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Building Inclusive Financial Sectors to Achieve
the Millennium Development Goals

MICROFINANCE IN INDIA : SECTORAL ISSUES AND CHALLENGES

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Ladies and Gentlemen

This is a policy level conference and I believe that for policy to be effective it must, among others, incorporate the lessons of history. Let me, therefore, briefly set the context by providing the historical perspective on microFinance in India.

The first thing to remember is that in India the history of rural credit, poverty alleviation and microFinance are inextricably interwoven. Any effort to understand one without reference to the others, can only lead to a fragmented understanding. The forces and compulsions that shaped the initiatives in these areas are best understood in context of State and banking policy over time. Thus, for e.g., there were peasant riots in the Deccan in the late 19th Century on account of coercive alienation of land by moneylenders. The policy response of the then British Government to this problem of rural indebtedness was to initiate the process of organization of cooperative societies as alternative institutions for providing credit to the farmers as also to ensure settled conditions in the rural areas, so necessary for a colonial power to sustain itself.

In the development strategy adopted by independent India, institutional credit was perceived as a powerful instrument for enhancing production and productivity and for alleviating poverty. The formal view was that lending to the poor should be a part of the normal business of banks. Simple as that.

To achieve the objectives of production, productivity and poverty alleviation, the stance of policy on rural credit was to ensure that sufficient and timely credit was reached as expeditiously as possible to as large a segment of the rural population at reasonable rates of interest.

The strategy devised for this purpose comprised :

- Expansion of the institutional structure,
- Directed lending to disadvantaged borrowers and sectors and
- Interest rates supported by subsidies.

The institutional vehicles chosen for this were cooperatives, commercial banks and Regional Rural Banks [RRBs].

Between 1950 & 1969, the emphasis was on the promoting of cooperatives. The nationalization of the major commercial banks in 1969 marks a watershed inasmuch as from

this time onwards the focus shifted from the cooperatives as the sole providers of rural credit to the multi agency approach. This also marks the beginning of the phenomenal expansion of the institutional structure in terms of commercial bank branch expansion in the rural and semi-urban areas. For the next decade and half, the Indian banking scene was dominated by this expansion. However, even as this expansion was taking place, doubts were being raised about the systemic capability to reach the poor. Regional Rural Banks were set up in 1976 as low cost institutions mandated to reach the poorest in the credit-deficient areas of the country. In hindsight it may not be wrong to say that RRBs are perhaps the only institutions in the Indian context which were created with a specific poverty alleviation - microFinance – mandate.

During this period, intervention of the Central Bank (Reserve Bank of India) was essential to enable the system to overcome factors which were perceived as discouraging the flow of credit to the rural sector such as absence of collateral among the poor, high cost of servicing geographically dispersed customers, lack of trained and motivated rural bankers, etc. The policy response was multi dimensional and included special credit programmes for channeling subsidized credit to the rural sector and operationalising the concept of “priority sector”. The latter was evolved in the late sixties to focus attention on the credit needs of neglected sectors and under-privileged borrowers.

There is a general consensus that the strategies followed

- helped to build a broad based institutional infrastructure for the delivery and deployment of credit and
- ensured a wider physical access of financial services to the poor.

The indicators speak for themselves.

- Access in terms of rural branches increased from 1,833 in 1969 to around 32,200 at present,
- the population per rural branch declined from 2,01,854 in 1969 to around 16,000 at present.
- The proportion of borrowings of rural households from institutional sources increased from 7 per cent in 1951 to more than 60 per cent at present.

This significant increase in the credit flow from institutional sources gave rise to a strong sense of expectation from the state agencies. However, this expectation could not be sustained because the emphasis, among others, was on achieving certain quantitative targets. As a result, inadequate attention was paid to the qualitative aspects of lending leading to loan defaults and erosion of repayment ethics by all categories of borrowers. The end result was a disturbing growth in overdues, which not only hampered the recycling of scarce resources of banks, but also affected profitability and viability of financial institutions. This not only blunted the desire of banks to lend to the poor but also the development impact of rural finance.

