Microfinance in India

Relevance of micro finance in poverty alleviation

Today's Challenges

Discussion Paper by Aloysius John

Introduction

Microfinance is becoming more and more an instrument for poverty alleviation in many parts of the third world. Inspired from the traditional saving methods, it has come to be one of the potential and important means for reducing poverty, in particular among women. Micro finance emerged in India twenty years ago and since then it has been developed at the community level through the Self Help Groups and today it is even mainstreamed into the commercial sector.

This paper will explore the apparent dilemma of commercial microfinance with respect to serving the poor and chasing profits. Has microfinance become more commercialized to the extent that it has sidelined micro credits as essential means for micro community based development, the purpose for which it was created?

Are the social vocation and the social responsibility of microfinance still relevant ? How relevant and coherent is the community based approach to development through micro finance vis a vis the commercial turn microfinance is taking? What are the critical, moral and social responsibilities of the funding organizations both national and international? How are the HAP principles taken into account? With the lessons from the contemporary microfinance scenario in India what are the precautions to be adopted ?

1. **The fatal famine and the rural revolution, to micro credits**

Since independence, one of India's major preoccupations was food self-sufficiency which took a critical turn after the fatal famine of the 60's, after almost 15 years of unsuccessful efforts since 1947, to achieve food self-sufficiency for a fast growing demography. From 1965 onwards, India shifted its focus to determined rural development and this was undertaken through two major steps. The first one being the "white revolution", a rural development program started by the national Diary Development Board in 1970, and focusing on one major objective, to create a nationwide milk production which proved to be a success. This successful effort was followed by the "green revolution" from 1967 onwards to 1978, putting India on the path of food self-sufficiency, and leading to drastic action to increase the yield. These revolutions helped in alleviating dire poverty and famine levels taking dangerous proportions in India during the concerned period.

These revolutions did not only affect the Indian economy but the Indian social scenario as well. Traditionally, India's dairy cooperative societies were run by men, but with time, this was gradually changed. Today, a large number of cooperative members, more than $1/5^{th,}$ are women and these cooperatives are functioning well in the country. Several NGOs started to be more inclusive of women. The Self Employed Women's Association (SEWA), Ahmadabad, Gujarat was the first one to start the concept of all- women dairy cooperatives in Banaskantha district. Through intensive training sessions, women began to see the benefits of associating with the dairy.

From the above, we reach the conclusion that the White revolution has had a tremendous impact on the economic as well as the social life of the rural sector of India. But what is important is that it opened the door for credits for the poor through rural cooperatives with peer guarantee or through assets (livestock or agricultural land) becoming guarantees for taking loans. These revolutions through the creation of cooperatives contributed to increase the solvability of the rural poor, the sole purpose being to help the poor to become self-employed and thus escape the clutches of poverty. Many of these programs provided credits using social mechanisms, such as group lending with peer guarantee, peer pressure etc. and thus reached the poor, in particular women, who lacked access to normal financial institutions.

At the same period in Bangladesh, Mohamed Yunus founded the Grameen Bank as a project in 1976,and later transformed it into a microcredit banking institution in 1983. The principal purpose was to increase the poor’s access to institutional credit, which was an important means for ending poverty. Thus the Grameen Bank shaped the self-supporting financial institution with strong local roots that would be of utmost importance for economic development and, as a consequence, for poverty reduction too.

The Grameen Bank’s group-based lending program had two important dimensions that attracted the poor: Borrowers have the possibility to deal with a financial institution through a group and members themselves select their groups. Thus Grameen Bank was able to pool the resources and diversify the risks of lending by lending across communities and groups thus enabling it to provide loans at an affordable rate.

All such developments and their success pushed India into the systematization of the cooperatives that were soon to be influenced by the Grameen Bank experience. The post-nationalization period in the banking sector in the early 70’s earmarked substantial amounts of funds towards meeting the credit needs of the poor. There were several objectives for the bank nationalization strategy including expanding the outreach of financial services to neglected sectors. Credit came to be recognized as a remedy for many of the ills of poverty, hence the emergence of several pro-poor financial services, supported by both the State and Central governments, including credit packages and programs customized to the perceived needs of the poor. The pioneering efforts at this stage were made by the National Bank for Agriculture and Rural Development (NABARD), which was given the tasks of framing appropriate policy for rural credit, provision of technical assistance backing liquidity support to banks, supervision of rural credit institutions and other development initiatives.

