MicroSave India Focus Note 10

Microfinance – Challenges and Response

Professor V.S. Vyas

India has a vast network of financial institutions comprising over 30,000 rural and semi urban branches of commercial banks: over 14,000 branches of Regional Rural Banks; around 12,000 branches of District Cooperative Banks; and nearly 60,000 functioning primary societies (and as many number of non functioning, dormant societies). Consequently, the introduction of a new category of financial institution, such as Microfinance Institutions (MFIs), requires special justification. The rationale for their existence has to be provided and challenges that they face have to be appreciated. This note briefly discusses four major concerns/opinions voiced by different stakeholders: the promoters, the beneficiaries and the general public. These are:

1. Justification for a new breed of financial institution;
2. Cost of providing financial services by MFIs;
3. Nature and types of services they could provide; and
4. Human resource development policies congruent with their role.

1. Justification for a new breed of financial institution: Despite the large number of financial outlets, the population covered by the formal financial institutions is not substantial. Indeed, recent findings suggest that since 1991 there seems to be a decline in their customer base in the economically backward areas, and among the marginalised sections of society. It is estimated that not even 10% of the credit needs of the poor are met by the formal credit system; and 80% of the needs of poor households are still met by the informal market, primarily moneylenders[1]. The reason given by the banks for their poor performance in this respect are: (i) the high transaction costs of dealing with a large number of customers whose requirements are intermittent and for small amounts; and (ii) the substantial risks involved in dealing with such clients without proper knowledge of their credit history.

MFIs have built in, design-based, advantages on both these counts. They are organised specifically to advance small loans according to the requirements of their clients; and they have a closer rapport with their clientele and therefore can assess the risks more realistically. The lack of infrastructure in the backward areas poses another handicap for the urban oriented staff of the commercial banks - as does their union-negotiated salary structure, which drives up their operating costs. MFIs, which are more solidly rooted in the areas of their operations, can face these handicaps with relative ease. India has accepted the multi agency approach to credit delivery; therefore microfinance institutions, are justified as they can fill the gaps in credit delivery by commercial banks. As a corollary, MFIs have already distinguished themselves as purveyors of credit and other financial services to the poor and the needy, even in backward areas.

2. Cost of providing financial services: The need for institutions, such as MFIs, to fill the gaps identified above is now well appreciated. However, there is widespread debate on the rate of interest they charge, which in most cases ranges between 24% and 30% per annum. It is suggested by some of the critics that, in this respect, MFIs are not much different from moneylenders. To a large extent this criticism is unjustified. One has to take into account the nature of services that they provide: catering to specific needs of a large number of their clients; frequent visits to the borrowers; and support for accessing livelihood options etc. Besides, the cost of capital is much higher for them, as they are not authorised to collect deposits, and thus have to take recourse to borrowing from banks at commercial rates of interest. In these circumstances, lowering of the interest rate can only be achieved at the cost of viability of the institutions.

At the same time there is no need to be complacent. Efforts have to be made to bring down the cost of capital. It is important to fulfil the requirements that would enable them to accept deposits from their members. MFIs that already have deposit-taking status (typically through Correspondent Banking arrangement) should strive to encourage savings among their clients. There are possibilities of accessing cheaper funds from domestic and, also, foreign sources. It is ironic that for all the pressure on MFIs to reduce their interest rates, they still remain prohibited from borrowing the plentiful low-cost funds from abroad, which are available at 3-4%, in contrast to the 12-13% currently being charged by the local banks financing the MFIs.

The possibility of cross subsidisation on the basis of the nature, amount and purpose of loans should also be carefully considered. Many MFIs are already effectively cross-subsidising their smaller loans to poorer clients through making larger (more profitable) ones to their more established and entrepreneurial customers.

[1] **World Bank,** "Microfinance in India: Issues, Constraints, and Potential for Sustainable Growth" World Bank, 2001