This was the position on the eve of reforms, which marks the second watershed, in the history of rural credit.

The basic aim of the financial sector reforms was to improve the efficiency and productivity of all credit institutions including rural financial institutions (RFIs) whose financial health was far from satisfactory. In regard to RFIs, the reforms sought to enhance the areas of commercial freedom, increase their outreach to the poor and stimulate additional flows to the sector. The reforms included far reaching changes in the incentive regime through liberalising interest rates for cooperatives and RRBs, relaxing controls on where, for what

purpose and for whom RFI could lend, reworking the sub-heads under the priority sector, introducing prudential norms and restructuring and recapitalising of RRBs.

The object of this narrative is to bring home to you two facts and four effects.

The two facts are:

That right from the time of independence, the overriding concern of development policy makers has been to find ways and means to finance the poor and reduce the burden upon them.

Between the concern of the policy makers and the quality of the effort, however, there has been a gap. The efforts made were not able to achieve the success envisaged for a variety of reasons mainly, defects in policy design, infirmities in implementation and the inability of the government of the day to desist from resorting to measures such as loan waivers.

The four consequences flowing from these facts are:

That the banking system - was not able to internalise lending to the poor as a viable activity but only as a social obligation – something that had to be done because the authorities wanted it so.

This was translated into the banking language of the day : Loans to the poor were part of social sector lending and not commercial lending ; the poor were not borrowers, they were beneficiaries ; poor beneficiaries did not avail of loans they availed of assistance.

The language of the time resulted in an attitude of carefully disguised cynicism towards the poor. The attitude was that the poor are not bankable, that they can never be bankable, that commercial principles cannot be applied in lending to the poor, that what the poor require are not loans but charity. Once this mindset hardened it became more and more difficult for commercial bankers to accept that lending to the poor could be a viable activity. It is significant to note that the system had to wait for almost a decade for the concept of microFinance to become credible.

microFinance : The Paradigm

The financial sector reforms motivated policy planners to search for products and strategies for delivering financial services to the poor – microFinance - in a sustainable manner consistent with high repayment rates. The search for these alternatives started with internal introspection regarding the arrangements which the poor had been traditionally making to meet their financial services needs. It was found that the poor tended to – and could be induced to - come together in a variety of informal ways for pooling their savings and dispensing small and unsecured loans at varying costs to group members on the basis of need. The essential genius of NABARD in the Bank – SHG programme was to recognize this empirical observation that had been catalysed by NGOs and to create a formal interface of these informal arrangements of the poor with the banking system. This is the beginning of the story of the Bank-SHG Linkage Programme.

3. SHG - Bank Linkage Programme

The SHG – Bank Linkage Programme started as an Action Research Project in 1989. In 1992, the findings led to the setting up of a Pilot Project. The pilot project was designed as a partnership model between three agencies, viz., the SHGs, banks and Non Governmental Organisations (NGOs).

SHGs were to facilitate collective decision-making by the poor and provide 'doorstep banking';

Banks as wholesalers of credit, were to provide the resources and

NGOs were to act as agencies to organise the poor, build their capacities and facilitate the process of empowering them.

3.1 Achievements

The programme has come a long way from the pilot stage of financing 500 SHGs across the country. Of the total SHGs formed more than 1.6 million have been linked with 35,294 bank branches of 560 banks in 563 districts across 30 States of the Indian Union. Cumulatively, they have so far accessed credit of Rs.6.86 billion. About 24 million poor households have gained access to the formal banking system through the programme.

3.2 Impact of the SHG Bank Linkage Programme

Given these quantitative achievements, what has been the impact of the programme.

