

The Indian Microfinance Experience – Accomplishments and Challenges*

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Abstract:

Microfinance is gathering momentum to become a major force in India. The self-help group (SHG) model with bank lending to groups of (often) poor women without collateral has become an accepted part of rural finance. The paper discusses the state of SHG-based microfinance in India. With traditionally loss-making rural banks shifting their portfolio away from the rural poor in the post-reform period, SHG-based microfinance, nurtured and aided by NGOs, have become an important alternative to traditional lending in terms of reaching the poor without incurring a fortune in operating and monitoring costs. The government and NABARD have recognized this and have emphasized the SHG approach and working along with NGOs in its initiatives. Over half a million SHGs have been linked to banks over the years but a handful of states, mostly in South India, account for over three-fourth of this figure with Andhra Pradesh being an undisputed leader. In spite of the impressive figures, microfinance in India is still presently too small to create a massive impact in poverty alleviation, but if pursued with skill and opportunity development of the poor, it holds the promise to alter the socioeconomic face of the India's poor.

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I. Introduction

Home to the largest population of poor in the world, India has been a natural candidate for experimenting with microfinance as a tool for poverty alleviation. With a nationalized formal banking sector that has emphasized rural and developmental banking for several decades now, India's involvement with small credit targeted primarily at the rural poor is hardly new. However, recent years have generated unprecedented interest in microcredit and microfinance in the form of group-lending without collateral; thanks in part to the remarkable success of institutions like the Grameen Bank in neighboring Bangladesh and BRI, BancoSol and others in more distant lands. The performance of organizations like SEWA in Western India and SHARE and BASIX in Southern India have convinced many a sceptic that microfinance can indeed make a difference in India as well. Over the past decade, NABARD's "SHG-Bank Linkage Program" aimed at connecting self-help groups of poor people with banks, has, in fact, created the *largest microfinance network in the world*. The self-help group approach has won enthusiastic supporters among influential policymakers like the Andhra Pradesh CM, Chandrababu Naidu. Even the central government has recognized the advantages of group lending and has adopted the approach in its battle against poverty.

Microcredit, in the sense of small loans to the poor, is of ancient origins in India. Traders and moneylenders have traditionally provided credit to the rural poor, usually at

exorbitant rates of interest leading to considerable hardship and impoverishment of borrowers, including undesirable and illegal practices like bonded labor. What we refer to as microfinance today does not include such exploitative practices, but rather lending to the poor at reasonable but sustainable rates.

Within India the microfinance movement in Western and Southern India have received most attention, both in the media as well as in academic research¹. The poster boys among the Indian microfinance NGOs – SHARE, BASIX, SEWA, MYRADA and PRADAN, for instance – have deservedly received attention from academicians, media-persons as well as the government. Andhra Pradesh, in particular, has witnessed a remarkable growth in microfinance activities and its success stories have been widely reported as well.

However Self-Help Groups (SHGs), usually at the behest of certain developmental non-government organizations (NGOs), have quietly mushroomed in most districts of India over the last few years. Millions of poor, predominantly women, are now members of thousands of SHGs. Given the lack of an easily accessible data source covering the operation and performance of multiple MFIs and SHGs spread out over a region, it is hardly surprising that much of the extant research on microfinance in India, as in most other countries, has focused on developing case studies, often covering the well-known success stories. In this paper, we seek to follow a slightly different approach.

The paper is organized in the following manner. The next section provides a brief background of lending to the rural poor by the rural banking sector in India. The following section takes a look at the different aspects of Self-Help Groups as the emerging entity in microfinance. The fourth section studies the performance of the rural banking system in the microfinance area. The fifth and final section concludes with a pointer towards the future.

II. The Banking Sector and lending to the rural poor – A Background

With directed priority-sector lending an explicit feature of the formal banking sector, India has built up a network of rural banks that is rare if not unparalleled in the world. In 1999, 196 RRBs had over 14,000 branches in 375 districts nation-wide, covering, on an average, about three villages per branch. The rural banking system, in its entirety, has an even more impressive coverage. Together, the RRBs, the nationalized commercial banks and the credit cooperatives — comprising of Primary Agricultural Credit Societies (PACS) and Primary/State Land Development Banks (P/SLDS) — have one branch for every 4,000 rural residents (Bhatt and Thorat, 2001).

