

ROLE OF MICROFINANCE INSTITUTIONS IN RURAL DEVELOPMENT

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More than subsidies poor need access to credit. Absence of formal employment make them non 'bankable'. This forces them to borrow from local moneylenders at exorbitant interest rates. Many innovative institutional mechanisms have been developed across the world to enhance credit to poor even in the absence of formal mortgage. The present paper discusses conceptual framework of a microfinance institution in India. The successes and failures of various microfinance institutions around the world have been evaluated and lessons learnt have been incorporated in a model microfinance institutional mechanism for India.

1. MICRO-FINANCE AND POVERTY ALLEVIATION

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

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

Over the last ten years, however, successful experiences in providing finance to small entrepreneur and producers demonstrate that poor people, when given access to responsive and timely financial services at market rates, repay their loans and use the proceeds to increase their income and assets. This is not surprising since the only realistic alternative for them is to borrow from informal market at an interest much higher than market rates. Community banks, NGOs and grass root savings and credit groups around the world have shown that these micro enterprise loans can be profitable for borrowers and for the lenders, making microfinance one of the most effective poverty reducing strategies.

To the extent that microfinance institutions become financially viable, self sustaining, and integral to the communities in which they operate, they have the potential to attract more resources and expand services to clients. Despite the success of microfinance institutions, only about 2% of world's roughly 500 million small entrepreneurs is estimated to have access to financial services (Barry et al. 1996). Although there is demand for credit by poor and women at market interest rates, the volume of financial transaction of microfinance institution must reach a certain level before their financial operation becomes self sustaining. In other words, although microfinance offers a promising institutional structure to provide access to credit to the poor, the scale problem needs to be resolved so that it can reach the vast majority of potential customers who demand access to credit at market rates. The question then is how micro enterprise lending geared to providing short term capital to small businesses in the informal sector can be sustained as an integral part of the financial sector and how their financial services can be further expanded using the principles, standards and modalities that have proven to be effective.

To be successful, financial intermediaries that provide services and generate domestic resources must have the

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capacity to meet high performance standards. They must achieve excellent repayments and provide access to clients. And they must build toward operating and financial self-sufficiency and expanding client reach. In order to do so, microfinance institutions need to find ways to cut down on their administrative costs and also to broaden their resource base. Cost reductions can be achieved through simplified and decentralized loan application, approval and collection processes, for instance, through group loans which give borrowers responsibilities for much of the loan application process, allow the loan officers to handle many more clients and hence reduce costs (Otero et al. 1994).

Microfinance institutions can broaden their resource base by mobilizing savings, accessing capital markets, loan funds and effective institutional development support. A logical way to tap capital market is securitization through a corporation that purchases loans made by micro enterprise institutions with the funds raised through the bonds issuance on the capital market. There is at least one pilot attempt to securitize microfinance portfolio along these lines in Ecuador. As an alternative, BancoSol of Bolivia issued a certificate of deposit which are traded in Bolivian stock exchange. In 1994, it also issued certificates of deposit in the U.S. (Churchill 1996). The Foundation for Cooperation and Development of Paraguay issued bonds to raise capital for micro enterprise lending (Grameen Trust 1995).

Savings facilities make large scale lending operations possible. On the other hand, studies also show that the poor operating in the informal sector do save, although not in financial assets, and hence value access to client-friendly savings service at least as much access to credit. Savings mobilization also makes financial institutions accountable to local shareholders. Therefore, adequate savings facilities both serve the demand for financial services by the customers and fulfil an important requirement of financial sustainability to the lenders. Microfinance institutions can either provide savings services directly through deposit taking or make arrangements with other financial institutions to provide savings facilities to tap small savings in a flexible manner (Barry 1995).

Convenience of location, positive real rate of return, liquidity, and security of savings are essential ingredients of successful savings mobilization (Christen et al. 1994).

Once microfinance institutions are engaged in deposit taking in order to mobilize household savings, they become financial intermediaries. Consequently, prudential financial regulations become necessary to ensure the solvency and financial soundness of the institution and to protect the depositors. However, excessive regulations that do not consider the nature of microfinance institution and their operation can hamper their viability. In view of small loan size, microfinance institutions should be subjected to a minimum capital requirement which is lower than that

applicable to commercial banks. On the other hand, a more stringent capital adequacy rate (the ratio between capital and risk assets) should be maintained because microfinance institutions provide uncollateralized loans.