The main findings are that:

- i. microfinance has reduced the incidence of poverty through increase in income, enabled the poor to build assets and thereby reduce their vulnerability.
- ii. It has enabled households that have access to it to spend more on education than non-client households. Families participating in the programme have reported better school attendance and lower drop out rates.
- iii. It has empowered women by enhancing their contribution to household income, increasing the value of their assets and generally by giving them better control over decisions that affect their lives.
- iv. In certain areas it has reduced child mortality, improved maternal health and the ability of the poor to combat disease through better nutrition, housing and health - especially among women and children.
- v. It has contributed to a reduced dependency on informal money lenders and other non-institutional sources.
- vi. It has facilitated significant research into the provision of financial services for the poor and helped in building "capacity" at the SHG level.
- vii. Finally it has offered space for different stakeholders to innovate, learn and replicate. As a result, some NGOs have added micro-insurance products to their portfolios, a couple of federations have experimented with undertaking livelihood activities and grain banks have been successfully built into the SHG model in the eastern region. SHGs in some areas have employed local accountants for keeping their books; and IT applications are now being explored by almost all for better MIS, accounting and internal controls.

Key Learnings :

Given this scale and impact, what have been the learning points ?

- (1) The first point is that the “poor are bankable”. Sounds simple, but, when we view this in context of the attitudinal constraints which characterized bankers on the eve of the linkage programme, one realizes what an immense learning point this has been. But, for this we would still have been in the “middle ages”.
- (2) The second point is that the poor, organized into SHGs, are ready and willing to partner mainstream financial institutions and banks on their part find their SHG portfolios “safe” and “performing”.
- (3) The third point is that despite being contra intuitive, the poor can and do save in a variety of ways and the creative harnessing of such savings is a key design feature and success factor.
- (4) The fourth point is that successful programmes are those that afford opportunity to stakeholders to contribute to it on their own terms. When this happens, the chances of success multiply manifold. This has been possible in the Bank - SHG linkage programme on account of the space given to each partner and the synergy built in the programme between the informal sector comprising the poor and their SHGs, the semi-formal sector comprising NGOs, and the formal sector comprising banks, government and the development agencies.
- (5) Yet another learning point has been that when a programme is built on existing structures, it leverages all strengths. Thus, because the Bank-SHG programme is built upon the existing banking infrastructure, it has obviated the need for the creation of a new institutional set-up or introduction of a separate legal and regulatory framework. Since financial resources are sourced from regular banking channels and members’ savings, the programme bypasses issues relating to regulation and supervision. Lastly, since the Group acts as a collateral substitute, the model neatly addresses the irksome problem of provision of collateral by the poor.
- (6) The last learning point is that central banks, apex development banks and governments have an important role in creating the enabling environment and putting appropriate policies and interventions in position which enable rapid upscaling of efforts consistent with prudential practices. But for this opportunity, no innovation can take place.

3.4 Challenges :

Regional Imbalances – The first challenge is the skewed distribution of SHGs across States. About 60% of the total SHG credit linkages in the country are concentrated in the Southern States. However, in States which have a larger share of the poor, the coverage is comparatively low. The skewed distribution is attributed to

- The over zealous support extended by some the State Governments to the programme.
- Skewed distribution of NGOs and
- Local cultures & practices.

NABARD has since identified 13 states where the volumes of SHGs linked are low and has already initiated steps to correct the imbalance.

From credit to enterprise

The second challenge is that having formed SHGs and having linked them to banks, how can they be induced to graduate into matured levels of enterprise, how they be induced to factor in livelihood diversification, how can they increase their access to the supply chain, linkages to the capital market and to appropriate/ production and processing technologies.

A spin off of this challenge is how to address the investment capital requirements of matured SHGs, which have met their consumption needs and are now on the threshold of taking off into “Enterprise”. The SHG Bank-Linkage programme needs to introspect whether it is sufficient for SHGs to only meet the financial needs of their members, or whether there is also a further obligation on their part to meet the non-financial requirements necessary for setting up businesses and enterprises. In my view, we must meet both.

Quality of SHGs – The third challenge is how to ensure the quality of SHGs in an environment of exponential growth. Due to the fast growth of the SHG Bank Linkage Program, the quality of SHGs has come under stress. This is reflected particularly in indicators such as the poor maintenance of books and accounts etc. The deterioration in the quality of SHGs is explained by a variety of factors including

- The intrusive involvement of government departments in promoting groups,
- Inadequate long-term incentives to NGOs for nurturing them on a sustainable basis and
- Diminishing skill sets on part of the SHG members in managing their groups.

