

**The Transformation of the Microfinance Sector in India:
Experiences, Options, and Future**

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Abstract

This paper discusses the growth and transformation of micro-finance organizations (MFO) in India. To understand the transformation better, we discuss issues that trigger transformation: size, diversity, sustainability, focus and taxation. We briefly examine the global experiences in transformation, before moving to the Indian context.

The transformation experiences in India are few. When non-governmental organizations (NGOs) want to move to the mainstream, they choose from three popular forms of organizations -- non-banking finance companies (NBFCs), banks and co-operatives. After examining the experiences of Indian MFOs, we conclude that there is no ideal path for spin off.

The experiences hold out implications for regulation. We argue for regulatory changes allowing MFOs to graduate to other legal forms as they grow organically. We also argue for permitting NGOs to invest in the equity of MFOs, as is the case in Bolivia and Africa. We do not subscribe to the argument that norms should be eased for setting up MFOs under current legal forms. Regulations should ensure that they help genuine MFOs and not others masquerading as MFOs.

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THE TRANSFORMATION OF THE MICROFINANCE SECTOR IN INDIA:

EXPERIENCES, OPTIONS, AND FUTURE

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INTRODUCTION

Microfinance in India started in the early 1980s, with small efforts of forming informal self-help groups (SHG) providing access to much-needed savings and credit services. From this small beginning, the microfinance sector has grown significantly in the past decades. National bodies like the Small Industries Development Bank of India (SIDBI) and the National Bank for Agriculture and Rural Development (NABARD) are devoting significant time and financial resources on microfinance. This points to the growing importance of the sector. The strength of the microfinance organizations (MFOs) in India is in the diversity of approaches and forms that have evolved over time. In addition to the home-grown models of SHGs and mutually aided cooperative societies (MACS), the country has learnt from other microfinance experiments across the world, particularly Bangladesh, Indonesia, Thailand, and Bolivia, in terms of delivery of microfinancial services. Indian organizations could also learn from the transformation experiences of these microfinance initiatives. This paper examines transformation in the Indian context.

UNDERSTANDING MICROFINANCE

Robinson (2001) defines microfinance as “small-scale financial services – primarily credit and savings – provided to people who farm, fish or herd” and adds that it “refers to all types of financial services provided to low-income households and enterprises.”

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In India microfinance is generally understood, but not clearly defined. For instance, if a SHG gives a loan for an economic activity, it is seen as microfinance. But if a commercial bank gives a similar loan, it is unlikely that it would be treated as microfinance. In the Indian context there are some value attributes of microfinance:

- a. Microfinance is an activity undertaken by the **alternate sector** (NGOs). Therefore, a loan given by a market intermediary to a small borrower is not seen as microfinance. However when a NGO gives a similar loan it is treated as microfinance. It is assumed that microfinance is given with a laudable intention and has institutional and non-exploitative connotations. Therefore, we define microfinance not by form but by the intent of the lender.
- b. Microfinance is something done predominantly with the **poor**. Banks usually do not qualify to be MFOs because they do not predominantly cater to the poor. However, there is ambivalence about the regional rural banks (RRBs) and the new local area banks (LABs). In normal course one would not ascribe the value attribute of a MFO to them.
- c. Third, microfinance grows out of **developmental** roots. This can be termed as the "alternative commercial sector." MFOs classified under this head are promoted by the alternative sector, and target the poor. However these MFOs need not necessarily be "developmental" in incorporation. There are MFOs that are offshoots of NGOs, and run commercially. There are commercial MFOs promoted by people who have developmental credentials. We do not find commercial organizations having "microfinance business".
- d. Last, the Reserve Bank of India (RBI) has defined microfinance by specifying criteria for exempting MFOs from its registration guidelines. This definition is limited to not-for-profit companies and only two MFOs in India qualify to be classified as microfinance companies.

MICROFINANCE IN INDIA

First, let us see how microfinance is organized in India. Microfinance is done by organizations having diverse orientations, as shown in Figure-1: Defining the Microfinance Egg.

Insert Figure 1 about here.

At a broad level, we find NGOs with a range of developmental activities; they usually have microfinance as a sub-component. Some of these NGOs just organize groups and link them to an existing provider of financial services. In some cases NGOs have a “revolving fund” that is used for lending. But, in either case microfinance is not a core activity for these NGOs. An example is the Aga Khan Rural Support Programme India (AKRSP-I). For AKRSP-I, the microfinance component is incidental to its work in natural resource management.

Examples like MYRADA and Self-Employed Women’s Association (SEWA) fall under the same category. However, as the microfinance portfolio grew, both the organizations decided to form separate entities for microfinance. MYRADA set up an MFO called Sanghamitra Rural Financial Services (SRFS) while SEWA set up the SEWA Cooperative Bank.

At the next level we find NGOs helping the poor in economic activities. Their purpose is developmental. They see microfinance as an activity that feeds into economic activities. For instance, the South Indian Federation of Fishermen’s Societies (SIFFS) started as a support organization for fishermen, providing technical and marketing support. It then arranged for loans to its members through banks. When the arrangement was not effective, it started providing loans itself.