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

One way of expanding the successful operation of microfinance institutions in the informal sector is through strengthened linkages with their formal sector counterparts. A mutually beneficial partnership should be based on comparative strengths of each sectors. Informal sector microfinance institutions have comparative advantage in terms of small transaction costs achieved through adaptability and flexibility of operations (Ghate et al. 1992). They are better equipped to deal with credit assessment of the urban poor and hence to absorb the transaction costs associated with loan processing. On the other hand, formal sector institutions have access to broader resource-base and high leverage through deposit mobilization (Christen et al. 1994).

Therefore, formal sector finance institutions could form a joint venture with informal sector institutions in which the former provide funds in the form of equity and the later extends savings and loan facilities to the urban poor. Another form of partnership can involve the formal sector institutions refinancing loans made by the informal sector lenders. Under these settings, the informal sector institutions are able to tap additional resources as well as having an incentive to exercise greater financial discipline in their management.

Microfinance institutions could also serve as intermediaries between borrowers and the formal financial sector and on-lend funds backed by a public sector guarantee (Phelps 1995). Business-like NGOs can offer commercial banks ways of funding micro entrepreneurs at low cost and risk, for example, through leveraged bank-NGO-client credit lines. Under this arrangement, banks make one bulk loan to NGOs and the NGOs packages it into large number of small loans at market rates and recover them (Women's World Banking 1994). There are many on-going research on this line but context specific research is needed to identify the most appropriate model. With this in mind we discuss

various possible alternatives of formal-informal sector linkages in India.

In this context, following strategic, institutional and connectivity issues related to micro-finance arise.

Strategic Issues

- Is there a prevailing paradigm for micro-finance?
- Are there clearly visible pattern across the country?
- Is there a clearly defined foundation building blocks such as organizing principles, gender preferences and operational imperatives?
- What are methodological issues?

Institutional Issues

- Is there a need for a new institution?
- Should it operate all India or in a state?
- Where should it be located?
- Who can lead an institution of this sort?
- What will its contextual interconnections be?
- Who will be its beneficiaries?

Connectivity Issues

- How should the Corporate Financial Sector be involved?
- What is the role of donor agencies?
- How should communities be involved?
- Are there political issues that should be explicitly considered?
- Are there government policy issues?

2. THE FORMAL SECTOR INSTITUTIONS

Traditionally, the formal sector Banking Institutions in India have been serving only the needs of the commercial sector and providing loans for middle and upper income groups. Similarly, for housing the HFIs have generally not evolved a lending product to serve the needs of the Very LIG primarily because of the perceived risks of lending to this sector. Following risks are generally perceived by the formal sector financial institutions:

- Credit Risk;
- High transaction and service cost;
- Absence of land tenure for financing housing;
- Irregular flow of income due to seasonality;

- Lack of tangible proof for assessment of income;
- Unacceptable collaterals such as crops, utensils and jewellery.

As far as the formal financial institutions are concerned, there are Commercial Banks, Housing Finance Institutions (HFIs), NABARD, Rural Development Banks (RDBs), Land Development Banks Land Development Banks and Co-operative Banks (CBs).

As regards the Co-operative Structures, the Urban Co.op Banks (UCB) or Urban Credit Co.op Societies (UCCS) are the two primary co-operative financial institutions operating in the urban areas. There are about 1400 UCBs with over 3400 branches in India having 14 million members, Their total lending outstanding in 1990-91 has been reported at over Rs 80 billion with deposits worth Rs 101 billion.

Similarly there exist about 32000 credit co.op societies with over 15 million members with their total outstanding lending in 1990-91 being Rs 20 billion with deposits of Rs 12 billion.

Few of the UCCS also have external borrowings from the District Central Co.op Banks (DCCBs) at 18-19%. The loans given by the UCBs or the UCCS are for short term and unsecured except for few which are secured by personal guarantees. The most effective security being the group or the peer pressure.

The Government has taken several initiatives to strengthen the institutional rural credit system. The rural branch network of commercial banks have been expanded and certain policy prescriptions imposed in order to ensure greater flow of credit to agriculture and other preferred sectors. The commercial banks are required to ensure that 40% of total credit is provided to the priority sectors out of which 18% in the form of direct finance to agriculture and 25% to priority sector in favour of weaker sections besides maintaining a credit deposit ratio of 60% in rural and semi-urban branches. Further the IRDP introduced in 1979 ensures supply of credit and subsidies to weaker section beneficiaries. Although these measures have helped in widening the access of rural households to institutional credit, vast majority of the rural poor have still not been covered. Also, such lending done under the poverty alleviation schemes suffered high repayment defaults and left little sustainable impact on the economic condition of the beneficiaries.

