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# INDIAN MICROFINANCE SECTOR IN THE NEW MILLENNIUM: DEVELOPMENTS AND CONCERNS

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**Abstract:** *Microfinance is not merely a concept but a revolution. It is going to change the face of financial services and add to the movement of socially responsible financial system provided it is effectively organized for present and future challenges. Being identified as a tool for poverty alleviation, it has become a mantra for policy makers in accomplishment of their common agenda of peace, poverty and economic development. This has been identified as a strategic sector that needs sufficient funding, monitoring, regulation and development. The experiences of the world in realizing the concept have certain similarities and differences. The approach varied across regions and nations. In India, contemporary research and policy initiatives identified that the dream of inclusive growth can be achieved with the help of financial inclusion and private public partnership is prompted in this direction. This paper makes a comparision of evolution and developments in microfinance across the globe with Indian scenario and suggests various measures to improve the sector.*

***Key words:*** *Microfinance in India, State of Microfinance, Evolution and growth of microfinance, Policy initiatives for Micro finance*

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Microfinance is better understood as financial service that includes the most common banking services designed for specific target consumer especially the economically weaker sections, with an objective of poverty eradication. World estimates on microfinance suggest that the outreach of the services is much limited to a meager of 150 million customers which accounts only for 60 percent of the demand. Such estimates are based on the eligible set of individuals who are mostly self employed and operating in unorganized sector across the globe. Several issues and concerns are against the growth and penetration of the sector.

## NEED FOR THE STUDY

The concept of microfinance is well appreciated all over the world and as a new development in the field of financial services, an understanding about the evolution, status, future prospects and methods for improvement is a felt need across policy makers and research scholars. India, as the largest democracy, needs to formulate and implement strategies for uplifting of underprivileged and ignorant sections of the society to make better and informed financial service choice through financial education and there is a dire need to bring these sections into the organized financial system to safeguard their interests. On the other hand, poverty alleviation is the sole objective of governance in countries like India where nearly 25 percent of people are living below poverty line. The concept of microfinance is strategic initiative in this perspective that encompasses unique model of credit to the poor sections of the society. We would like to present a brief note on the evolution of microfinance across select regions and nations of the world and compare the status of Indian microfinance sector with its present position subjectively and offer suggestions for improvement for the same.

## REVIEW OF LITERATURE

IMF working paper on Income Inequalities in Southeast Asia (2011) brought out the concerns on commercialization of microfinance. While supporting the commercialization and suggesting the need for flow of equity into the sector, IMF calls for the need for proper monitoring and regulation of microfinance business. Aparna Bharathy Krishnan (2009) identified the progress of microfinance and calls for specific measures to address poverty and inequality to reduce the inequalities. In her paper she portrayed the experiences of Southeast Asian Nations and noted the challenges and concerns over commercialization.

Sylvie K.Bossoutrot (2005) pointed out the developments in microfinance across Brazil, Indonesia and Thailand in his working paper on behalf of International Bank for Reconstruction and Development. In his paper, he identifies the common characteristics of microfinance in these nations. The World Bank in its publication edited by Thorsten Beck et.al (2013) has highlighted the impediments for growth of microfinance institutions. The paper includes several factors for growth of microfinance institutions such as affordability of technology, low performance, failure in identification of needs of clients, and adaptability. In another paper Sylvie K.Bossoutrot (2013) on Microfinance in Russia, finds lack of initiative from commercial banks in microfinance. He noted that banks in Russia have few incentives to lend small business and regulatory constraints on collateral recovery and absence of well developed market for realization from seized collateral along with inadequate skills in lending. Mathew Richard (2010) pointed out that structure of microfinance encourages the formation of solidarity groups and friendship among women clients and help them gain rights to property and provides safety in times of hardship. Michael Tan et.al (2013) brought out that China Association of Microfinance is moving from experiment to large-scale commercial development. Their paper included the developments in microfinance sector of China is not going to affect the commercial banks as the sector is operating for the benefit of farmers and peasants who are, at the lower end of the market. Padmalochan Mehta et.al (2012) have detailed the concept and evolution of microfinance in India and the models of delivery and progress of the sector in their paper Status of Microfinance in India. They remarkably noted that lending through microfinance is not the end of the era but it needs to be effectively operated by bundling with capacity building programs.

Microfinance were initiated by civil society, built upon the principles of cooperation and from socially responsible non-governmental organizations (NGOs). Some of the early onlookers into the sector include Reseau de Caisses Popularies de Burkina Faso (1972), Grameen Bank (Chittagong, Bangladesh 1976) and BancoSol of Bolivia (1986). These institutions have made remarkable progress in the sector through change in lending methodology. They include

1. Lending through self help groups of women,
2. Change in the supply of financial products-savings, insurance, remittances and more.

3. Larger and more diverse pool of suppliers-Commercial banks, socially responsible investors apart from NGOs
4. Radical transformation in supervision and regulation-prevented from monopolistic practices,
5. Fundamental change in financial priorities-focus on self-sustainability does not seem to be the greatest challenge anymore.

Commercialization of microfinance is new phenomenon that has taken its shape in the last two decades. The goal of microfinance is to provide organized financial services to the under privileged individuals and households that provides vivid services to enhance their livelihood by actively participating in the production of goods and services. This in turn improves their income levels and helps in economic growth. Unlike other financial services, micro finance extends financial services to group of individuals who voluntarily associate for mutual benefit. Some of the characteristics of microfinance are

1. Micro-credit transactions those are collateral-free
2. Lending for groups of individuals
3. Focus on female clients
4. Lending for productive and income generating purposes
5. Interest rates on par with market.