At the third level we have organizations with microfinance at the core. They have developmental roots, but are diverse in their operational details, orientation, and form of incorporation.

This paper focuses on organizations that have microfinance at the core. It also examines NGOs that have created new MFOs to deal with the specialized function of microfinance. It deals with

issues of transformation of these organizations, while moving from a developmental root to a commercial sprout.

ISSUES THAT TRIGGER TRANSFORMATION

We examine the five significant issues that trigger the transformation of NGOs into MFOs.

SIZE

The most significant issue that triggers a transformation is growth. This affects the promoters as well as providers of microfinance.¹ In organizations like MYRADA and SIFFS which promoted credit groups, banks were unwilling to provide loans at the same pace at which microfinance customers needed. It was not easy for MYRADA or SIFFS to deal with the attitudes of people manning these organizations. In several instances it was an enthusiastic bank manager who made the difference and this was not institutionalized. In such situations, NGOs tend to get into action by opening a microfinance division, or by setting up a separate MFO. The geneses of several Indian MFOs are rooted in the failure of banks to meet the needs of the poor.

DIVERSITY

Another trigger for transformation is the diversity of financial services that a MFO wants to offer. In most cases, NGOs start with credit but soon realize the need to provide other support services. While MFOs have reduced their own lending risks through group guarantees and addressed the issue of willful default, they have not been able to grapple with the situation where the underlying economic activity fails and the borrower faces a genuine problem. This can be tackled with a combination of savings and risk mitigation products. But, MFOs realize that the NGO

format is not suited for carrying out these activities owing to stringent regulations. They necessarily have to look at transformation options.

SUSTAINABILITY

Sustainability is closely linked to growth. Beyond a certain level, MFOs have to seek external funds for keeping the credit activity going. When MFOs seek funds from financial institutions, issues like ownership structure and capital adequacy become critical. For an MFO to survive in the long run, it has to transform itself into an institution with transparent systems and accountability. In most cases the promoters of MFOs do not have sufficient capital to invest and therefore the main constraint is that they are dealing with "other people's money." NGOs have no clear-cut ownership structure and making people liable under this format is a problem. If they were to be sustainable, the only option is to deal with mainstream institutions (Rhyne, 2001).

FOCUS

NGOs need to maintain focus on their original mandate. Undertaking microfinance is transaction intensive and requires distinct orientation and skills. For NGOs, there is always a conflict between microfinance, which earns returns, and therefore "commercial" and other activities that are "developmental". This is one reason for NGOs to spin off their microfinance activities. The entity that emerges to carry out microfinance should be understood by the mainstream and therefore it should have an appropriate institutional form.

TAXATION

When an NGO carries out commercial activities (microfinance) on a large scale, it could lose its "tax free" status and might jeopardize other activities. Even grants may become taxable. This is a

major concern for NGO-MFOs. This also triggers a search for an alternative where microfinance could be kept isolated.

TRANSFORMATION EXPERIENCES: INTERNATIONAL

This section attempts to review the transformation experiences through three examples. While the Bolivian experience indicates transformation of an NGO to an MFO-Bank, the Indonesian experience is unique as banks have adopted MFO methods to provide financial services to the poor. We also review the Bangladesh experience, which is the transformation of a project into a MFO.

BOLIVIA: MAINSTREAMING MICROFINANCE

Like in many parts of the world, NGOs triggered the microfinance revolution in Bolivia. The economic turmoil in the mid-1980s seeded the microfinance initiatives there. The sector grew rapidly and presently Bolivia has an array of MFOs including banks, NGOs, and Fondos Financieros Privados (FFPs). Among the banks, the most celebrated is BancoSol, an offshoot of an NGO called Prodem. Most NGOs operating microfinance programs tend to become FFPs when they reach a critical stage. Very few get to the level of full-scale commercial banks like BancoSol. Prodem, while it promoted BancoSol, also continued as an NGO to address the developmental needs of its rural customers. Recently Prodem converted itself into an FFP. Apart from BancoSol, another bank that has a significant microfinance portfolio is a relatively young one, Banco Economico (Rhyne, 2001).

FFP in is an innovative institutional structure for microfinance, as it allows NGOs to take an equity position in a commercial activity. The Indian microfinance sector has been arguing for policy reforms on the lines of FFP. For instance, Sa-Dhan, the association of community development

finance institutions argues that there should be a new category of companies with a lower level of capitalization and providing a limited range of banking services (Sa-Dhan, 2002). Sa-Dhan argues that such companies could limit their savings services to borrowers. This is similar to the FFPs of Bolivia, which have lower capital requirements and are restricted from providing certain services that banks provide. In Bolivia, many large NGOs have converted themselves to FFPs. In addition, there were organizations such as Fassil and Acceso that came from the commercial world. While Fassil survived, Acceso quickly closed shop as it went on an overdrive in consumer credit. Acceso's collapse has lessons for evolving regulatory norms to suit the MFO needs, and has implications for future entrants to the market.

Gabriel Schor (quoted in Rhyne, 2001) says that this transformation in Bolivia has revealed the concept of an "ideal capitalist". It brought four key elements to the ownership of MFOs: NGOs came in through developmental mission; private investors who came in were motivated by recognition with returns; public sector investors came for safe investment and prestige; and international technical partners to disseminate the best practices (Rhyne, 2001).

