Round Table

Microfinance: An Introduction

R Srinivasan and M S Sriram

R Srinivasan is Dean (Academic) and Professor, Finance and Control, at the Indian Institute of Management Bangalore. rsrini@iimb.ernet.in

M S Sriram is Associate Professor, Centre for Management in Agriculture and Co-ordinator, Management Education Programme at the Indian Institute of Management, Ahmedabad.
mssriram@iimahd.ernet.in

The most important finding in the last two decades in the world of finance did not come from the world of the rich or the relatively well-off. More important than the hedge fund or the liquid-yield option note was the finding that the poor can save, can borrow (can indeed decide on loans to fellow poor), and will certainly repay loans. This is the world of microfinance.

A good definition of microfinance as provided by Robinson[1] is, 'Microfinance refers to small-scale financial services for both credits and deposits — that are provided to people who farm or fish or herd; operate small or microenterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and local groups in developing countries, in both rural and urban areas'.

For several decades, many economies, including the Indian, experimented with subsidised credit for the poor. But the only tangible outcome perhaps was the increase in Non-Performing Assets (NPA). Then came the realisation that the core issue for the poor was access to credit rather than the cost of credit. In fact one of the contributions of microfinance can possibly be the 'end of interest rate debate'. Microfinance has proved time and again that it is access and not interest rates that are a constraint for the poor. Another discovery followed, that the poor can and will save, and can indeed use a wide range of financial services such as remittances facilities and insurance products. The most well-known and cited international example of a microcredit institution is the Grameen Bank in Bangladesh. But there are numerous others. Even during the Asian financial crisis, Bank Rayat Indonesia not only survived but thrived; as did BancoSol in Bolivia.

A bewildering range of players have jumped on to the microfinance bandwagon — for a variety of reasons. There have been NGOs which gradually metamorphosed into lending institutions, developmental professionals who have set up microfinance companies and banks that have experimented with working exclusively with groups and therefore have 'microfinance branches'. These range from not-for-profits that see microfinance as having a role in 'development', to commercial banks that view microfinance as 'good, sound banking', an excellent way of raising deposits, and lending at low risk. In fact the success of groups in microfinance has attracted the attention of wide-ranging players to use these groups for a range of purposes. Several governmental schemes are being routed through microfinance, including a very large project funded by the World Bank and being implemented in the state of Andhra Pradesh. Similarly organisations like Hindustan Lever have looked at the potential of these groups as a channel for retailing and have launched a programme called 'Project Shakti' to tap the smaller villages through the microcredit channel. Microfinance leaders are gaining prominence and it is said that some of the leaders, particularly women, have been taking a more active role in other social spheres, including contesting elections for the panchayat and so on.

This round table focusses on issues relating to microfinance in India. The Indian microfinance sector is a museum of several approaches found across the world. Indian microfinance has lapped up the Grameen blueprint; it has replicated some aspects of the Indonesian and the Bolivian model. In addition to the imported artifacts of microfinance, we also have the home-grown model of self-help groups (SHGs). Sanjay Sinha provides a summary of some of the issues that the poor face and an analysis of the performance of microfinance in India. The round table discussion thereafter looks at four major issues: the economic attractiveness of microfinance both to NGOs and to commercial banks; the relative merits of various delivery channels; the issue of growth; and finally, what lies beyond microcredit.

In choosing these issues we are aware that several other issues were omitted. One is the role of the state. Both the NABARD and the Small Industries Development Bank of India (SIDBI) illustrate that state-held financial institutions can make meaningful interventions. But governments across the country have jumped on to the microfinance bandwagon and have started 'building' groups. One must remember that even the smallest group is an institution in its own right; a group takes competence, dedication and time to build. There is the fear that the state while building a few good groups may build a large number of groups that have all the properties of a good group on paper but not in spirit. The nicest thing one can say about many such groups is that they are harmless parodies. But as a collectivity, they have the potential to bring the SHG into disrepute. Regulation is another consideration. Already because of the restrictions placed on Non-banking Financial Companies (NBFCs) we have Platypus structures. Such typically involve one NBFC that lends (but is unable by law to raise deposits) and a large number of trusts/mutually-aided cooperatives that take deposits. Allowing a hundred organisations to bloom where one would suffice is a recipe for disaster. The third issue is business promotion. There are a large number of micro-enterprises that need skills in elementary business management, such as marketing and production. Delivery of these skills has never been resolved satisfactorily.

References

1 Robinson, Marguerite S, 'Microfinance: the Paradigm Shift From credit Delivery to Sustainable Financial Intermediation', in Mwangi S Kimenyi, Robert C Wieland and J D Von Pischke (eds), 1998, *Strategic Issues in Microfinance*, Ashgate Publishing: Aldershot.

Round Table

Financial Services for Low Income Families: An Appraisal

Sanjay Sinha

Sanjay Sinha is Managing Director of Micro-Credit Ratings International Limited (M-CRIL), which professionally assesses microfinance institutions and provides other services designed to promote the flow of investments into the microfinance sector. An MPhil in Economics from Oxford University, Sanjay Sinha has over 25 years of development consulting experience in South and Southeast Asia, specialising in livelihoods sector activities, microenterprise promotion, agriculture and livestock production as well as forestry, in addition to microfinance. In 1983, he co-founded EDA Rural Systems, which is now one of the premier development consulting companies in South Asia. edarural@giasdl01.vsnl.net.in

Informal financial services have always been an integral part of the traditional economy of India[1] and even semi-formal and formal financial services through agricultural cooperatives and banks are within physical reach (less than 5 km) of perhaps 99% of the population of the country. A vast network of commercial banks, cooperative banks and regional rural banks as well as other financial institutions provides such services. The other financial institutions include non-bank finance companies (NBFCs), insurance companies, provident funds and mutual funds. There are more than 160,000 retail credit outlets in the cooperative and banking sectors, augmented by another 25,000 or so NBFCs. In addition, there are some 94,000 cooperative societies or branches of cooperative banks, around 60,000 branches of 27 public sector commercial banks and 196 regional rural banks (RRBs) and another 4,700 branches of 55 smaller private banks providing financial services in India. There is also a growing number of foreign banks operating, but their reach, through some 200 branches, is limited to the main cities[2].

Formal financial services are, in theory, available to low-income families mainly through the 33,000 or so rural and 14,000 suburban branches of the major banks and RRBs and by 94,000 cooperative outlets – either bank branches or village level societies.

Financial services to the poor are also available from the village or (town) neighbourhood-level agents of NBFCs. The RRBs, in particular, were established specifically in order to meet the credit requirements of the poor – small and marginal farmers, landless workers, artisans and small entrepreneurs and should, therefore, have emerged as a major source of microfinance. A total of 140,000 institutional outlets serving the rural sector and the poor implies the availability of one outlet for every 5,600 persons – in theory, a very favourable ratio for catering to the financial needs of the poor.

However, their availability is questionable. For many years, bankers and senior government officers were fond of describing the Government of India's main poverty alleviation programme, the Integrated Rural Development Programme (IRDP), as 'the world's largest microfinance programme'. And so it was. It involved the commercial banks in giving loans of less than Rs 15,000 to poor people and in nearly 20 years, resulted in financial assistance of around Rs 250 billion to roughly 55 million families[3]. The problem with IRDP was that its design incorporated a substantial element of subsidy (25-50% of each family's project cost) and this resulted in extensive malpractice and misutilisation of funds. This situation led bankers too to view the IRDP loan as a politically motivated handout and they largely failed to follow up with borrowers. The net result was that estimates of the repayment rates in the IRDP ranged from 25-33%. Not surprisingly, the two decades of IRDP experience – in the 1980s and 1990s – affected the credibility of micro-borrowers in the view of bankers and ultimately, hindered access of the less literate poor to banking services.

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Similarly, the entire network of primary cooperatives in the country and the RRBs – both sets of institutions established to meet the needs of the rural sector in general and the poor, in particular – has proved a colossal failure. Saddled with the burden of directed credit and a restrictive interest rate regime, the financial position of the RRBs deteriorated quickly while the cooperatives suffered from the malaise of mismanagement, privileged leadership and corruption born of excessive state patronage and protection[4].

Role of NGO Sector[5]

Over the past 20-25 years, the resultant vacuum in the financial system has started to be filled, initially with the pioneering efforts of organisations such as the SEWA Bank, Ahmedabad and Working Women's Forum, Chennai, but more vigorously during the 1990s, by the entrance of significant numbers of non-government organisations (NGOs) into microfinance. Current estimates of the number of NGOs engaged in mobilising savings and providing micro-loan services to the poor lie in the range of 800-1,000 organisations[6].

Initially, many NGO microfinance institutions (MFIs) were funded by donor support in the form of revolving funds and operating grants. In recent years (roughly since 1994), development finance institutions such as the National Bank for Agriculture and Rural Development (NABARD) and the Small Industries Development Bank of India (SIDBI) and micro-finance promotion organisations such as the Rashtriya Mahila Kosh (RMK—the National Women's Fund) have also started to provide bulk loans to MFIs. This has resulted in the MFIs becoming intermediaries between the largely public sector development finance institutions and retail borrowers consisting of groups of poor people or individual borrowers living in rural areas or urban slums. In another model, NABARD refinances commercial bank loans to self-help groups (SHGs) in order to facilitate relationships between the banks and poor borrowers.

Though the (mainly) NGO micro-finance sector has made a start in providing 'user friendly' formal financial services to the poor its outreach is still minuscule in comparison with the need. Recent compilations of support provided by major financial institutions shows that the microfinance outstandings of domestic financial institutions (including NGO-MFIs) did not exceed Rs 800 crores (US$170 million) by March 2002 with an outreach to less than 5.5 million families – at best less than 10% of the 60 million poor families in the country. This includes the NABARD scheme for linking self-help groups directly with banks. The available data indicates that progress and outreach in the scheme was around Rs 650 crores (US$140 million) outstanding and covering, at most, 4.5 million families at end-March 2002[7].

At the same time, the involvement of commercial banks in microfinance is negligible both in relation to the current volume of microfinance and (even more so) to their broader engagement in rural areas. The total credit from the scheduled commercial banks to the 'weaker sections'[8] is estimated at Rs 29,000 crores (US$ 6.7 billion) at the end of March 2001 compared to the total rural deposits of Rs 133,000 crores (US$ 31 billion)[9].

Ways of Delivering Microfinance

MFIs around the world follow a variety of different methodologies for the provision of financial services to low-income families. These methodologies are overwhelmingly based on the principle of financial services being related to the cash flows of the low-income client groups and thus aim to facilitate relatively frequent and very small or micro-loan and savings transactions. The focus of such services is on women, based on the observation that in financial matters, they are more responsible than men particularly since their mobility is restricted by family responsibilities.

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The following is a typology of major methodologies employed by MFIs for the delivery of financial services to low income families:

Self-help Group (SHG)

The SHG is the dominant microfinance methodology in India. The operations of 15-25 member SHGs are based on the principle of revolving the members' own savings. External financial assistance – by MFIs or banks – augments the resources available to the group-operated revolving fund. Savings thus precede borrowing by the members. In many SHG programmes, the volume of individual borrowing is determined either by the volume of member savings or the savings of the group as a whole. Some NGOs operate microfinance programmes by organising federations of SHGs to act as the MFI which obtains external loan funds in bulk to be channelled to the members via the SHGs. NABARD has facilitated and extensively supported a programme which entails commercial banks lending directly to SHGs rather than via bulk loans to MFIs. NABARD re-finances the loans of the commercial banks to SHGs.

Individual Banking Programmes (IBPs)

IBPs entail the provision by MFIs of financial services to individual clients – though they may sometimes be organised into joint liability groups, credit and savings cooperatives or even SHGs. The model is increasingly popular for microfinance particularly through cooperatives.

In the case of cooperatives, all borrowers are members of the organisation either directly, or indirectly by being members of primary cooperatives or associations which are members of the apex society. Creditworthiness and loan security are a function of cooperative membership within which member savings and peer pressure are assumed to be a key factor. Though the magnitude and timing of savings and loans are largely unrelated, a special effort is made to mobilise savings from members. There are now a large number of 'new generation' cooperative credit societies in India devoted specifically to providing financial services to the poor. Most of these are in Andhra Pradesh which was the first to enact a law permitting mutually-aided – as opposed to traditional government-assisted – cooperative societies. Elsewhere, a number of well known programmes such as the SEWA Bank in Ahmedabad, the Indian Cooperative Network for Women, Tamil Nadu and the Annapurna Mahila Cooperative Credit Society in Mumbai have still survived under the traditional cooperative laws.

Grameen Model

This model was initially promoted by the well known Grameen Bank of Bangladesh. These undertake individual lending but all borrowers are members of 5-member joint liability groups which, in turn, get together with 7-10 other such groups from the same village or neighbourhood to form a centre. Within each group and centre peer pressure is the key factor in ensuring repayment. Each borrower's creditworthiness is determined by the overall creditworthiness of the group. Savings are a compulsory component of the loan repayment schedule but do not determine the magnitude or timing of the loan. There are some two dozen MFIs in India known to

Characteristics of Microfinance Delivery Models in India		
Financial Service	**Characteristic**	**Description**
Credit	Loan amount	Determined by the longevity of the client's association with the MFI. Not often directly related to the credit needs of the borrower.
	Loan term	Usually 12 months, occasionally less, sometimes greater
	Repayment instalments	Monthly or weekly – usually fixed, equal amounts
	Interest charges	Range: 24-36%, usually levied as a flat charge, partly to simplify calculations for both the MFI and the client. Some MFIs charge lower rates but suffer from poor sustainability as a result.
	Collateral	No physical collateral but often linked to some compulsory savings component which acts as financial collateral. Reinforced by joint liability (Grameen) with other clients or peer pressure arising from membership of a community group revolving its own as well as borrowed funds (SHGs, cooperatives). Some MFIs also create reserve funds to cover the risk of default.
Savings	Amount deposited	Grameen: Compulsory – usually a fixed proportion of the repayment instalment SHG: Compulsory – fixed amounts per (weekly or monthly) meeting to be deposited as part of the group fund; occasionally also voluntary Some MFIs now offer long term fixed deposits.
	Withdrawals	Compulsory savings cannot be withdrawn except when the client leaves the group. Voluntary savings often require some notice of withdrawal.
	Interest paid	Most programmes pay 4-6% interest (not consistent)
Insurance	Life	Some MFIs are starting to offer life insurance covering client loan repayments plus a small payment to the family in case of the death of the client. A reserve fund is created for the purpose or insurance is bought from the organised sector on behalf of the client.
	Animal	Usually linked with a formal insurance company which obtains bulk business from the MFI while the latter provides the service of premium collection; assists in the verification of claims

Exhibit 1

follow this model.