In the early 1980s, the Government of India launched the Integrated Rural Development Program (IRDP), a large poverty alleviation credit program, which provided government subsidized credit through banks to the poor. It was aimed that the poor would be able to use the inexpensive credit to finance micro projects and get out of the poverty line.

Over the years several studies were conducted and analyzed the credit systems. The results revealed that what the poor really needed was better access to these services and products, rather than cheap subsidized credit. Against this background, a need was felt for alternative policies, systems and procedures, savings and loan products, other complementary services, and new delivery mechanisms, which would fulfill the requirements of the poorest, especially of the women members of such households. The emphasis therefore was on improving the access of the poor to microfinance rather than just micro-credit.

2.a. Micro Credits and MFI: Clarification of concepts.

Very often there is a confused understanding of the two concepts and they need to be clarified in the Indian context.

Microcredit is the allocation of very small loans to those in situation of poverty with the aim of motivating the poor to undertake economic activities to build their economic assets. Most of the time the poor, in particular the rural poor, lack collateral, have no employment, and do not have any past verifiable credit records to be able to qualify for loans in the traditional banking system. They are kept out of the mainstream of the banking system.

Microcredit then becomes an important means to successfully enable the poor to have access to economic development by getting engaged in income generating programs. Microcredit is based on a separate set of principles, which are distinguished from general financing or credit. Microcredit is a tool for socioeconomic development.

Micro credits are given to groups and are the outcome of a process of community mobilization and organization. In India, SHG were created and are the means for savings and accessing to loans.

Microfinance is the provision of financial services to poor communities or consumers and is based on solidarity lending groups. Micro finance is a means to build not only financial assets, but also build human capital, through community organization, which is a basic condition for the success of the program. Thus the poor are able to have access to savings, loaning and the possibility to get into a collective economic enterprise.

MFI -Microfinance institutions - are intermediary structures which will at term contribute to mainstream the poor into the normal economical system by rendering them economically resilient.

Microfinance will succeed only if the human capital is achieved both individually and collectively, there is individual and collective empowerment leading to interdependence among the members of the community.
Micro Finance (MFI) has also become popular throughout India as one form of financial intermediary between the poor and the traditional banking system. Self help groups (SHG) organized around an informal set of norms of mutuality and trust was the earliest institutional form of microfinance in the country.

In 1999, the Government of India merged various credit programs together, refined them and launched a new program called Swaranjayanti Gram Swarazagar Yojana (SGSY). The mandate of SGSY was to continue to provide subsidized credit to the poor through the banking sector to generate self-employment through a self-help group approach. The program has grown to an enormous size.
In the 1990s, the MFIs, motivated by the funding NGO to systematize microfinance, reached a 'near-commercial' basis. Supplemented by private foundations and 'social' investors, such funding encouraged MFIs to operate with more commerciality and professionalism. International commercial banks made experimental investments during this period, usually through their charitable foundations.

Today, Self-Help Groups and MFIs are the two dominant forms of microfinance in India.
This report will also focus on the aspects of the SHG as an effective means to provide financial services to the poor.

2.b Emergence of the SHG Movement

A Self-help group (**SHG**) is a village-based financial intermediary usually composed of 10-20 local women. Most self-help groups are located in India, though SHGs can also be found in other countries, especially in South Asia and South East Asia.

While no precise moment of the creation of SHG can be identified, the practice of small groups of rural and urban people banding together to form a saving and credit organization set the foundation for what is the SHG today. In the early stages, NGOs played a pivotal role in innovating the SHG model and in implementing the model to develop the process fully.

Self-Help Groups (SHG) are registered or unregistered groups of micro entrepreneurs having homogenous social and economic backgrounds, voluntarily coming together to save regular small sums of money, mutually agreeing to contribute to a common fund and to meet their emergency needs on the basis of mutual help. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment. This system eliminates the need for collateral, is closely related to that of solidarity lending widely used by microfinance institutions. To make the bookkeeping simple enough to be handled by the members, flat interest rates are used for most loan calculations.

In the 1980s, policy makers looked up to these existing models as an opportunity and worked with development organizations and bankers to discuss the possibility of promoting these saving and credit groups. These efforts and the easiness to create SHG helped to generalize them and make them into a movement across the country. State governments established revolving loan funds that were used to fund SHGs.

In the 90's, SHGs were perceived by state governments and NGOs to be more than just a financial intermediation but as a common interest group, working on the integral development of the community, taking into consideration other concerns as well. The agenda of SHGs included social and political issues too. The Panchayat Raj considered the SHG as an important vector for the political mainstreaming of the poor.