In my assessment, significant financial investment and technical support is required for meeting this challenge.

Impact of SGSY – Imitation is the best form of flattery – but not always. The success of the programme has motivated the Government to borrow its design features and incorporate them in their poverty alleviation programme. This is certainly welcome but for the fact that the Government’s Programme (SGSY) has an inbuilt subsidy element which tends to attract linkage group members and cause migration generally for the wrong reasons. Also, micro level studies have raised concerns regarding the process through which groups are formed under the SGSY and have commented that in many cases members are induced to come together not for self help, but for subsidy. I would urge a debate on this, as there is a need to resolve the tension between SGSY and linkage programme groups. One way out of the impasse would be to place the subsidy element in the SGSY programme with NABARD for best utilisation for providing indirect subsidy support for purposes such as sensitisation, capacity building, exposure visits to successful models, etc.

Role of State Governments – A derivative of the above is perhaps the need to extend the above debate to understanding and defining the role of the State Governments vis-à-vis the linkage programme. Let’s be clear: on the one hand, the programme would not have achieved its outreach and scale, but for the proactive involvement of the State Governments; on the other hand, many State Governments have been overzealous to achieve scale and access without a critical assessment of the manpower and skill sets available with them for forming, and nurturing groups and handholding and maintaining them over time.

Emergence of Federations – The emergence of SHG Federations has thrown up another challenge. On the one hand, such federations represent the aggregation of collective bargaining power, economies of scale, and are fora for addressing social & economic issues; on the other hand there is evidence to show that every additional tier, in addition to increasing

costs, tends to weaken the primaries. There is a need to study the best practices in the area and evolve a policy by learning from them.

While we are upbeat about the success achieved and the potential that the SHG – Linkage programme offers, we need to be realistic and not to view this instrument as a one-stop solution for all developmental problems. SHGs are local institutions having an inherent potential to flower as decentralised platform for development, but multiple expectations could overload them and impair their long-term sustainability. Second, in focusing on the poor let us not forget the rest. The rural sector is a large field and even today the need for good old-fashioned rural credit and investment in agriculture and infrastructure continues with the same rigour as yesterday.

4.0 Emergence of MFIs :

Having indicated my thoughts on the SHG-Bank Linkage programme, may I now briefly turn to the MFI model ? MFIs are an extremely heterogenous group comprising NBFCs, societies, trusts and cooperatives. They are provided financial support from external donors and apex institutions including the Rashtriya Mahila Kosh (RMK), SIDBI Foundation for micro-credit and NABARD and employ a variety of ways for credit delivery.

Since 2000, commercial banks including Regional Rural Banks have been providing funds to MFIs for on lending to poor clients. Though initially, only a handful of NGOs were “into” financial intermediation using a variety of delivery methods, their numbers have increased considerably today. While there is no published data on private MFIs operating in the country, the number of MFIs is estimated to be around 800. One set of data which I have indicate that not more than a dozen MFIs have an outreach of 1,00,000 microFinance clients. A large majority of them operate on much smaller scale with clients ranging between 500 and 1,500 per MFI. It is estimated that the MFIs’ share of the total institution-based micro-credit portfolio is about 8%.

5. MFIs : Critical Issues

MFIs can play a vital role in bridging the gap between demand & supply of financial services if the critical challenges confronting them are addressed.

Sustainability : The first challenge relates to sustainability. It has been reported in literature that the MFI model is comparatively costlier in terms of delivery of financial services. An analysis of 36 leading MFIs by Jindal & Sharma shows that 89% MFIs sample were subsidy dependent and only 9 were able to cover more than 80% of their costs. This is partly explained by the fact that while the cost of supervision of credit is high, the loan volumes and loan size is low. It has also been commented that MFIs pass on the higher cost of credit to their clients who are ‘interest insensitive’ for small loans but may not be so as loan sizes increase. It is, therefore, necessary for MFIs to develop strategies for increasing the range and volume of their financial services.

