The Transforming World of Indian Microfinance

Upscaling the provision of microfinance on the strength of its performance, measured primarily in terms of the repayment rates and financial sustainability indicators of a handful of microfinance institutions and without a serious reconsideration of certain vital development issues, may prove in the long-run to be an imprudent development strategy. Any effort at upscaling thus needs to be viewed with caution as it could actually lead to increased failures and credit indiscipline in the field. In the meanwhile, globally there is a visible trend of the commercialisation of microfinance, with NGOs transforming themselves into regulated financial institutions or non-banking financial companies and commercial banks entering the business of microfinance.

TARA S NAIR

I
Introduction

Be it a developmental fad promoted aggressively by neoliberal advocates, or an intervention made necessary by the conditions of material deprivation of millions of people in the not so developed part of the world, microfinance seems to have worked. It has worked in the sense of creating a euphoria that is unparalleled in the recent history of development practice. It has worked because right from international donors and national policy-makers to financial system agents, NGO practitioners and local bureaucrats, everyone is passionately pushing it as the answer to the worries of the 'bottom of the development pyramid'. Even the most conservative development practitioners cannot but take note of the rapid pace of expansion in the outreach of microfinance institutions, mostly functioning outside the formal channels of credit delivery.[1] By end 2003 about 80 million clients across the world were being serviced by approximately 2,900 such institutions (Table 1). India's share in the global (reported) microcredit market in 2003 was 13 per cent of all clients and 16 per cent of the poorest clients, thanks to the SHG linkage programme of the National Bank for Agriculture and Rural Development (NABARD). India, thus, is home to one of the largest microcredit/microfinance programmes in the world.

II
Approches to Microfinance

Two different approaches have been identified in the evolution of the microfinance industry [Christen and Drake 2002]. The Latin American model that may be called the 'commercial model' has recognised from the outset the significance of allying with the formal financial system rather than donors or targeted government programmes. Focus on social and community development, on the poor and marginalised women is conspicuous by its absence in this system. There is an accent instead on enterprise creation and growth. The south Asian model, largely drawing on the strategic and operational features of the Grameen model, has its spotlight clearly on women and poverty.

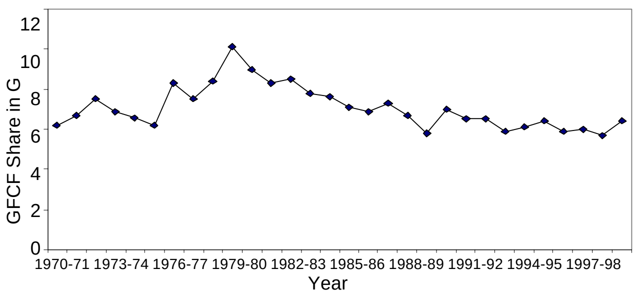
In India, the industry has grown under two different systems of patronage. While the SHG linkage programme anchored by NABARD has the patronage of the state and formal banking institutions, a parallel system promoted by non-statal agencies has been depending almost exclusively on subsidised external grants to finance both social mobilisation and onlending. Both target the poor and women, predominantly. In the absence of any suitable legal and regulatory framework to carry on with the business of financial service provision, most players in the latter category have devised strategies to circumvent the 'governmental gaze' in the most innovative ways. Though there are no comprehensive estimates available on the outreach of the microfinance sector to the poor, available evidence suggests that about 80 per cent of the clients are without any formal savings, and 91 per cent, without formal credit. Nearly 77 per cent of the clients are in the rural sector [EDA 2004].

At the macro level, however, microfinance sector has not been able to make much impact. The cumulative disbursement of bank loans to SHGs stood at Rs 2,049 crore as on March 31, 2003 with an average loan of Rs 28,559 per SHG and Rs 1,766 per family [RBI 2003]. As on March 2002, SHG advances formed only 0.15 per cent of outstanding priority sector loans and 0.51 per cent of the accounts of scheduled commercial banks [RBI 2003]. Even if one considers credit disbursal through other models like the Grameen, the share of microcredit will be well below 1 per cent. Lack of access for MFIs to risk capital and restrictions on them in deposit mobilisation have been cited as the major reasons that prevent the 'upscaling' of operations of this sector [Gibbons 2002]. Both issues are intricately related to the prevailing legal/institutional structure of the country's financial sector.

