Micro-finance and Its role in India
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ABSTRACT

The paper looks at the growth and transformation of microfinance institution in India with different features in providing services. The structure of microfinance institutions has been discussed and in order to penetrate into the poverty and downtrodden segment for their alleviation. The growth with transformation of MFIs studied by SHG-bank linkage programmes. Though there was dependence on the financial institutions, the progress of MFIs was significant. However, it has been found that there is absence of regulatory control in India and interference of political sensitivity in the MFOs. Moreover, it was found that governance within the MFIs was weak. Having examined various options, we conclude that there is no ideal or easy path for MFIs to mainstream in India. This has implications for regulatory framework. There should be regulatory changes that allow smaller MFOs to get into more complex forms as they grow organically. The suggestion has been given that, NGO-MFIs should be allowed to invest in the equity and debt as these are larger enough to maintain adequate leverage ratio and able to raise capital as NBFCs.

Key words : MFIs ,leverage ratio, NBFCs , governance, regulatory control.

Introduction:

In India, despite the economic growth at national level at 9.4% in 2006-07 it has declined to around 6% in 2008-09, poverty remains a serious problem for policy makers because the growth is mainly driven by growth in a few sectors in urban areas, such as industry and service sectors. Incidence of poverty in India is estimated by the quintessential large sample surveys on household consumer expenditure and according to the Uniform Recall

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1 Govt of India, Fact sheet, 2009
2 The average annual output growth rates in industry and services sectors in the period 1994-2004 and 5.6% and 8.2% respectively, while that in agricultural sector is 2.0% (based on World Bank Data in 2005 taken from http://devdata.worldbank.org/AAG/ind_aag.pdf). The poverty head count ratio has been much higher in rural areas than in urban areas (e.g. Deaton and Kozel 2005 and Sen and Himanshu 2004).
Period(URP) consumption distribution data in 2004-05, rural areas yields a poverty ratio of 28.3 per cent, 25.7 per cent in urban areas and 27.5 per cent for the country as a whole (Government of India, 2009). Although the proportion of persons below the poverty line has declined from around 36 percent of the population in 1993-94 to 28 per cent in 2004-05, the poverty reduction still remains the country’s major challenge in the 21st century.

Until the early 1990s, the financial services were provided through a variety of state sponsored institutions, which resulted in impressive achievements in expanding access to credit, particularly among the rural poor (Arun and Mosley, 2003). Although many of these commercial bank branches in rural areas were unprofitable, they did play a positive role in financial savings and reducing poverty which is evident in the fact during the period 1951-1991 the share of total financial institutions in rural household debt has increased from 8.8 percent to 53.3 percent and the role of money lenders has declined significantly during this period (Arun and Mosley, 2003; Basu and Srivastava, 2005). However, despite the vast network of banking and cooperative finance institutions and strong micro components in various programmes, the performance of formal financial sector is still far behind in reaching out to reflect and respond the requirements of the poor.

The term micro finance refers to small-scale financial service both credit and savings—that are extended to the poor in rural, semi-urban and urban areas. The poor need microfinance to undertake economic activity, smoothen consumption, mitigate vulnerability to income shocks (in times of illness and natural disasters), increase savings and support self-empowerment. Micro credit is the most common product offering. Micro-finance in India is synonymous with micro credit; because savings, thrift and micro-insurance constitute a miniscule segment of the micro finance space. In India, most micro finance loans are in the range of Rs.5,000 to Rs.20,000 (the Development and Regulation Bill, 2007, defines micro finance loans as loans with amounts not exceeding Rs.50,000 in aggregate per individual/ small enterprise). CRISIL estimates that around 120 million households in India continue to face

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3 This bill, which envisages the regulation of the microfinance sector is under the parliament consideration.
financial exclusion. This translates into a credit demand of around Rs.1.2 trillion\(^4\). MFIs are the main players in the microfinance space in India, their primary product is micro credit. Other players that extend micro finance services, in addition to their core business, include banks and insurance companies, agricultural and diary co-operatives, corporate organizations such as fertilizer companies and handloom houses and the postal network. Additionally there are specialized lenders, called apex MFIs that provide both loans and capacity building support to MFIs\(^5\).