The development of SHGs led to the formation of SHG Federations which are a more sophisticated form of organization that involves several SHGs forming Village Organizations (VO) / Cluster Federations and then ultimately, higher level federations (called as Makkal Sanghams). SHG Federations are formal institutions while the SHGs are informal. Many of these SHG federations are registered as societies, mutual benefit trusts and mutually aided cooperative societies. SHG Federations resulted in several key benefits including:

- Stronger political and advocacy capabilities
- Sharing of knowledge and experiences
- Economies of scale
- Access to greater capital

It needs to be emphasized that the relevance of the impact of SHG depends to a very large extent on how these groups are formed through a community motivation and organization process. The indispensable dimension of SHG is the individual human capital built through a collective process, by creating interdependence among the members. The success of the microfinance and its impact will be high only when the self help groups have been well prepared and are able to work together with a common vision.

This is all the more important in the context of the Panchyat Raj which promotes the local political mainstreaming of the poor for which the SHG are a real asset. At the same time in this context of political mainstreaming, if the groups are not well knitted, there is a risk of political recuperation by the political parties. The poor then, would be the losers and would not gain anything out of the program.

As on today, nearly 1.4 million SHGs comprising approximately 20 million women now borrow from banks, which makes the Indian SHG-Bank Linkage model the largest microfinance program in the world.

2.c. The SHG Methodology

Structure of SHG

A SHG is a group of about 10 to 20 people, usually women, belonging to the same village and having similar problems, who are ready to gather as a group and have the will to act collectively. From the very first, they contribute to savings. The finances thus collected are invested and bring interest. Money is loaned to the members on a common agreement. This process focuses primarily on the savings. The group members themselves undertake the financial managements related to the savings and loaning. In a village there could be several SHG.

But in many SHG under the control of NGO, to build the capacity of the group and to empower the members come before enterprising into finances. Each group has a president, a treasurer and a secretary.

SHG Village Clustering

At the village level the SHG are federated into clusters and they have different names. But commonly they are called village cluster groups or village clusters. These are village-based organizations and they have their own systems and structures. Typically, about 5 SHGs make up a Cluster / VO with the office bearers of the SHG as representatives of the members.

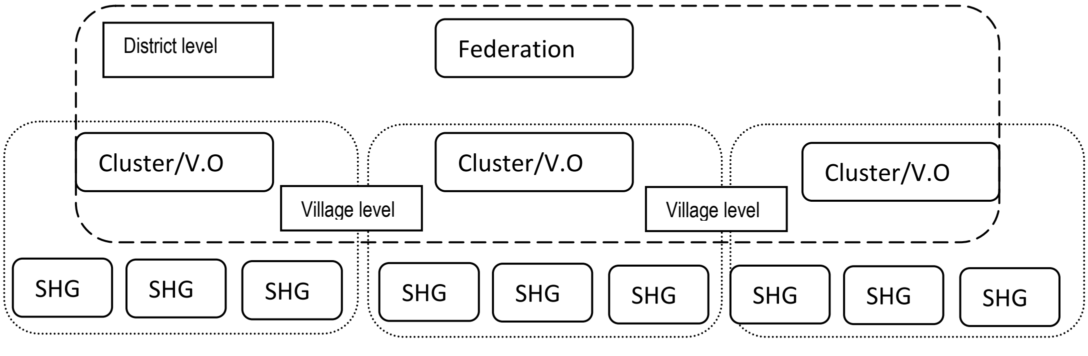
The village organizations or village clusters are the intermediary between the SHG and the higher-level federations. Each cluster has an elected President, a treasurer and a Secretary General.

SHG Federation

The different village clusters at the district level come together as a federation. The federation is represented by the office bearers of the village clusters. Out of them a federation President is elected, as well as a treasurer and a secretary. The members of the federation are the representatives of the SHG.

At the cluster and federation level, capacity building to empower the members is one of the most important activities undertaken. There are also inter-group borrowings, exchange of ideas, sharing of costs and discussion of common interests. Various subcommittees could be created to deal with a variety of issues including loan collections, accounting and social issues.

Thus the SHG models become self-supporting financial institutions with strong local roots and are of utmost importance for local economic development, and, as a consequence, for poverty reduction too.