III
Upscaling of Microcredit: An Alternative View

Interestingly, there does not seem to be much appreciation of the factors that constrain growth on the demand side in the discussions on microcredit/microfinance. These include factors that broadly determine the credit absorption capacity of households and regions. With sector being explicitly biased towards rural areas, other than credit, factors like rural infrastructure,

Figure: Gross Fixed Capital Formation in Agriculture
(At 1993-94 prices)



especially irrigation, are critically important from the perspective of development. Microcredit, as in the case of targeted lending, cannot address these issues by its very mission and scope for its focus is on individuals. Thus, enterprise creation and expansion in the non-farm sector is the preferred lending purpose of most microcredit programmes, especially those following the non-SHG linkage methodology (Table 2). This approach has led in many instances of growing dissonance between local economic endowment and microcredit inputs, finally cracking up group morale and affecting repayment in certain regions within specific programmes.

Given this fact, any effort at upscaling needs to be viewed with caution as it could actually lead to increased failures and disruption of credit discipline in the field. The industry, it is clear, has taken a cautious approach which is evident from the data on the regional spread of microcredit (Table 3). State level data shows significant correlation between share in credit disbursal, priority sector advances, and SHG advances (see Appendix). Thus, it appears that the peculiar spatial spread of the microcredit sector in India is a major explanatory factor for its performance so far. It may be noted that the non-SHG model MFIs too are concentrated in the south of India.

Further, advocates of upscaling believe that an extended base of microcredit would contribute significantly to the diversification of livelihoods in the non-farm sector. There is evidence to suggest that increased access to the formal banking sector and the increased flow of bank credit and savings to rural areas subsequent to bank nationalisation helped the growth of non-farm rather than the farm sector [Burgess and Pande 2003]. However, there is no conclusive evidence to prove that microcredit infusion in rural areas automatically leads to livelihood diversification unless the MFI insists on lending to productive purposes. In the case of the relatively flexible SHG model, as revealed from Table 2, loans are generally invested in supplementary activities in the farm and allied sectors.

There is also the related issue of the productivity of micro ventures. It is not clear whether the non-agricultural activities supported by microcredit are dynamic and growing. The pertinent question is whether microcredit promotes an 'involutionary' pattern of diversification wherein rural households engage in a spectrum of low productivity activities to maintain their incomes, or in a more positive diversification accompanied by high productivity and increased consumption levels.[2] No systematic enquiries have been made so far on the linkages between microcredit supported enterprises and the larger issues of productivity and employment. The author's field research in a fishing village in western India has brought forth another interesting phenomenon. The clients of a credit programme did enhance their asset position – fishing nets in this case – with the help of soft loans. But many of them cut down on the number of fishing days. Thus even when the loan has increased the productivity of fishing activity technically, the average income and consumption levels of many of the households have not gone up to any significant extent. The inability of MFIs to address structural issues including imperfections in the factor and product markets tend to limit their efficacy in delivering services in a sustainable manner [Nair 2001].

Growth of the non-farm sector, which is seen as both an effect and driver of the microfinance revolution does not depend only on the availability of credit. Various studies have time and again argued that there are significant externalities attached to investments in the farm sector that can impact the level and composition of local economic activity and the income and consumption of rural households. Hence, underinvestment in agriculture leads to rural underdevelopment [Ravallion 2002]. This is the reason why Mellor calls for an industrial strategy

Table 1: Global Outreach of Microcredit, 1997-2003

Year	No of Reporting Institutions	Number of Clients Reached (Million)	Poorest Clients Reached (Per Cent)
1997	618	13.5	56.3
1998	925	20.9	58.4
1999	1065	23.6	58.5
2000	1567	30.7	62.9
2002	2572	67.6	61.5
2003	2931	80.9	67.7

Source: Morduch 2004, Daley-Harris 2004.