**The differentiating factors of MFIs.**

MFIs differ from one another in terms of:

1. Lending model
2. Loan repayment structure
3. Mode of interest rate calculation
4. Product Offerings
5. Legal structure

In terms of lending model, MFIs may be classified as lenders to groups or as lenders to individuals. In India, MFIs usually adopt the group-based lending models, which are of two types—the Self-Help Group (SHG) model and the Joint-Liability Group (JLG) / solidarity group model. Under the SHG model, an MFI lends to a group of 10 to 20 women. Under the SHG-bank linkage model, an NGO promotes a group and gets banks to extend loans to the group. Under the JLG model, loans are extended to and recovered from, each member of the group ( unlike under the SHG model, where the loans is extended to the group as a whole). The most popular JLG models are the Grameen Bank model (developed by Grameen Bank, Bangladesh) and the ASA model (developed by ASA, a leading Bangladesh –based NGO-MFI). Most of the large MFIs in India follow a hybrid of the group models.

The model of lending to individuals is similar to the retail loan financing model of banks. In India, MFIs adopting the group –lending models extend individual loans to more

\(^4\). The number of households facing exclusion has been arrived at by adding rural households facing financial exclusion (93 million) and urban below poverty line (BPL) households (18 million). The average credit demand per household has been estimated at Rs. 10,000 per annum.

\(^5\). National Bank for Agriculture and Rural Development, Small Industries Development Bank of India, Rastriya Mahila Kosha and Friends of Women’s World Banking are the apex MFIs in India.
successful borrowers who have completed a few loans cycles as part of a group (who have relatively large credit requirements and good repayment bank record). Corporates and co-operatives typically diary firms and sugar mills are also known to undertake microfinance by extending credit to farmers, this helps the companies strengthen their procurement and distribution networks.

MFIs are also differentiated on the basis of their loan repayment structures. Most MFIs following the JLG model adopt the weekly and fortnightly repayment structure. Those under the SHG model have a monthly repayment structure. MFIs lending to traders in market places also offer daily repayment, while MFIs extending agricultural loans have bullet and cash-flow based repayment structures depending on the crop patterns. MFIs following the JLG model charge flat interest rates of 12 to 18% on their loans, while MFIs following the SHG model charge 18 to 24% interest per annum based on the reducing balancing method. In addition to interest rates, some MFIs also charge a processing fee comprising a certain proportion of the loan amount sanctioned at the time of disbursement.

Most MFIs in India are solely engaged in extending micro credit, a few also extend saving, thrift, insurance, pension and remittance facilities. For providing insurance facilities, MFIs have tied up with insurance companies and mutual networks (funds created by community-owned organizations), some MFIs also do underwriting on their own.

MFIs offer savings services in two ways—the savings are either collected by the MFIs on the SHG. In the later method, the MFIs or NGOs encourage the SHG to collect savings/thrift from each member of the group on a weekly/monthly basis and rotate the savings/thrift among members. An MFI collecting savings from borrowers may either make it compulsory for borrowers/members to have savings with it, or offer voluntary savings services to both members/non-members. Only MFIs registered as cooperatives or depositing NBFCs can collect savings/deposits, a few MFIs registered as societies and trusts continue to accept saving/deposits, and thus face regulatory risks (for more details, refer section on absence of regulatory control)

By taking into account legal structures, MFIs may be classified as follows:-
Not for profit MFIs:

- Societies (e.g such as Bandhan, Rashtria Seva Samithi and Gram Utthan.)
- Public trusts (such as Shri Khetra Dharmasthala Rural Development Project, and community development centre.)
- Non-profit companies (such as Indian Association for savings and credit, and cash per micro credit)

Mutual benefit MFIs

- Co-operatives registered under state or National Acts (such as Pustikar Lagh Vyaparik Pratisthan Bachat and sakh Sahkari Samiti Limited)
- Mutually-aided Co-operative societies (MACS, such as Sewa Mutually Aided Co-operative Thrift Societies Federation Ltd.)