Mixed Model

Some MFIs started with the Grameen model but converted to the SHG model at a later stage. However they did not completely do away with Grameen type lending and smaller groups. They are an equal mix of SHG and Grameen model. Others have chosen to adapt either the Grameen or the SHG model to cater to their markets while some organisations like BASIX use a number of delivery channels and methodologies (including lending to SHGs) to provide financial services. Such MFIs are still relatively few but with increasing innovation becoming the norm in Indian microfinance, their numbers are growing.

Common Characteristics of Microfinance Models

The common characteristics across the current approaches to the provision of microfinance services are summarised in Exhibit 1. In practice, the average microfinance client's relationship with an MFI can be defined by a fairly standard *set of obligations*.

- Attendance of regular weekly (fortnightly or monthly) meetings of her group
- Training in 'loan utilisation' or participation in discussions of developmentally relevant issues such as social discrimination, gender awareness, health, sanitation and education
- Contribution of fixed amounts, termed

Outreach of Sample MFIs – Key Indicators					
Indicators	**SHG**	**IBP**	**Grameen**	**Mixed**	**All sample MFIs**
Sample size	**43**	**10**	**7**	**9**	**69**
Total membership, '000s	**1,032**	**112**	**174**	**105**	**1,423**
Average membership, '000s	**24.0**	**14.0**	**24.8**	**11.7**	**20.6**
Active borrowers/MFI, '000s	**4.6**	**5.5**	**21.9**	**5.0**	**6.5**
Loans outstanding, cr Rs	**54.6**	**35.6**	**45.6**	**28.0**	**163.8**
Average portfolio, cr Rs	**1.3**	**3.6**	**6.5**	**3.1**	**2.4**
Avge loan outstanding, Rs	**2,800**	**6,500**	**3,000**	**6,200**	**3,600**
Savings, cr Rs	**45.1**	**28.5**	**12.4**	**6.2**	**92.2**
Savings per member, Rs	**440**	**2,550**	**710**	**590**	**650**
Productivity – loan clients per staff member	**118**	**205**	**131**	**119**	**126**
Portfolio per staff member, Rs lakhs	**2.8**	**16.6**	**3.6**	**5.0**	**4.0**

Exhibit 2

'savings', to a fund managed either by her group or by the MFI with direct access of the member limited or even barred

- Repayment of fixed amounts as instalments on any loan she obtains from the MFI or from her group.

What she actually *receives* in return for fulfilling these obligations are:

- Fixed amounts of loan apparently 'for productive activities' – with the size of the loan usually determined by the longevity of her relationship with the MFI rather than by her financial needs
- Emergency loans for 'consumption' – in the case of some MFIs – but relatively small amounts and subject to the approval of her group
- Insurance – provided by a risk fund or insurance fund created by a few MFIs, or by an insurance company in collaboration with the MFI
- Other development services, in the case of multi-service NGO/MFIs.

Assessment of Microfinance Services/ Institutions

Direct finance to MFIs is limited by continuing widespread scepticism about the credibility of micro-borrowers and, by extension, of the MFIs who provide finance to them. The problem is compounded by the lack of exposure of most bankers and others with large sums of money to lend to MFIs for on-lending to the poor. This lack of exposure translates into inability to assess the MFI's performance and appraise its creditworthiness easily and economically. It was to bridge this gap that the rating of MFIs was introduced in India in 1998 by Micro-Credit Ratings International Limited (M-CRIL). The rating of MFIs is an innovative service that, virtually for the first time in the world, enabled a systematic, detailed and standardised assessment of the performance of large numbers of MFIs.

M-CRIL's analysis of the performance of microfinance in India covers 69 MFIs until June 2002 (Exhibit 2). While the cross-sectional data for these 69 organisations does not relate to a fixed point of time, it does serve the purpose of providing a broad picture of microfinance in the region as seen through M-CRIL's rating activity.[10]

For the purpose of analysis, the M-CRIL database sample has been classified using the typology set out earlier. As Exhibit 2 shows, over 60% (43) of the sample of 69 Indian MFIs rated by M-CRIL until June 2002, use the SHG model to provide microfinance services. The much smaller numbers of MFIs in the sample following models other than the SHG is a reflection of their relatively smaller number in the universe of Indian MFIs.

M-CRIL's rating incorporates a weighted scoring of key indicators on governance, management systems and financial performance of an MFI. Based on this rating system, at the time of assessment, only 6 of the 69 sample organisations had achieved the levels of performance (α or α+ grades awarded by M-CRIL) to classify as highly creditworthy, another 26 were moderately creditworthy (α- or β+ grades, 17 were marginal (β) and the remaining 20 were not creditworthy.

Outreach

The outreach of the 69 sample MFIs is to some 1.4 million persons (overwhelmingly women) receiving financial services though only 450,000 of these are borrowers from the MFI. Others are all savers with the MFI though they may also be borrowers from SHGs. As Exhibit 2 shows, their total loans outstanding to client members amount to just Rs164 crores (US$34.5 million) – a very small amount compared to the potential. Even within the MFIs, the distribution is skewed with the best ten organisations in terms of performance (the Top10) – broadly but not invariably the largest – accounting for over 40% of this portfolio.

Grameen programmes have traditionally not given much importance to savings as a source of funds, IBPs place considerable emphasis on this source. The SHG programmes have compulsory deposit schemes in which the members themselves determine the amount.

Microfinance in India is broadly characterised by a small number of large MFIs that are relatively strong and a larger number of relatively small and weak organisations. By model, the Grameen MFIs are substantially larger than the other types in terms of credit with more than three times the average number of borrowers and nearly 2.7 times the average portfolio of all sample MFIs. A few of the prominent Grameen programmes in the country are growing fairly fast compared to the others. IBPs have much larger loans outstanding per borrower as well as far higher individual savings. This is both because some of the more prominent cooperative model MFIs are urban institutions and also because they have a very high savings orientation.

Savings Mobilisation

Not all MFIs in the sample are able to offer savings services – particularly the organisations registered as 'for profit' NBFCs and, therefore, regulated by India's central bank. Further, the Grameen MFIs traditionally do not place much emphasis, beyond compulsory savings, on providing savings services to their members. Nevertheless, deposits mobilised directly by the MFIs amount to Rs 92 crores (or 56% of the total amount outstanding with clients). Actual mobilisation – including amounts generated by SHGs for internal circulation but not deposited with the MFI – is substantially higher (likely to be 90% or more of the amount outstanding). This shows the value microfinance clients place on savings services and also demonstrates the potential for raising lending resources locally. As of now, the average savings with the MFI of just Rs 650 per client are less than a quarter of the Rs 2,550 average mobilised by the (on average) more mature IBPs.

The average level of savings deposited with MFIs is mainly a function of three factors — implementation strategy, age and location.

Thus, the average savings deposited with Grameen programmes are less than a quarter of those of the IBPs. While it is well known that Grameen programmes have traditionally not given much importance to savings as a source of funds, IBPs place considerable emphasis on this source.

The SHG programmes, by contrast, have compulsory deposit schemes in which the members themselves determine the amount of the recurring savings deposit. This often results in minimalist norms and leads to deposits that are far lower than the members' savings potential. This is also reflected in the average figures which show that while individual banking clients have savings deposits of around Rs 2,550 each, Grameen and SHG clients have saved only Rs 400-700 each.

Age affects the absolute amount of the average savings deposited by each member with the MFI as even small amounts deposited regularly over a longer period of time do add up. However, some of the oldest MFIs (more than 7 years old) report somewhat lower savings per member than the Rs 800 average found for 5-7 year old MFIs. This is because as MFIs mature they transform into other institutional forms such as NBFCs (prohibited initially from raising deposits) or they reduce emphasis on savings as a funding source on account of the easier availability of wholesale loans from SIDBI, RMK and others for on-lending. At the same time, the economic conditions prevailing in an MFI's operational area are likely to affect the members' ability to save so that the average savings generated by a programme in Tamil Nadu are likely to be far higher than those generated by a similar programme in Orissa.

Staff Productivities

The 69 sample MFIs between them employ some 4,100 persons to provide microfinance services. Staff productivity is highest amongst the IBPs with 205 loan clients per staff member – partly because the large ones are urban, slum-based programmes – but even the newer, smaller IBPs' 135 loan clients per member of staff is better than the MicroBanking Bulletin (MBB) international sample average of 114. Grameen MFIs, with 131 clients per staff member are well known to be relatively staff intensive but the SHG programmes with 118 borrowers per staff member are even more staff intensive. This negates the expectation that village banking programmes can be efficient in the long term as client representatives take over many staff functions. This is partly on account of the orientation of SHG programmes that aim to fulfil social objectives such as promoting the self-governance capabilities of members and, therefore, are not strongly motivated to maximising productivity and limiting operating costs in the short term. It is, nevertheless, interesting to note that even the SHG programmes in India are, at least marginally, more productive than the MBB's international average.

In terms of the number of loans serviced, the 175 clients and nearly Rs 7 lakh ($14,500) per staff member average of the M-CRIL Top10 indicates the potential improvement that could be achieved by the others. Yet, salary scales and other cost levels in India are so low that the Rs 530 ($11.20) cost per borrower in the sample is less than one-twelfth of the MBB sample's $133 per borrower.

Portfolio Quality

M-CRIL measures portfolio at risk (PAR) at the 60-day level[11]. Grameen MFIs are the best performers in the sample with an average PAR of 3.8%. The poor performers in this case, as in the case of cost coverage, are the mature programmes. This is largely on account of the stronger welfare (rather than commercial) orientation of the early entrants into microfinance. The managements of many of the older MFIs in the sample have a limited understanding and even weaker resolve in relation to the need for credit discipline as the basis for any financial services activity.

Some of the mixed programmes in the sample have suffered not so much from methodological or ideological constraints as from lack of experience in the management of risk associated with different types of loan products – particularly crop loans. The sample average of over 13% is far higher than the MBB sample PAR (>90days) of 2% and emphasises the impression that MFIs in India do not pay enough attention to portfolio quality. Further, they are reluctant to write off unrecoverable loans for fear of clients getting the impression that loans remaining unpaid for extended periods of time would simply not be pursued by the organisation. However, this gives the MFI management an unrealistic picture of its asset quality and confuses decision-making.

MFIs in India have been dependent on donor funding for financing both their portfolios and their operations. This is changing and around 30% of the total currently deployed in the sample, is made up primarily of donated equity. Some 17% of the funds could be described as member funds.

Financing

Microfinance institutions in India have historically been heavily dependent on donor funding for financing both their portfolios and their operations. However, this is gradually changing and around 30% of the total of Rs 278 crores ($59 million) currently deployed in the sample MFIs consists of the organisations' net worth, made up primarily of donated equity. Accumulated losses amounting to Rs 25 crores, 55 of the 69 organisations have contributed to the erosion of equity. Exhibit 3 shows the Indian MFIs' sources of funds.

Some 17% of the funds deployed in microfinance by sample MFIs could be described as member funds consisting of both withdrawable and non-withdrawable savings and emergency funds accumulated to cover loan losses due to disasters affecting MFI clients. While a large proportion of these savings is generated by cooperative institutions with a legal mandate to take deposits, even

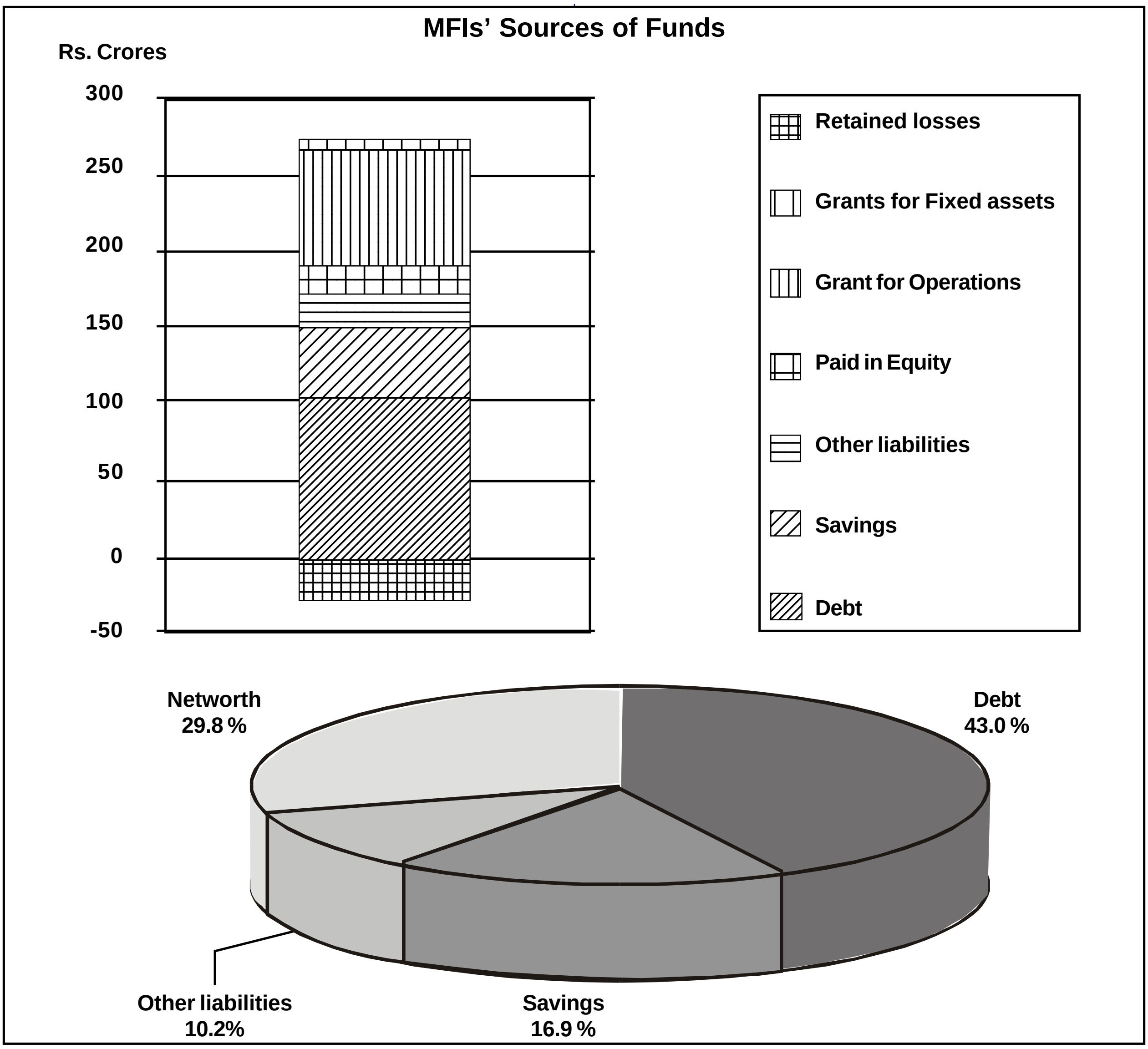

Exhibit 3

MFIs with charitable status do generate savings from members. This is accepted by the regulatory authorities largely because they accept that there is a dearth of financial services for the poor. The authorities also recognise their own inability to regulate hundreds of MFIs in an effective manner and are relatively sanguine about MFI deposit collection largely because there has not so far been any significant case of default or misappropriation by any MFI in the country.