INDONESIA: TRANSFORMATION OF THE MAINSTREAM

While most microfinance initiatives worldwide have taken the "supply" route, in Indonesia, the initiative took the "demand" route. It is, therefore, useful to understand this perspective.

In Indonesia, microfinance did not move from organizing people into groups and training them. Neither did it emerge from self-help groups. The pioneering institutions in microfinance did not have any of the value attributes discussed earlier. Of the two most well known institutions, Bank Dagang Bali (BDB) was established in 1970 as a private bank. The promoters of BDB were two enterprising people with first-hand experience of small enterprise and finance (M-Cril, 2002). The

bank grew and survived through innovation of products, seizing the opportunity for arbitrage between low interest on savings and high interest on loans.

BDB became a model for the state-owned Bank Rakyat Indonesia (BRI). It set the mainstream to move downwards towards the poor. The move was to provide banking and not just credit or savings to the poor. The trigger provided by BDB attained nationwide coverage in 1984 with the restructuring of the unit *desa* (local banking) system of the state-owned BRI (Wardhana, 2001).

This has lessons for embedding microfinance in the general financial system. Under the old system the state channeled resources for the poor through the banking system offering a line of credit at subsidized interest. However, the banking system soon realized that this was not sustainable. The state accepted the challenge to move from subsidized credit to sustainable microbanking. By moving towards packaging of credit to meet the needs of the poor, the system sorted out problems of arbitrage between the cost of credit available from the institutions that were sponsored by the state and the local players. The problem of improper identification of the “beneficiary” leading to leakage was solved. The question of continuing access to the services was, therefore, successfully addressed by embracing microfinance methods. After conscious shift towards microbanking, the banks offer complete financial services to the poor and people who transact in small amounts.

BANGLADESH: TRANSFORMATION OF A PROJECT

The Bangladesh experience is widely discussed and well quoted in the literature on microfinance. Here there are no issues pertaining to transformation, because microfinance did not branch out from developmental activities, but was a core. Microfinance emerged in response to the inability of commercial banks, the Bangladesh Krishi Bank, and other financial institutions to meet the banking needs of the poor. In the 1970s loan recovery of these institutions averaged 65% of the

dues. During that period, political parties offered to waive the loans of the farmers (Montgomery, Bhattacharya, and Hulme, 1996). Around this time, Professor Yunus started action research on effective delivery of credit to rural poor – which later grew into a large microcredit program, known as the Grameen Bank. The program was successful, and in 1983, the project was converted to an independent bank through legislation.

Unlike the experiences of other countries, the Bangladesh experience looks at legitimizing a successful experiment and not allowing it to drift into other forms of inappropriate incorporation. The Bangladesh experiment gained overall approval in as much as it has become a universal standard in microfinance. This is one of the most replicated models of microfinance in the world.

Following Grameen, other institutions in Bangladesh also entered the field. The Bangladesh Rural Advancement Committee (BRAC), set up in 1970, got into organizing groups under two pilot programs in the first half of the 1980s. BRAC's methodology shared similarities with Grameen. With Grameen being a worldwide fable, it was not difficult for other institutions in Bangladesh to get regulatory support. BRAC eventually did spin off a banking company in 2001. In the case of Association for Social Advancement (ASA), the metamorphosis was even stark. Though ASA was established in 1978 as an organization of social and political activists, it changed its focus to social and economic upliftment of poor in 1985. By 1991 it was a fully focused organization using microfinance as a singular tool for achieving its objectives (www.asabd.org).

However, with institutions like Grameen Bank, BRAC, ASA pioneering microfinance and providing models for other countries to follow, they did not have a need to transform. They could grow at their own pace without transformation. One reason why they had no regulatory problems was that they were focused exclusively on credit. It was only after they reached a very large size and sophistication that they wanted offer other banking services. It was only recently that Professor Yunus of Grameen Bank raised the issue of the need for an appropriate legislation for

microfinance banks (Yunus, 2003). In Bangladesh we have a dual example of something that started off as an MFO entering other areas of development, and NGOs picking tab from Grameen and launching their own successful microcredit programs. The transformation was two way. Unlike Indonesia, MFOs in Bangladesh also carry the value attributes listed earlier in the paper – dealing predominantly with the poor and having developmental roots.

TRANSFORMATION EXPERIENCES OF INDIA

We have reviewed literature pertaining to experiences in the world to understand the approaches used to get an identity for microfinance. Indian MFOs are also a Diaspora of similar approaches. We examine the types of transformation that have taken place in India and highlight the implications for the growth of the sector. We look at the transformation experiences of the Indian microfinance sector from two viewpoints. First we discuss the responses for the issues raised earlier in the paper. We then discuss the transformation processes of a few Indian MFOs.

