles, which would supplement the credit role that banks and MFIs are playing. The roles include: identifying promising livelihood opportunities; motivating, training and organising the poor to participate in these opportunities; arranging for credit and infrastructure; establishing the supply chain and the production processes; developing market linkages; seeking appropriate policy changes; stabilising the pioneering units; and ensuring wider replication. The box below describes an "LPO" already in existence.

A Livelihood Promotion Organisation: The Case of SIFFS, Kerala [28]

The South Indian Federation of Fishermen's Societies, Thiruvananthapuram, works with over 8000 marine artisanal fishermen along the coast of Kerala and Tamil Nadu. Apart from providing technical assistance in terms of improving the fishing craft and nets, and providing marketing assistance, it also arranges for credit. Credit has been, together with fish marketing and savings, one of the three central themes of the SIFFS model of fishermen societies, right from the time of the first such society. Credit is an essential input for small-scale fisheries for a variety of important needs, and is effectively the lubricant that keeps the sector going.

SIFFS was under pressure from members to start a credit programme, since existing credit delivery systems like revolving their own savings, and district federation's credit system, were not in position to give appropriate credit amount. Banks, on the other hand, do not meet fishermen needs and insist

[28] Drawn from www.siffs.org Section on credit.

on collateral. Most of the SIFFS loans do not fit into the conventional classification of micro-credit, because the amounts are larger. The loans to women, however, can be described as micro-credit. The credit programmes under SIFFS network (SIFFS, district federations and primary societies) cover purchase and renewal of fishing equipment, repair and maintenance of fishing equipment, post harvest activities (fish vending, fish processing), food credit, employment diversification and other consumption credit (festivals, marriage, education, hospitalisation, and debt redemption).

The most important of these, and the main component that the SIFFS itself handles, is the first one, often called production loans. At the district and village levels, production loans are sourced from commercial banks. Funds under the SIFFS credit programme are meant for addressing the gap between the demand for credit and its availability from commercial banks. The credit programme is tightly coupled with fish marketing and savings. Loan repayment is generally based on a percentage (5-15% depending on the quantum of loan) of fish catches, and not on a fixed instalment. This system is 'natural' for fisheries, but it suffers from the same uncertainties as the incomes of fishermen.

The future of the SIFFS Credit Program: The demand for credit has rapidly increased with the changing profile of the sector. Trends like motorisation, use of plywood canoes, and use of large fishing gear have resulted in a sharp increase in the cost of inputs. SIFFS as a premier fishermen organisation that is expanding to all parts of south India would like to enhance its credit programme as well. Given the relatively high-risk nature of fishing in general, and small-scale fisheries in particular, credit programme requires a substantial financial "cushion" to operate. The risk involved in fisheries credit necessitates mechanisms such as insurance, which have to be boked into. SIFFS is on the way to strengthen the credit programme. Presently, it is based on borrowed funds and is currently examine the feasibility of setting up a separate financial institution under the control of SIFFS, which could mobilize equity.

Though banks and financial institutions are not enthusiastic about meeting the credit demand of the artisanal fishing sector, the fishermen organisations are able to channelise credit from banks, relatively in a small way, only based on the credibility of organisation This points to the necessity of making the small scale fisheries organisations strong, credible and well managed. Alternate sources of credit exclusively for small-scale fisheries are the need of the hour since credit is an integral part in the development of the sector.

VII. Conclusions

142. IFAD should consider going well beyond micro-credit. IFAD needs to be more experimental, and it should encourage "livelihood promotion", which at its core has financial services of savings and credit, as well as insurance through community-based institutions, such as SHG federations, mutually aided co-operative societies and producer companies. However, it goes beyond micro-finance to provide the whole range of services that we have discussed above.

143. The experience for this has been accumulated to some extent in programmes such as the DPIP in AP, where "community investment funds" are placed in the hands of village organisations, comprising a number of SHGs of the poor. The CIF can use the fund to make investments in land and water resources, such as in replanting wastelands, in regenerating forests and tank rehabilitation. This is "livelihood finance" though it is not micro-credit. But it is this kind of investment, which would create the long-term basis for livelihoods. This would enable long-term investments in productive natural resources such as land, water, livestock and forests, which are not possible under the conventional micro-credit paradigm.