3. THE EXISTING INFORMAL FINANCIAL SOURCES

The informal financial sources generally include funds available from family sources or local money lenders. The local money lenders charge exorbitant rates, generally ranging from 36% to 60% interest due to their monopoly in the absence of any other source of credit for non-

conventional needs. Chit Funds and Bishis are other forms of credit system operated by groups of people for their mutual benefit which however have their own limitations.

Lately, few of the NGOs engaged in activities related to community mobilization for their socio-economic development have initiated savings and credit programmes for their target groups. These Community based financial systems (CBFS) can broadly be categorized into two models: Group Based Financial Intermediary and the NGO Linked Financial Intermediary.

Most of the NGOs like SHARAN in Delhi, FEDERATION OF THRIFT AND CREDIT ASSOCIATION (FTCA) in Hyderabad or SPARC in Bombay have adopted the first model where they initiate the groups and provide the necessary management support. Others like SEWA in Ahmedabad or BARODA CITIZEN'S COUNCIL in Baroda pertain to the second model.

The experience of these informal intermediaries shows that although the savings of group members, small in nature do not attract high returns, it is still practiced due to security reasons and for getting loans at lower rates compared to that available from money lenders. These are short term loans meant for crisis, consumption and income generation needs of the members. The interest rates on such credit are not subsidized and generally range between 12 to 36%. Most of the loans are unsecured. In few cases personal or group guarantees or other collaterals like jewellery is offered as security.

While a census of NGOs in micro-finance is yet to be carried out, there are perhaps 250-300 NGOs, each with 50-100 Self Help Groups (SHG). Few of them, not more than 20-30 NGOs have started forming SHG Federations. There are also agencies which provide bulk funds to the system through NGOs. Thus organizations engaged in micro finance activities in India may be categorized as Wholesalers, NGOs supporting SHG Federations and NGOs directly retailing credit borrowers or groups of borrower.

The Wholesalers will include agencies like NABARD, Rashtriya Mahila Kosh-New Delhi and the Friends of Women's World Banking in Ahmedabad. Few of the NGOs supporting SHG Federations include MYRADA in Bangalore, SEWA in Ahmedabad, PRADAN in Tamilnadu and Bihar, ADITHI in Patna, SPARC in Mumbai, ASSEFA in Madras etc. While few of the NGOs directly retailing credit to Borrowers are SHARE in Hyderabad, ASA in Trichy, RDO Loyalam Bank in Manipur.

4. CREDIT MECHANISMS ADOPTED BY HDFC (INDIA) FOR FUNDING THE LOW INCOME GROUP BENEFICIARIES

HDFC has been making continuous and sustained efforts to reach the lower income groups of society, especially the

economically weaker sections, thus enabling them to realise their dreams of possessing a house of their own.

HDFCs' response to the need for better housing and living environment for the poor, both, in the urban and rural sectors materialized in its collaboration with Kreditanstalt fur Wiederaufbau (KfW), a German Development bank. KfW sanctioned DM 55 million to HDFC for low cost housing projects in India. HDFCs' approach to low-income lending has been extremely professional and developmental in nature. Negating the concept of dependence, HDFCs' low cost housing schemes are marked by the emphasis on peoples participation and usage of self-help approach wherein the beneficiaries contribute both in terms of cash and labour for construction of their houses. HDFC also ensures that the newly constructed houses are within the affordability of the beneficiaries, and thus promotes the usage of innovative low cost technologies and locally available materials for construction of the houses.

For the purpose of actual implementation of the low cost housing projects, HDFC collaborates with organisations, both, Governmental and Non-Governmental. Such organisations act as co-ordinating agencies for the projects involving a collective of individuals belonging to the Economically Weaker Sections. The projects could be either in urban or rural areas. The security for the loan is generally the mortgage of the property being financed.

The construction work is regularly monitored by the co-ordinating agencies and HDFC. The loans from HDFC are disbursed depending upon the stages of construction. To date, HDFC has experienced 100% recovery for the loans disbursed to various projects.

5. STRENGTHS OF INFORMAL SECTOR

A synthesis that can be evolved out of the success of NGOs/ CBOs engaged in microfinance is based on certain preconditions, institutional and facilitating factors.

5.1. Preconditions to Success

Those NGOs/ CBOs have been successful that have instilled financial value/ discipline through savings and have demonstrated a matching value themselves before lending. A recovery system based on social intermediation and various options including non-financial mechanisms has proved to be effective. Another important feature has been the community governance. The communities in which households are direct stake holders have successfully demonstrated the success of programs. A precondition for success is to involve community directly in the program. Experience indicates that savings and credit are both critical for success and savings should precede credit. Chances of success more with women: Programs designed with women are more successful.