In spite of such an impressive coverage, the formal banking sector has had a limited impact on microfinance or lending to the poor. The RRBs were set up in the mid-70's with a clear mandate for lending to the poor as it was felt that the cooperative banks were being dominated by the rural wealthy and that the commercial banks had an urban bias.

¹ See, for instance, Fisher and Sriram (2002) .

For the first two decades of their existence, political pressure and focus on outreach at the expense of prudent lending practices led to very high default rates with accumulated losses exceeding Rs. 3,000 crores in 1999. The reforms in the mid-90's, following the recommendations of the Narsimhan Committee Report, removed some of the constraints on the functioning of RRBs, easing their interest ceiling and allowing them to invest in the money market. The financial situation of the RRBs has improved since then with declining losses and over 80% of the RRBs are now profitable. However, much of this turnaround has resulted from a shift to investment in government bonds (that have gained with falling interest rates) and loans to the non-poor in rural areas.

The focus on financial sustainability has cost outreach dearly. Recent years have witnessed – perhaps predictably – a sharp decline in the share of rural and small loans in the portfolio of the banks. The locational distribution of bank branches has also undergone a considerable shift away from the rural areas (see Figure 1).

[Figure 1 about here]

Over its entire lifetime, the formal rural banking system in India has struggled to balance the dual objectives of outreach and financial performance. A post-reform shift in focus has benefited the latter only at the expense of the former.

The lending portfolio of scheduled commercial banks also reflects this shift away from rural areas. At the end of 2001-2002, the share of agriculture in the outstanding

credit of scheduled commercial banks was less than 10% which is even less than the share of personal loans (housing loans and loans for consumer durables).

Small loans have also declined in importance in recent years. Since over 98% of rural loans are below Rs 2 lakhs, this implies a concomitant shift out of rural areas. The logic of this shift is easy to appreciate. In 2002, 45% of the borrowers of scheduled commercial banks were from rural areas, but they accounted for only 13.4% of their outstanding loans. For metros, the corresponding numbers were 15% and 54% respectively. With their focus shifted to financial performance, the banks are naturally shifting their portfolio to the low cost segment.

Microfinance provides an important way to balance the outreach among the rural poor while keep the cost of lending low. To the extent that the costs of credit risk assessment and monitoring can be reduced with the help of NGOs, banks can actually reach out to a large number of truly poor households without incurring heavy transactional expenses

III. Self Help Groups (SHGs) as borrowing units

Self Help Groups (SHGs) form the basic constituent unit of the microfinance movement in India. An SHG is a group of a few individuals – usually poor and often women – who pool their savings into a fund from which they can borrow as and when necessary. Such a group is linked with a bank – a rural, co-operative or commercial bank– where they maintain a group account. Over time the bank begins to lend to the

group as a unit, without collateral, relying on self-monitoring and peer pressure within the group for repayment of these loans.

An SHG consists of five to twenty persons, usually all from different families. Often a group like this is given a name. Each such group has a leader and a deputy leader, elected by the group members. The members decide among themselves the amount of deposit they have to make individually to the group account. The starting monthly individual deposit level is usually low – Rs. 10 or Rs. 20 (about 20-40 US cents). For a group of size 10, this translates to Rs. 100 to 200 (about \$2 to \$ 4) of group savings per month. On the basis of the resolutions adopted and signed by all members of the group, the manager of a local rural or commercial bank opens a savings bank account. The savings are collected by a certain date (often the 10th of the month) from individual members and deposited in the bank account.

Joining an existing SHG is often a costly affair for an aspiring villager. In order to maintain parity among the members a new member has to join by depositing the total accumulated individual savings and interest of the group. Besides the new member has to be accepted by every member of the existing group. Thus it is often easier for a person not affiliated with an SHG to start a new SHG than joining a pre-existing one.