For-Profit MFIs

- Non-banking financial Companies (NBFCs, such as Bharatiya Samruddhi Finance Ltd, Share Microfin Ltd, SKS Microfinance Ltd and Spandan Sphoorthy Finance Ltd.)
- Producer Companies (such as Sri Vijaya Visakha Milk Producers Co. Ltd.)
- Local area banks (the only such MFI is Krishna Bhima Samruddhi Local Area Bank.)

Growth of MFIs in India.

The microfinance market in India is expected to grow rapidly, supported by the Govt. of India’s initiatives to achieve greater financial inclusion, and growth in the country’s retail sector. MFIs have a grass root level reach and understanding of the economic needs of the poor. The growing retail market in India provides opportunities for MFIs to act as intermediaries in the retail supply chain. The banking sector will also help the microfinance sector grow. Banks are expected to use MFIs to meet their financial inclusion targets by allowing MFIs to open bank accounts, and distribute financial services and other structured products.

The microfinance sector has passed its revolutionary phase, when the profit oriented working model of MFIs was perceived by the market as exceptionable. Also investors now have wider choice of MFIs with scalable process. NGO-MFIs have been acquiring dormant NBFC for
regulatory financial and operational reasons. Many large players are now focused on urban microfinance and have begun extending loans to individuals.

The Microfinance sector in India is estimated to have outstanding total loans of Rs.160 to Rs.175 billion and Rs.110 to Rs.120 billion respectively, as on March, 31, 2001. The Microfinance sector in India is fragmented—there are more than 3000 MFIs, NGOs and NGO-MFIs, of which about 400 have active lending programmes. The top MFIs are estimated to account for around 74% of the total loans outstanding for MFIs, around 17 MFIs had outstanding loans of more than Rs.1 billion as on March, 31, 2009 with the top three MFIs crossing Rs.10 billion in terms of outstanding loan portfolios on that date. The outstanding loans of MFIs have increased to Rs114 billion as on March, 31, 2009 from Rs.60 billion a year ago. The growth in disbursements by MFIs was more than that of the SHG-bank linkage programme during 2007-08. MFIs disbursements have increased aggressively at a compound annual growth rate (CAGR) of 90%, over the past four years. CRISIL estimates the overall disbursements during 2008-09 to be around Rs.287 billion of which disbursements of Rs.185 billion were made by MFIs (Refer Table-2). This is resultant ability to attract capital and resources during the past two years.

A majority of MFIs, including the larger players, operated mainly in South India till 2005-06. Since, 2006-07, however the large MFIs have extended their presence to states such as Maharashtra, Chandigarh, Orissa, Jharkhand and West Bengal. Over the past two years, the growth of the microfinance sector in eastern India was driven primarily by capacity enhancement initiatives by the apex MFIs, and tapping of growth opportunities in the eastern market by South India based MFIs and banks. Many of the large MFIs, nevertheless continue to have a significant exposure to South India.

Table-1: Growth Trend of loans outstanding and borrowers

<table>
<thead>
<tr>
<th>Year</th>
<th>Loans Outstanding (Rs.in billion)</th>
<th>Borrowers (No. in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 2006</td>
<td>16</td>
<td>3</td>
</tr>
<tr>
<td>March 2007</td>
<td>32</td>
<td>5</td>
</tr>
</tbody>
</table>
Table-2: Trend in disbursements (Rs. In billion)

<table>
<thead>
<tr>
<th>Year</th>
<th>MFIs</th>
<th>SHG-Bank linkage</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004-05</td>
<td>15</td>
<td>30</td>
<td>45</td>
</tr>
<tr>
<td>2005-06</td>
<td>27</td>
<td>45</td>
<td>72</td>
</tr>
<tr>
<td>2006-07</td>
<td>44</td>
<td>66</td>
<td>110</td>
</tr>
<tr>
<td>2007-08</td>
<td>95</td>
<td>88</td>
<td>183</td>
</tr>
<tr>
<td>2008-09</td>
<td>185</td>
<td>102</td>
<td>287</td>
</tr>
</tbody>
</table>

Source: Industry, NABARD.