Table 2: Deployment of Microcredit by Economic Activity and Delivery Model
(In per cent)

Model/Sector	Agriculture	Animal Husbandry	Non-Farm Enterprise
Grameen	16	26	57
Individual banking	19	13	68
SHG	34	48	17

Source: EDA (2004), chapter 5.

Table 3: Formal Sector Microcredit, Regional Spread, 2002
(In per cent)

	Of All Commercial Banks			Total Priority Sector Advances		Advances to SHGs	
	Share in Deposit	Share in Credit	Credit/ Deposit Ratio	No of Accounts	Amount O/S	No of Accounts	Amount O/S
South	23.4	23.9	63.7	42.4	29.9	84.0	76.4
West	24.5	35.2	89.6	11.4	26.1	3.5	7.9
North	23.2	24.6	66.3	12.6	21.7	3.0	4.1
Central	14.0	7.5	33.6	16.1	12.5	5.0	7.2
East	13.3	8.0	37.4	15.7	8.8	4.0	4.1
North-east	1.7	0.7	26.9	1.9	1.0	0.5	0.3

Source: RBI, *Statistical Tables Relating to Banks in India*, 2002-03.

Table 4: Share of Bank Deposits in Gross Financial Savings

Period	Increment to GFS	Increment to BD	Percentage Share of BD in GFS
1970-71 to 1979-80	8139	3905	47.9
1980-81 to 1989-90	36115	8437	23.3
1990-91 to 2000-01	205791	91520	44.4

Notes: GFS: Gross Financial Savings; BD: Bank Deposits.
Source: CSO, *National Accounts Statistics*, Government of India, New Delhi, various years.

'which both conserves capital so that as much as possible is made available for agricultural investment, and taps new sources of savings' [Harriss 1991]. Given these, a thrust on non-farm ventures per se would lead to an unsustainable model of development in the long-run. Unfortunately, the trend in capital formation in the agriculture sector has not been very encouraging in the case of India, especially since the 1980s (see the figure).

It appears, therefore, that upscaling the provision of microfinance on the strength of its performance measured primarily in terms of the repayment rates and financial sustainability indicators of a handful of MFIs, and without a serious reconsideration of certain vital development issues, may prove in the long-run to be an imprudent development strategy.

IV
Macro Trends in Financial Intermediation

The excitement about turning the conventional banking approach to rural and poverty lending on its head needs to be tempered by a realistic assessment of the broad context of financial service provision in the country. It needs to be noted that the role and participation of the state and the formal system of credit delivery in the microfinance sector is more evident in India than elsewhere. Post-nationalisation, the formal banking system, especially the commercial banking system, has made significant contributions towards rural financial intermediation and rural economic growth. The findings of Burgess and Pande (2003) relating to the social banking experience in India are worth mentioning here. Their main finding is that the policy driven branch expansion programme significantly contributed to the reduction of rural poverty during the period between 1961 and 2000, mainly through supporting non-primary activities – trade and services – in the informal sector.

After a period of sluggish response, the commercial banking sector seems to have regained some of its developmental focus in the 1990s as evident from Tables 4 and 5. The share of bank deposits in gross financial savings went up during the decade of the 1990s, though the level in still below what was achieved in the immediate post-nationalisation phase. Notwithstanding the shortfalls in meeting annual plan targets, the credit flow to agriculture has steadily increased in both absolute and relative terms.

