MicroSave India Focus Note 19

SHGs Should Balance or Break

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In the words of NABARD, "*internal savings mobilised by its members is the core of the SHG*[1]". Banks size their loans to SHGs as a multiple of the savings accumulated. Strangely though, it is not routine for banks to verify SHG balance sheets before lending. Few SHGs try to balance their books, and even fewer have provisions for audits.

Auditing SHG balance sheets is vital for detecting errors, sloppy disclosure practices and fraud. It is the only way a bank can assure itself of a SHG's capacity to repay in future. It is the only way members can assure themselves that their savings are really all present and accounted for.

In the SHG-bank linkage model, the size of bank loans is determined by the size of the SHG corpus, more than by any other single factor. As a result, SHGs face very strong systemic incentives to neglect errors that overstate their collective savings or understate losses.

The bank linkage programme has achieved rapid growth, with over 4 million groups "credit-linked". But the lack of balancing or audit risks undercutting the evolving trust between rural poor people and banks. If there is inadequate money to pay all claims, should it be the lender or the SHG member whose obligations take seniority? Banks should not lend to SHGs if member savings may be at risk as a result.

Savings Require a Balanced Foundation

Even though SHG members join groups primarily to access credit, they also believe that SHGs are useful for saving. In the past decade many microfinance studies have shown that poor people save at home in large amounts. This helps them achieve many critical goals. Savings drive health and education planning, large asset acquisitions like improved housing, transport or farm equipment, and preparation for expected or unexpected income gaps, among other goals.[2]

Because SHG members have no way to confirm whether their savings are all accounted for, they cannot use SHG savings as a reliable foundation for accomplishing these goals. And it is equally impossible to build sustainable SHG federations on such an unstable foundation.

Vertigo Leads to Breaking

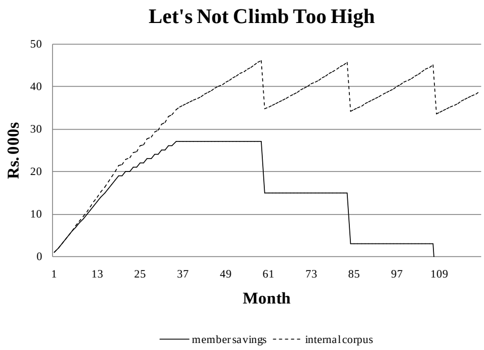
Decades of microfinance experience have shown that sooner or later, subsidised funds attract elite capture. The larger the fund, and the longer its life, the more robust the defences required to protect it. Bank linkage loans are very cheap compared to other options of villagers, so it's natural that powerful villagers seek to corner the benefits. "*They get this money for nominal interest rates like 7% which they put in chit funds where they get returns of 30% or more. This is a big fraud on the system* [3]".

In the first years SHGs build their internal savings to access bank loans. But gradually, devious people find the gaps in the control system. Transactions may increasingly take place outside meetings, or the group's only record-keeper may leave. The longer gaps beckon and money piles up, and the clearer it becomes that no one is in control, the larger and more frequent the abuses can be expected to become.

Accumulating saving and credit associations (ASCAs) in India have succeeded by staying short term. After 6-12 months of saving and lending they "break" by distributing all savings and profits to their members. While limiting options for long term savings, this provides an "action audit" and limits the risk of elite interest while neatly side-stepping the complexities of creating control systems for larger funds.[4] By breaking, ASCAs protect members' rights to:

- receive all individual savings plus profits in cash, to use as desired without conditions,
- leave the group without conditions, and
- elect new leadership and accept new members.

Some SHG support institutions (SHPIs), such as BWDA and Chaitanya, require their groups to formally break. This responds to a felt need among members themselves. To avoid becoming targets for elite capture and other forms of misappropriation, members have for years engaged in incremental cash-outs (as depicted in the graph). Member drop-outs are also high, in spite of the fact that drop-outs usually lose any claim to retained earnings inside the group.[5]



In practice SHGs limit the size of their corpus by withdrawing savings from the bank and distributing it. When their internal fund is large enough to lever the loans they want, they skip savings contributions or stop them altogether. Within a few years the savings exposure of

[1] NABARD, *SHGs-Banks Linkage Project*. NABARD Regional Office, Bhopal, 1998, p. 5.
[2] **Wright**, Graham A.N., "The Relative Risks of the Savings of Poor People", *MicroSave, Kampala*, 2000.
[3] **Somanath,** VS of Nano Ventures, cited in "Microfinance Cos Sniff Big Biz", TNN, 17 February 2009.
[4] **Rutherford**, Stuart, "The Poor and Their Money", Oxford University Press, *Delhi*, 2000.
[5] **Srinivasan**, N. "State of the Sector Report 2008", p. 23. Sage Publications, *Delhi*, 2009.

members (as distinct from internally generated profits) can start to drop, and may eventually disappear altogether.