Given that it is the better MFIs that have been rated so far, this analysis of the rating information shows that microfinance in India has a long way to go before it can collectively achieve commercial viability. However, M-CRIL's experience also shows that the importance of donor funds is declining and that MFI managements are increasingly aware of the need to obtain more resources both from members (as deposits) and from various types of institutional lenders. Since most MFIs in India do not see themselves as commercial entities their preference is to obtain resources from development loan funds on 'soft' terms. Therefore, it is not surprising that perhaps 90% of the funds raised by MFIs for their activities are accounted for by soft loans from organisations like SIDBI, HUDCO, the Rashtriya Mahila Kosh and dedicated microfinance wholesalers such as Friends of Women's World Banking, India. The share of the commercial banks in this total is quite small.

As is well known, the major involvement by commercial banks in Indian microfinance is through the SHG-linking programme pioneered by the NGO MYRADA and now extensively promoted by

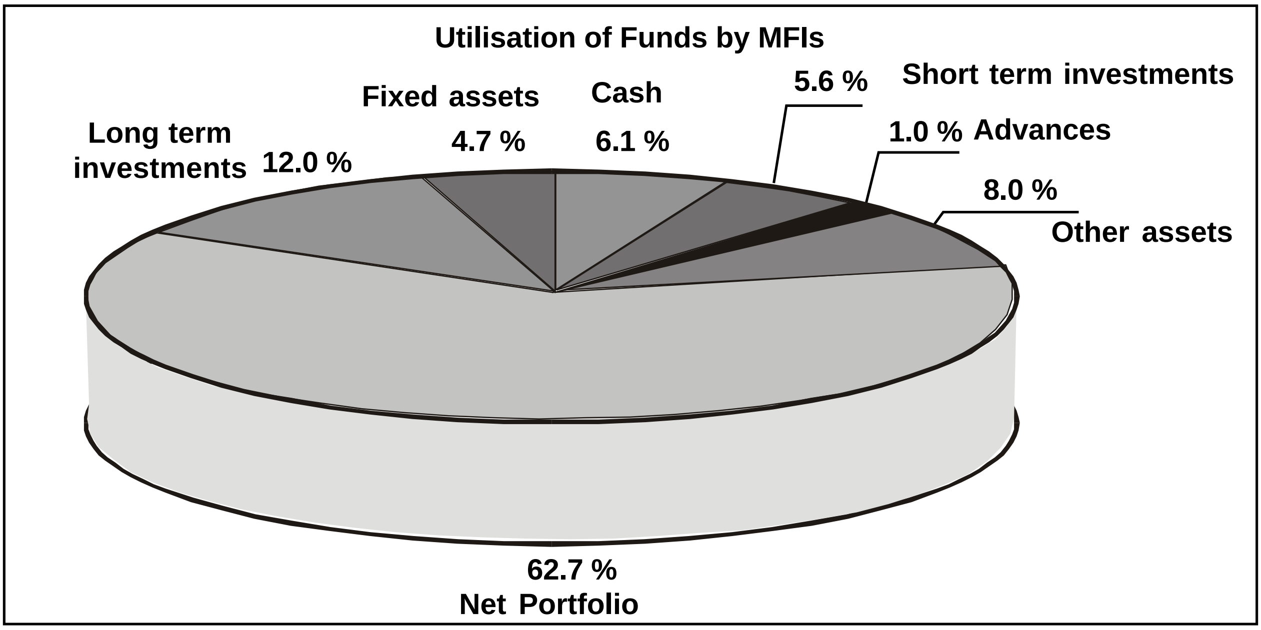

Exhibit 4

NABARD. This programme entails direct lending by banks to SHGs without any financial intermediation by MFIs. Nevertheless, some of the largest and best known NGOs in the country, such as MYRADA, PRADAN and the Dhan Foundation have focussed on the promotion of SHGs as part of the linking programme and have specifically avoided becoming involved in financial intermediation. These NGOs have emphasised the civil society objective of ensuring that the banking system fulfils its social responsibility of providing financial services to the poor. Their strategy has, therefore, been to promote SHGs as autonomous local groups with self-governance capabilities that can act as intermediaries for the financial services provided by the banking system. Since the rating of thousands of village level SHGs could not be cost-effective, M-CRIL's ratings have not covered them and the SHG linking programme does not figure in this discussion. Overall, until March 2002, NABARD's data indicates that over 450,000 loans to a cumulative value of Rs 1,026 crores (10.26 bn) had been made to SHGs by commercial banks[12].

Exhibit 4 illustrates how funds have been utilised by MFIs. Some 63% of the total resources of Rs 252 crores (2520 mn) available to the Indian MFIs in the sample has been deployed by them in loans to clients while nearly 18% has been placed in short and long term investments – mainly with banks. These investments – even in long-term bank deposits – now earn no more than 8-9%. Yet, the conditions on MFI loans to clients amount to annual effective interest rates of 18-45% and could potentially yield them very high returns. The inefficiency of the strategy of sourcing debt financing – even at 8-11% – and then failing to apply it fully to the intended purpose of lending to clients, is apparent.

Portfolio Management

The efficient, effective and prudential management of an MFI's assets is also important for achieving financial sustainability. Such management depends on a number of factors:

- The use of member deposits as a (relatively cheap) source of funds
- The minimisation of the need for fixed assets relative to total assets
- The maximum investment of financial resources either in the loan portfolio or in high return, long term investments
- Limitation of the risk associated with the MFI's financial assets to levels consistent with the organisation's own funds or net worth.

M-CRIL's analysis of the management of the sample MFIs' assets shows that IBPs are amongst the most efficiently managed. The mature IBPs are savings-based organisations with high deposit-credit ratios (80%), reasonable fixed to total assets (3.3%) and low ratios of liquid to total assets (2.1%). While the sample average of 5.2% fixed assets is reasonable, 9% liquid assets is relatively high and, as the earlier discussion showed, the deposit-credit ratio of 34% could certainly be improved. Another important concern here is that at least four – not very small — MFIs have actually eroded their equity to the extent that they have negative net worth.

Operating Performance

Surprisingly, in the context of the well-known management deficiencies of MFIs in the region, the database shows that operating efficiency compares well with international best practice norms. Operating expense[13] ratios of many of the rated MFIs are less than 30%. Though Grameen MFIs record the highest operating expense ratios, typically 86% (though the weighted average is just 24.5%), the sample average for Indian MFIs is just 18.5% compared with the equivalent average of over 27% for the MicroBanking Bulletin (MBB) sample of 116 MFIs. On the other hand, the average portfolio yield – the actual revenues generated from lending to clients as a proportion of the average portfolio – for the M-CRIL sample of Indian MFIs is just 19.2% compared to the MBB's international sample average of 36.6%. So low is the portfolio yield, indeed, that the financial spread[14] being earned by the average MFI in India is barely 11% leaving a 7.5% gap between it and the operating expense level of 18.5% of average portfolio.

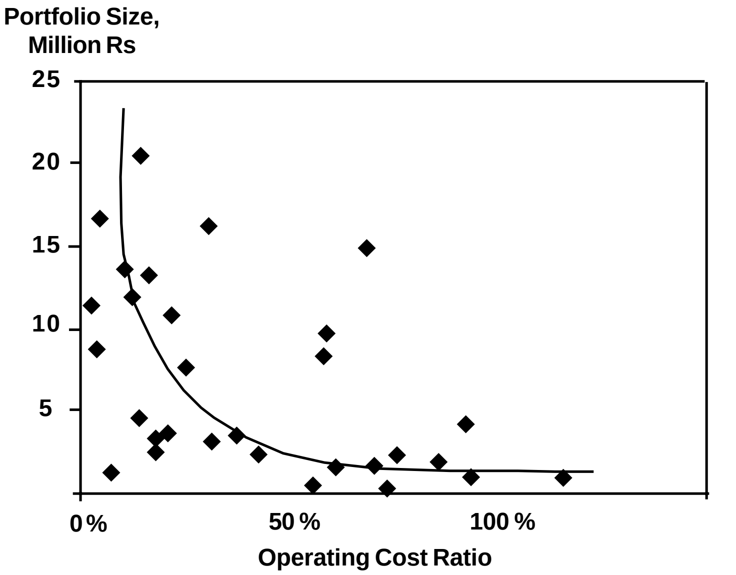

Exhibit 5

Since economies of scale are generally expected in any economic activity, the relationship between the operating cost ratio and portfolio size of individual MFIs has been illustrated in Exhibit 5. Though the correlation is not perfect, a clear inverse relationship between portfolio size and operating cost ratio emerges from the sample information. It is also interesting to note here that there is apparently a minimum operating cost ratio – around 10% — below which it is all but impossible for MFIs to function. Further, even MFIs with relatively small portfolios Rs 50 lakhs ($106,000) or less are able to achieve low operating cost ratios of 10-15% if they make an effort. This finding is methodology-neutral.

Return on Assets

The lack of commercial viability of MFIs in India becomes apparent from a review of the returns on their assets. The sample average indicates a loss of 2.2% on total assets with the typical MFI (simple rather than weighted average) losing over 20% per year. Surprisingly, here the Indian average is significantly better than the MBB international average loss of 2.7%. The hope this generates for the sector is tempered by the M-CRIL Top10 average surplus of just 1%, significantly lower than the MBB sample's 5.5% return on assets for fully sustainable institutions. Between the models, the Grameen organisations perform the best with overall high deployment of funds in portfolios reinforced by greater emphasis on portfolio quality and significantly higher yields. This enables the Grameen MFIs collectively to earn a marginal positive return despite their higher operating costs.

The disaggregated information from the database shows that 5 Indian MFIs in the M-CRIL sample earn more than 3% returns on assets and as many as 14 earn positive returns. On account of their relatively good fund management the IBPs perform better than other types of MFIs and have average losses of just 0.3% of total assets.

Dependence on Subsidies

Operational self-sufficiency measures the ability of an MFI to meet all its operational and financial costs out of its income from operations. As expected from the above discussion, the IBPs as a group come close to achieving full operational self-sufficiency (OSS=97%) – though the distribution of the 10 such MFIs indicates that three of them are still quite far from the 100% target. Out of the 43 SHG programmes, only six have been able to cover all their costs so far.

Since MFIs do receive significant subsidies not only in the form of grants but also as soft loans and in-kind donations, a calculation of financial self-sufficiency (FSS) provides a more accurate picture of their sustainability performance.

The average of 80.2% for OSS and 68.3% for FSS for the sample MFIs in India compares poorly with the MBB sample average of 108.9% OSS and 92.5%. The Top10 MFIs rated by M-CRIL, on the other hand, show comparable performance to the MBB sample with average OSS of 107.6% and FSS of 92.0%. However, with relatively low operating cost ratios, there are still enough MFIs in the M-CRIL sample with positive returns to provide some grounds to hope for better overall performance in the future.

Institutional Assessment

It is apparent from the foregoing discussion that the performance of the rated MFIs in India in terms of financial sustainability has been relatively weak. Though systematic information on sectoral trends is not presently available, the experience of M-CRIL's team with the performance of MFIs in the country over the past few years indicates that the message of sustainability is starting to permeate through the microfinance sector. Consequently, there is a positive trend in overall performance both in terms of sustainability and in terms of growth.

Like all development activities in the region, mediocrity at the staff level also plagues microfinance. The geographical spread of programmes affects their operational efficiency. Amongst the least satisfactory aspects of MFI functioning is the quality of management information systems.

There are, however, a number of institutional and systemic issues that still seriously constrain the sustainability of MFIs in the region.

- Staff Quality: Like all development activities in the region, the disease of mediocrity at the staff level also plagues microfinance. By and large, remuneration in the sector is uncompetitive with the public sector and significantly lower than much of the private commercial sector. This results in a high turnover of competent junior staff and mediocrity at supervisory levels. The few organisations that have introduced appropriate remuneration and incentive systems are also the best functioning MFIs in the region.

- Scale of Operations and Geographical Spread: The typical number of borrowers of sample MFIs in India is no more than 3,000-4,000 with average loan sizes of just $100-125. While M-CRIL is convinced that scale is not the only cause of low financial sustainability of MFIs in the region, it is certainly a factor. For this reason, more than half the 69 MFIs in the sample were urged by M-CRIL to expand their lending activities.

At the same time, in many cases, there is a concern that the geographical spread of programmes affects their operational efficiency. Many MFI leaders, in their concern to work with particular communities or reach especially poor regions, spread their programmes over distances – often in excess of a 100 km radius – which, for small organisations, substantially adds to the cost of operations and hampers managerial supervision. M-CRIL has recommended consolidation of operations in 23 (33%) of cases. Seven of the sample MFIs were found to be both small and spread thinly over a wide area.