CHALLENGES POSED BY ISSUES THAT TRIGGER TRANSFORMATION

SIZE

NGOs have multiple developmental objectives and microfinance meets a sub-set of these. The microfinance activity is visible and has scope for rapid growth. However, the incorporation of an NGO as a not-for-profit entity (trust, public society) is not ideal for lending activities. When the activity is small, it would be possible to work within this framework, but growth means documentation, regulation, follow-up, and money management (Sriram, 2002). To ensure that there is a clear demarcation between the charitable and commercial activities of an organization, it is necessary to keep microfinance as a distinct activity/division. Growth needs infusion of funds for microfinance operations. A not-for-profit entity does not help scaling up borrowings or attract

investments from outsiders. As there is no capital base in an NGO, leveraging is difficult. If microfinance activities form the biggest chunk of the surplus earning activities of an NGO, taxability of its operations is a concern.

Share illustrates the transformation of an NGO to a non-banking finance company because of growth in size and focus on financial services. The specifics of this transformation are discussed later.

DIVERSITY

Although diversity is closely linked to size, it need not necessarily be so. Apart from loans, MFOs would want to offer savings services to customers. This is an essential service. It is also a source to help the loaning services grow. Some MFOs also want to offer insurance and other services. For instance, when SEWA wanted to work with poor women a few decades ago, an important gap that was seen by them was that women did not have savings and products that addressed the needs of social security. For meeting these needs it was necessary to open a bank. In most cases the first step in diversity is offering savings services. Unlike microcredit which is not as closely regulated, savings is very closely regulated and monitored. Not all forms of organizations are permitted to offer savings products. Therefore any foray into savings will trigger an NGO to examine options of transformation.

SUSTAINABILITY

The trigger for sustainability could be from within or outside. For instance donors may be prime movers by granting seed money. However, they may want the activity to be ongoing without further investments. In the case of BASIX in India, the Sir Ratan Tata Trust (SRTT) was willing to extend a returnable grant for BASIX for a year to start pilot operations with an understanding

that the grant would not be renewed or enhanced. BASIX started its operations as an NGO, pilot tested some products and delivery channels, and in the meantime, got the commercial arm incorporated. The operations, which were field-tested, could be carried out in a sustainable manner. There are donors who grant revolving funds for starting microfinance activities. However, if the activities were to continue, a transformation would be necessary.

FOCUS

Some NGOs have an exclusive entity to manage microfinance. NGOs may want to continue other activities and microfinance diffuses the focus. There are two instances of such a spin-off in the Indian context. The first is SEWA Bank set up by SEWA. The bank focused on financial services and provided a diverse range of financial services – savings risk management and credit. As its insurance portfolio grew, the bank recognized that this was a specialized function. It has decided to offer risk products through a new organization, Vimo Sewa.

Another instance is the setting up of the Sanghamithra Rural Financial Services (SRFS) by MYRADA to address the needs of the self-help groups promoted by it. Before SRFS, MYRADA was donning the role of a “promoter” of microfinance, i.e. facilitating credit through promoting and linking groups with banks. When it realized that the linking of the groups with banks was not happening at the planned pace, it decided to assume the role of a “provider”. This involved specialized systems and procedures and a change in the orientation of staff members. Besides, MYRADA also wanted to make SRFS as an example that could commercially provide financial services to the poor. Thus, MYRADA decided to build an arm’s length relationship between the developmental work of promotion and the commercial work of provision of credit related services. It can be seen in this case that one of the sub-processes of transformation is spin-off of new organizations.

TRANSFORMATION OF INSTITUTIONS

The transformation process in India is still at a nascent stage. Microfinance has not grown to the size that warrants a full-scale study on the transformation processes. There are a large number of small initiatives being carried out at various places. The estimated number of microfinance institutions that have requested finances from SIDBI, have contracted rating agencies like M-Cril, Planet Finance and CRISIL for rating, and MACS promoted by Co-operative Development Foundation (CDF) are indicated in Table 1.

Insert Table 1 about here

The figures are only indicative. The number of public societies/trusts is likely to be an underestimate, whereas other forms are more realistic. We discuss the transformation options under each regulatory category.

OPTION 1: IN GOOD COMPANY

If we treat setting up “for-profit companies” to mean transformation, not much has happened on the field. We examine a few examples of transformation from the limited experiences that the Indian microfinance sector has had.

Let us look at instances of MFOs that have registered as NBFCs. Here, there are two approaches: one taken by Share and Cashpor Financial and Technical Services (CFTS), and the other by BASIX.

Share and CFTS are similar in orientation and focus. Both are inspired by Grameen and focus on reaching the poorest. Share operated as a public society for a long time before setting up a NBFC. CFTS started as a NBFC and is still trying to grapple with the norms applicable to NBFCs.

When Share set up an NBFC, it transferred a portion of grants received from C-Gap to the poor customers and encouraged them to re-invest those grants as equity in the new NBFC. This ensured adequate capital for Share to start an NBFC. This was similar to the Bolivian approach. However, important difference is that it was possible for the Bolivian NGO to invest in an FFP (a similar arrangement was with K-Rep, Kenya). In the case of Share, it had to transfer all the clients to a new legal entity, slowly and gradually winding down the operations in the NGO and transferring the clients to the NBFC branch by branch (Sriram, 2001). This posed some problems for Share. First, being governed by the prudential norms, an NBFC is prohibited from accepting savings till it gets an investment grade rating. Even if Share gets the rating, its flexibility of offering savings services to clients will be very restricted. Share found an innovative solution where it also promoted a cooperative (Share India MACS) to collect savings. This cooperative in turn would lend to the NBFC. But this has limitations, as both entities are incorporated under different laws and have different governance structures.