Loans are then given out to individual members from out of these funds upon application and unanimous resolution drawn at a group meeting. The bank permits withdrawal from the group account on the basis of such resolutions. Such loans, fully

funded out of the savings generated by the group members themselves, are called “inter-loans”. The repayment periods of loans are usually short, 3-6 months. After regular loan issuance and repayment for six months, the bank considers making a bank loan to the SHG. The maximum loan amount is a multiple (usually 4:1) of the total funds in the group account. This limit is also reached gradually starting from a lower (2:1 or 1:1) figure. Thus a 10 member SHG with individual monthly deposit level of Rs. 20, completing a six-month successful “inter-loaning”, accumulates total savings of Rs.1200/- (part of which may be lent out to individual members) and is eligible for a maximum bank loan of Rs. 4800/-.

The role of NGOs in Microfinance

Self Help Groups are almost always formed with outside assistance. Developmental NGOs, often with considerable history of working in a particular area for projects like literacy, sanitation etc., take to organizing SHGs, bringing together people, explaining the concept to them, attending and helping coordinate a few of the initial group meetings, helping them maintain accounts and linking them with the banks. Of late, some of the rural banks themselves are being designated as Self Help Promoting Institutions (SHPIs) and they help in the formation and ‘nursing’ of SHGs. Figure 2 gives the country-level breakdown of SHGs according to their promoting institution. While Figure 2 shows that over half of the SHGs are formed by government agencies, it should be remembered that

about 60% of government-formed SHGs come from a single state, Andhra Pradesh, where the state government has played a very pro-active role in SHG financing.

[Figure 2 about here]

Over the last quarter century, a few organizations, outside the purview of the public sector, have succeeded in effective poverty alleviation through micro-credit. Self Employed Women's Association (SEWA) in the Western Indian state of Gujarat and Working Women's Forum in the Southern state of Tamilnadu were among the pioneers in this effort. The sector received a major boost in the 1990s with the entry of several non-government organizations (NGOs). Many of these NGOs have been previously functioning in different developmental roles among the poor, and now added microcredit to the list of services they provided. A few others, impressed by the success of microfinance elsewhere, started off as MFIs. Self-Help Groups (SHGs) among the poor, mostly women, have rapidly become a common rural phenomenon in many Indian states. NGOs provide the leadership and management necessary in forming and running such groups in most cases. They also act as the crucial link between these groups and the formal banking system. Presently well over 500 NGO-MFIs are actively engaged in microfinance intermediation across the country.

There are several major legal, regulatory and financial challenges for NGOs involved in microfinance activities. Legally, they are usually registered as societies and trusts with no equity capital and consequently can never be "capital adequate" in leveraging debt.

Also, these NGOs do not come under any specific control by any regulatory body and their only responsibility is to submit annual accounts to the registrar of societies. This lack of specific regulatory provisions has acted as a mixed blessing in the area – it has allowed for organic growth and spread of NGO MFIs and at the same time has led to lack of financial sustainability for most of these organizations, sometimes with disastrous effects on the goodwill of microfinance at large.

Linking SHGs to the formal rural banking sector

The main advantage of Self-Help Groups lies in their joint liability and consequent “peer monitoring” of member borrowers. In association with sponsoring NGOs, they serve to reduce the transaction and monitoring costs of small lending for the banks as well as reach credit to the absolute poor. It is therefore hardly a surprise that they have attracted considerable attention in the rural banking sector as well as from the government in recent years.

Several alternative models of SHG-NGO-bank relationship have emerged in recent years. One such model is where the bank lends directly to the SHG and the latter further lends it to individual members. As a variant of this model, an NGO may provide training and guidance to the SHG still dealing directly with the bank. This has been the most popular model in the Indian context. Alternatively, the NGO itself may act as an intermediary between the bank and the SHG, borrowing from the bank and lending it to

(usually multiple) SHGs. Yet another model involves the bank lending directly to the individual borrower with the NGO and the SHG acquiring an advisory role. Here the NGO assists the bank in loan monitoring and recovery. Figure 3 gives the approximate nationwide distribution of SHGs among the different bank financing models.

[Figure 3 about here]

Government support for SHG-based financing

While most of the SHG formation/nursing process has initially been in non-government hands, the developmental potential of the SHG-based microfinance process has not gone unnoticed by the government. In recent years, government developmental programs have also sought to target the poor through the SHGs. Starting with the Rashtriya Mahila Kosh and the Indira Mahila Yojana, the government has used the SHG approach in many of its anti-poverty projects. The most important of the government programs using the SHG approach is the *Swarnajayanti Gram Swarojgar Yojana (SGSY)* launched in 1999. With increasing acceptance of the SHG based developmental approach there is pressure set on village and block level administrators to achieve targets of forming a certain number of SHGs by a specified date. Thus Panchayats are also promoting SHGs in many areas.