Lack of Capital – The second area of concern for MFIs, which are on the growth path, is that they face a paucity of owned funds. This is a critical constraint in their being able to scale up. Many of the MFIs are socially oriented institutions and do not have adequate access to financial capital. As a result they have high debt equity ratios. Presently, there is no reliable mechanism in the country for meeting the equity requirements of MFIs. As you know, the Micro Finance Development Fund (MFDF), set up with NABARD, has been augmented and

re-designated as the Micro Finance Development Equity Fund (MFDEF). This fund is expected to play a vital role in meeting the equity needs of MFIs.

Borrowings – In comparison with earlier years, MFIs are now finding it relatively easier to raise loan funds from banks. This change came after the year 2000, when RBI allowed banks to lend to MFIs and treat such lending as part of their priority sector-funding obligations. Private sector banks have since designed innovative products such as the Bank Partnership Model to fund MFIs and have started viewing the sector as a good business proposition. Being an ex-regulator I may be forgiven for reminding banks that they need to be most careful when they feel most optimistic. At a time when they are enthusiastic about MFIs, banks would do well to find the right technologies to assess the risk of funding MFIs. They would also benefit by improving their skill sets for appraising such institutions and assessing their credit needs. I believe that appropriate credit rating of MFIs will help in increasing the comfort level of the banking system. It may be of interest to note that NABARD has put in position a scheme under which 75% of the cost of the rating exercise will be borne by it.

Capacity of MFIs - It is now recognised that widening and deepening the outreach of the poor through MFIs has both social and commercial dimensions. Since the sustainability of MFIs and their clients complement each other, it follows that building up the capacities of the MFIs and their primary stakeholders are pre-conditions for the successful delivery of flexible, client responsive and innovative microfinance services to the poor. Here, innovations are important – both of social intermediation, strategic linkages and new approaches centered on the livelihood issues surrounding the poor, and the re-engineering of the financial products offered by them as in the case of the Bank Partnership model.

Bank Partnership Model :

This model is an innovative way of financing MFIs. The bank is the lender and the MFI acts as an agent for handling items of work relating to credit monitoring, supervision and recovery. In other words, the MFI acts as an agent and takes care of all relationships with the client, from first contact to final repayment. The model has the potential to significantly increase the amount of funding that MFIs can leverage on a relatively small equity base.

A sub - variation of this model is where the MFI, as an NBFC, holds the individual loans on its books for a while before securitizing them and selling them to the bank. Such refinancing through securitization enables the MFI enlarged funding access. If the MFI fulfils the “true sale” criteria, the exposure of the bank is treated as being to the individual borrower and the prudential exposure norms do not then inhibit such funding of MFIs by commercial banks through the securitization structure.

Banking Correspondents :

The proposal of “banking correspondents” could take this model a step further extending it to savings. It would allow MFIs to collect savings deposits from the poor on behalf of the bank. It would use the ability of the MFI to get close to poor clients while relying on the financial strength of the bank to safeguard the deposits. Currently, RBI regulations do not allow banks to employ agents for liability - i.e deposit - products. This regulation evolved at a time when there were genuine fears that fly-by-night agents purporting to act on behalf of banks in whom the people have confidence could mobilize savings of gullible public and then vanish

with them. It remains to be seen whether the mechanics of such relationships can be worked out in a way that minimizes the risk of misuse.

Service Company Model :

In this context, the Service Company Model developed by ACCION and used in some of the Latin American Countries is interesting. The model may hold significant interest for state owned banks and private banks with large branch networks. Under this model, the bank forms its own MFI, perhaps as an NBFC, and then works hand in hand with that MFI to extend loans and other services. On paper, the model is similar to the partnership model: the MFI originates the loans and the bank books them. But in fact, this model has two very different and interesting operational features :

(a) The MFI uses the branch network of the bank as its outlets to reach clients. This allows the client to be reached at lower cost than in the case of a stand-alone MFI. In case of banks which have large branch networks, it also allows rapid scale up. In the partnership model, MFIs may contract with many banks in an arms length relationship. In the service company model, the MFI works specifically for the bank and develops an intensive operational cooperation between them to their mutual advantage.