However, there are some trends that are worrisome in the agricultural lending scenario as noted by the advisory committee that looked into the flow of credit to agriculture and allied activities. The decline in the share of agricultural credit in total credit from 20.5 per cent to 10.5 per cent between the 1970s and 2001-02 (despite an increase in the ratio of agricultural credit to agricultural GDP from 5.4 per cent to 8.7 per cent) suggests a decline in the capital and credit intensity of the sector [RBI 2004]. Regional disparities in disbursement of credit with the southern states claiming nearly 43 per cent indicates a near perpetuation of the existing inequitable distribution of development benefits across regions. The predominance of large farmers in total credit disbursement is yet another disturbing trend.

Recent data have highlighted another dimension of formal banking inequity. Male borrowers still dominate the small borrowal accounts both in terms of number of accounts and amount outstanding (Table 6). Though this is more a reflection of the institutional constraints that prevent women from accessing vital productive resources, lessons from the microcredit movement the world over underscore the positive effects of actively including women in banking operations.

V
Formal-Informal Convergence: Future Microfinance in India?

As the microfinance industry in the country is coming of age, a substantial degree of organisational diversity and complexity has come to characterise this sector. A couple of trends are worth noticing. For one, the boundaries that demarcate straightforward models, such as the SHG-bank linkage or Grameen, are increasingly blurring as commercial prospects inherent in the underlying financial services business take precedence over the social development/poverty alleviation focus of the initial years. Though the industry has grown in outreach and disbursements, it is still starved of adequate resources to service the estimated gap between demand and supply of funds. In fact, there is a trend visible globally of the 'commercialisation' of microfinance or a "movement of microfinance out of the heavily donor dependent arena of subsidised operations into one in which microfinance institutions manage on a business basis as part of the regulated financial system" [Christen and Drake 2002: 4]. This movement has taken two routes: (i) MF-NGOs becoming regulated financial institutions like non-banking financial intermediaries and banks (through a process of transformation); and (ii) traditional commercial banks in private and public sectors entering the business of microfinance (through downscaling).

In India, transformation and downscaling are relatively new phenomena, the drivers being the MFIs need for capital, both to expand outreach and leverage funds available with commercial banks. In terms of transformation, non-banking financial companies, mutual benefit trusts and cooperative companies are some of the legal formats preferred by the NGO-MFIs. Coming to downscaling, ICICI Bank is the first commercial bank to move into the microcredit market in search of the best risk-adjusted returns [Nair et al 2005]. The share of the bank in total

Table 5: Agencywise Ground Level Credit Flow for Agriculture and Allied Activities

(In Rs crore)

Agency/Year	1997-98	1999-2000	2000-01	2001-02	2002-03
Cooperative banks	14085	18260	20718	23524	23636
	(44.1)	(39.5)	(39.2)	(37.9)	(34.0)
Regional rural banks	2040	3172	4220	4854	6070
	(6.4)	(6.9)	(8.0)	(7.8)	(8.7)
Commercial banks	15831	24733	27807	33587	39774
	(49.5)	(53.5)	(52.6)	(54.1)	(57.2)
Other agencies	–	103(0.2)	82 (0.2)	80 (0.1)	80 (0.1)
Total	31956	46268	52827	62045	69560
	(100)	(100)	(100)	(100)	(100)

Source: RBI (2004).

Table 6: Distribution of Outstanding Credit of Small Borrowal Accounts by Gender, March 2003

Population Group	Male Borrowers		Female Borrowers	
	No of Accounts	Amount Outstanding	No of Accounts	Amount Outstanding
Rural	81.0	83.0	17.4	14.1
Semi-urban	78.1	79.6	18.5	14.7
Urban	78.4	78.5	16.1	14.0
Metrpolitan	83.3	80.6	12.1	13.0
All-India	80.3	80.8	16.6	14.0

Source: RBI (2003).

disbursement by the end of fiscal 2004-05 is estimated to be close to 40 per cent. While the bank resorts to the conventional 'linkage logic' in promoting MFI partnership to build its microcredit portfolio, it has broken new grounds by securitising a part of it. This is seen by many as having ushered a new phase in the Indian microfinance industry as the impending interest-led competition may leave old concerns like capital adequacy look redundant, while NGOs can develop a realistic understanding of leveraging funds from the market. In the absence of many rated microfinance companies who could act as mass retailers of microcredit, commercial banks will have to continue to depend on NGO-MFIs as their sales agents. This is what has led ICICI Bank to promote partnership with NGOs. It may be noted that the micro loans do not appear on the books of such intermediaries as they form part of the bank's assets. At present such innovations are limited to the private sector banks like ICICI Bank, ABN Amro, UTI Bank and HDFC Bank.