144. How can livelihood finance be integrated with micro-credit, savings and insurance services delivery? This can be seen from a number of examples of community-based organisations have been given earlier, the SEWA Bank in Ahmedabad being the leading one and that of SIFFS, Thiruvananthapuram, given in the box above. It is by promoting and supporting Livelihood promotion

Organisations (LPOs) that IFAD can make the same kind of path-breaking contribution to the sector, as it did nearly two decades ago by supporting micro-credit through self-help groups, long before it became widely accepted. Adopting this strategy would significantly contribute to the fulfilment of all the three objectives of the IFAD Strategic Framework.

ANNEXURE A: THE SHG-BANK LINKAGE PROGRAMME

Commercial and regional rural banks are now mainly involved in micro-finance through the Self-Help Group-Bank Linkage Program. With the success of the SHG model, it has become more widely accepted that a large segment of the population traditionally excluded from the formal financial sector could be a profitable market niche for innovative banking systems. The repayment rates of SHG loans are high and the transaction cots are in the nature of existing sunk costs. Thus everyone is happy so far.

The SHG Bank Linkage Program grew out of the basic SHG model established by NGOs such as MYRADA and PRADAN. The first link established with the official system, in this case NABARD, with the objective of changing policy to accept the SHG model, was taken by MYRADA when it approached NABARD for a grant from its R & D fund in 1986-87. MYRADA's objective was to ensure that the official system took ownership of the pilot experiment.

The support of NABARD was critical to initiate policy change. The guiding philosophy was that the alternate SHG model, if proved viable, would be mainstreamed and integrated with the financial institutions, in which case it would have to follow the official policy and procedures, but that the official financial system would accept the alternate model and support it. The spread of the SHGs through the many IFAD supported programmes played a major role in formalising the SHG strategy as an integral part of Government's initiatives to bring credit to the poor. Today it accounts for the largest volumes in micro finance lending in India and involves partnerships between banks and NGOs/other community based organisations.

The NABARD Report gives the following figures as on March 2003.

Cumulative number of SHGs financed by banks upto March 2003	717,360
Cumulative bank loans disbursed to SHGs upto March 2003 Number of poor families who have accessed bank credit upto March 2003	> Rs.20 billion 11.6 million
Average loan per SHG from banks	Rs.28,560
On-time repayment reported by participating banks	Over 95 %
Number of participating Banks,RRBs and Coops	504
Commercial banks	48
Regional Rural Banks (RRBs)	192
Co-operatives	264
Number of branches of banks lending to SHGs	30,942
Number of participating NGOs and other agencies	2,800

Recent NABARD studies[29] make an emphatic point on the profitability of micro finance operations for the branch following this model. The sample chosen revealed that:

1. Non-performing assets[30] (NPAs) to SHGs were 0 per cent. In contrast, consolidated NPL ratios ranged from 2.6 per cent to 18 per cent and of cash credit and agricultural term loans up to 55 per cent and 62 per cent respectively.
2. Return on average assets (ROA) of SHG banking ranged from 1.4 per cent to 7.5 per cent in an average costs analysis as compared to –1.7 per cent to 2.3 per cent consolidated.
3. The operational self-sufficiency (OSS) of SHG banking ranged from 110 per cent to 165 per cent by average as compared to 86 per cent to 145 per cent consolidated.

[29] Seibel and Dave, 2002
[30] Amount overdue > 180 days from end of quarter/ Portfolio outstanding

Within this program, three distinct models of credit linkage have evolved based on the roles of the participating entities. Growth rates and profitability across these models have not been uniform for reasons analysed below.

Model I: SHGs formed and financed by banks

In this model, the bank staff independently form groups, train members and link them to the branch. The first pilot initiative promoted by NABARD was with the Cauvery Grameen Bank. The CGB's role was to identify affinity groups and to assess them before lending; the training of the SHGs was left to NGOs initially. With NABARD's financial and capacity building support, this model has since been adopted by 69 RRBs in 19 States which together have promoted 27,150 SHGs as of March 31,2003. Twenty per cent of the SHGs financed under the bank linkage program are from this category.