In the case of CFTS, the incorporation itself was a process of transformation. Cashpor is an NGO operating in multiple countries. When CFTS set up its operations in India, it was registered as a company. However, unlike Share it did not have prior operations in India as an NGO. It was, therefore, difficult to raise the start-up capital. Local laws make it difficult for small international investments to come in the form of equity in the financial sector. For a long time, CFTS did not have the adequate domestic capital to be registered as an NBFC. CFTS had to go through the process of raising capital, by finding donor money that could go to the clients and then be re-invested in the company to reach a size that gained economies of scale and recognition. The Activists for Social Alternatives is another organization which follows the Grameen model and is trying to transform itself as a company. It is attempting an innovative route of forming private mutual benefit trusts of clients. The trusts would seek donor grants and in turn hold equity in the NBFC. However, the scheme is yet to take a concrete shape.

The path followed by BASIX was different. BASIX had a design that looked at mainstreaming microfinance right from inception. The structuring of BASIX was complicated. BASIX sought a mix of developmental and commercial funding for its operations and had a separate vehicle through which the operating entity was adequately capitalized. This involved setting up a holding company which had large external borrowings from donor organizations. The holding company was heavily leveraged. As the formalities of getting clearances for setting up a NBFC was going on, BASIX carried on its operations for a year through an existing NGO – Indian Grameen Services. BASIX represents a mix of developmental capital flowing in on the promise of sustainability and commercial capital flowing in from the developmental windows of large financial institutions.

While Share and BASIX have similar institutional investors, the shareholding in BASIX is not as disperse as in Share. The laws have become more stringent since BASIX was established and it is now impossible to replicate that model of financing.

All three institutions have faced barriers in incorporation and operation. The major constraints pertain to regulations as listed below:

- Steep entry norms to register NBFCs. If the promoters have a development background, it is difficult for them to raise commercial capital to start an NBFC. Routing donor money into commercial organizations is not easy, though BASIX did it with a lot of innovative thinking.
- Restrictions placed on the type of activity that can be undertaken by these companies – especially in accepting savings from clients, and on financial services that can be provided.
- Restrictions on accessing finance from outside the country. These restrictions are more in terms of obtaining clearances and permissions, and have eased over time. However matters get complicated if domestically raised capital is insufficient.

OPTION 2: LET US COOPERATE

As debates continue in the microfinance world on issues of mainstreaming, initial capital norms, and incorporation, there is silent revolution in parts of Andhra Pradesh, particularly in the districts of Karimnagar and Warangal. There are nearly 250 small thrift cooperatives with an average membership of around 500 carrying on successfully and offering all the services offered by MFOs for more than a decade. While there are a good number of women's cooperatives, there have been an equally large number of men's cooperatives, all promoted by CDF.

The microfinance world usually does not recognize traditional banking or credit union movement as "microfinance", unless it has adopted some of the symbolisms. Even by that note, these thrift cooperatives qualify to be called MFOs. About a decade ago, CDF was working exclusively with agricultural finance cooperatives. State interference in cooperatives was one of the major problems. The interference culminated in the nation-wide loan pardon scheme of 1989, resulting in the impairment of the portfolio of many a cooperative. At that point CDF thought it was time to spin off the thrift and credit activity out of the cooperative fold and actively started promoting informal mutual benefit groups. Simultaneously, CDF also lobbied for a change in the legislation seeking greater autonomy for cooperatives in the state. This culminated in the Mutually Aided Co-operative Societies (MACS) Act. This act gives ample autonomy for cooperatives, provided they do not seek state funding. After the legislation was passed, the mutual benefit groups promoted by CDF were registered under the new act. Simultaneously other NGOs encouraged their groups to be formally registered as MACS.

The transformation of small groups to cooperatives has been painless. The advantage of a cooperative is that it can access various types of savings from its members besides providing credit like other MFOs. It can also easily get its stakeholders in the governance structure by the use of democratic processes. Besides, cooperatives can grow organically by setting up

federations as and when they have a need to wield clout and negotiate on matters of policy. However, until now, the federations have played a limited role in the context of CDF cooperatives.

One major drawback of cooperatives is the geographic limitation. State and not federal, legislation governs cooperation, and even within that, usually the area of operations of a cooperative is demarcated. Cooperatives also experience problems in accessing mainstream finance, because of their poor image. Nevertheless, they seem to be a good mechanism to get the informal groups into a formal incorporation when the groups reach the limit of size. But it is also important to note that no single cooperative has grown big enough to cross Rs.10 million in outstanding.