The new competition in the microfinance sector may bring forth some interesting changes in the structure of the sector. An imminent possibility is the entry of public sector banks in this competitive scenario. As the banks take initiative in asset building through microcredit, the intermediary layer of MFIs will have to limit themselves to the role of sales agents or commission agents. The government thinking in this matter does not seem to be any different.[3] This may, in turn, lead to standardisation of the multi-model and largely fragmented microfinance industry of today. The convergence between formal and informal systems, the former deriving its strength from adequate financial resources and a robust system of regulation and governance, and the latter from its capacity to streamline the grassroots delivery of services, appears to be the microfinance model that would eventually evolve in the country. EPW

Email: tara01@gmail.com

Appendix

Regions	Advance to SHGs		Total Priority Sector Advances		Of All Scheduled Commercial Banks		
	No of Accounts	Amount O/S	No of Accounts	Amount O/S	Share in Deposit	Share in Credit	CD Ratio
Northern	3.0	4.1	12.6	21.7	23.2	24.6	66.3
Rajasthan	0.2	0.9	2.6	3.3	2.8	2.2	48.9
Punjab	0.4	0.6	0.8	0.5	4.6	3.1	42.3
Haryana	0.0		0.4	0.7	2.1	1.5	43.3
Delhi	0.3		3.6	5.0	10.9	15.5	88.1
Himachal Pradesh	2.0	1.6	4.1	3.9	0.8	0.3	23.0
Jammu and Kashmir	0.0		0.1	0.8	1.1	0.6	35.9
Chandigarh	0.0		0.9	7.7	0.8	1.4	112.3
North-east	0.5	0.3	1.9	1.0	1.7	0.7	26.9
Assam	0.5	0.3	1.1	0.6	1.1	0.5	31.4
Tripura			0.1	0.0	0.2	0.1	22.3
Meghalaya	0.0	0.0	0.1	0.1	0.2	0.1	18.0
Sikkim			0.1	0.0			
Nagaland	0.0	0.0	0.4	0.1	0.1	0	12.5
Manipur	0.0	0.0	0.1	0.0	0.1	0	25.5
Arunachal Pradesh	0.0	0.0	0.0	0.0	0.1	0	15.8
Mizoram	0.0	0.0	0.1	0.1	0	0	25.9
East	4.0	4.1	15.7	8.8	13.3	8	37.4
West Bengal	1.1	1.6	4.9	1.7	7.1	5.2	45.8
Bihar	0.4	0.3	1.1	0.6	2.7	0.9	21.3
Orissa	1.4	1.6	3.9	1.7	1.7	1.1	42.4
Jharkhand	1.2	0.6	5.8	4.7	1.7	0.7	24.9
Andaman and Nicobar			0.0	0.0	0	0	18.7
Central	5.0	7.2	16.1	12.5	14	7.5	33.6
Uttar Pradesh	1.1	2.5	4.2	3.7	9	4.3	29.4
Madhya Pradesh	0.3	0.3	0.8	0.5	3	2.3	46.5
Chhattisgarh	3.7	4.4	10.6	7.8	0.9	0.6	43.9
Uttaranchal	0.1		0.5	0.4	1.1	0.4	23.3
West	3.5	7.9	11.4	26.1	24.5	35.2	89.6
Maharashtra	2.1	6.3	6.9	21.1	17.9	30.7	107.1
Gujarat	1.4	1.6	4.3	4.6	5.8	4.2	45.1
Dadra and Nagar Haveli	0.0	0.0	0.0	0.0	0	0	22.1
Daman and Diu	0.0	0.0	0.2	0.4	0	0	9.9
Goa	0.0	0.0	0.0	0.0	0.7	0.3	24.9
South	84.0	76.4	42.4	29.9	23.4	23.9	63.7
Andhra Pradesh	47.3	40.6	14.0	8.1	5.8	5.7	61.6
Tamil Nadu	31.5	27.7	14.8	10.1	6.8	9.2	84.3
Karnataka	1.9	5.0	7.4	7.3	5.8	5.6	59.8
Kerala	2.4	2.8	6.0	4.2	4.8	3.3	42.8
Pondicherry	0.9	0.3	0.2	0.1	0.2	0.1	31.1
All India	100	100	100	100	100	100	62.3