Non-banking Financial Corporations (NBFCs) and other non-government organizations (NGOs) typically connect these SHGs to local banks or to the funds

provided by wholesale credit suppliers like NABARD or SIDBI (Small Industries Development Bank of India). The SHGs develop a habit of saving among its members for a period of time and then begin making loans to applying members from the collective savings of the group. After a few rounds of successfully repaid loans, an SHG begins borrowing from an outside source (i.e. a bank). Banks usually consider SHGs “bankable” after six months of their existence.

Government involvement in microfinance has, however, not been an unmixed blessing. Politicizing of the subsidy allotment among SHGs has become a big problem. Qualification for government subsidy is easily influenced by Panchayat members. Thus, Panchayats are now competing with NGOs and rural banks in forming SHGs. While the Panchayat-formed SHGs have the lure of government grants they are often open to political pressure and misuse of funds by the recommending Panchayats and/or political parties. Besides, the NGO-formed SHGs have the benefit of honest and expert counseling from the nursing NGOs. Thus the quality of NGO-formed groups are usually superior to those formed by the local government (Panchayats) and villagers are often keen to join the former. These age-old problems of government initiatives in poverty reduction, unless stemmed quickly, can actually harm the movement by eroding the fundamental precepts of self-help and empowerment of the poor.

The Swarnjayanti Gram Swarajgar Yojana

Swarnjayanti Gram Swarozgar Yojana (SGSY) has emerged as a main anti-poverty programme instituted by the government in recent years. Started in April, 1999, it seeks to lift the rural poor out of poverty in three years by generating significant sustainable income. Organizing the poor into self- help groups (SHGs) lies at the heart of this approach. The goal of the programme is to enable the poor attain income generating assets. According to the SGSY Guidelines, *“The SHG approach helps the poor to build their self-confidence through community action. Interactions in group meetings and collective decision making enable them in identification and prioritization of their needs and resources. This process would ultimately lead to the strengthening and socio-economic empowerment of the rural poor as well as improve their collective bargaining power.”*²

The SGSY strategy includes identifying a cluster of activities at the block level and funding SHGs to perform these activities. The programme is implemented countrywide through a hierarchy of SGSY committees, at the central, state, district and block levels. The actual implementation requires close interaction between the government officials at various levels, particularly the DRDAs (District Rural Development Agencies), managers from the participating banks, NABARD, as well as NGOs. The actual disbursement of government funds would be through the DRDAs who would distribute the subsidy to banks. The programme recognizes the important role that NGOs play in the formation and nurturing of Self-Help Groups and seeks to include them in the exercise.

² Swarnjayanti Gram Swarozgar Yojana Guidelines, Government of India, Ministry of Rural Development, New Delhi.

From the point of view of SHGs, SGSY is an excellent source of subsidized credit. If a group survives for 6 months it becomes eligible for a revolving fund of Rs. 25,000 from a participating bank. Out of this loan, Rs. 10,000 is in the form of government subsidy and banks may charge interest only the amount exceeding this Rs. 10,000. The Rs. 25,000 fund injection becomes part of the group corpus. With some exceptions, six months after the receipt of the revolving fund the groups would be tested for their preparedness to take up economic activities. If they pass the test, they would be eligible for loan-and-subsidy for economic activity up to a maximum of Rs. 10,000 per group member or Rs. 1.25 lakhs per group, whichever is less. There are also incentives, payable in several stages, to NGOs or “animators” incubating and nurturing SHGs.

Though financing is a very important part of SGSY, it is not the only element. Identification of activity clusters, recognizing training needs of *swarozgaris*, imparting proper training and building capacity of the groups and group members in the selected activities are all essential elements of the programme. Also, SGSY is not the first or only government programme to try the SHG approach. DWCRA (Development of Women and Children in Rural Areas), for instance, is also based on the same approach.