- MIS and Portfolio Quality: Amongst the least satisfactory aspects of MFI functioning in the region is the quality of management information systems (MIS). A number of organisations do not have adequate systems even to track basic member and borrower information in a manner that will enable an accurate enumeration of clients served. Others suffer from inconsistencies at various levels of operation so that appropriate information is either not available at head office level or at branch level. Many do not even collate information on portfolio quality. Only 13 of the sample MFIs were found by M-CRIL to have a fully effective MIS, while 24 (35% of the total) have adequate systems for tracking portfolio quality. In the latter case, this is related to the predominant (and inappropriate) use of the cumulative repayment rate as a portfolio quality indicator. In this scenario, greater than 90% repayment rates are regarded as satisfactory on the part of MFI managements and breed complacency despite being (often) associated with a 15-20% portfolio at risk ratio.

- Financial Control Systems: Overall accounting systems in sample MFIs have been found to be reasonably satisfactory. However, relatively few (29, 42%) have internal audit mechanisms in place. This is a risky situation in the context of the failure of most (43, 62%) even to undertake any formal budgeting or cash planning. Further, as discussed earlier, liquidity management is an area of concern in the operations of many MFIs with inefficiencies in the sourcing of funds from lenders/donors, in the transfer of cash between branches and head office and in their slackness related to placing idle funds in short term investments.

- Development Orientation of CEOs: This approach to microfinance management is, of course, largely a reflection of the welfare oriented background of most MFI CEOs who have yet to recognise the potential of microfinance as a commercially viable business proposition, albeit one with a social purpose. Most MFIs in India have either evolved from NGOs undertaking a wide range of development activities or continue to be divisions of such institutions. Though, there is an increasing recognition of the need for sustainability, this is yet to become an over-riding priority in the practice of microfinance in the region. The sustainability of MFIs thus is critically affected by the self-perception of the promoting NGOs.

Growth Pangs of a New Economy

In the context of sustainability, the conclusion of this analysis is that the microfinance sector in India is currently experiencing substantial problems. Yet, for the first time in the history of Indian development a serious effort is being made to provide systematic financial services to low-income families who are not served by the formal financial sector. A new economy of financial intermediation is thus starting to emerge. Though the outreach of the microfinance sector is still very limited (at most 5%) in relation to demand, the sector is growing at 20-30% per year and there are a number of organisations striving for sustainability. Indeed, despite the relative pessimism of the analysis in this paper, M-CRIL's work in the wider Asian region indicates that Indian MFIs have undertaken considerable innovation in recent years and are ahead, in this way, of many of their Asian counterparts. In addition, some of the more sustainable Indian MFIs that have also achieved reasonable scale (of 40,000 and more clients) have now started to be replicated in other regions of the country – especially outside the well served states of Andhra Pradesh and Tamil Nadu. To this extent, there are signs that the challenge of microfinance in India is starting to produce an appropriate response. Thus, the concerns emerging from the analysis in this paper are likely, in the long run, to be no more than a documentation of the growth pangs of a new economy.

References and Notes

1 See Ghate, P, 1992, *Informal Finance*, Oxford: Oxford University Press and Rutherford, S, and S S Arora, 1997, *City Savers*, New Delhi: DFID, amongst other sources of information on ROSCAs, Chit Funds and other informal means of obtaining finance.

2 Reserve Bank of India, 'Report on Currency and Finance', 1997-98.

3 This suggests that virtually all the 60 million or so poor families were covered by the IRDP. Alas, this was not the case as the numbers include many cases of repeat assistance (deliberate) and perhaps even more cases of unjustified selection of 'beneficiaries'.

4 For a more detailed discussion, see Sinha, Sanjay, 'India Country Study', Asian Development Bank, 2000.

5 Much of the discussion in this and the foregoing section is based on Sinha, 'India Country Study'; The Role of Central Banks in Microfinance in Asia and the Pacific, ADB: Manila.

6 This number includes all registered societies, trusts, a few NBFCs and 'new generation' cooperatives acting as financial intermediaries. It specifically excludes unregistered self help groups that are usually established and facilitated by the NGOs; and it also excludes conventional cooperatives.

7 Author's estimate for the number of families. The information available on this programme does not cover amounts outstanding or the number of SHGs with outstanding loans.

8 'Weaker sections', official parlance for the poor and underprivileged sections of society, includes all families officially classified as poor but also some non-poor who belong to the lower castes or to specified groups of religious minorities.

9 Bankers' attitudes which limit commercial bank exposure to microfinance are extensively discussed in Goodwin-Groen, Ruth, 1998, 'The Role of Commercial Banks in Microfinance: Asia Pacific Region', Brisbane, Australia: Foundation for Development Cooperation.

10 Until end-June 2002 – nearly four years after its launch – M-CRIL had completed 122 rating assignments. Of these, 24 were updates of earlier ratings so M-CRIL's database contained information on 98 MFIs of which 84 operate in India. Since the basis on which rating information was collected has evolved over time some of the MFIs rated early in M-CRIL's activities have had to be eliminated for lack of comparable data. Similarly, a few of the MFIs rated were found to have seriously deficient data and have been eliminated on these grounds.

11 Loans with overdues more than 60 days beyond the designated date of payment are regarded as being at risk of default.

12 Since this data is cumulative, it is likely that the number of extant SHGs with outstanding loans in March 2002 was of the order of 300,000 with outstanding loans of around Rs700 crores.

13 Staff, travel and other expenses incurred in MFI operations (excluding financial costs) as a proportion of average loan portfolio.

14 Portfolio yield minus financial costs (the total cost of funds for the period plus loan loss provision expenses divided by the average portfolio).

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Round Table

Microfinance in India: Discussion

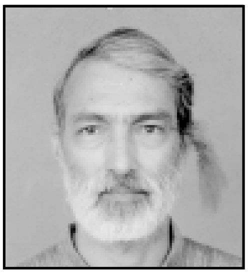
R Srinivasan and M S Sriram

R Srinivasan is Dean (Academic) and Professor, Finance and Control, at the Indian Institute of Management Bangalore.
rsrini@iimb.ernet.in

M S Sriram is Associate Professor, Centre for Management in Agriculture, and Co-ordinator, Management Education Programme, at the Indian Institute of Management, Ahmedabad.
mssriram@iimahd.ernet.in

Microfinance as a developmental and economic tool has caught the imagination of banks and other financial institutions, and NGOs in India. What makes microfinance such an attractive business proposition? Given their ideological leanings and their competencies, should NGOs be encouraged to morph into microfinance institutions (MFIs) or remain as social intermediaries between Self-help Groups (SHGs) and banks? How effective are the alternate delivery models such as the Grameen Bank, Self-help Groups and individual banking models, and schemes such as the linkage between banks and SHGs? How do these models fare on the essential counts of growth and sustainability? Have they made the leap from 'economics' to 'empowerment'? And what of the target segment, the poor themselves? While they are now admitted to be 'bankable', how do we define 'the poor' and how successfully have these models incorporated their actual needs? While government policy and the regulatory framework have been responsive to changing needs, has the system been successful in providing an integrated set of microfinance services, including savings, credit and insurance products, to the poor?

A panel of financial experts, academics, activists, bankers and policy makers who have long been working in the field, debated these questions among others, with R Srinivasan and M S Sriram.



Deep Joshi is Executive Director, PRADAN.

The participants in the discussion included Vijayalaxmi Das, Chief Executive, Friends of Women's World Banking; Aloysius Fernandez, Executive Director, MYRADA; David Gibbons, Executive Chairman, Cashpor Financial Technical Services; Malcolm Harper, Professor Emeritus, Cranfield University; Deep Joshi, Executive Director, PRADAN; M Udaia Kumar, Managing Director, Share Microfin; Vijay Mahajan, Managing Director, BASIX; Ramesh Ramanathan, Vice Chairman, Sanghamithra Rural Financial Services and Jayashree Vyas, Managing Director, Shree Mahila Sewa Sahakari Bank.

Microfinance: Attractive Business Proposition

MSS/RS: What makes microfinance economically attractive as a business? Let us start with non-governmental organisations (NGOs), why have they taken to microfinance?

Deep Joshi

The image of the NGO is led by the exceptional few that are mission focussed and strategic. The majority, however, tend to take on current ideas, and funding for current ideas often spawns new NGOs. For example, when the Janata Party Government (1977-79) launched the adult education programme and encouraged NGO participation, many NGOs, previously uninvolved in education, took up the programme. The story was repeated during 1985-90 with wastelands development and social forestry and later, with biogas. Microfinance in that sense is the current flavour. The field of development itself expands and shifts emphasis with the pull of ideas, and NGOs perhaps more readily adopt new ideas, especially if the resources required are small, entry and exit are easy, tasks are (perceived to be) simple and people's acceptance is high – all characteristics (real or presumed) of microfinance.

Canvassing by various actors, including the National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), Friends of Women's World Banking (FWWB), Rashtriya Mahila Kosh (RMK), Council for Advancement of People's Action and Rural Technologies (CAPART), Rashtriya Gramin Vikas Nidhi (RGVN), various donor funded programmes [especially by the International Fund for Agricultural Development (IFAD), United Nations Development Programme (UNDP), World Bank and Department for International Development, UK (DFID)], and lately commercial banks, has greatly added to the idea pull. Induced by the worldwide focus on microfinance, donor NGOs too have been funding microfinance projects. One might call it the supply push.

The field of development expands and shifts emphasis with the pull of ideas, and NGOs adopt new ideas, especially if the resources required are small, entry and exit are easy, tasks are (perceived to be) simple and people's acceptance is high – all characteristics (real or presumed) of microfinance.

A third factor, as a Sarvodaya leader of long standing pointed out to me, is that the idea seems to work! He said he had tried all kinds of things for 25 years, from khadi spinning to Nadep compost to balwadis, but nothing produces such concrete results and sustained interest among beneficiaries as microfinance. He has lately been promoting women's self-help groups (SHGs) and finds great enthusiasm among women, who are flocking to his NGO for inclusion. Most NGO-led microfinance is with poor women, for whom access to small loans to meet dire emergencies is a valued outcome. Thus, quick and high 'customer satisfaction' is the USP that has attracted NGOs to this trade.

The idea appears simple to implement. The most common route followed by NGOs is promotion of SHGs. A majority of SHG promoters do not conceive of SHGs as entities that would function independently of the promoters. It is thus implicitly assumed that no 'technical skill' is involved. Though the term 'social infrastructure' is often used, implying creation of an 'institution', most promoters and supporters are innocent of the conceptual underpinnings of these terms. NABARD and banks have further reinforced this notion. Besides, external resources are not needed as SHGs begin with their own savings. Those NGOs

Vijay Mahajan is Managing Director, BASIX.

that have access to revolving funds from donors do not have to worry about financial performance any way. Others are able to link groups to banks for small sums where repayment history is yet to catch up and therefore not of any consequence (the promoters in any case continue to pursue repayment, free of cost). The chickens will eventually come home to roost but in the first flush, it seems all so easy. Social forestry, for example, is far more difficult – one has at least to know how to raise saplings and survival rates become known within a few months of planting! Here, 'all you have to do' is ask women to form a samuha (group), start tiny savings and the rest takes care of itself. This is a bit of a caricature but not all that far from reality. For many NGOs the idea of 'organising' – forming a samuha – has inherent appeal. Groups connote empowerment and organising women is a double bonus.

Finally, to many NGOs, microfinance is a way to financial sustainability. Especially for the medium-to-large NGOs that are able to access bulk funds for on-lending, for example from SIDBI, the interest rate spread could be an attractive source of revenue, superior to uncertain, highly competitive and increasingly difficult-to-raise donor funding. Only a few NGOs might ever become full-fledged MFIs that combine savings and credit (if not insurance), but in the interim, credit retailing itself can yield attractive dividends without much regulatory burden.

Vijay Mahajan

The reasons given by Deep as to why a large number of NGOs have entered microfinance resonate with my own observations. As Deep has said, after a long time NGOs found in microfinance, an idea that works. I see nothing wrong with many of them taking to the idea. Funding agencies too are constantly searching for developmental ideas that work, scanning the world of practice as well as academics, and also in response to the prevailing global and national political-economy. Thus funding becomes available only for a very small sub-set of developmental ideas, which have been subjected to a lot of a priori analysis. (The fact that many still do not work has a lot to do with factors beyond the control of development agencies). Widespread support and funding for microfinance took almost two decades to build up. There is thus nothing wrong if a number of smaller NGOs (which are not mission-focused and strategic) adopt a programme which is widely accepted as 'working' and for which funding is available.

There is nothing wrong if NGOs adopt a programme which is accepted as 'working' and for which funding is available. However, in the process, a large number of NGOs decided to become financial intermediaries. What was earlier a facilitator role, changed to a lender role.

The critical mistake that has been made, however, is that in the process, a large number of NGOs decided to become financial intermediaries, borrowing from wholesale institutions such as the RMK and SIDBI and lending in retail to their constituents. Thus what was earlier a facilitator, enabler or welfare/service provider role, changed to a lender role. Most NGOs did not see that this role, if it had to be played seriously, needed changes in their attitudes, competencies and systems. They did not bring about these changes and in the early years at least, suffered delinquency and default. Through inputs from a number of capacity building agencies and also in response to funder pressure, NGOs have improved their performance on this front steadily.

Having said this, I do not see much scope for NGOs in financial intermediation roles to be able to make a surplus large enough to run their other activities. Nor is the possibility of 'time-sharing' of staff involved in microfinance so easy, since the work flow is intense and time-bound and any loading of staff with other work shows up in the form of delinquency or default.

Thus many NGOs have figured that they should not be financial intermediaries and so have taken to the role of forming SHGs and linking those with banks. NABARD's encouragement of this model has also had a lot to do with the change in the role of NGOs to social intermediation – that is forming groups and hand-holding them on an ongoing basis. However, NABARD has not been paying NGOs for this work, at all initially and inadequately lately. More recently, other sources of funds have come up including Swaran Jayanti Swarojgar Yojana (SJSY), SIDBI Foundation for Micro Credit (SFMC) and the ICICI bank, all of whom are now paying NGOs for the valuable role of social intermediation.

Udaia Kumar

NGOs may have taken up microfinance for their own reasons, but today most institutions are actively thinking of regulating/regularising their micro-credit activities. Much learning has been taking place in the sector. Workshops are being organised all round the year to educate NGOs and MFIs on regulation and sustainability. Micro-credit is not as simple a task as it is perceived to be.