5.2. Operating Indicators

The operating indicators show that programs which are designed taking into account the localized and geographical differences have been successful. Effective and responsive accounting and monitoring mechanisms have been an important and critical ingredient for the success of programs. The operational success has been more when interest rates are at or near market rates: The experience of NGOs/CBOs indicates that low income households are willing to pay market rates. The crucial problem is not the interest rates but access to finance. Eventually in absence of such programs households end up paying much higher rates when borrowing from informal markets. Some NGOs have experimented where members of community decide on interest rates. This is slightly different from Thailand experience where community decides on repayment terms and loan amount. A combination of the three i.e. interest rates, amount and repayment period if decided by community, the program is most likely to succeed. A program which is able to leverage maximum funds from formal market has been successful. Experience indicates that it is possible to leverage higher funds against deposits.

The spreads should be available to meet operational costs of NGOs. Most of the directed credit program in India like KfW have a ceiling on the maximum interest rate and the spread available to NGOs. A flexible rate of interest scheme would indicate a wider spread for NGOs. Selected non-financial services, viz. business, marketing support services enhance success. Appropriate incentives for borrowing and proper graduation of credit has been essential component of success. A successful program can not be generalized for all needs and geographical spread. The programs which are simple and replicable in similar contexts have contributed to success.

Betterment in quality of life through better housing or better economic opportunities is a tangible indicator of success. The programs which have been able to demonstrate on some measurable scale that the quality of life has improved have been successful. To be successful the program productivity with outreach should match. The credit mechanism should be flexible meeting multiple credit needs: The programs which have taken care of other needs such as consumption, marriage etc. besides the main shelter, infrastructure or economic needs are successful.

5.3. Facilitating Factor

Another factor that has contributed to the success is the broad environment. A facilitative environment and enabling regulatory regime contributes to the success. The NGOs/CBOs which have been able to leverage funds from formal programs have been successful. An essential factor for success is that all development programs should converge across sectors.

6. WEAKNESSES OF EXISTING MICROFINANCE MODELS

One of the most successful models discussed around the world is the Grameen type. The bank has successfully served the rural poor in Bangladesh with no physical collateral relying on group responsibility to replace the collateral requirements. This model, however, has some weaknesses. It involves too much of external subsidy which is not replicable. Grameen bank has not oriented itself towards mobilising peoples' resources. The repayment system of 50 weekly equal instalments is not practical because poor do not have a stable job and have to migrate to other places for jobs. If the communities are agrarian during lean seasons it becomes impossible for them to repay the loan. Pressure for high repayment drives members to money lenders. Credit alone cannot alleviate poverty and the Grameen model is based only on credit. Micro-finance is time taking process. Haste can lead to wrong selection of activities and beneficiaries.

Another model is Kerala model (Shreyas). The rules make it difficult to give adequate credit (only 40-50 percent of amount available for lending). In Nari Nidhi/Pradan system perhaps not reaching the very poor.

Most of the existing microfinance institutions are facing problems regarding skilled labour which is not available for local level accounting. Drop out of trained staff is very high. One alternative is automation which is not looked at as yet. Most of the models do not lend for agriculture. Agriculture lending has not been experimented.

- Risk Management : yield risk and price risk;
- Insurance & Commodity Future Exchange could be explored.

All the models lack in appropriate legal and financial structure. There is a need to have a sub-group to brainstorm on statutory structure/ ownership control/ management/ taxation aspects/ financial sector prudential norms. A forum/ network of micro-financier (self regulating organization) is desired.

7. A NEW PARADIGM

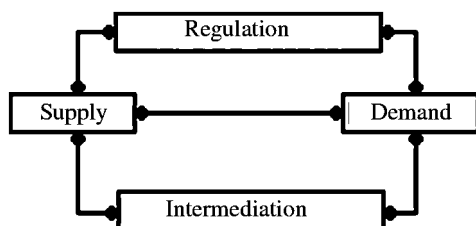
A new paradigm that emerges is that it is very critical to link poor to formal financial system, whatever the mechanism may be, if the goal of poverty alleviation has to be achieved. NGOs and CBOs have been involved in community development for long and the experience shows that they have been able to improve the quality of life of poor, if this is an indicator of development. The strengths and weaknesses of existing NGOs/CBOs and microfinance institutions in India indicate that despite their best of efforts they have not been able to link themselves with formal systems. It is desired that an intermediary institution is required between formal financial markets and grassroots.