The success of the new generation cooperatives is limited to Andhra Pradesh, even though other states have passed a similar legislation. The only exception to this is the SEWA Cooperative Bank based in Ahmedabad. SEWA Bank is being increasingly recognized as one of the oldest MFOs in India – being in existence for over 25 years. While there have been several urban cooperative banks across the country, none is recognized as an MFO. SEWA Bank did not go through the pains of transformation, because the moment its parent SEWA decided that the poor women of Ahmedabad needed a financial service institution of their own, SEWA lost no time in promoting a women's bank independent of the NGO. SEWA proves the point that if the client group and geographical focus exist, there is no need to go through the painful process of starting as an NGO and moving towards mainstream. However, under current norms, an urban cooperative bank can only be set up with a start-up capital of Rs. 5 million (Sinha, 2001). Though this is less than the amount needed for setting up a commercial bank, but it is still a steep amount if it were to be contributed by poor women to run as a self-governed institution.

OPTION 3: BANKING ON INNOVATION

The third alternative is setting up a local area bank (LAB). We have only one instance that can be classified as “microfinance” – the case of BASIX. The setting up of this bank was not a “transformation” but part of the design of the BASIX group. BASIX has started the Krishna Bhima Samruddhi LAB (KBSLAB) in 2001 and is the only instance of how microfinance principles can be adopted by the banking sector. The entry norms for LABs are more stringent than for NBFCs. While NBFCs are expected to bring in a start-up capital of Rs.20 million, LABs are expected to start with an initial capital of Rs.50 million. There are further restrictions on LABs – they can only operate in a geographical area limited to three contiguous districts. Every branch of the LAB has to be opened with the permission and license of the Reserve Bank of India (RBI). This is stifling. While there is tremendous flexibility in launching savings products, it comes with inflexibility in expansion and growth. Recently, RBI has decided not to issue further LAB licenses (Business Line, 2003).

Other possibilities include in RRBs contributing for the promotion of microfinance and setting up cooperative banks. Some RRBs are doing an excellent job of linking SHGs and thereby bringing them to the mainstream banking sector. Harper (2002) has studied the case of a commercial bank being active in microfinance. If commercial banks and RRBs do adopt some microfinance methods, it is possible to replicate the Indonesian experience in India.

The other area where microfinance could happen is in the cooperative banking sector. Cooperative banks in India have lower entry norms compared to mainstream banks and LABs (see Table 2 for details). SEWA Bank is one example of how an NGO promoted a cooperative bank to offer an array of services. However, we do not have many other examples. A possible reason for the banking option not gaining popularity is because of the urban focus. While there are several cooperative societies in rural areas, banking has been restricted to the urban sector.

However, recently there have been a series of bankruptcies in urban cooperative banking and therefore it is likely that there might be regulatory tightening.

Insert Table 2 about here.

TRANSFORMATION OPTIONS AND THEIR IMPLICATIONS

If we consider the view taken by Robinson (2001) on what would be treated as MFOs, we will address the issue head on. She has classified the institutions that are “expected” to operate in the microfinance realm under the following categories:

- Institutions that provide microcredit but are not permitted to mobilize savings from the public (most institutions that are not regulated and publicly supervised)
- Institutions that do well in lending but poorly in mobilizing savings (such as Bangladesh’s Grameen Bank)
- Institutions that do well in savings but poorly in lending (India’s RRB and China’s Rural Credit Cooperatives)
- Institutions that fail in both (most microfinance institutions that provide subsidized credit are permitted to raise public savings, particularly state-owned banks).

Considering this view, microfinance could not only happen by transformation of small NGOs into bigger institutions, but also by the transformation of larger financial institutions embracing the microfinance methodology and microfinance clients.

The options available for transformation within India and their implications are detailed in Table 3. In brief, we do not have an optimal route for transformation of NGOs into mainstream MFOs. NBFCs that could operate across the country will have to go through a steep entry hurdle and

registration process. LABs have a double disadvantage of steep entry norms and limited operational area. This option is also not available with the recent decision of RBI.

With the concerns that most MFOs have for community involvement and with the existing legislation in India, the obvious choice for microfinance initiatives is a cooperative. This involves the clients in governance because of its democratic nature. Even though cooperatives seem to be an obvious alternative, they are not so across the country as only a few states have passed liberal cooperative legislation. Besides, the major disadvantage of cooperatives is its geographic limitations. Further, the cooperative institutions, owing to historical baggage, do not make glamorous MFOs. The credit union movement represents more of an individual banking model in India with formal systems, while microfinance is around groups, social collateral, and social capital. Few cooperatives use the microfinance methodology in providing financial services.

Insert Table 3 about here.

IMPLICATIONS FOR REGULATION

Based on the transformation experiences of NGOs, we discuss the implications for the regulatory framework. The microfinance sector represented by Sa-Dhan has been advocating for easing of entry point capitalization norms for microfinance “companies”.

While this would help a large number of NGOs to hive off their commercial operations and help operations to grow organically, it does not prevent other individuals or institutions masquerading as MFOs. The recent experiences of a series of urban cooperative bank failures in Gujarat and Andhra Pradesh are an indication of what would happen when the easier entry norm is misused. For instance, the easier entry norm for cooperative banks was introduced because these were democratic institutions, member-owned, and member-driven. However, over a period of time, all

these banks started transacting heavily with non-members. The institutions lost the cooperative nature for which the entry norms were eased, but turned out to be in the hands of a handful of “investors”. In proposing regulatory reform, we need to be wary of the potential misuse of the easing of entry hurdles.