The microfinance sector is not only restricted to the SHG mode. There are a number of Grameen replications and other programmes that retail microcredit. These programmes have accessed commercial sources and proved that microfinance can be sustainable while reaching the poorest. It is one of the best means to reduce poverty. The SHG model is far more visible because of government support and funding. But SHGs will not be sustainable in the long run as they are primarily grant-driven and the supervision on loans is minimal. Although forming groups may be an easy task for SHGs because of the high demand for microfinance services, repayment rates are not very commendable. Whereas in the case of regulated MFIs, repayment rates are very high, with fewer chances of default. Most SHGs are promoter based because they are not formalised organisations. They work as a project based team rather than a formal organisation.

Organising a group is not all that simple. It is extremely difficult to build instantaneous rapport with issues like better work place, hygienic living conditions, legal aid and other support systems that the poor sorely need. Microfinance is a good entry point to get people together.

Jayashree Vyas is Managing Director, Shree Mahila Sewa Sahakari Bank.

Jayashree Vyas

The attractiveness of microfinance is more developmental than economic, and this is the key to answering our questions. Of course economic attractiveness follows – but the root of the MFI approach has been developmental in orientation.

While there is a lot of truth in what Deep Joshi says – that microfinance (unlike other developmental efforts) gives quick, tangible and satisfying results, I do not think that organising a group is all that simple. It is as difficult as any other developmental intervention. It appears simple only because the results are quick to see. For instance, when MFIs start forming groups or any other microfinance activity, they are servicing almost the same clients who were either served or deprived of loans by all the governmental schemes like the Integrated Rural Development Programme (IRDP), and have seen loan melas. Organising them and ensuring financial discipline from these people is a lot of hard work. MFIs do take a lot of risk by lending to people who are otherwise classified as 'non-bankable'. Considerable work goes into teaching them how to keep accounts, process transactions and design systems to make the intervention last. The very fact that there are a large number of experts working in this area indicates the amount of intellectual input that this activity demands.

I do agree that the idea of 'organising' people, especially women, is very attractive. But organising women for what? In our experience, we have found that it is extremely difficult to build instantaneous rapport with issues like better work place, hygienic living conditions, legal aid and other support systems that the poor sorely need. Microfinance is a good entry point to get people together. They then start talking a common language, a link is established, it gives a reason to meet regularly and establish a relationship – and the fall out is that other developmental issues gradually start coming out.

I am not sure if the entire edifice of microfinance has been 'supply driven' as Deep Joshi points out

– whether the supply is from the funding institutions of the banks such as SIDBI or NABARD. It may have been supply driven soon after 1969 when the banks were nationalised and a policy push was given. But we know that the policy push did not work, and there was a negative backlash. It was only when the push failed that people started getting organised, and it has been the demonstrated success of the microfinance sector that has given a second renewed push to both the funding and the governmental agencies. Therefore we have to recognise that the success was driven by a demand pull than a supply push.

Perhaps the most important factor that got banks involved is what one might call the policy push. This was followed by diligent promotional work by NABARD. The policy push was to some extent accompanied by (and also generated) demand pull.

Microfinance has been attractive to the lending agencies because of demonstrated sustainability and of low costs of operation. Institutions like SIDBI and NABARD are hard nosed bankers and would not work with the idea if they did not see a long term engagement – which only comes out of sustainability (that is economic attractiveness). However in dealing with these bankers over the years, I have found that they are bankers with a heart and will back projects that are development oriented as long as they are adding a marginal amount to the bottom line.

On the supply side, it is also true that it has all the trappings of a business enterprise, its output is tangible and it is easily understood by the mainstream. This also seems to sound nice to the government, which in the post liberalisation era is trying to explain the logic of every rupee spent. That is the reason why microfinance has attracted mainstream institutions like no other developmental project.

MSS/RS:Why is the commercial world (banks and other financial institutions — FIs) interested in microfinance?

Deep Joshi

I am not sure that the commercial world (even as narrowly defined as banks and other FIs) is truly interested yet. Admittedly, the performance of NABARD's SHG-bank linkage programme (loans worth over Rs 10 billion, mostly during 1999-2002 to nearly half a million SHGs) is impressive and a few banks – in the public as well as private sector – have shown a higher level of interest in the past six months. The State Bank of India (SBI) and Andhra Bank have announced interest rates ranging from 9.5 to 10.5% for SHGs, a large private bank is working with several NGOs and another private bank has commissioned an elaborate study of SHGs. However, an overwhelming majority of the SHG-bank linkages are in the four south Indian States, the average loan per household works out to about Rs 1,200 and the few banks that have shown some aggression in the past few months are all looking for deals with well established NGOs, of whom there are only a handful in the country. Similar is the story with other FIs that are involved in microfinance. I do not think banks have quite figured out yet how to do microfinance on a large scale and I do not see signs of widespread interest. Even so, it is true that a proposal to link an SHG to a bank has a far higher probability of success today than three years ago; and five years ago the probability was close to zero. Let me hazard a few guesses to explain why.

Perhaps the most important factor that got banks involved (in spite of the horrendous IRDP experience) is what one might call the policy push. Given that most of our banks are in the public sector, public policy (including frowns and nods from the Finance Minister), does have some influence on what they will or will not do. In this case, policy was followed by diligent, if meandering, promotional work by NABARD. (It would be worthwhile to look at how this particular policy was implemented compared to the other policy and programme interventions by the state). The policy change about a decade ago by RBI to allow banks to lend to SHGs was initially followed by a seven-page memo by NABARD to all bank chairmen, and later by sensitisation and training programmes for bank staff across the country. Several hundred such programmes were conducted by NGOs alone, each involving 15 to 20 bank staff, all paid for by NABARD. The policy push was sweetened by the NABARD refinance scheme that offers much more favourable terms (100% refinance, wider spread) than for other rural lending by banks. NABARD also did some system setting work and banks lately have been given targets. The canvassing, training, refinance and close follow up by NABARD has resulted in widespread bank involvement.

The policy push was to some extent accompanied by (and also generated) demand pull. The SHG bug spread among NGOs rather quickly and they began going to banks to get SHGs linked. But the favourable policy environment made it possible for NGOs and others to draw the banks out.

The most recent interest among banks, particularly regional rural banks, is perhaps because they are looking for alternative markets given their present high liquidity. Their SHG portfolio, though small volumetrically, is performing well (comparable to their prime clients). The average SHG loan, insignificant though developmentally, is larger than an average crop loan.

Finally, for banks the operating cost of microfinance is perhaps much less than for pure MFIs. The banks already have a vast network of branches. To the extent that an NGO has already promoted SHGs and the SHG portfolio is performing better than the rest of the rural (if not the entire) portfolio, microfinance via SHGs in the worst case would represent marginal addition to cost and would often reduce marginal cost through better capacity utilisation. In the process the bank also earns brownie points with policy makers and meets its priority sector targets!

Vijay Mahajan

Once again, Deep's observations significantly capture the motivation of banks and FIs to be in this business. It is true that banks will do what their masters tell them (which till recently, and even now substantially, was the government). But as the market is taking over from the master, at least the more foresighted of the banks, such as SBI in the public sector and the ICICI Bank in the private sector, are looking out for emerging markets.

It does not take much analysis to figure out that the market for financial services for the 50-60 million poor households of India, coupled with about the same number who are technically above the poverty line but are severely under-served by the financial sector, is a very large one. Moreover, as in any emerging market, though the perceived risks are higher, the spreads are much greater. The traditional commercial markets of corporates, business, trade, and now even housing and consumer finance are being sought by all the banks, leading to price competition and wafer thin spreads.

Further, bank-groups are motivated by a number of cross-selling opportunities in the market, for deposits, insurance, remittances and eventually mutual funds. Since the larger banks are offering all these services now through their group companies, it becomes imperative for them to expand their distribution channels as far and deep as possible, in the hope of capturing the entire financial services business of a household. Banks and insurance companies have realised that NGOs offer a gateway to the large market of the lower-income households and that accounts for why a number of them, the ICICI Group leading, are establishing business alliances with NGOs. As long as this enables the spread of financial services to the under-served at competitive rates, I think it is a good thing that is happening.

Banks and insurance companies have realised that NGOs offer a gateway to the large market of the lower-income households, and have established business alliances with them. Agri-input, processing and consumer durable companies are using SHGs as entry points.

Finally, both agri-input and processing companies such as EID Parry, fast-moving consumer goods (FMCG) companies such as Hindustan Levers, and consumer durable companies such as Philips have realised the potential of this big market and are actively using SHGs as entry points. Some amount of free-riding is taking place here by companies, for they are using channels which were built at a significant cost to NGOs, funding agencies and/or the government. In response to this, BASIX has launched an initiative in retail mutual marketing called 'Our Way', where it has encouraged, trained and financed SHG federations to act as wholesalers for not one but any number of companies and capture the margins as well as bargain for higher discounts on the strength of their 'ownership of demand'. Once again, if this initiative works, it would not be such a bad thing, for low-income households will get things 5-10% cheaper.

On the whole, the economic attractiveness of microfinance as a business is getting established and this is a sure step towards mainstreaming. We know that mainstreaming is a mixed blessing, and one tends to exchange scale at the cost of objectives. So it needs to be watched carefully.

Udaia Kumar is Managing Director, Share Microfin.

Udaia Kumar

It is true that there is a huge gap between demand and supply. The outreach of MFIs/NGOs is negligible. But things have started to move slightly in favour of microfinance. While commercial banks today are interested in microfinance they do not have the expertise to enter the business directly. But they are keen to invest in loan funds. The SHG programme supported by NABARD may have attracted a lot of nationalised banks to support SHGs but otherwise, regulated MFIs have been able to access loan funds from commercial banks. Regulated MFIs which are not grant driven have been thriving on commercial funds and are sustainable. The commercial world is interested in lending directly to retail MFIs that have had a good track record. Today commercial banks are thinking of allocating a good chunk of their portfolio to regulate MFIs. So, MFIs should be thinking in terms of regulating their businesses rather than depending on the grant component and NABARD refinancing.

The Grameen model follows a fairly regimented routine. It is cost intensive rather than meeting intensive. The greatness of the model is in the simplicity of design of products and delivery. The focus on the poorest has also made the model a favourite among the donor community.

Alternative Delivery Models

MSS/RS: What about the alternative delivery models used: group models such as Grameen and SHG and individual banking?

Vijay Mahajan

In India there are three major models of delivery of microfinance. We at BASIX have distilled the principles of some of the best practices across the world and improvised upon them. However each model has its own merits and seems to work under differing conditions.

The Grameen Model

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

- Homogeneous affinity group of five
- Eight groups form a Centre
- Centre meets every week
- Regular savings by all members
- Loan proposals approved at Centre meeting
- Loan disbursed directly to individuals
- All loans repaid in 50 instalments

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

The greatness of the Grameen model is in the simplicity of design of products and delivery. The process of delivery is scalable and the model could be replicated widely. The focus on the poorest, which is a value attribute of Grameen, has also made the model a favourite among the donor community.

However, the Grameen model works only under certain assumptions. As all the loans are only for enterprise promotion, it assumes that all the poor want to be self-employed. The repayment of loans starts the week after the loan is disbursed – the inherent assumption being that the borrowers can service their loan from the ex-ante income. Both these assumptions could be questioned.

There is enough literature to question whether it is the best model for the poorest – particularly when their ability to take risks with new enterprise might

Malcolm Harper is Professor Emeritus, Cranfield University.

not be up to the mark. There are also questions raised on the fact that the Grameen model excludes many.

One of the necessary conditions for this model to work is discipline and growth of the number of clients. By design this model might not be appropriate for sparsely populated areas like Kutch in Gujarat, or areas where there is a widespread migration of the labour class such as in parts of Rajasthan, Mahaboobnagar District of Andhra Pradesh and Bharuch District of Gujarat.

Malcolm Harper

To add to what Vijay has been saying about the Grameen Model — in its operations, 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 decisions they have to make as a group are 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 rota basis. It is indeed quite simple for the bank but also, perhaps more important, for the members. Hence it may be the best method for seriously 'disempowered' people who lack confidence. An SHG is a bank, albeit on a micro-scale, and it takes skill and persuasive powers to run it.

The SHG model is homegrown. Unlike other models of micro-credit, it starts off with savings as a base. The model is like the Grameen model, but not as regimented. Mainstream banking has accepted this model for a nationwide bank linkage programme.

People do not borrow for 'enterprise purposes only' as Vijay said. They do borrow 'officially' for non-enterprise purposes, particularly for their husbands' businesses, and unofficially a great deal more, for marriage, food, sickness and all that.

As to whether it is the best model for the poorest, there is quite a lot of evidence from Bangladesh in particular that the Grameen model benefits the poorest least, and that it actually harms many people. Its very simplicity leads staff to focus exclusively on recoveries, and hence to mobilise fierce group pressure which has led to seizure of roofing material as security, hence houses being torn down, and even suicides.

Vijay Mahajan

The Self-help Group Model

The SHG model is a model that is homegrown. Unlike other models of micro-credit, the SHG model starts off with savings as a base. The model is like the Grameen model, but not as regimented. Mainstream banking has accepted this model for a nationwide bank linkage programme and it is quite popular with bankers who see potential in microfinance. The essential design elements of the SHG model are as follows:

- Homogenous affinity group of 15-20 members
- Regular meetings
- Regular savings
- Lending decisions are of the group
- Group selects their leaders
- Group accesses external funds

Groups federate at Cluster/Block level. Most of the groups in India have been promoted by NGOs. The groups tend to be dependent on the intervening agency for a long time to help them not only maintain accounts and conduct meetings, but also to manage the external interface with the bankers and others. The rate of growth of SHGs is not as fast as the Grameen groups, because of the heterogeneity of group formation. Since the design allows for flexibility and focusses on internal capability development, it may take a long time for penetration. Moreover not all promoters of SHGs have the same focus towards the poorest of the poor.

Since there is no single external agency channelling credit, there is every danger that the groups might wither away after a while. However, some of the agencies of the state have seen these as effective channels for delivering the programme funds of various line departments. Since there is no single apex body, and most of the groups are independent, there is every danger that they would get misused as the co-operatives got misused in the past.