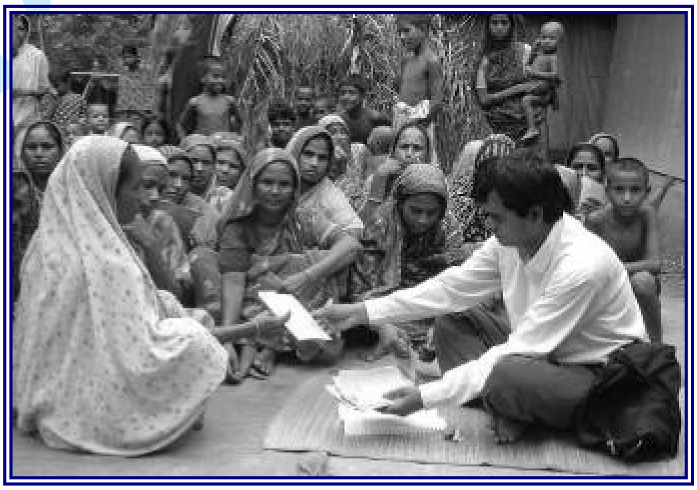
Finally, and perhaps most importantly, the scope for minimising transactions' cost should be constantly examined and re-examined as part of MFIs' on-going management routines. Technological as well as organisational options are available to reduce transaction costs. Imaginative use of IT can bring down administrative costs[2]. Internet-enabled access points are increasing in number which can be used for improving the quality of services and contributing to cost reduction. Strong linkages with grass root organisations, including Panchayati Raj institutions, could be developed for disbursing loans, monitoring transactions and repayment of loans. Working through SHGs and Joint Liability Groups not only reduces transaction costs, it also minimises risks. And of course, careful process analysis allows MFIs to optimise the trade-off between efficiency of operations and risk management[3].

3. Nature and types of services: One of the reasons for the higher administrative costs, and thus higher interest rates charged by MFIs, is the variety of services they provide. Quite a few of them, following 'credit plus' approach, are involved in promoting thrift, introducing microinsurance, (particularly life, and in some few cases health insurance) and facilitating remittances. All this adds to the cost of their services. Similarly, MFIs that want to move from microfinance to 'livelihood finance', apart from enhancing the scale of finance, also enlarge the scope of their services, and therefore costs they have to incur. The services they provide are essential for social security and economic viability of their customers.

In this context MFIs need to focus on two issues. In the first place, MFI leaders have to ask themselves whether they have the comparative advantage in providing a particular service to their clients, or are there other, better, alternatives available. Also, MFIs should carefully evaluate the mode in which they provide the services, (i.e. as sole provider, as partner, or a franchisee), in order to minimise the cost of delivery of the services. Secondly, there should be effective and real demand for a particular service by the clientele. If not, then first the demand has to be created. However, of course, unnecessary services should not be provided simply to increase the turnover or profit margin of MFI.

4. Human resource development: The most challenging task in Indian microfinance today is to get the right personnel. Usually two streams of professional have entered this field; those with NGO-background, and those with banking background. The MFI of the type discussed above needs personnel who have people-friendly approach of NGO workers with capacity to mobilise and motivate people. At the same time, to build a robust, effective microfinance sector in India, professionals who understand the banking business will also be required. It is difficult to find individuals with proficiency in both the areas. There is a need, therefore, for extensive capacity development and systematic training with the appropriate orientation – to strengthen both the people and the technical skills of staff working in MFIs.

Areas in which capacity building is urgently needed include: managing capital resources and interest rates; delivery management; risk mitigation; market research and product development etc. With the rapid changes taking place in India's economy, this training has to be an on-going, recurring exercise. In addition to upgrading the skills of their personnel, MFIs also have to inculcate tolerant and helpful attitudes towards their clients, ensure



transparency in their dealings and, guarantee adherence to commonly agreed code of conduct[4].

Conclusion: The current emphasis on inclusive banking, coupled with high overheads and urban orientation of the commercial banking system, provides excellent opportunity for the growth of MFIs to serve the poor and the marginalised sections … but also throws up equally daunting challenges.

Professor V.S. Vyas is Professor Emeritus, IDS Jaipur. This *MicroSave* India Focus Note was developed on the basis of the Inaugural Keynote Speech made at the first *MicroSave*/ISMW "Applied Microfinance Institute", held in Jaipur June 2007.

[2] See *MicroSave*'s India Focus Note # 4: "E-Banking: The Next Revolution in Financial Access?" and Briefing Notes # 31 "Electronic Banking for the Poor" and # 43 "What CEOs Need To Know About Software Selection"
[3] See *MicroSave*'s Briefing Note # 29 "Process Mapping for Risk Management and Process Improvement" and Briefing Note # 41 "Process Mapping in Practice".
[4] See Sa-Dhan's "Code of Conduct" and *MicroSave*'s Briefing Note # 28 "Customer Service – Why It Is Important For MFIs".