There are also have a good number of residuary NBFCs that collect savings from the poor and the unorganized sector. While these are closely regulated, their leeway in providing credit is cramped, as they have to invest a major chunk of the savings in safe government securities. Therefore, MFOs have not considered residuary NBFCs as a viable option. The microfinance sector does not treat residuary NBFCs as MFOs for the obvious reason of “value attributes” discussed earlier.

When entry norms are eased, there may be several other institutions – without the value attributes - claiming to be MFOs, and the microfinance sector will encounter a credibility crisis. In Bolivia, FFPs were seen as an intermediary step for NGOs to enter the mainstream. The entry norms were steep, but they allowed an NGO to invest in a bank or FFP. In this scenario, it is possible for an NGO to convert the donor money received for pump-priming as equity in a new and proper banking entity. In the case of K-Rep in Kenya, the NGO is registered as a company limited by guarantee, and resources are held in a charitable trust that is invested in the bank. In both cases some norms were relaxed, but the new institutions were treated as proper financial institutions.

Graduating from an NGO to an NBFC to a LAB to a commercial bank is impossible in India because the laws do not provide for transformation. It is also not possible because the steps between these stages are steep. A LAB can never hope to go beyond its area of operation. It would be useful if MFOs can argue for a legislation that allows them to graduate to bigger institutions – one on cooperative lines and another on corporate lines.

Another route that the microfinance sector can advocate is to adhere to the current norms of entry and capitalization for NBFCs and LABs but seek permission for NGOs to invest in such for-profit entities without prejudice to the tax status of NGOs. This would mean that only NGOs that can raise enough funds from various sources could actually set up a mainstream-type NBFC. This gives no short cuts for entrants from the non-NGO sector, since if they have to bring in substantial capital, for them, it does not make matters simpler if they can adopt the not-for-profit entity route. After all they will have to find somebody to put in money into the not-for-profit entity in the first place.