3.Critical Analysis of Microfinance

Currently, the microfinance sector in India stands clearly divided into three segments – (i) slow growing, informal and community based (SHG bank linkage program), (ii) moderately growing and not for profit NGO- MFIs and cooperatives, and (iii) fast growing, regulated and commercial (non banking finance companies such as NBFCs).

By 2008-09, the number of bank linked SHGs stood at around 45 000 000 and the cumulative bank loans availed by SHGs are about 3,360 Bn€ (equivalent to Rs. 22000 crore - RBI, 2009). Though the country is yet to have an authentic, all-inclusive and single point database on the number and spread of microfinance intermediaries – known popularly as microfinance institutions or MFIs - the available information suggests that both client and credit outreach figures of such organizations are very impressive, with the top 50 MFIs together claiming an outreach of more than 1.2 crore clients.

In this context of success of the MFI and the integrating of the poor in the banking system there is a thrust to initiate development of MFI working within the logic of maximizing profit and investor returns. In this phase, the strategic focus of microfinance seems to have shifted from poor borrowers to profits.

The commercial transformation of MFIs has been accompanied by changes in the structure of ownership, control and management of MFIs and the nature of their stakeholder commitment. What are the implications of this rather dramatic change for the sector's assumed ability to be responsible for and responsive to the communities that they serve? As the conflict of interests and claims among clients, management and investors become rampant, whose interests will assume primacy and determine MFI strategies - the prescriptions and priorities of the financial market players or the needs, constraints and priorities of the ultimate users of microfinance services? What are the available safeguards that can save the sector from moving farther away from serving its social change agenda? In this context of high competition for profit how will value oriented MFI resist before such commercial tendencies. In all these developments it is also crucial to question the role and responsibilities of the funding organizations and to what extent they have the possibilities to ensure the initial vocation of the MFI.

Social Responsibility of MFI

It is now evident that the commercialization of microfinance is leading to an increased need for reasserting the social development role of microfinance. This results in the need to develop tools and methods to assess social performance of the MFI. On the contrary, investors focus their attention and interest to make sure that their investments have attained the optimal gains and the sustainability of the micro finance rather than on making sure that the impact of the livelihood on the households are successful and contributing to poverty alleviation. This would mean a regular monitoring mechanism and clear strategies to follow-up the implementation of the program and its impact on the beneficiaries.

Performance Monitoring of the MFI

The social performance of the MFI needs to be regularly monitored and the articulation between the organizational mission, strategies and development outcomes must be analyzed and measured. Such monitoring will enclose different aspects such as the setting of objectives, the certainty that risks are managed and deflected in time, good talents are retained and there is good governance at the organizational level. It also means that there are relevant ODP initiated and good strategic plans are introduced, in order to enhance the performance. Tracking the performance and, above all, making sure the relevant staff has the capacity to accompany the process are essential. The effective success of MFI will be achieved only if there is qualified committed staff, if the strategies are clear and the operational plan is well introduced with relevant goals and objectives.

Regulation mechanisms

This is another important and major challenge for MFI. It is indispensable to introduce a set of desired practices that will serve the collective interests of all involved. Promoting regulation with microfinance institutions mainly contributes to avoid problems associated with over lending and delinquency. The NGO or the MBT concerned must be vigilant to ensure that there is no lending to the same clients by multiple agencies. There is a need to come up with a 'code of conduct' that urge MFIs to restrict from over lending, which could lead to create instability in the process.
There is also a need to take into consideration some critical aspects and questions related to power and dominance, which largely decides the ultimate distribution of benefits among the members.

In the context of corruption and feudalism combined with the risk of political clientelism, it is important to establish checks and balances within the federation and the MFI structures so that the beneficiaries have their say in all decision making and there is democratic power-sharing. This also refers to the need to have strong leadership and empowerment of the leaders through capacity building and relevant accompaniment. In other words, there is a need to ensure that the organizational decisions are not influenced by the 'morality of the mighty'.

Clients

In the current phase of expansion of MFI, it is important to examine the role and importance of the stakeholders within the MFI. Which stakeholder(s) has all the attributes that guarantee the management of the MF organizations – the clients, the promoters, the investors or the funding agent? How do organizations address the complexities involved in ethically incorporating multiple stakeholders' concerns and priorities in routine management? Questions like these assume critical significance in any assessment of the capability of Indian microfinance to be socially responsive and responsible.
This means three attributes related to the participants and stakeholders need much attention and this must be taken into consideration in the identification of stakeholders :

1) The power to influence firm decisions
2) The legitimacy of relationship with the MFI
3) The reactivity before claims

It needs to be recalled that the ideal stakeholders are those who have the power to influence decisions, legitimacy and have able reactivity capacity before claims. They must be independent, outspoken, have the legitimacy and be reactive. This is not often natural and can only be achieved through an empowerment process of the members, who have to become part of the MFI process. This also refers to Amartya Sen's concept of building social capital.