The 2008 *State of the Sector Report* has confirmed that rising delinquency is a trend across Indian SHGs.[6] By keeping savings amounts small, based on a belief that saving at home is probably safer, SHG members protect themselves from loss. Once members limit their savings commitments, attention paid to the group corpus and member solidarity drops, and the potential for delinquency rises steadily.

Why SHGs Do Not Balance

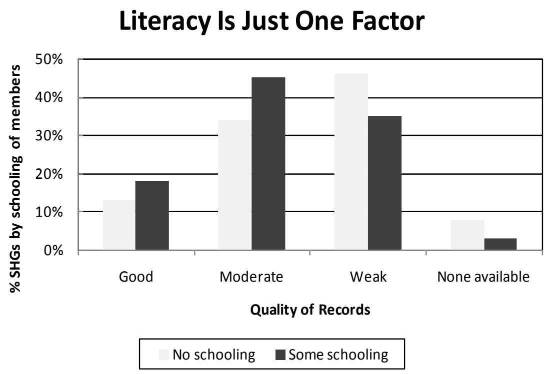
Compared to other record-keeping tasks of SHGs, preparing a balance sheet is a relatively infrequent event, and more challenging as well as abstract. Once an SHG has been operating for years without balancing, replacing old books with new ones on a running account basis, even an SHPI may shrink from the effort involved in balancing.

In addition, most SHPIs view external financing as the main source of funds for SHGs, rather than compounding of savings over time. They have neglected protection of the SHG asset foundation. They risk killing the goose that is laying the golden eggs.

Can SHGs Balance?

Outside stakeholders often believe SHG members are not interested in or capable of preparing or understanding a balance sheet. Most SHG members, like most other people, do not enjoy basic book-keeping. But SHGs do not have to balance. MFIs/banks and SHG federations can do it for them and also charge them for the service.

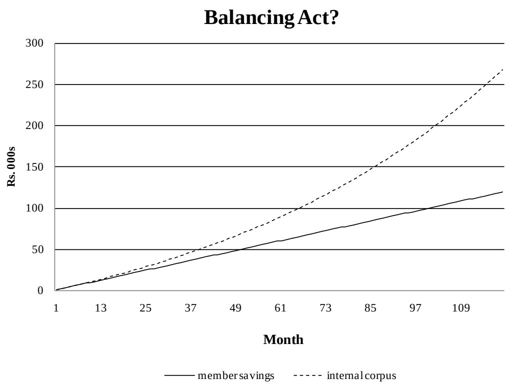
Doubtless most SHGs will find balancing a daunting, even pointless exercise. But, studies of SHG quality by APMAS have shown that 15% of groups, or about 600,000 SHGs, have good records. Furthermore, the difference in record quality between literate and illiterate groups is not as great as sometimes believed (see chart).[7]



Which SHGs Should Balance, and Which Should Break?

If SHGs that have formed mainly to access bank loans break every few years, they can retain the confidence of lenders – and reduce their monitoring costs - without balancing.

SHGs committed to saving are fewer. But identifying them and investing in their capabilities has key developmental benefits. A firmer foundation can be built, able to support greater local capital formation through compounding of retained earnings over time. This can help members achieve their savings goals, while fuelling village development through reinvestment of retained earnings (see graph).



In a recent paper[8] CGAP suggested that banks are charging SHGs rates that would be unsustainable without subsidies. Regular breaking can be expected to reduce monitoring costs and delinquencies. Regular balancing will increase monitoring costs *and* the capacity of SHGs to borrow, repay, and purchase other financial services.

Management Tools

Unless they balance annually, SHGs should break every 2-3 years by providing an unconditional cash-out opportunity (or Rutherford's "action audit") to all members.

Unless a current audit is available from a trusted source, lenders should do the following before lending to SHGs:

- require it to break a minimum of once in 3 years;
- prepare a field balance sheet;
- verify loan amounts by random sampling of members' passbooks and testimony in private, in their homes;
- total all savings contributions based on the number of members and the number of expected contributions;
- add reasonable expected profit based on rates charged on loans and compare the total to the actual corpus; and
- make sure all old cash ledger books have been tallied and signed off by a trusted source.

SHGs that want to protect savings enough to limit their consumption of credit should be taught how to balance:

- The steps involved in balancing can be analysed by SHPIs through process mapping.
- SHPI facilitators should identify through groups of non-literate SHG members ways of tracking balances.
- Focus groups of non-literate members can also identify ways to transparently present balance sheet results.
- A cadre of private-sector *munshis* can be developed to check balance sheets periodically.
- The most effective auditor may be a local school-teacher or an SHG leader from another village.

[6] Srinivasan, N., p. 26.
[7] EDA Rural Systems and APMAS, "Self Help Groups in India: A Study of Lights and Shades", *Delhi*, 2006, p. 106.
[8] **Isern**, Elizabeth, Robert Peck Christen et. al., "Sustainability of Self-Help Groups in India: Two Analyses", CGAP Occasional Paper #12.