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 disciplined – seems to work in areas where the credit culture is severely impaired – particularly in the north and eastern parts.

One of the benefits of the SHG model is that it begins with, and continues to promote member savings. Though SHGs rarely act as the main mode of saving for their members, they at least promote this fundamental financial habit. Further, the SHG model builds on the fact that India already has a large number of bank branches and this channel builds the 'last mile' linkage with the lower-income customers.

Malcolm Harper

SHGs do not always access external funds; there are many SHGs which find that their members' savings plus the high earnings from internal lending are sufficient for their needs. As for Vijay's statement about groups federating at Cluster/ Block level, it is not always the case. Less than 50% of SHGs ever federate or will federate, I suspect. Banks are promoting an increasing share of new SHGs, as are government agencies, and members themselves are more and more forming their own groups as they learn about the concept from their neighbours.

Regarding the SHG and bank linkage, in theory, and increasingly in fact, any bank branch can do business with an SHG. This institutional advantage may be the strongest feature of SHGs.

Vijay Mahajan

One way to look at the Grameen vs SHGs question is the way time is spent in the group meetings. In case of Grameen, perhaps 70-80% of the time is spent in carrying out transactions whereas in SHGs, 70-80% of the time is spent on member interactions. In both cases, a lot of time is spent on counting and recounting currency notes and making accounting entries in passbooks. Some attempts have been made to automate the latter, including smart cards and hand-held terminals, but the time-savings are not good enough to enable the staff to hold more meetings per day than at present. SHG meetings tend to be less frequent, monthly not weekly. And a bank worker need not attend every time, or even ever, as the group develops.

Individual Banking

Under the individual banking model, there are two sub models: one where joint liability groups are formed – thereby providing social collateral to the lending institution, the other being direct lending to individual clients. BASIX offers both the products, in addition to offering loans to intermediaries for on-lending. Both the models seem to be appropriate for larger clients – who either carry out enterprise on their own, or carry out enterprises that hire the other poor who want to be self employed. The reason why this works with larger clients is because the transaction size is large enough to justify the transaction costs.

Malcolm Harper

In Tanzania, Mongolia, and some other places there have been quite successful attempts to 'force down' the minimum level for individual loans, and thus to spare quite poor people from the burden of working with a group. And we should not forget the village unit system of Bank Rakyat Indonesia, arguably the world's biggest and most profitable microfinance institution. They do not reach all the poor, and maybe only a few of the very poorest, but they do not use and never have used any form of group at all.

Vijay Mahajan

The SHG and the Grameen models offer economies of transaction costs to the MFI, but at the cost of the members' time, because the unit of dealing is the 'group' rather than the individual. In contrast, MFIs offering individual loans incur higher transaction costs for servicing their borrowers, particularly where they are engaged in farming, since it is difficult to locate a farmer, as compared to a weaver

The SHG and the Grameen models offer economies of transaction costs to the MFI, but at the cost of the members' time, because the unit of dealing is the 'group' rather than the individual. In contrast, MFIs offering individual loans incur higher transaction costs for servicing their borrowers.

or a shop-keeper in a village.

In summary, Exhibit 1 captures the appropriateness of each of the models described and discussed above:

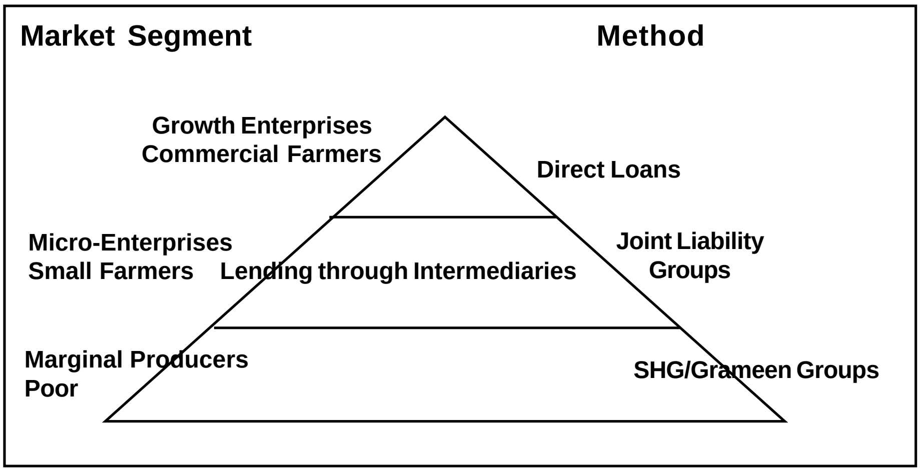


Exhibit 1

Malcolm Harper

I like to see it as a time line. Start with the poorest, most disempowered in Grameen groups, then go to SHGs (this has happened a lot in Kenya) and then such members as wish can 'graduate' to individual loans, at first with and later without group guarantees. But maybe I am too optimistic about the possibility of many of India's (or Africa's) poor ever becoming significantly less poor.

Vijayalaxmi Das

Vijay Mahajan's introduction gives a good perspective on the models that are being tried out in the Indian context. However, we need some basic analysis on the strengths and appropriateness of the models in different contexts.

The Indian sub-continent is diverse and we need to understand why some things work in some areas and not in others. This has to be seen in the context of the overall fabric of the state, the alternate institutions and their growth. We also need to very closely examine why alternative models of reaching out to the poor are not working in certain parts of the country. Is it the absence of a sufficient number of appropriate social intermediaries? Is the cost of promoting appropriate delivery mechanisms too high?

The typology of the microfinance delivery mechanism is but only a route taken to address the basic issue of poverty. Therefore, it does not matter what the typology or the ideology behind the typology is, as long as the channel is appropriate for the social milieu and can deliver the services to the deserving people.

I also do not believe that growth has something to do with the typology. If the objective is outreach, then growth should naturally happen. There are fast growing Grameen models and equally fast growing individual banking models. But these are working in a certain given environment. If we are able to crack the issue of what it is in the environment that makes one model more effective than the other, we would have multiple models working in the country – more than the three listed by Vijay, each appropriate to its context. However, classifying the models will help understand their attributes better.

MSS/RS: MYRADA is the pioneer in SHGs. Al, can you talk about how the alternate model (the SHG) emerged?

Aloysius Fernandez

The first SHGs emerged in MYRADA in 1984-85 when the co-operative societies we had organised broke down. Small groups of members of the co-operatives emerged; the members decided to return the money they owed to the co-operative society to their group. By 1986-87 about 300 such Credit Management Groups emerged in MYRADA's projects. In 1986 MYRADA approached NABARD with a proposal to support the formation of an alternate model of credit provision for the poor. In 1987, after several field studies, NABARD gave MYRADA a sum of Rs 1 million. The groups were now called Self Help Groups at NABARD's request. This amount from NABARD was used to train the groups and to match their savings. Between 1988 and 1990 NABARD conducted studies to assess the progress of this pilot; a study of the comparative transaction costs of three models was also carried out. The Self-help Affinity group (SAG) model emerged as the most cost effective. NABARD organised several meetings with MYRADA and the bankers to convince them that this was a viable model. In 1990-1991 the Reserve Bank of India (RBI) allowed banks to lend directly to groups and in 1991 NABARD came out with guidelines which have been reviewed and updated regularly. When the SHG strategy was adopted by the government in 1999,

Aloysius Fernandez is Executive Director, MYRADA

MYRADA decided to change the name to SAGs to stress the basis on which the group was formed, namely affinity (a network of relations based on trust and mutual support) and to distinguish these groups from those that were being formed to meet targets of beneficiaries and whose profile was decided by a particular scheme. In 1992, NABARD launched the SHG-Bank Linkage strategy which has spread all over the country.

Growth in Microfinance

MSS/RS: There is significant debate on the growth of the microfinance sector, with enormous sums of money bandied about. Can you comment on growth in microfinance?

Aloysius Fernandez

If you read the literature on MFIs, one of the assumptions made is that about Rs.15–20 thousand crores (150-200 bn) is required to meet the demand in the microfinance sector, and that the MFI sector should grow to meet this demand.

First, I question the assumption that the microfinance sector has to meet the total demand. The goal is to promote an environment (policies, systems, culture and practices) in which the poor can access credit and other financial services quickly, easily and at minimum cost. In some of our projects where the SAGs have met around 20–25% of the demand, the entire interest structure in the private or the informal sector, has come down. The informal sector was always easy to access, it was the interest rate that was exploitative. If this is reduced, not through legislation (which anyway is ineffective) but through competition, the informal/private sector will always have a role as credit demand cannot be met fully by the formal sector and the MFIs. If the MFIs can provide 20–25% of demand, the interest rates in the area will come down. This is a debatable point, but worth putting on the floor.

I question the assumption that the microfinance sector has to meet the total demand of 15-20 thousand crores. The goal is to promote an environment in which the poor can access credit and other financial services quickly, easily and at minimum cost.

Secondly, there is also the emerging view that the NGO-MFI animal has to grow and to professionalise in order to cope with demand. But the literature seems to take the position that for an NGO to professionalise it should do so by adopting the functions of an MFI. I think this is a dangerous one-track path. There is a whole sector of NGOs which will continue to function without entering into microfinance, and such NGOs too need to professionalise, which they are not doing.

In an article that I wrote some time ago entitled ‘Is Micro Finance Heading Towards a Macro Mess?’ I concluded that it is a mistake to expect (and urge) the NGO into becoming an MFI. My recent experience in Bangladesh seems to confirm my position. I’ve been involved with Bangladesh since 1971 and till about 10 years ago the Bangladesh Rural Advancement Committee (BRAC) groups spent 80% of their time discussing issues related to education, health and religion. Over the last 10–12 years, BRAC has promoted a major microfinance programme (which was not on the agenda in the earlier years) and the groups today spend 80% of their time discussing loans, recoveries and savings. Hardly 10% of the time is spent on the broader issues for which the groups were first formed. Within a few years of its creation the finance sector has over ridden the development one, for the simple reason that at the end of the day, you really must report on loans, recoveries and payments, but you do not need to report on how empowerment has progressed.

It would be self-defeating to make an NGO into an MFI. MYRADA is an NGO, it does not work like an MFI, nor is it equipped to run an MFI. We have excellent systems, financial/compliance audits, etc, but at the end of the month we are not interested in a break-even analysis. Disbursement and recovery pressures, break-even analysis, a lender-borrower relationship (which does not promote the building of institutions) are all features of a sound financial institution, not of an NGO. We are not interested in disbursing funds like an MFI, which has to reach disbursement (and repayment) targets and so on. On the contrary, we hesitate to push funds which people's capacity cannot absorb, so we are very careful to see that our pushing funds into groups does not disturb their learning and empowerment process. We use credit as an empowering instrument – even in our microfinance strategy, we do not give priority to the provision of funds but to their management. The entire model concerns the management of funds. That is why in MYRADA, the SAGs decide on the loans, the interest the repayments and the sanctions. There are no decisions taken outside the group which in itself is an empowering process. It is not just in the financial systems that we differ from an MFI but the whole culture. Further, most NGOs have traditional people who like us subscribe to Gandhian ideology or an ideology with leftist leanings. Turning an NGO into an MFI is like asking a banana tree to produce coconuts. This is my second point, which I know will be debated hotly.

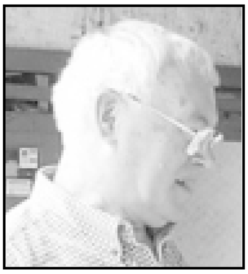
NGO-MFIs complain that in the present environment they feel insecure as they are not supported by a legal framework and are not allowed to take deposits from the public and therefore, have no low cost capital and stable resource mobilisation opportunities. NGOs need to live with a sense of insecurity in order to be effective. They need to have a strategy for withdrawal (from sectors and from areas) after their objective is achieved; this sense of insecurity is not a negative one which fosters a sense of exclusion but one that promotes a renewed vision, increased commitment and new strategies which allow other institutions to grow. So it is insecurity in a positive sense.

Instead of trying to morph into an MFI, the NGO should promote a separate financial institution. Possible models are companies (for profit or not-for-profit), co-operatives and others. MYRADA promoted Sanghamithra (a not-for-profit company), which lends only to SAGs.

What then do I propose? Instead of trying to morph into an MFI, the NGO should promote a separate financial institution. Possible models are companies (for profit or not-for-profit), co-operatives (various types) and others. MYRADA promoted Sanghamithra (a not-for-profit company), which lends only to SAGs. The Sanghamithra Board believes that an MFI should be comparatively small – around Rs 20-25 crores (200-250 mn). The growth strategy adopted is to promote several Sanghamithras and an asset (or fund) management institution which will monitor/supervise, mobilise/manage funds, influence policy and represent the several Sanghamithras. The basic financial institution will continue to be the SAG, the second tier institution will be the Sanghamithras (all not-for-profit companies) mobilising grants, subsidised loans and graduating to loans at market rates of interest. The Asset (Fund) Management Institution will be a for profit institution.

Finally, included in the growth scenario is the trajectory of individual members of SAGs. The MYRADA experience indicates that in the first year or so the number of loans for consumption is large (though the amounts are comparatively small), in the second and third years the number of consumption loans fall and the number of loans for trading and small assets increase – the average size of the loan is around Rs 3000. After the third year the average increases to Rs 5000, with several loans ranging from Rs 10,000 to Rs 15,000. During this period, the SAGs link up with banks or with Sanghamithra. After the fourth year, several members approach the banks directly for larger loans. The banks assess their credibility on the basis of their performance in the SAGs.

The other issue is the question of mainstreaming. The basic reason why credit from the formal sector did not reach the poor is not only because of extra paper work, but because we have always tried to mainstream the poor. The formal system has insisted that they fall in line with the official system. The poor have never been allowed to develop a sound alternate system that the mainstream financial institutions would recognise in its own right. For example, we have SAGs which function according to all the norms of registered institutions but do not want to be formally registered for fear of petty official harassment. But the banks would not give them loans unless they were registered. Further, our SAGs wanted to be assessed as institutions and they want group loans and not individual loans so that the purpose of each loan is not questioned (as the banks do now). The formal institutions also insist on lending only for assets or productive purposes when the SAGs want to be free to lend for any purpose including health, food, repayment to money lenders, purchase of land, trading and so on. MYRADA studies indicated that over 60% of repayments on



David Gibbons is Executive Chairman, Cashpor Financial Technical Services.

asset loans do not come from the income derived form the asset at the time of repayment.