SHG lending is increasingly being viewed as a viable proposition, but group formation by itself has proved to be expensive for the bankers. The Oriental Bank of Commerce, Rudrapur branch in present day Uttaranchal, which was set up exclusively for SHG lending, was unable to break even after four years of operation in 1999[31]. Losses for the first three years were attributed to high initial establishment expenses and the expenditure on training. However, direct non-interest operating expenses have steadily declined over the years and were expected to be less than 25 per cent at the end of the fifth year.

The **District Co-operative Central Bank, Bihar**, Karnataka, which was started in 1996 has a micro-finance development department. All the expenditure related to group formation and training is booked at the DCCB and it was observed to be marginally breaking even[32]. However, at the branch and PACS level, SHG banking is found to be highly profitable because the associated costs have been already accounted for at the DCCB.

This model appears to be an exception as the later analysis of relative volumes seeks to illustrate. It appears that the skills of social mobilisation reside more with NGOs and other community based organisations. Bankers' involvement in this activity could be a mismatch of roles and an expensive strategy.

Model II: SHGs formed by NGOs and formal agencies, but directly financed by banks

This represents a partnership model where the bank restricts itself to financial intermediation. The activities preceding linkage are undertaken by an NGO/formal agency in the area. This model accounts for the largest share of credit flow under the SHG-linkage program totalling Rs.1149 crore as on March 31,2003. Seventy two per cent of the SHGs financed up to March 31, 2003 fall in this category. Studies show this approach as having resulted in profitability.

During 2001-02, the ROA of **Kakathiya Grameena Bank's** (KGB) SHG banking, a Regional Rural Bank in Warangal, AP went up to 2.5 per cent, even while the bank was heavily in losses. The corresponding ROA of the bank was -1.7 percent[33]. KGB had started its SHG Banking operations from 1997 and within two years, demonstrated substantial profitability. The Operating Self- Sufficiency (OSS) for the micro finance portfolio in 2001-02 was 126 per cent. The methodology for these calculations is based on average cost i.e., treating SHG Banking as a normal product, which shares in all costs.

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[31] Malhotra and Chauhan, 1999

[32] Seibel and Dave, 2002

[33] ibid.

One study[34] shows that the intermediation of NGOs and SHGs helped banks to reduce transaction costs by between 21 and 41 per cent when compared with direct lending.[35] Among the different models involving intermediation, this model where banks use SHGs as financial intermediaries and NGOs as non-financial intermediaries proved to be most efficient. This was possible because of the active role played by NGOs and SHGs in identification of borrowers, follow-up and recovery, which resulted in significant reductions in the time spent on these functions. The intermediation of NGOs and SHGs proved useful in improving recovery rates. While the estimated default risk was very high for direct lending (22 per cent), it was negligible under the other models where intermediation occurs.

Model III: SHGs financed by banks using NGOs as financial intermediaries

In this model the NGO/Federation plays both a financial intermediation as well as intermediation roles. This model has been of advantage to banks that do not have a rural branch network. The cumulative share of SHGs linked through this model has progressively come down to eight per cent, as of March 2003 .

Credit Flow - Comparison of growth of linkage models[36]

Proportion of lending under SHG-BL	March '97	March '98	March '99	March '00	March '01	March '02
Model - I:	13 %	18 %	17 %	14 %	13 %	16 %
Model – II:	45 %	46 %	56 %	70 %	76 %	**75 %**
Model – III:	42 %	36 %	27 %	16 %	11 %	9 %

[34] Puhazhendhi (1995),

[35] ibid. The estimated average transaction cost of lending per account was Rs 195, constituting 3.68 per cent of the loan amount, if the loan was delivered via a direct lending channel. The estimated borrower transaction cost of dealing directly with a bank, per loan account of individual borrowers, was Rs 272. Of this amount about 40 per cent was for cash expenditure, while the balance represents the opportunity cost of time spent by borrowers in negotiating loans with banks and proving their creditworthiness.