IV. Banking Sector and Microfinance

The formal banking sector has played an important role in microfinance in India. Much of the microfinance initiative in India has involved Self-Help Groups (SHGs), predominantly of poor women. NABARD's Bank Linkage Program, pilot-tested in 1991-92 and launched in full vigor in 1996, has been a major effort to connect thousands of such SHGs across the country with the formal banking system. By late 2002, it connected about *half a million* SHGs to the banking system with total loan disbursement of about Rs. 1026 crores. Efforts of other organizations supplement that of NABARD. By March 2001, SIDBI, for instance, had disbursed over Rs 30 crore to SHGs through 142 MFI-NGOs.

The emphasis on linking the self-help groups of rural poor to the formal banking system was made in the mid-80s in the Asia and Pacific Regional Agricultural Credit Association and the SHG-Bank Linkage emerged as a result of that. RBI included the program in its "priority sector lending" and in 1999, the Government of India recognized in its Budget. A few studies commissioned by NABARD on the tenth anniversary of the launching of the program in 2002 attempted an assessment of the program. The findings indicate that the program has emerged as the largest microfinance network in the world with some impressive statistics.

As of March 2002 the program covered 461,478 SHGs with total cumulative lending of Rs 1,026 cores (US \$ 218.27 million). The accumulated savings in SHGs exceeds Rs 875 crores (US \$ 186.31 million) by unofficial estimates. 90% of SHGs financed were exclusive women groups. 444 Banks (121 RRBs, 209 cooperatives banks,

all 27 public sector banks and 17 private banks) with a total of 17,085 branches participated in the program providing credit to about 7.8 million poor households in 488 districts. Average loan sizes are Rs 22,240 (US \$ 463) per SHG and 1,300 (US \$27) per member. Today, the program is estimated to cover well over 500,000 SHGs with cumulative loans exceeding Rs. 1200 crore reaching over 8 million households. (Kropp and Suran (2002) and Seibel and Dave (2002)).

The state-wise distribution of SHGs linked with banks shows considerable variation in the share of total SHGs (see Figure 3). Andhra Pradesh has a disproportionately large share of over 42% of all linked SHGs. Tamil Nadu and Uttar Pradesh (including Uttaranchal) follow with about 12% and 11% share respectively. Karnataka come next with about 9%. The rest of country thus accounts for about a quarter of the total SHGs combined. From an all-India perspective therefore, the SHG-bank linkage experience has been very strongly biased towards the South and has not provided a balanced access to credit for the poor in India.

[Figure 4 about here]

In spite of the impressive rise of microfinance institutions, the scope of further microfinance efforts in India is almost unlimited. Indeed poverty alleviation in India is a Herculean task. India has roughly about 60 million poor households, accounting for over 350 million people, about 35% of the entire population. Even NABARD aims at reaching only 100 million of the poor (less than a third) by 2008. Clearly, a quantum leap in

microfinance activities is necessary if it is expected to make a serious impact on the poverty situation in India. There are, of course, other issues connected with microfinance and poverty alleviation. As elsewhere in the world, it is contended that in India too microfinance often eludes the “poorest of the poor” and it is people above poverty line – barely or comfortably – who can benefit from such micro-financial services.

V. The Road Ahead – Prospects and Challenges

In this paper we have sought to provide a bird’s-eye view of the microfinance sector in India. There have definitely been significant advances in recent years and the concept and practice of SHG-based microfinance has now developed deep roots in many parts of the country. Impact assessment being rather limited so far, it is hard to measure and quantify the effect that this Indian microcredit experience so far has had on the poverty situation in India. Doubtlessly, a lot needs to be accomplished in terms of outreach to make a serious dent on poverty. However, the logic and rationale of SHG-based microfinance have been established firmly enough that microcredit has effectively graduated from an “experiment” to a widely-accepted paradigm of rural and developmental financing in India. This is no mean achievement. In fact to the extent that people’s mindsets are the biggest roadblock in the success of an innovation, it may well be one of the most important steps in the saga of microfinance.

The path ahead is obviously strewn with challenges. Scaling up of projects and bringing millions of people within the fold of microfinance is no mean task. The most

convincing feature of this form of financing, that justifies its admittedly higher costs, is the near-perfect repayment rates. The expansionary zeal of microcredit practitioners should be balanced with the quality of loans – indeed a momentous challenge.