Improving earning profile:-

Improvement in lending rates, in branch and employee productivity, and increasing efficiencies on account of growth in loan portfolios have helped MFIs of II categories enhance their operating self-sufficiency (OSS) ratios. CRISIL believes that MFIs OSS ratios will increase over the medium term; this is because MFIs (particularly the large ones) have increased their lending rates, with several players also charging upfront processing fees.

Heavy dependence on banks and financial institutions (FIs):-

MFIs are dependent on borrowings from banks and FIs, and do not raise debt from the capital market. Thus, large NBFC-MFIs face higher cost of borrowing than most large retail finance NBFCs in the country. Banks categorize their lending to MFIs as priority sector advance, which has helped MFIs raise timely resources. However, for many MFIs funding sources are restricted to private banks and apex MFIs. The public sector banks have not been aggressive lenders to MFIs. The large and Mid-sized MFIs and NBFC-MFIs primarily borrow from private and foreign banks, while the smaller MFIs borrow mainly from private banks and apex lenders.

The lending model plays a key role in determining a MFIs borrowing profile. Public sector banks (PSBs) with their wide spread branch networks; prefer lending directly through the

6 Defined as ratio of total income to total expense. It does not include revenue grants received and expenses out of revenue grants.
SHG-bank linkage route. Moreover, PSBs prefer to lend to those MFIs that have adopted the SHG model. PSBs accounted for 36 percent of total borrowings of societies and trusts (refer table—Borrowing profile) as against only 10 percent of MFI following the JLG model, as on March’2008. Thus NGO-MFIs (societies and trust) have better access to funds from PSBs than MFIs that are companies. However, this scenario of PSBs lending predominantly to SHG model based MFIs seems poised for change, with the large NBFCs continuing to aggressively target PSBs to meet their credit demands.

**Table-3 : Borrowing Profile (Based on lending model)**

<table>
<thead>
<tr>
<th></th>
<th>SHG</th>
<th>JLG</th>
<th>Diversified</th>
</tr>
</thead>
<tbody>
<tr>
<td>PSB</td>
<td>36%</td>
<td>10%</td>
<td>8%</td>
</tr>
<tr>
<td>Pvt. Banks</td>
<td>30%</td>
<td>35%</td>
<td>34%</td>
</tr>
<tr>
<td>Foreign Banks</td>
<td>10%</td>
<td>30%</td>
<td>28%</td>
</tr>
<tr>
<td>Apex MFIs</td>
<td>20%</td>
<td>19%</td>
<td>20%</td>
</tr>
<tr>
<td>Others</td>
<td>4%</td>
<td>6%</td>
<td>10%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Industry, NABARD.

**Absence of regulatory control:**

Microfinance activities are undertaken by organizations that are registered under sectoral legal forms. However, currently, only NBFCs are under the regulatory and supervisory purview—the NBFCs are regulated by RBI. The absence of prudential norms and accounting guidelines for non-NBFC MFI leads to lack of uniformity in accounting practices and highly-leveraged balance sheets among MFIs. The financial statements of the microfinance programmes of most non-NBFC MFIs do not provide the true financial picture. There was a proposal by Government of India to bring in legislation in 2006 to regulate the entire microfinance sector in India, the regulation, however, is yet to be materialized.

Savings is an important component of microfinance. Currently however, savings and deposit services can be offered only by banks and cooperatives. NBFCs can raise deposits only after obtaining a license from RBI and meeting norms (such as having an investment grade credit rating). Trusts and societies (un incorporated bodies) cannot accept savings / deposits as per Section 455 of RBI Act, 1934.
A few NGO-MFIs and non-NGO-MFIs continue to offer in-house insurance facilities by underwriting on their own, although this is a clear violation of insurance regulations.