[36] NABARD data

ANNEXURE B
IRDA OBLIGATIONS FOR THE RURAL AND SOCIAL SECTOR INSURANCE [37]

For the development of the insurance market and improvement in the insurance density and insurance penetration leading to an adequate social security and health protection, the Authority has prescribed rural and social sector norms in respect of insurance business being underwritten by the companies. The companies have also been asked to devise covers addressed to specific sectors in the economically weak population.

Every insurer, who carries on insurance business after the commencement of the IRDA Act, 1999 is required to ensure that the following obligations are undertaken, during the first five financial years, in respect of the following: (a) rural sector (where the population is not more than 5000; population density not more than 400 per Sq Km; and at least 75% of male working population is engaged in agriculture)

(i) in respect of a life insurer

- 5% in the first financial year;
- 7% in the second financial year;
- 10% in the third financial year;
- 12% in the fourth financial year;
- 15% in the fifth year;

of total policies written direct in that year;

(ii) in respect of a general insurer

- 2% in the first financial year;
- 3% in the second financial year;
- 5% thereafter,

of total gross premium income written direct in that year.

(b) social sector, (includes unorganised sector, informal sector, economically vulnerable or backward classes and other categories of persons, both rural and urban areas) in respect of all insurers,

- 5000 lives in the first financial year;
- 7500 lives in the second financial year;
- 10000 lives in the third financial year;
- 15000 lives in the fourth financial year;
- 20000 lives in the fifth year;

In the case of government insurers the quantum of insurance business to be done shall not be less than what has been recorded by them for the accounting year ended 31st March, 2000.

[37] Insurance Regulatory and Development Authority (IRDA), First Annual Report 2001-01.

ANNEXURE C: IMPACT OF SHG LENDING: EVALUATION STUDY[38]

A study by NABARD which covered 560 SHG member households from 223 SHGs spread over 11 States showed positive results. There have been perceptible and wholesome changes in the living standards of the SHG members in terms of ownership of assets, increase in savings and borrowing capacity, income generating activities and in income levels.

- Member households: land-less agricultural labourers 31 percent; marginal farmers 23 percent; small farmers 29 percent; and other 17 percent. About 43 percent of the incremental income generated was from Non Farm sector activities followed by farm 28 percent and off farm 21 percent activities
- The average borrowing/year/household increased from Rs.4282 to Rs.8341. The share of consumption loans declined from 50 to 25 percent. About 70 percent loans taken in post SHG situation were for income generating purposes.
- Average net income per household increased from Rs.20,177 to Rs.26889 or by about 33 percent
- Employment increased by 18 percent from 318 man days to 375 man days per household between pre and post SHG situations.
- About 74 percent of the sample members had income below Rs.22,500 in pre-SHG situation. During the post-SHG period, the proportion came down to 57 percent reflecting improvement in the incomes of about 17 percent of the households.
- Average value of assets/household which included livestock and consumer durables etc., increased by 72 percent from Rs.6843 in pre-SHG stage to Rs.11793 in post-SHG stage.
- About 58 percent of the households reported increase in assets.
- Housing conditions generally improved with a shift in the ownership form kuchha (mud walls, thatched roofs) to pucca (brick walls, tiled roofs) houses.
- Almost all members developed saving habit in the post-SHG situation as against only 23 percent of households who had this habit. Average annual savings per household registered over threefold increase from Rs.460 to Rs.1444
- Annualised interest rates on loans from SHGs to members were in 12 to 24 percent range
- Overall loan repayments improved from 84 percent to 94 percent between the two periods with an impressive improvement of 29 percentage points in the repayment of loans to banks.

The above impact assessment shows the SHG-Bank Linkage program in good light, and the picture is not incorrect. However, there are a number of problems with the SHG model and to think that is the sole answer to extending micro-credit, even less micro-finance services to the poor, is to overstate the case.

[38] Puhazhendhi, V. and K.J.S. Satyasai. Micro Finance for Rural People: An Impact Evaluation. Mumbai: National Bank for Agriculture and Rural Development, 2000.

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