Government involvement in SHG-based microfinance is a welcome development but it is not free from its ills. Government aid almost always brings in its wake political favoritism and corruption. It is important to ensure that the government microfinance initiatives do not go the way of their several well-intentioned predecessors.

The biggest challenge in development, however, is the simultaneous development of investment potential and improvement of skill levels of the borrowers. A glut of low-skilled services is an unwelcome substitute for scarcity of credit. As microcredit alleviates the credit availability problem, the need for micro-consulting, business planning and services like marketing, are being felt with greater acuteness. Microcredit cannot be expected to be a panacea to rural developmental problems. In some sense, its role is similar to that of credit in the general economy. It is a string that can hold back progress, but it is almost impossible to push on a string. There is a very real need of investments that yield higher returns than the sustainable microcredit interest rates for the microcredit initiative to be truly successful.

However, so far the evidence – largely anecdotal – points to the several beneficial side-effects of microcredit. In particular, empowerment of women and the inculcation of financial training and discipline amongst the poor will undoubtedly have long-term socio-economic benefits. The principles of self-help and microcredit thus hold the key to economic and socio-cultural freedom for India's millions of poor, opening the gates of a hitherto untapped reservoir of human enterprise.

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Fig. 1: Reorganization of the banking sector

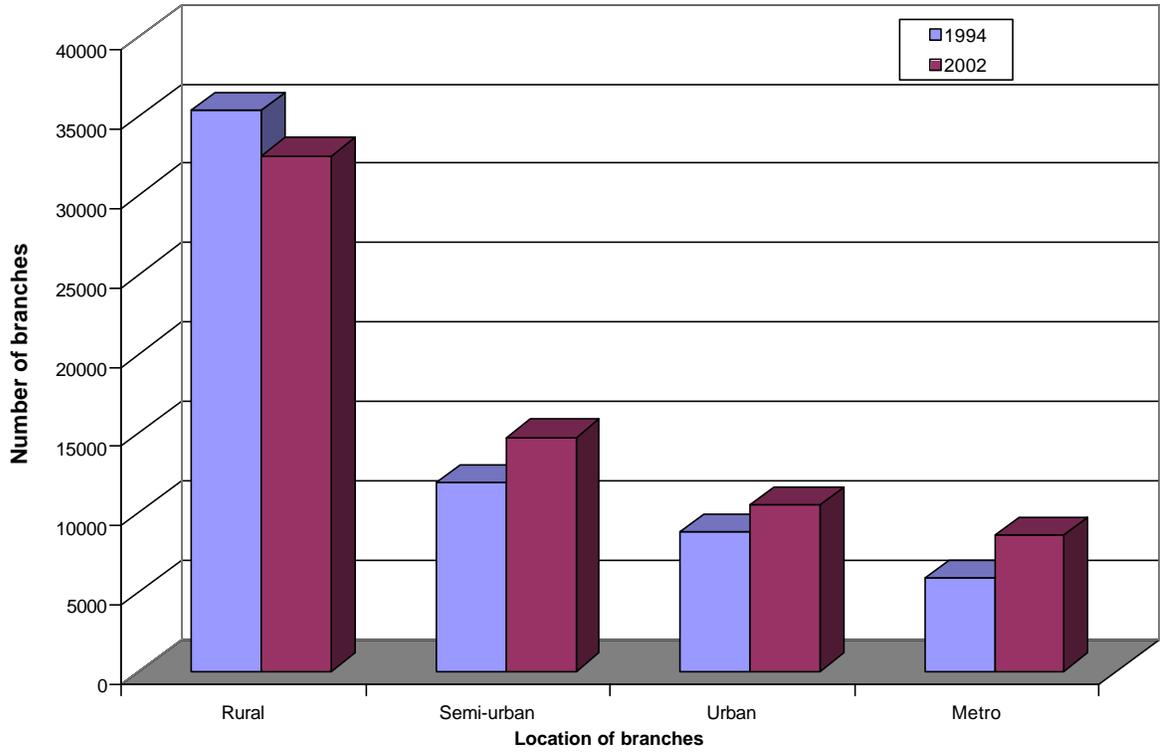
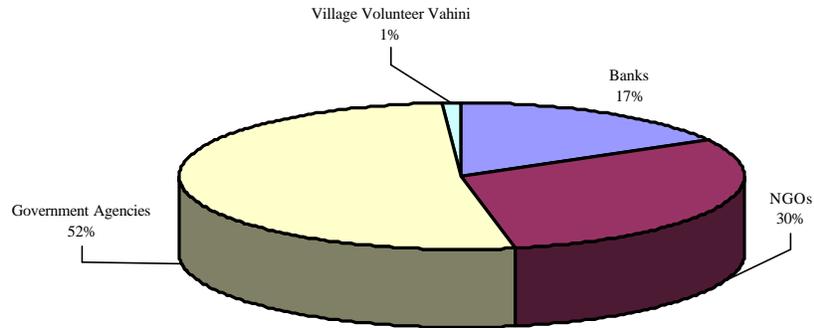
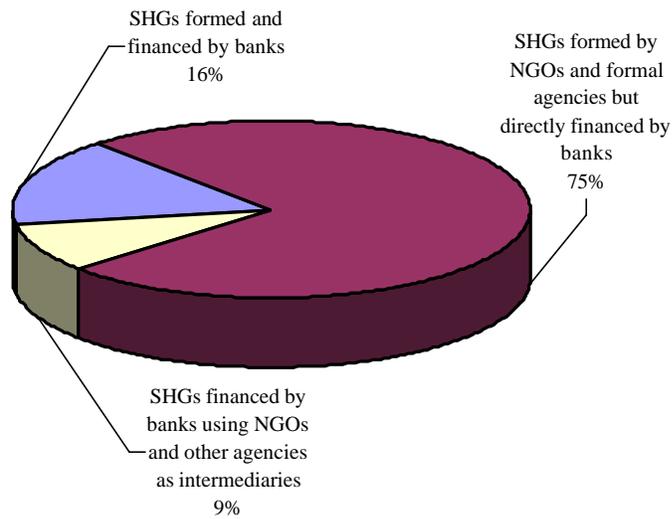