The intermediary should encompass the strengths of both formal financial systems and NGOs and CBOs and should be flexible to the needs of end users. There are, however, certain unresolved dilemmas regarding the nature of the intermediary institutions. There are arguments both for and against each structure. These dilemmas are very contextual and only strengthen the argument that no unique model is applicable for all situations. They have to be context specific.

DILEMMAS

Community Based	Investor Owned
<ul style="list-style-type: none"> • Community Managed • Community (self) financed • Integrated (social & finance) • Non profit / mutual benefit • Only for poor • 'Self regulated' 	<ul style="list-style-type: none"> • Professionally managed • Accepting outside funds for on-lending • Minimalist (finance only) • For profit • For all under served clients • Externally regulated

The four pillars of microfinance credit system (Fig. 1) are supply, demand for finance, intermediation and regulation. Whatever may the model of the intermediary institution, the end situation is accessibility of finance to poor. The following tables indicate the existing and desired situation for each component.



DEMAND

Existing Situation	Desired Situation
<ul style="list-style-type: none"> • fragmented • Community Managed • Undifferentiated • Addicted, corrupted by capital & subsidies • Communities not aware of rights and responsibilities 	<ul style="list-style-type: none"> • Professionally managed • Organized • Differentiated (for consumption, housing) • Deaddicted from capital & subsidies • Aware of rights and responsibilities

SUPPLY

Existing Situation	Desired Situation
<ul style="list-style-type: none"> • Grant based (Foreign/GOI) • Directed Credit - unwilling and corrupt 	<ul style="list-style-type: none"> • Regular fund sources (borrowings/deposits) • Demand responsive

- | | |
|---|--|
| <ul style="list-style-type: none"> • Not linked with mainstream • Mainly focussed for credit • Dominated | <ul style="list-style-type: none"> • Part of mainstream (banks/FIs) • Add savings and insurance • Reduce dominance of informal, unregulated suppliers |
|---|--|

INTERMEDIATION

Existing Situation	Desired Situation
<ul style="list-style-type: none"> • Non specialized • Not oriented to financial analysis • Non profit capital • Not linked to mainstream FIs • Not organized 	<ul style="list-style-type: none"> • Specialized in financial services • Thorough in financial analysis • For profit • Link up to FIs • Self regulating

REGULATION

Existing Situation	Desired Situation
<ul style="list-style-type: none"> • Focused on formal service providers (informal not regulated) • regulating the wrong things e.g. interest rates • Multiple and conflicting (FCRA, RBI, IT, ROC, MOF/FIPB, ROS/ Commerce) • Negatively oriented 	<ul style="list-style-type: none"> • include/informal recognize e.g. SHGs • Regulate rules of game e.g. interest rates • Coherence and coordination across regulators • Enabling environment

8. CONCLUSION

Some valuable lessons can be drawn from the experience of successful Microfinance operation. First of all, the poor repay their loans and are willing to pay for higher interest rates than commercial banks provided that access to credit is provided. The solidarity group pressure and sequential lending provide strong repayment motivation and produce extremely low default rates. Secondly, the poor save and hence microfinance should provide both savings and loan facilities. These two findings imply that banking on the poor can be a profitable business. However, attaining financial viability and sustainability is the major institutional challenge. Deposit mobilization is the major means for microfinance institutions to expand outreach by leveraging equity (Sacay et al 1996). In order to be sustainable, microfinance lending should be grounded on market principles because large scale lending cannot be accomplished through subsidies.

A main conclusion of this paper is that microfinance can contribute to solving the problem of inadequate housing and urban services as an integral part of poverty alleviation

programmes. The challenge lies in finding the level of flexibility in the credit instrument that could make it match the multiple credit requirements of the low income borrowers without imposing unbearably high cost of monitoring its end-use upon the lenders.

A promising solution is to provide multi-purpose loans or composite credit for income generation, housing improvement and consumption support. Consumption loan is found to be especially important during the gestation period between commencing a new economic activity and deriving positive income. Careful research on demand for financing and savings behaviour of the potential borrowers and their participation in determining the mix of multi-purpose loans are essential in making the concept work (tall 1996).

Eventually it would be ideal to enhance the creditworthiness of the poor and to make them more "bankable" to financial institutions and enable them to qualify for long-term credit from the formal sector. Microfinance institutions have a lot to contribute to this by building financial discipline and educating borrowers about repayment requirements.

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