The SAG-Bank Linkage programme has succeeded because we have allowed the groups to develop their own alternate systems without trying to mainstream them. We have managed to get the mainstream (thanks to NABARD and the RBI) to accept the SAGs policies and practices, their interest rates and schedule of payments, restricting the role of the banks to focussing on assessing the SAGs as institutions, on repayments and on reducing transaction costs. Thus, mainstreaming can be disempowering.

David Gibbons

My concern is, growth for whom by whom? The problems facing all of us are the huge number of below the poverty-line (BPL) households in the country, and how to give access to sustainable microfinance services to them.

The alternative system (SHG Linkage to Banks), is not nation-wide. It is concentrated mainly in the southern states which are relatively less poor, both in percentage and in absolute numbers of households below the poverty-line. SHGs have not caught on in the north and east, particularly in the BIMARU states (Bihar, Madhya Pradesh, Rajasthan, Uttar Pradesh), Orissa and West Bengal, in which much more than half of the country's BPL households live. So definitely other approaches, both alternative and mainstream, are needed to grow the outreach of microfinance services to a significant proportion of the poor, all over the country.

Its skewed growth aside, there are other limitations of the SHG-Bank Linkage programme. What proportion of the MYRADA SAG members and those who get loans from the Linkage programme are genuine BPL households, that is households whose normal annual income is less than the official poverty line income for the state and region? How do you know? What about SHGs in general? In theory, the SHG-Bank Linkage programme is open to considerable leakage of funds and subsidies meant for the poor, to the non-poor. This is because normally being a BPL household is not a condition for entry into SHGs, and SHG-promoting NGOs do not normally take the trouble (and cost) of identifying on the ground in the villages, who is BPL and who is not. Given that BPL households are less than half of all rural households in the country, probably they are less than half of SHG members, as well. If so, a huge amount of effort and funds, made and allocated in the name of the poor, are not reaching them. Is this is the same old story of so-called 'poverty-focussed' programmes being hijacked by the non-poor?

BPL households must be cost-effectively identified on the ground in their villages, and SHGs should be formed among them alone, if we are to ensure that the SHG-Bank Linkage programme provides access to microfinance services to significant numbers of the poor.

BPL households must be cost-effectively identified on the ground in their villages, and SHGs should be formed among them alone, if we are to ensure that the SHG-Bank Linkage programme provides access to microfinance services to significant numbers of the poor.

Further to Al Fernandez's reasons why NGOs should not be expected to meet most of the huge demand for microfinance services or become formal financial institutions, I would like to add their chronic capital shortage and dependence upon donors. Realistically most NGOs cannot hope to build up sufficient corpus to leverage from banks the large amount of funds that would be required for on-lending to a significant number, say even 500,000, of BPL households; and the RBI is not going to let them raise these funds as public deposits.

MFIs, including those established by NGOs, cannot have a significant impact on their own because of the capital/fund constraint that they inevitably face. Establishment of equity funds for MFIs is not the answer either, because before long they themselves would be crippled by capital constraint.

A New Linkage Programme: Banks and MFI Agents

If NGOs can promote Sanghamithras, why cannot the Sanghamithras get around their inevitable capital constraint by linking with banks, with MFIs acting as agents for the banks' financial intermediation with BPL households? MFIs could receive bulk funds from the banks, and deliver the microfinance services to poor women in their villages (the only way that the latter could participate). The MFI could charge its clients an administrative fee to cover the additional costs of delivering the financial services, so that the service becomes sustainable, and the banks could charge their prime lending rate for the loans. Provided large numbers of BPL households could be reached, the programme would be profitable for banks. If it were profitable, it would spread to even larger numbers of BPL households, and make a significant impact on rural poverty in India. That would be growth worth aiming for!

Al Fernandez

In reply to Prof David Gibbons' statement that the SHG-Bank Linkage has not caught on in Orissa and West Bengal, my figures show that the difference in these states and the south Indian states is not much; while in Andhra Pradesh the figures are lopsided as it has become a political issue. The performance in the south Indian states has been better as the movement started in the south first. Moreover, studies reveal that the whole financial system is reasonably good in the south and in the west, with the graph declining significantly as you go east.

The need for alternate models is accepted. What we are saying is that the potential of the poor to organise into groups and the pervasive presence of banks make the SHG model currently the one with the most potential for upscaling in a reasonably sustainable manner. As to why some states remain stubbornly poor and whether an alternative model of credit outreach would serve any better in these states, there are other issues, basically of governance which come into play here. This is not true only of the microfinance sector but of overall finance and governance as well. So alternatives are not just welcome, they are necessary. But I would like to know what concrete options Prof Gibbons has, that build in some of the essential pillars of sustainability that the SHG model builds in, such as linking up with banks and so on.

His statement that the SHG movement does not reach the poor, is loaded with ideology; conceptions of the poorest of the poor and so on. (My studies on the subject have been documented in my book, *Putting Institutions First*.) The issue is, how do we define the poorest of the poor? Should it be according to the official definition of BPL criteria? When we asked the people themselves to identify who they considered to be the poorest, their list and their criteria were in variance with the official BPL list. They did not include the landless who have regular jobs among the poorest whereas large families with irrigated land but with a number of sick people were identified as the poorest because they did not have labour. There are many other issues and our survey lists how people identify the poorest. It is on that basis that we identify the poorest. Our survey shows around 85% of our SHG members are genuinely poor people. They're not necessarily on the BPL list, which is precisely the point, as the list does not reflect reality.

When we asked the people themselves to identify who they considered to be the poorest, they did not include the landless who have regular jobs. Large families with irrigated land but with a number of sick people were identified as the poorest because they did not have labour.

Once the people identify the poor amongst themselves, we invite them to form their own affinity groups. I think Prof Gibbons' assumption that with 50% of the community being non-poor, 50% of the SHG members must also be non-poor is invalid. If the organising strategy is what I suggested earlier and if the NGO is sensitively pro-poor, obviously there may be a queue, and we find that the non-poor usually drop out very fast. We also need to remember that loans from banks to SHGs are drawn from priority sector funds and not from poverty programme funds.

Further, the poor do not need microfinance alone. A large number of our people do not want credit. They are part of SHGs because they have other social needs – some are ill, others aged, and they need other kinds of help. Our SHGs are engaged in getting pensions for the old, and medical care for the sick, as responsibilities that they themselves have adopted. And there are some people that the SHGs will not accept, like the perpetual drunkards, or those who have a reputation of being unreliable in

Vijayalaxmi Das is Chief Executive, Friends of Women's World Banking.

the village, though officially they may be poor. Since we have some criteria to classify people as poor, why not give them the same privilege?

As for Prof Gibbons' question, if NGOs can promote Sanghamitras (I presume he's interpolating from MYRADA) why can't Sanghamitras link with banks is a question we ourselves asked five years ago. Sanghamitra has taken a loan from NABARD and is also now negotiating one with the Canara Bank. This is one way of raising capital until we can mobilise capital through savings and deposits. Further, I would like to clarify that Sanghamitra is not there to expand and push out financial institutions. Banks are the major lending institutions. Sanghamitra is there as an option, for people to approach if they are not happy with the bank, to keep the bank on its toes.

Many NGOs are concerned about the way the SHGs are made the 'beneficiaries' of all development programmes of the government, leading to distortions in the original concept of mutual help and affinity. Many NGOs, have looked for opportunities to discontinue this role.

Vijayalaxmi Das

Al Fernandez's views on the role of NGOs in the microfinance sector is based on the assumption that once the NGOs play the social intermediary role and build SHG/SAGs the poor will have access to affordable credit facilities. Most of the NGOs would love to do this instead of borrowing from financial institutions and on-lend to groups they had promoted. What makes them take this risk?

- The linkage between the SHGs and the banks is not as smooth as the NGOs had expected. There are geographic variations in the bankers' response and the NGOs' ability to link the groups.

- Not all the NGOs have sufficient grant fund to play the role of 'social intermediary'. They are able to cross-subsidise the costs of 'social intermediation' through the income from 'financial intermediation'.

- Many NGOs are concerned, like Al Fernandez, about the way the SHGs are made the 'beneficiaries' of all development programmes of the government, leading to distortions in the original concept of mutual help and affinity. (Even the focus on the poor has been compromised while forming these 'target-led SHGs').This concern had led many NGOs, reluctantly, to play the role of financial intermediary, and they have looked for opportunities to discontinue this role. (Eg: Federations of SHGs was one such option many opted for but this did not work as expected.)

- The few NGOs that were focussing only on financial services created non-banking finance companies (NBFCs)/ mutually-aided co-operative societies (MACs) etc. once their member base had increased and they were confident of reaching out to larger numbers of people.

Further, the NGO-promoted alternate financial service delivery models emerged in the early 1970s, when bank nationalisation did not assure the poor the expected access to banking services. Till the banks fully recognise that the poor are bankable and not just 'programme targets', NGOs concerned about poverty issues will continue to look for alternative mechanisms to deliver financial services to the poor.

Ramesh Ramanathan

Al has made three or four key points. While Al's point that if MFIs can meet 20–25% of the demand, you create a comparative environment for the pricing of credit, is based on a very reasonable premise, I would like to see some data supporting the validity of this 20–25%. Secondly, how sustainable is it? And who are the actors in the issue of sustainable growth?

Today the actors are the formal financial institutions, the informal lenders as well as the new breed of either MFIs or NGO-MFIs, or NGOs and so on. What is the role of these actors as we move into the growth phase? If MFIs have come together to create the 20–25% threshold in a particular district (and if this data is valid) what is the economic capacity of that MFI to remain in business, say ten years from now, in that same district, to continue to ensure that the 20–25% threshold is held? We could

Ramesh Ramanathan is Vice Chairman, Sanghamitra Rural Financial Services.

break down a virtual monopoly or an oligopoly for a short period of time, but entrenched players can simply outlast this temporary scenario. If five years from now the MFI in question does not exist then you'll go back to a different pricing structure altogether.

I completely agree with Al that the NGO has to professionalise independently and the core competencies required to be an MFI simply do not exist. One of the key questions in financial viability is the rate of interest. If you talk about growth and its sustainability, the key question is how you price your service and your financial product. In Sangamithra itself we have had this interesting tension over the pricing. Sangamithra has two different pricing structures. In the rural areas we price at 12%, in our urban areas we price at 24%. There are two reasons why this emerged. One reason for this I think is that since MYRADA with its pro-poor, NGO thinking is present in the rural areas, we had to cost ourselves at a price acceptable to the poor. In the urban areas, given the absence of MYRADA, we didn't have the pressure to price ourselves at a lower point. But there is a larger, more fundamental economic issue here. You are a price-taker in the rural areas because you are dealing with an entrenched banking system which is already doing a fair amount of microlending. Now the problem arises when the incumbent is pricing without understanding that there are hidden subsidies under which they are operating. If the microfinance transactions are separated, they would understand that 12% is impossible. But such a separation is unlikely as it will just get embedded with their various products. The only other way in which I can see this happening is, as microcredit becomes a larger and larger portion of their portfolio, organisations are going to realise that this pricing is not sustainable. We need to track this with NABARD and ask, are there districts where SHG lending as a proportion of a particular bank's portfolio has gone beyond 20-30%? And there we should ask the bank managers, what do you feel about lending at 12%? I am sure we will get data to say that we should increase the prices. If we want sustainable growth we really need to talk about price points. This is an eight hundred pound gorilla for the development sector to deal with because it's combined with ideological issues as well.

If you talk about growth and its sustainability, the key question is how you price your service and your financial product. The problem arises when the incumbent is pricing without understanding that there are hidden subsidies under which he is operating.

In the urban areas for example, Sangamithra is lending at 24% because we are the price makers. There is no formal sector, no other development NGO here, and as we improve our operating environment we think we can reduce our price.

MSS/RS: Don't the NGOs you deal with in the urban sector object to this 24%?

Ramesh Ramanathan

They do but they're not the size of MYRADA. When we work with an NGO as a partner, one of the first questions that comes up is pricing. We sit down and walk them through our entire economics so that there is an awareness building. Then we explain things to the poor as well. There, what works is the fact that we're a not-for-profit institution. We make it very clear that this 24% is not excess rent and it becomes palatable when they understand the transparencies. Sangamithra discloses its financials to all partners every month, so it makes it acceptable that we're charging 24%.

MSS/RS: You're saying 24% is a reasonable cost for any kind of institution. If you're a for-profit MFI, then would you be looking at an even higher number?

Ramesh Ramanathan

Of the 24% we give 3% to the NGO partner, so we're actually getting only 21%. And in the 21% we're factoring in a cost of funds of about 10%, whereas for a banking institution their true cost of funds is only about 6-6.5%. So there's a three hundred basis point spread, which is more than sufficient for them. We believe that a not-for-profit MFI will have a cost of fund which is about three hundred basis points more than a for-profit institution and that should be sufficient for their profitability.

Al's suggestion that NGOs promote MFIs is a valid one but we should probe that question a little deeper to ask under what circumstances should an NGO or a cluster of NGOs come together to form an MFI. An individual NGO may not have a critical mass. So how do you create a set of critical mass conditions for a cluster of NGOs to come in?

Further, what have we proven about the economic sustainability of the MFI itself? If you want to create competitive conditions, and if you believe that the MFI is one of the key players in creating those competitive conditions, then the MFI must be economically viable long term. But that question still has not been answered.

MSS/RS: Are you saying that based on the current experience you're not sure whether MFIs can be economically viable in the long-term?

Ramesh Ramanathan

Well, how many MFIs are there? We literally have five or six experiments in the country. Vijay's BASIX model, despite its value add to the idea of microfinance, I do not think is replicable throughout the country. Al has suggested a very interesting multiplier model, but in order to onset that multiplier model we need to show that the individual Sangamithra is capable of breaking even so that it can be the catalyst for the 20-25% credit needs, and that it is sustainable in the medium to long term.