Figure 2
Distribution of SHGs among different promoting institutions



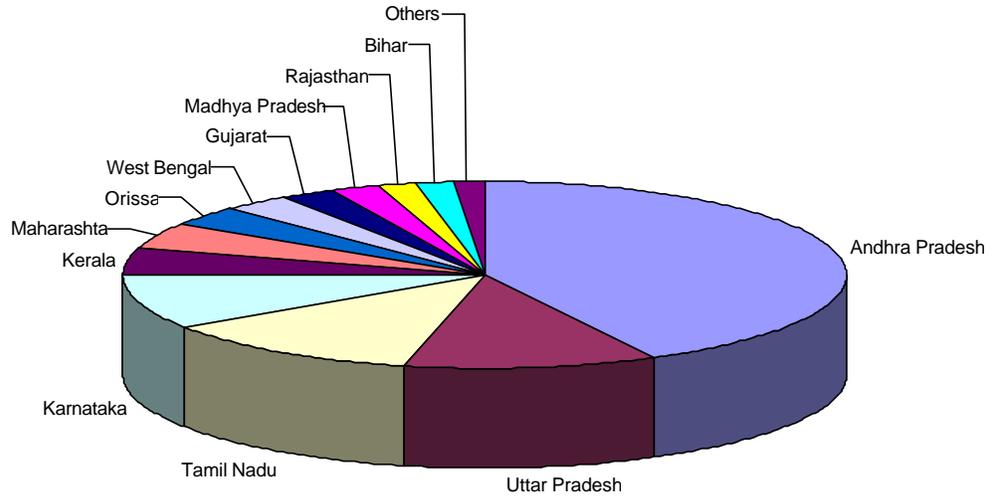
Source: Harper (2002)

Figure 3
Distribution of SHGs among different bank financing models



Source: Kropp and Suran (2002)

Figure 4: State-wise distribution of linked SHGs



Source: Created from data in Bansal (2003). The state names refer to the pre-reorganization states. "Others" include Himachal Pradesh, Haryana, Punjab, Jammu & Kashmir, Assam, Meghalaya, Tripura, Sikkim, Manipur, UT of Andaman and Nicobar Islands, Goa, and Pondichery.