MFI Questions of ethics and accountability to the poor

There is a clear indication that there is a growing tendency to use clients as sheer instruments to build promoters' profits. This is very visible in several instances in the recent history of microfinance growth in India. Many of the current leading for-profit MFI entities – SKS, Spandana Sphoorty, Share Microfin and Asmitha Microfin - started off their commercial transformation with predominant "community ownership" which took the same form of creating Mutual Benefit Trusts (MBT) of borrower groups, pooling their resources and making them invest in the new company.

It may be noted that an MBT is a form of trust where the entity is created not for the larger public good, but to control the benefits accruing to individuals, members or families who belong to the group. Paradoxically, the resources were largely donated by the MFIs themselves through their non-profit parent entities. Thus the MBTs subscribed to the equity shares of the new companies with cash grants made available to them by the MFIs.

In this regard there is a real danger that the new companies could also conveniently circumvent the legal hassles related to non-profit societies or trusts making investments in profit-making companies at the time of incorporation. This will have a double implication: on one hand it will be a deviation from the initial aims and objectives of the project and on the other hand it will put the development of the communities in danger.

There is also the potential risk that the companies bring in external investors and thus dilute the community stake. One of the unfortunate bad example is the case of Asmitha Microfin (established in 2002 with its headquarters in Hyderabad), which transformed into a company with more than 97 per cent of the shares 'owned' by the clients, the promoters and their relatives who acquired majority stake in the company through a buyout in 2006. From 2006 onwards the company also started distributing dividends. In 2008 the managing director of Asmitha was offered sweat equity worth USD 2.5 million by one of the equity investors. Thus, profits are deliberately withheld by the affluent stakeholder through systematic increase in the share holding of the chief promoters and drastic reduction in equity held by community.

Accountability to the poor has to be the prime concern, because there is no one to question, the misuse of the powerless client communities, as just a stepping-stone to the world of profits. Another important question is often neglected: to what extent has the social and economic capital of the poor been improved through the participation in the microfinance program? The co-responsibility of the external funding partner along with the local partner who is the initiator of the MFI can be questioned here.

Defining the right model and the right criteria

The MFI must be built on relevant solid grounds and the assets generated out of the grants received have to be owned by the communities. Even benefits that are targeted at individuals can be given as a soft loan to be contributed back to the community organization, so that those resources could in turn be used for a larger good of the other members of the community. Similarly it will also be equally important that not only the assets would be owned by the communities, but institutions set up for their benefit would also be ultimately owned by them.

The structures introduced must clearly define directions of linkages between the community (represented by individuals, SHGs, SHG Federations and MBTs at different levels) and the company. This means there will be a need to explore possibilities for designing for-profit-microfinance models that can strategically position clients as the primary and definitive stakeholders. It also needs to promote maximization of client/ community value (defined in terms of the accumulated social, economic and political benefits that accrue to individual members and communities) as the long term objective opposed to profit maximization of individual shareholders.

This implies that the social responsibility of the MFI be relevantly ascertained, which means a clear formulation of a social contract. Social contracts are the informal, implicit, but critical agreements that bind social and economic entities into moral communities and provide them with a moral framework for engaging in economic activities (Donaldson and Dunfee, 1994 and 2000). It is a space where the diverse interests of multiple stakeholders are negotiated (reflecting their relative moral universes) and

evaluated against certain ethical values. In the case of microfinance, a sector, which, by its very definition is focused on improving the living conditions of the poor, a social contract is expected to assert their salience by incorporating terms that grant them power and legitimacy while addressing their claims. It also ensures that the economical and social capital of the beneficiaries is enhanced.
This would certainly ensure accountability and redevability to the poor and on the long run contribute to safeguard good governance. This means that the implementing agency is a duty bearer to the community.

Conclusion
Microfinance, no doubt, is a distinct institutional arrangement that blends the social and the economical dimension, where resources are applied in clear pursuit of the simultaneous creation of both economic and social values. There is always a real risk and danger that the thirst for quick profit making brings the companies to deviate from the initial aims that is the poor, their empowerment both social and economical, leading to undermining the social value creation role of the MFI.