Figure 1:
Defining the
microfinance
egg

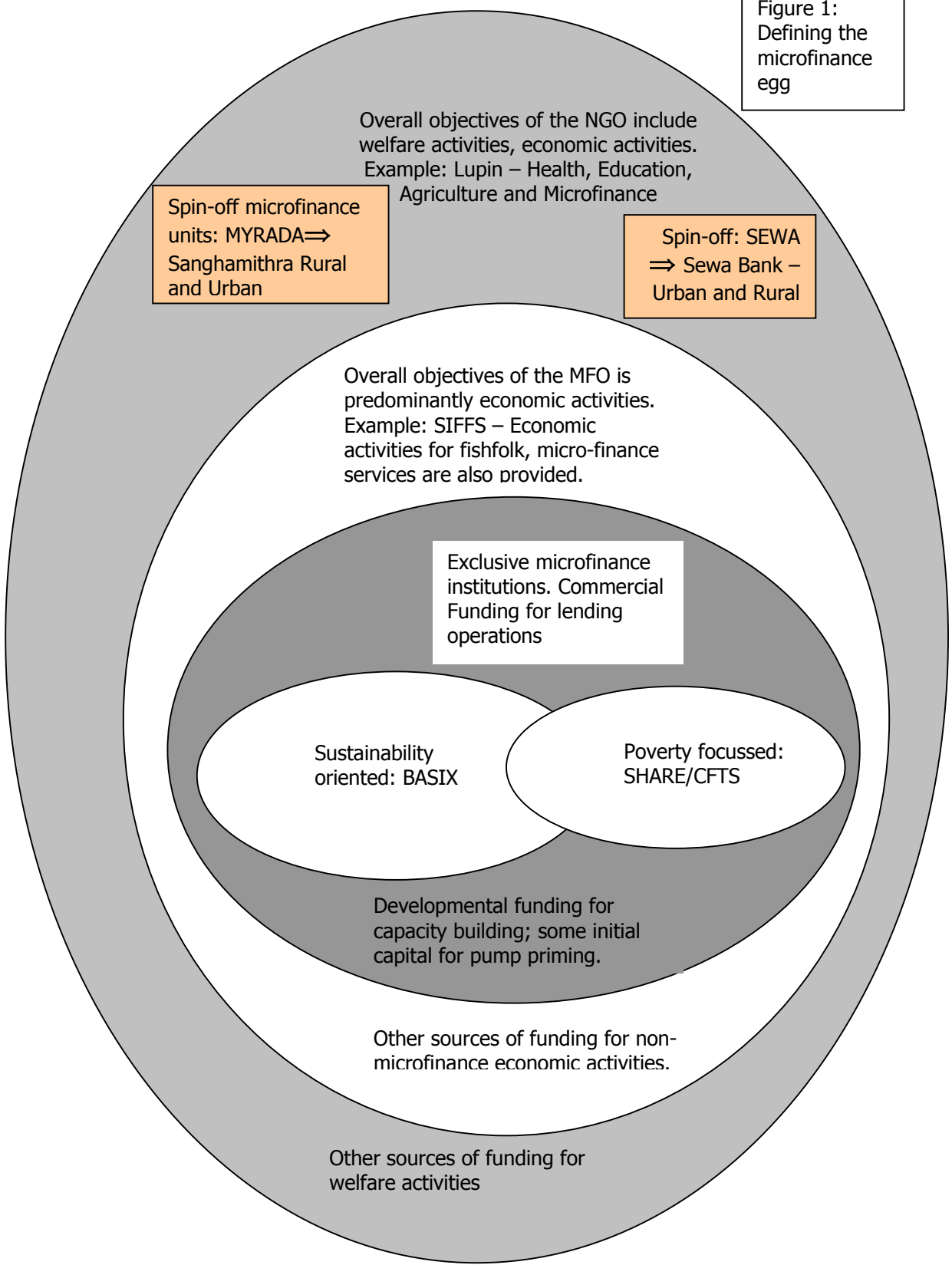


Table 1: Estimated Number of MFI under Different Organizational Forms*

Legal Status	Estimated Number	Important Institutions
Not-for-Profit Company	2	IASC, Sanghamithra
For-Profit Company (NBFC)	6	Samruddhi, SHARE Microfin, CFTS, Sarvodaya Nano Finance, Kosh, Asmitha
Local Area Banks	1	KBS Lab, Andhra Pradesh
Co-operatives: Co-op Society	6	AMCCS, JMSSM, Bhuttico, VYCCU, ICNW, , Pushtikar Samiti,
Co-operative bank	1	SEWA Bank
Mutually Aided Co-operative Society	250	SWDMACTS, Sneha MACS, PWDMACS, APDSFLMACS, Share India MACS and others including mens' and womens' thriftco-ops promoted by CDF – All in Andhra Pradesh
Public Society/Trust#	400	Assist, SKS, RASS, ASA, FWWB, GDS, Outreach, RGVN, SIFFS, WWF, VWS, YCO.
Estimated Number	666	

*Source: SFMC Database, M-Cril Database, C-Gap Rating Fund Database, CDF Annual Report.

#Source: Sinha, Sanjay: The role of Central Banks in Microfinance in Asia and the Pacific. Manila: Asian Development Bank (This is one of the estimates)

Table 2: Entry Point Norms for Urban Co-operative Banks (other than Unit Banks)

Category of Centre	Capital (Rs. million)	Membership (No.)
A – population over 1.5 million	50	3000
B – population over 1 million but not exceeding 1.5 million	25	2500
C – population over 0.5 million but not exceeding 1 million	20	2000
D – population over 0.2 million but not exceeding 0.5 million	10	1500
E – population not exceeding 0.2 million	5	1000
Entry point capital for LAB	Rs. 50 million (area of operation restricted to 3 contiguous districts)	
Entry point for Commercial Bank	Rs.1,000 million (area of operation open across the country)	

\$Source: **Report of the High Power Committee on Urban Cooperative Banks**. RBI Bulletin. 14 January 2002. Mumbai: Reserve Bank of India (for urban co-op banks).

Table 3: Transformation Options and their Implications

Form	Options	Organisational incorporation	Implications
NGO	Option 1: Spin off mF as a separate activity	Not for Profit MFI – a special vehicle only for purposes of demonstration at scale (SRFS)	Cannot grow beyond a point. While sustainability can be demonstrated, the organization will have to be roving – withdraw from one location and move to another, or grow organically, and gradually.
		For-profit Company (NBFC) – Transfer clients, investments and portfolio independently (SHARE, CFTS)	Issue of ownership and control. Initial capital contribution can come from the communities. Recapitalization is complex. Diversification to savings and risk products is not simple under current regulation. Even when permitted, the bouquet of products offered will be limited.
		For-profit co-operative either under the MACS Act or as a Co-op Bank	Can grow organically, but will have geographical limitations to growth. The geographic area of operation is demarcated. However, there is flexibility to offer savings products. Initial capitalization requirement is not daunting.
	Option 2: Promote independent MFOs	Promote (informal) Self-Help Groups, (Pradan, Myrada), encourage them to form federations., (Dhan Foundation)	Can grow organically. However, scaling up and infusion of large amounts of external funds are not simple, as the movement is scattered across several independent informal or legal entities. Embedding in the banking system is a solution, but there are limits to growth. Chances of withering away if the NGO withdraws support.
		Promote (formal) mutually aided co-operatives and encourage them to federate. (CDF)	Problems are similar to SHGs mentioned above. However, since each of these is an independent entity, dealing with banking institutions is likely to be simpler. Chances of withering away are low if systems are established.
Development Professionals with NGO background	Option 1	Promote NBFCs – seek developmental and commercial investments through complex mechanisms – private mutual benefit trusts, debt in holding company (CFTS, BASIX)	Problem in raising initial capital. Other limitations applicable to NBFCs discussed above also apply. It is difficult to pull off a complex structure of mutual benefit trusts and holding company structures.
	Option 2	Promote LABs, find equity for start up.	A difficult proposition for two reasons: steep initial capital requirements and complexity in licensing procedure of RBI and limitation in geographical area to three contiguous districts. Tremendous amount of flexibility in offering diverse products and services and great scope for customization.

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ENDNOTES

¹ Promoters of microfinance are those who help in formation of groups, invest in building the capacities of customers, and link them to a financial institution. Providers are those who involve themselves in direct financial transactions with clients. For a good discussion, see Rutherford (2001).