**Political sensitivity of Interest rates:** In April, 1999\(^7\), RBI issued a circular allowing MFIs to fix interest rates on the loans they extend. However, interest rates charged to the poor constitute a politically-sensitive issue, and therefore, a challenging proposition for MFIs. Although acts pertaining to money-lending and usurious loans in the states specify interest rate ceilings, these are applicable largely to societies and trusts. Over the past years, MFIs especially in Andhra Pradesh, Tamil Nadu, and Karnataka, have often been targeted by local district administrations.

Given MFIs operating & cost structures, most MFIs need to charge high interest rates to recover costs and remain in business. Sa-dhan, the industry association has suggested a voluntary mutually code of conduct under which MFIs provide information regarding interest rates and other charges to clients. Though many MFIs highlight only the flat interest rates and processing fees, a few MFIs did mention the effective interest rates in their borrowers’ passbooks as on March 31, 2009.

**Pressure on process and controls due to aggressive growth plans:** MFIs risk management practices have weakened over the past couple of years, on account of a shift in focus towards business growth and network expansion. Some credit sanction and monitoring practices have been diluted. These include lending to clients with multiple loans from different MFIs, reduction in the average waiting period for loans, and doing away with staggered disbursements to JLGs and loan utilization checks post disbursement. Rapid expansions to new geographies have also put pressure on the internal control mechanisms and audit function, as these have not received adequate focus in the past two years.

Nevertheless, there has been some improvement in MFIs’ operations, this includes installation of software for monitoring loans, upgrade in cash management services, and availability of banking facilities to MFIs operating in rural and semi-urban areas. Many small and mid-sized MFIs have also benefited from the technical support, such as documentation of internal policies and process mapping, with capacity-building support, particularly from apex MFIs.

**Weak in Governance of MFIs:**

The legal structure and the attendant regulatory requirements of an MFI have a strong bearing on governance practices because they influence management practices and levels of transparency. All legal structures other than the formal company structure, suffer for want of

\(^7\) RBI, Circular RPCD. No.PLBC. 94/04.09.01/98-99,dated:April 24,1999.
adequate regulations and disclosure standards. This also creates a virtuous/vicious cycle phenomenon like; MFIs that have the willingness and minimum capital funds to embrace a corporate structure as an NBFC attract outside investors more easily, which in turn fosters better governance and disclosure standards. In contrast, MFIs that are either unable (for lack of adequate sponsor funding) or unwilling to convert to a corporate structures tend to remain “Closed” to transparency and improved governance standards, and therefore, continue to be unable to attract capital. Moreover, some MFIs particularly, NGO-MFIs, continue to face challenges in striking a balance between their social and business goals, two seemingly conflicting objectives. This often results in poor internal control systems, lack of accountability, and suboptimal performance.

The relatively new sheen that Microfinance has acquired in India as an economically viable (even moderately, profitable, scalable and sustainable) lending activity, applies only to a few MFIs that are typically structured as NBFCs with notable participation from international private equity funds. Many MFIs are new and have begun operations on a relatively clean state, focusing on establishing a strong board, and internal control systems.

With donor and grant funds drying up and related voluntary services dwindling, microfinance has become a key activity for several NGO-MFIs in India. However, their managements have not adapted and equipped themselves adequately to manage this evolution, with the result that governance, disclosure and accountability have suffered in many cases. Unless NGO-MFIs restructure their boards and management to drive a reasonable commercial orientation into their operating philosophy and mission, the attendant benefits of good internal control systems and transparency are unlikely to materialize. This will ultimately hinder the sustainability of their operations.

**Conclusion:-**

Funding (both equity and debt) will not be a constraint for the large players in India’s microfinance sector. The leverage ratio is expected to remain adequate for the larger NBFCs-MFIs( which are regulated ) as most of these entities are able to raise capital. Most mid-sized MFIs are in a process of charging their legal structure. The overall asset quality of MFIs is healthy however; this is expected to decline marginally.

The key factors that can drive success for MFIs are robust systems, and processes and efficiency and productivity levels, maintaining asset quality, prevention of credit losses and capital erosion and remaining adequately capitalized to fund growth plans.

**References:**