Which brings me to Al's point about NGOs feeling insecure and it being a healthy insecurity. I completely agree with that. But for a financial institution or an MFI insecurity has a very different implication. An NGO can afford to say we came into this area because we wanted to ensure a certain minimum development. Now that it's been met we can extract ourselves and go away. There is a sunset clause built into every NGO's activity. But what's the sunset clause for an MFI? If Sangamithra says since the credit needs are met here, we can move away, it may not be viable, because there's a certain investment cycle, a certain return on that cycle and so on. These are legitimate questions and unless we find answers for them, we can't say this is a replicable model.

For a financial institution or an MFI insecurity has a very different implication. There is a sunset clause built into every NGO's activity. But what's the sunset clause for an MFI? If Sangamithra says since the credit needs are met here, we can move away, it may not be viable.

Finally to come to Al's last point that the growth scenario included the trajectory of individual members of SAGs. I think it's an extraordinarily important point, both in terms of the development cycle as well as the role that the stakeholder plays in the long term scenario, which is the larger point. These groups of poor are also actors in this scenario and they figure in what is almost like a university environment, where every year a new set of students comes in. If our model is good, then every year a new set of poor will come into this group system and the graduating class will be those who are no longer poor, whether the period is one year or six years. As they move up the ladder of going from the poorest, to the poor, to the less poor and to the middleclass, and as they move up the ladder of going from a group loan for consumption, to a group loan for income generation to an individual loan, then clearly, by the end of the period, on graduation day they are no longer the poor. But there's another group coming in. So, what is the role of the graduating stakeholder in the sustainable growth environment? We don't know but we have to think about that, because they clearly play a role. As the poor become empowered and/or financially independent, do they influence the responses of other players?

MSS/RS: It's like saying the alumni need to work with educational institutions.

Ramesh Ramanathan

Exactly, it's too important to be left out. They play an important role in defining what that competitive environment is. My central comment in this growth paper is, who are the actors in a long term sustainable growth model, and what role do they play over time? You cannot have the MFI play a short term catalytic role and then vanish, because then that system will revert to its original state. My biggest fear is that we are not considering the economic implications for the long term sustainability of the MFI.

MSS/RS: In the urban context, how are NGOs coming to terms with microfinance in all of its various

aspects?

Ramesh Ramanathan

The single biggest issue, which is an ideological issue, is the question of pricing the service. We now have 20 NGO partners in the urban area and they have all recognised the complexity of the task, that this is banking where a whole set of competencies and backend processes are required. They have also recognised that there is a significant role for them here as well and that the process is complementary in many ways. Moreover, even building the capacity on the group side to access credit takes time, energy and effort. Connecting with Al's last point about what true empowerment is, so far, going by Sanghamitra's track record in the urban areas, we have helped to create credit management groups rather than true self help affinity groups. There is a definite discipline, they are talking about savings, rotation and loans, but whether it has graduated to the larger issues of empowerment, making their own decisions and so on, are outstanding questions. That's our challenge at the current moment. How do we get the NGOs to talk about the impact that the group has had on the larger issues rather than just the economic, credit and management issues.

> **Regardless of the microfinance methodology utilised, an integrated set of microfinance services, including savings, credit and insurance products, should be provided for the poor. These services are needed by them, especially by poor women who predominate among the clients.**

Beyond Micro-credit

MSS/RS: What do we see happening beyond micro-credit?

David Gibbons

Regardless of the microfinance methodology utilised, an integrated set of microfinance services, including savings, credit and insurance products, should be provided for the poor, as quickly as possible.

The most important reason is that all these services are needed by the poor, especially by poor women who predominate among the clients of microfinance. They need savings facilities for safekeeping and to tide them over food deficits and other periodic emergencies, as well as to accumulate larger amounts of funds for the marriage of their daughters and the purchase of productive assets. Micro-credit is needed for investment in income-generating activities, so as to break out of the vicious cycle of poverty. Life and large livestock insurance are needed so as not to burden survivors with debt, and to be able to cope with the death of a large farm animal purchased with loan funds.

As far as savings facilities and micro-credit are concerned, the usually strong demand from poor women is sufficient evidence. In the case of insurance, however, demand is usually weak; but objectively the need is strong. The unexpected death of a wife and mother, leaving a debt to an NGO-MFI that may not be repayable if she was the income-earner, usually pushes an uninsured household deeper into poverty. The death of a large farm animal purchased with loan funds not only deprives an uninsured household of the expected means of repayment of the loan, but also can deprive it of access to credit in future, if it is unable to repay the loan. While the practical attitude of most poor women toward insurance (that they don't benefit from it even if they die) is understandable, given their chronic shortage of surplus income to pay for it, continuing education by NGO-MFIs is necessary to open their minds.

A second important reason for NGO-MFIs to provide clients with an integrated set of microfinance services is that they promote the early attainment of institutional financial break-even and sustainability, without which NGO-MFIs will not be able to serve the poor for long. Not only do loan client savings provide an obvious 'cushion' for timely repayment; but even more important, client savings provide the basis for financial intermediation that makes possible the efficient supply of micro-credit to its clients. Normally, savings are an alternative and relatively cheap source of funds for NGO-MFIs, because the interest rates usually are less than those that have to be paid for debt. Therefore, by maximising its savings mobilisation, an NGO-MFI should be able to minimise its average cost of funds. This in turn should maximise its margin at any given interest rate to its clients, and thereby hasten the attainment of break-even and profitability.

Insurance products also promote the attainment of institutional financial break-even and sustainability; but indirectly through promoting loan portfolio quality. Insurance on the life of borrowers and large farm animals makes loan recovery possible at times when it could be quite difficult or impossible otherwise. Other things being equal this would tend to maximise loan repayment rates and to reduce any gap between expected and actual yield on portfolio. This in turn should promote the attainment of institutional financial break-even and sustainability for the NGO-MFI.

From the points of view of both client and institutional benefit, therefore, NGO-MFIs should offer their clients savings facilities, micro-credit and life and large farm animal insurance. To maximise their benefits, these financial services should be integrated. That is, some savings should be required before access is given to micro-credit, so as to provide funds for financial intermediation and as a cushion for loan repayment. Similarly, insurance on the life of borrowers and large farm animals should be compulsory as soon as clients can bear the premia, say after successful repayment of their first loan on time and in full, so as to maximise the recovery of subsequent loans.

The RBI prohibits the collection of savings by any institution except banks and NBFCs. Yet licensed banks and NBFCs do not normally provide savings facilities to poor women. This could be changed easily by the RBI accepting that micro finance for the poor is different from conventional finance.

Regulatory and Institutional Matters

In most countries, like in India, the provision of savings facilities, credit and insurance were regulated before microfinance for the poor became established. It is necessary now for these regulations to be reviewed in terms of whether they promote or hinder the impact of microfinance on poverty. Currently the RBI prohibits the collection of savings by any institution except banks and NBFCs, that have been licensed to do so. The minimum capital and other requirements for attaining such a license are stiff. Yet licensed banks and NBFCs do not normally provide savings facilities to poor women in their villages. Hence most of them do not have access to legal savings facilities.

This unacceptable situation could be changed easily by the RBI accepting that micro finance for the poor is different from conventional finance, in that nearly all microfinance clients are simultaneously savers and debtors with their NGO-MFIs. Normally they have much more of the NGO-MFI's money in their hands as loans outstanding, than it has of their money in the form of savings. Thus, if a micro finance client becomes concerned about the security of her savings with an NGO-MFI, she can protect them by deducting them from her repayment. RBI could provide adequate protection for the savings of the poor with NGO-MFIs, by limiting them to a safe proportion of loans outstanding to its savers, say 50%.

The ongoing de-regulation of the insurance sector in India provides adequate opportunities for NGO-MFIs to arrange the needed insurance cover for their clients, by becoming agents of established insurance companies.

On the institutional side it is of course necessary for NGO-MFIs to build the institutional capacity to provide quality savings and insurance products to their clients, including the necessary staff training and market research.

Deep Joshi

Considering that poor people spend a great deal of money on health (often 25 to 40% of micro-credit goes to meet medical costs), I would put a high premium on medical insurance. Of course, there are serious problems with medical insurance and often the problem lies with poor health consciousness and poor basic health services, but if we are concerned with improving the quality of life of the poor, we have to deal with difficult problems. We need not stop only at life insurance and insurance of (purchased) assets but go further into crop insurance and livelihood insurance, but all of those are tough ones ...

On micro-credit itself, I think there is a great deal that can be done. Most micro-credit presently deals with fairly conventional loan products — take a loan that is either related to your savings or to some investment idea and repay it in so many instalments. But poor people actually need a 'credit card' or line of credit kind of facility — they need a tap rather than dicrete bucketfuls of credit. On countless occasions I have met women who have mortgaged one-half or more of their crop to the moneylender at 50% interest per crop season (five to six months) to buy food during the lean season even as they had access to micro-credit. This leads to a vicious cycle — every time you mortgage your crop, the next time you have to mortgage even more as you will have less left with you ... till you become a share-cropper on your own land by mortaging it. Much micro-credit still remains focussed either on dire emergencies or micro-investments rather than full scale financial smoothening.

How about offering some sort of rating or valuation service to poor people? After all, poor people are producers or enterprises. They could offer their ‘enterprises’, including wage earning capacity, as a kind of standing equity? In a way the SHG is supposed to do that and members in any halfway-decent SHG assess each other in this fashion, but the external world does not quite deal with SHGs that way — in fact, the capacity to repay is rarely taken into account in rating SHGs by the umpteen tools now floating about.

Then there is the idea of ‘stopping the leaks in the bucket’ that BASIX has tried — the Apna Bazaar kind of idea of enabling poor people to procure and distribute among themselves various items of daily consumption. A village of 100 poor families would be buying between half to one million rupees worth of food and provisions a year. Finally, if one is concerned about livelihoods, micro-credit needs to become macro and for that you need to do something about increasing the absorption capacity.

Jayashree Vyas

I fully agree with David Gibbons, that regardless of the methodology used, we need to provide an integrated set of microfinance services. I would add financial counselling to his list of services, as we think that is an integral part of our responsibility in working with the poor.

As the poor are very vulnerable, it is not sufficient for us just to provide micro-credit, but to have a series of support systems provided at the appropriate time; if not they tend to slip back into abject poverty. We have conceptualised this in SEWA as in Exhibit 2.

Initially a poor woman has negative equity, in other words debt (point 1). By accumulating savings she can move upwards out of negative equity (2). However, because of her vulnerability she is quite likely to fall back into debt (3), and needs insurance and emergency loans, as well as her accumulated savings, to guard against such a scenario. Further savings, and increasingly loans for business investment, can then enable the woman to build positive equity as she moves from point 2 towards point 5. On the way, the woman continues to be vulnerable to shocks and emergencies, which could push her back to point 4, requiring an on-going need for her accumulated savings, insurance and emergency loans. In this way, poor women can gradually move out of the vicious cycle of poverty.

Throughout this process, financial advice and guidance are available to the clients, both in the bank itself, as well as at women’s doorsteps through the ‘hand holders’, to show them ways of increasing their assets and incomes as well as enhancing their

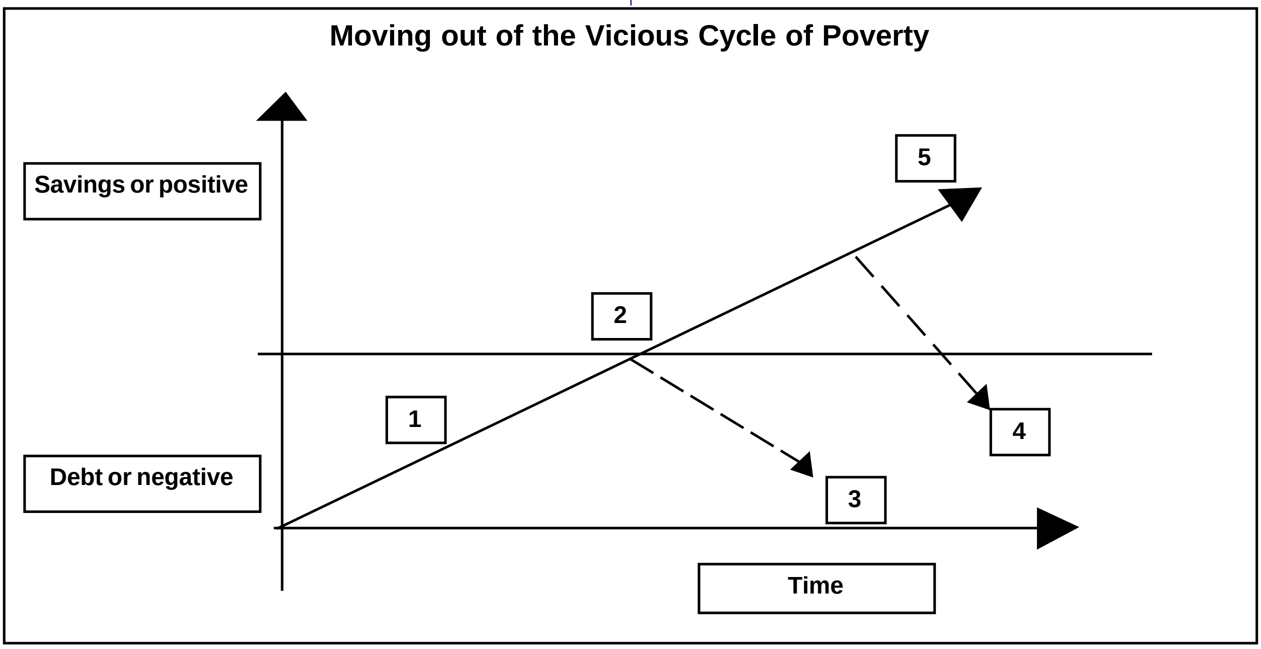


Exhibit 2

abilities to manage their limited resources effectively.

We believe that microfinance institutions could take such an integrated approach. This would help in looking at the overall financial flows of a poor family rather than at just the livelihood or the enterprise aspect. Ultimately the poor do need resources for consumption, health and education – and unless we look at this as a whole, we might lose sight of the ultimate goal.

We at Sewa Bank do not see regulation as a major constraint. We think that the cooperative form of organisation is best suited to carry out these activities because of the following features:

- It is democratic, and by definition calls for the involvement of the people
- It believes in sharing of risks and benefits and therefore people's stakes are built in right from the first day
- It allows the offering of a range of services without too much of regulatory interference and we have been providing not only savings and credit, but also insurance and financial counselling into our offerings.

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