(b) The Partnership model uses both the financial and infrastructure strength of the bank to create lower cost and faster growth. The Service Company Model has the potential to take the burden of overseeing microfinance operations off the management of the bank and put it in the hands of MFI managers who are focussed on microfinance to introduce additional products, such as individual loans for SHG graduates, remittances and so on without disrupting bank operations and provide a more advantageous cost structure for microfinance. We need to pilot test this.

6.0 The Road Ahead

I recently wrote an article together with Graham Wright called “Banking for the Poor and not Poor Banking”. What we wanted to say was that notwithstanding our significant achievements, there are still large sections of the population without access to financial services. A conservative estimate for example suggests that just 20% of low-income people have access to them. Thus, there is an urgent need to widen the scope, scale and outreach of financial services to reach the vast un-reached population.

In this context may I quote from the recent Annual Policy Statement (2005-06) of the Governor RBI. Drawing attention to the expansion, greater competition and diversification of ownership of banks leading to enhanced efficiency and systemic resilience in the banking sector, the Governor has said that notwithstanding this “there are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in unorganised sector. While commercial considerations are no doubt important, the banks have been bestowed with several privileges, especially of seeking public deposits on a highly leveraged basis, and consequently they should be obliged to provide banking services to all segments of the population, on equitable basis.” He has clarified that against this background, the RBI will implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged. Further, the nature, scope and cost of services will be monitored to assess whether there is any denial, implicit or explicit, of basic banking services

to the common person. He has advised banks to review their existing practices to align them with the objective of financial inclusion.

I have come to the end of my presentation. Looking back I find that the key players are banks as partners in the linkage programme and emerging MFIs. Banks through their rural branches have played and continue to play an important role in providing financial services to the poor on a stand-alone basis. Banks need to introspect on the quality and coverage of these portfolios. Further as key stakeholders in the Bank-SHG linkage programme, they, together with other partners need to take forward the good work they have been doing. The SHG – Bank Linkage Programme has done well, has made a tremendous contribution to “scale” and is on a high growth path. However, the programme is confronted with many challenges and these need to be addressed through appropriately structured policies and strategies. In so far as MFIs are concerned it is recognized that they hold significant potential. However, MFIs need to be challenged to make an increasing contribution to “scale” consistent with cost, sustainability and efficiency of operations. Given these and other challenges embedded in the microfinance context, this conference has been organised so that we can all deliberate on the issues involved and come up with appropriate recommendations for policy formulation.

We are living through challenging and upbeat times. Yet anyone who has worked in the field of development knows the ‘highs’ and ‘lows’ of working in this sector. Sometimes when I look at the vast unfinished agenda, the tasks undone, done partly or done poorly, when I factor in the forces of apathy and status quo, when I see how slowly things move when in fact they should be moving rapidly I feel a sense of despair - a realisation that in the end human endeavour is meagre and that the distance between effort and achievement is indeed long. At times such as these I recollect a message given to us many years ago when we were emerging from the trauma of the sub-continent’s partition between India and Pakistan, when there was great despair for the future of the two nations. In those dark and troubled days, a poet, Dr Sir Mohammad Iqbal - later the national poet of Pakistan - said to us :

Which translated into English means that when light fails and you are surrounded by darkness, do not despair, take heart - for a thousand million stars must die each night just so that a new dawn can be born tomorrow.

On this note of hope for a better tomorrow and with a sense of sincere appreciation for all those working in the sector – practitioners and policy makers, researchers and regulators and academicians and activists – I take leave and thank you for having given me this opportunity of sharing my thoughts with you today.

D:\backup\jjip\Speech\050429 Mr.Thorat-Speech