MicroSave India Focus Note 2

Microfinance – Meeting The Challenges To Realise The Potential

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Globally, over a billion poor people are still without access to formal financial services. Some 200 million of these people live in India. Microfinance, the provision of a wide range of financial services to poor people, has proved a very successful way of providing immensely valuable services to poor people on a sustainable basis. Access to financial services has allowed many families throughout the developing world (and indeed in poorer parts of the developed world) to make significant progress in their own efforts to escape poverty.

The microfinance industry has traditionally seen poor people's needs for financial services simply as "credit for enterprise". Recently has it become clear that poor people need access to lump sums of money to send their children to school, to buy medicines etc. as well, and thus that they need "financial services to reduce their vulnerability" too.

Worldwide the increasing competition among products and institutions is resulting in greater efficiency, as well as a broader range of products, to the benefit of the clients. Advances in technology is already leading to reduced transaction costs, thus overcoming the long-standing barriers to the expansion of services. E-banking offers a huge opportunity to leapt-frog bankers' traditional concerns about "high volumes of low value transactions" and "investing bricks in bricks and mortar", and will increase volumes while driving down marginal costs. New technologies can also improve information about clients, reducing risk and thus costs. These factors have resulted in a growing number of commercial financial institutions initiating efforts to serve the low-income market. This financial systems approach focuses on microfinance - commercial financial intermediation among poor borrowers and savers and places emphasis is on institutional financial self-sufficiency. But sustainability is not the goal. Sustainability is the means to large-scale provision of financial services to low-income people.

So what does all this mean for India? India has the world's most extensive banking infrastructure – indeed it is the envy of the world in this context. Today, there are about 60,000 retail credit outlets of the formal banking sector comprising 12,000 branches of district level cooperative banks, over 14,000 branches of the Regional Rural Banks (RRBs) and over 30,000 rural and semi-urban branches of commercial banks; in addition to 112,000 cooperatives credit societies at the village level. There is at least one retail credit outlet on average for about 5,600 rural people or every 1,100 households. This is clearly a remarkable and extensive network capable of meeting the financial needs of the entire rural population. However, poor credit-deposit ratios (except in the case of the Primary Agriculture Credit Societies), unsustainable lending and high-levels of non-performing assets, often cripple much of this infrastructure. As a result, according to "A Review of Rural Finance Institutions (RFIs)" conducted for the World Bank Rural Financial Access Survey (2004), "Many of these institutions continue to operate as banks despite having unacceptably low, and even negative levels of net worth."

Furthermore, notwithstanding such phenomenal expansion of the outreach of the formal banking structure and pro-poor directed policies and programmes, the All India Debt and Investment Survey, 1992, gave indications that the share of non-institutional agencies (informal sector) in the outstanding cash dues of the rural households was quite high at 36%. And there are strong suggestions that this may well be an under estimate. Recent studies commissioned for the World Bank and others suggest that this pattern has remained largely the same. Informal sources of finance are popular with poor households. The main players in this sector are traders/money lenders, friends and relatives, revolving savings and credit associations and other neighbourhood self-help groups.

Given this challenge and the large number of institutions within the Indian financial sector lead a report for the Asian Development Bank to conclude in 2002 that: "To reduce poverty, India needs, not to increase the number of institutions and programmes providing credit to the poor, but to introduce more effective and more efficient state of the art delivery mechanisms and better financial policies."

According to the Task Force on Revival of Cooperative Credit Institutions (2004), within the rural finance system, the commercial banks provide about 57% of the total institutional credit for agriculture, followed by cooperatives (34%)

and Regional Rural Banks (9%). By the end of the year to March 2006, 2.2 million SHGs had accessed credit through 35,000 branches of 560 commercial and cooperative banks under the SHG-bank linkage programme. NABARD continues to nurture the expansion of the outreach of the programme by providing umbrella support to the stakeholders. Today, the programme is growing at a pace of about 2.5 million households annually. NABARD hopes to provide sustainable microfinance services to at least 20 million poor households (equalling almost 40% of the rural poor in the country) by 2007. However, there are few empirical studies to prove the commercial viability and the comparative product strength of SHGs in banks' credit portfolios. Until rigorous and extensive studies are completed, the jury remains out on the sustainability of both the SHGs and of the SHG bank linkage model for the banks delivering it.

In addition to the SHG-Bank linkage approach spearheaded by NABARD**,** there were other experiments carried out by banks and microfinance institutions (MFIs) – usually using some form of the Grameen Bank model imported from Bangladesh. These alternate routes to serving the poor community through appropriate financial delivery institutions like MFIs also have an institutional space where the banking infrastructure is weak and or unresponsive. There are over 1,000 private MFIs operating in the country, however, not more than 10 of these have an outreach of 100,000 microfinance clients. An overwhelming majority of MFIs have 500 to 1,500 clients. It is estimated that the MFIs' share of the total institution-based microcredit portfolio is about 15%. Despite the opportunities offered by the RBI Circular of January 2006 on Correspondent Banking, NGO-MFIs continue to focus primarily on credit. Growing numbers of NGO-MFIs are transforming into Non Bank Financial Corporations (NBFCs) and others are forging agency agreements with insurance companies to offer this important risk management service too.

Recently, the comparatively higher interest rate charged by the MFIs has again become a contentious issue. The high interest rate collected by the MFIs from their poor clients is still perceived as exploitative in some quarters. It is argued that raising interest rates too high could undermine the social and economic impact on poor clients. Since most MFIs deliver their services to the villages (rather than requiring the clients to come to the bank's branches) and have lower business volumes, their transaction costs are far higher than that of the formal banking channels. All the above said, it is notable that the MFIs still experience significant demand for their products and services and that their growth is constrained by the capacity of their management and staff and the availability of equity funds rather than by market forces. Indeed many SHG members will also join these MFIs' groups to access additional financial services, often conveniently delivered to their doorsteps. So as the international experience (previously discussed) suggests interest rates may not be a significant issue for the borrowers – access is key.

The Indian microfinance sector reflects many of the key successes and remaining challenges common round the globe.

1. A wide range of financial institutions offer a variety of financial services to the poor.
2. The diversity of settings and the different levels of political, social and economic development necessitate this variety of institutional types adapted to the local context.
3. Liberalised interest rates are necessary to allow/encourage banks and MFIs to serve their low-income customers on a sustainable basis because of the high volume of low value transactions involved. But India's prowess in information technology should allow it to lead the world in the development of e-banking solutions for the poor.
4. The unparalleled banking infrastructure in India offers a significant opportunity to accelerate, deepen and improve the quality of access to financial services for the poor, and to develop an inclusive, sustainable financial system.
5. There is a growing recognition that lack of human capacity remains one of the key barriers to developing full-fledged inclusive, sustainable financial system.

With the infrastructure already available in India we have the perfect springboard for creating an inclusive, competitive and vibrant financial system that offers high quality, client-responsive products and services to all sectors of society on a commercial basis. The logic of commercialisation is simple - "banking for the poor cannot be poor banking".