This apprehension is legitimately mooted by the present trends in the Indian Micro finance that tends to shift towards the rise of profit-seeking stakeholders who wish to introduce themselves in MFI. This is also accompanied by the progressive marginalization of the poor microfinance clients who are subdued and undermined by the increasing influence of investor interests in the governance and management of transformed MFI.

There is an absolute need to make concerted efforts to put the “social” dimension back in this “social enterprise”, ie microfinance. There is a need for a systematic approach to measure the social impact and the “integral capital building” of the beneficiaries through community empowerment and collective action. This means elaborating relevant indicators to measure the impact and above all institutional strengthening of the partners, which will go in the way of formulating clear and coherent strategies and appropriate activities that will accompany them. In order for microfinance institutions and programs to achieve those outcomes they need to clarify and endorse their responsibility and responsiveness towards the communities whose future they are trying to shape. There is a need to build social contracts that are meaningful and introduced in a participatory way through inclusive processes and based on trust and reciprocity. It is also important to give consistent efforts at tracking client level impact. These efforts are central to being socially responsible.

The NGO introducing the MFI and the funding partners have responsibilities before the beneficiaries.
It is necessary to keep in mind a certain number of points :
SHG
- There is a need to introduce a systematic capacity building process for the SHG and the office bearers in order to empower them and make them active and definite stakeholders.
- The right type of skill and trainings must be imparted to the SHG members in order to facilitate their participation.
- The community members and the office bearers in particular must be well trained in order to contribute in decision making with authority, legitimacy and reactivity.
- The SHG office bearers at the village, cluster and federation levels must be capacitated to ensure good governance.

Activities
- The group members must be helped to choose the right type of activities and initiatives to enhance their social and economical capital.
- Relevant indicators and monitoring mechanism must be introduced to assess the impact of the program

- Feasibility study and risk analysis must be undertaken for clearly identifying areas of risk and avoid any failure of the program. In this regard the MFI must introduce business trainings and discussions with the members to enhance their capacity to be participative as stakeholders.

Legal issues

- The MBT must be capacitated and made aware of all legalities related to the Indian tax rules and regulations as well as Reserve Bank regulations and guidelines.

Political issues

- It is of prime importance to be vigilant on the political recuperation of the beneficiaries, which will consequently hamper the social and economical empowerment of the poor.
- With the members now getting more and more involved in the political field, there is a risk that they themselves became oppressors.

The Operational risks that an MFI faces can broadly be classified into five categories.

a) Human risks: Errors, frauds, collections, animosity.
b) Process risks: lack of clear procedures on operations such as disbursements, repayments, day to day matters, accounting, data recording and reporting, cash handling, auditing.
c) System and technology risks: failure software, computers, power failures.
d) Relationship risk: client dissatisfaction, dropouts, loss to competitions, poor products.
e) Asset loss and operational failure due to external events; loss of property and other assets or loss of work due to natural disaster, fires, robberies, thefts, riots etc.
f) Microfinance institutions (MFIs) operate with risks that investors need to be concerned about. Unfortunately, external audits, ratings, evaluations, and even supervision too often fail to identify the primary risk—faulty representation of portfolio quality. Due diligence guidelines are developed to help investors, donors, and regulators verify the real level of risk in an MFI's loan portfolio.

To conclude, these are some of the important aspects that any donor or implementer of the Microfinance must keep in mind, in order to fulfill the mission of helping the poor through the micro finance activities. The recent scams in India in the field of Micro finance where the poor were the first to be affected must not be put aside.

NGO engaged in the micro finance activities must realize that they are duty bearers towards the poor. In order to be effective they must capacitate their staff in the field of finance management and also the community organization dimension. This will be an important dimension for the success of the project, to help the beneficiaries adequately and above all to take the program forward with professionalism. One of the basic success factor for micro finance is the building of SHG and their key role at all levels starting from the basic informal SHG at the grassroot level to the high level formal and organized SHG federations.

Donors must also be aware that the compliance with the national finance department and tax regulations is capital. The responsibility of the donors does not end once the funds have been disbursed and integrated into the project accounts. There is a constant moral binding towards the poor and also the source of funds, especially foreign funds will also be constantly under surveillance of the central government. In this regard, the funding agencies need to have close linkage with the partners in order to accompany the partner on the right path and at the same time contribute to the strengthening and reinforcing of the capacities of the partner in order to attain the established goals and objectives.

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To probe further
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