Notes

[Sincere thanks to Deepa Iyer for her valuable research assistance.]

1 Not many countries have made efforts to incorporate NGO MFIs in their regulatory systems. Uganda, Ghana, South Africa and Ethiopia are among those who have made suitable regulatory provisions [White and Campion 2002].

2 For a detailed discussion on diversification and productivity, see Harriss (1991).

3 "I do not see any compelling arguments for MFIs to become credit institutions and accept deposits. There is enough lendable resources with banks. What is lacking is proper intermediation. You must examine whether intermediation could be your predominant role", P Chidambaram, minister of finance, government of India, in his address of the Conference on Regulatory Framework of MFIs, Delhi, January 20, 2005, *Hindu Business Line*, 'Enough Resources with Banks, No Need for Foreign Equity: Be Intermediaries, Government Tells Microfinance Iinstitutions', January 21, 2005. He also stated that the government does not have a positive view on the need expressed by MFIs for access to foreign equity and changes in tax laws to help them augment their capital base.

References

Burgess, Robin and Rohini Pande (2003): 'Do Rural Banks Matter? Evidence from the Indian Social Banking Experiment', Discussion Paper No DEDPS/40, Suntory Centre, London School of Economics and Political Science, August.

Daley-Harris, Sam (2004): *State of the Microcredit Summit Campaign Report 2004*, World Bank, New York.

EDA (2004): 'The Maturing Indian Microfinance: A Longitudinal Study', mimeo, EDA Rural System.

Gibbons, David S (2002): 'The CFTS Story', mimeo, November.

Harriss, John (1991): 'Agriculture/Non-Agriculture Linkages and the Diversification of Rural Economic Activity: A South Indian Case Study', in Jan Breman and Sudipto Mundle (eds), *Rural Transformation in Asia*, Oxford University Press, Delhi.

Morduch, Jonathan (2004): 'Microfinance: Transactions at the Bottom of the Pyramid', World Bank, November.

Nair, Tara (2001): 'Meeting the Credit Needs of the Micro Enterprise Sector' in Amitabh Kundu and Alakh N Sharma (eds), *Informal Sector in India: Perspectives and Policies,* Institute of Human Development/Institute of Applied Manpower Research, New Delhi.

Nair, Tara, M S Sriram and Viswanath Prasad (2005): 'ICICI Bank, India' in Malcolm Harper and Sukhwinder Arora (eds), *Small Customers, Big Market,* ITDG, Warwickshire.

Ravallion, Martin (2002): 'Externalities in Rural Development: Evidence from China', World Bank Policy Research Working Paper 2879, August.

RBI (2003): *Report on Trend and Progress of Banking in India, 2002-03*, Reserve Bank of India, Mumbai.

– (2004): *Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System*, Reserve Bank of India Mumbai, June.

White, Victoria and Anita Campion (2002): 'Transformation: Journey from NGO to Regulated MFI' in Deborah Drake and Elisabeth Rhyne (eds), *The Commercialisation of Microfinance: Balancing Business and Development,* Kumarian Press, CT.