Quite good reasons support the features. As the clientele customers are poor, they cannot afford offering collateral and due to the risk in lending, only small amounts are provided. To minimize the risk, the loans are made to group of individuals, who are jointly and severally responsible for repayment and the mutual interests are shared with in the group. On successful repayment of loans, further loans are issued to the group. On the other hand the backwardness of third world countries is due to economic dependency of women, causing low productivity and economic growth. Hence microfinance focused at women borrowers. Institutions engaged in microfinance are cautious to see that the borrowers make use of the money for productive and income generating activities. Lastly, most of such individuals have ever been dependent on loans from unorganized banking like money lenders and indigenous bankers who exploit the needs of such individuals.

Application of commercial principles is the strengthening factor for achievements of microfinance as emerging sector. Evolution of microfinance is noted from the experiences of various parts of the world and discussed hereunder.

Asian microfinance sector is on rapid commercialization. Since 2000, there has been a rapid rise in the number of profit oriented commercial microfinance institutions. 222 microfinance institutions were identified across the world in 2005-06 which are regulated and shareholder-owned institutions. These account for more than 50 percent of clients worldwide but account only for 26 percent of equity investment. South Asian institutions dominate the metrics over the south East Asian nations. However, the investment made by south East Asia is higher than south Asia with 80 percent of the total investment in the region. It is estimated that Vietnam, Cambodia and Laos are most attractive destinations for investment in the sector.

The largest state owned Bank Rakyat debuted the organized lending for poor through the network BRI Unit Desa. This system was established in 1980s to provide agricultural inputs for cultivation of rice. The system could not work well due to low profitability and failed to attract investment in the sector. The bank's focus shifted to commercial lines with an introduction of savings and other loan products. BRI Unit Desa started expanding after the modification with 4,000 unit banks established across the country with 30 million depositors and 3.1 million borrowers by the end of 2004. The system made remarkably high return on equity in the banking industry of the country setting example for other banking operators.

The Bank of Agriculture cooperatives of Thailand was established in 1996 as publicly owned agricultural development bank, known for its reform and achievement. In 2004 it accounted for 90 percent of farming household brought under its net with 2.7 million borrowers, investment of $6 billion and 10 million savings accounts.

Micro finance in China was initiated by the concerted effort of the government, NGOs and commercial banks which formed into The China Association of Micro finance. Though it was experimentally initiated, it has been moving into large-scale commercial development. Loans for microfinance in china range from RMB 10,000 to RMB 50,000.

In Russia commercial banks have not been actively involved in microfinance due to structural and environmental constraints and experienced the lending to small and micro business as unattractive. The participating banks have been deterred by the high investment of maintaining and expanding small business lending facilities and confined to mainstream business areas. Few banks had invested their own capital while most banks operated microfinance with donor-induced investment.

Africa is most deserving for growth of microfinance where the underprivileged population varies from 23.5 percent to 80 percent across nations in the continent. The investment and assets of microfinance in Africa have been increasing on par with the world. There are concerns on the low penetration of the sector. The total assets of MFIs in 2010 could reach only 7 million borrowers and 17 million depositors. The penetration of MFIs is still at 1.6 percent.

Brazil has been encouraging microfinance since 1997. Banco Do Nordeste Do Brasil (BNB), a state owned development bank launched a large-scale microfinance program 'Credit Amigo". It served nearly 60 percent of micro business borrowers and held about 45 percent of their outstanding loans. The bank distributes the microfinance products through 90 percent of its branches. It was one of the largest MFIs in Latin America with a clientele of 123,000 and an attractive portfolio of $72 million.

## EVOLUTION OF MICROFINANCE IN INDIA

The concept of microfinance in India was initiated by Syndicate Bank in 1921 that offered deposit services for low income individuals and loans on short term basis. The success of The Grameen Bank model suggested by Dr Mohammed Yunus in Bangladesh has given impetus for the growth movement of microfinance inspired the world along with India. The bank linkage lending to self help groups is predominant. In this model, individuals form into voluntary groups called self help group who approach a bank for a loan on mutual agreement with proper registration. Banks lend these groups and the members are jointly and severally responsible for repayment of loan. On the other hand, there are other models operative in the country namely business facilitator/business correspondence model, joint lending by banks and microfinance institutions and partnership models.

In the first model as mentioned above, there are two methods of lending to self help groups. In one method, banks lend directly to the groups after through consideration on the credit worthiness of group members. In the second method, banks lend the groups through Non-government organizations (NGOs) that are registered and are of good repute. In the first method, banks bear the risk of lending to SHGs while in the later; the sponsoring NGO bears the risk.

In India since independence, the government and the planning commission focused on the role of finance in promoting overall growth of the country. The government has launched many programs like Integrated Rural Development Programme (IRDP), Development of Women and Children in Rural Areas (DWACRA), Training for rural and Self Employment (TRYSEM), supply of improved tool kits for rural artisans etc. aimed at helping poor. Through RBI, differential interest rate scheme for socially and economically backward sections were initiated. The sector has reached only a small portion of potential market owing to fragmented operations. It is smaller in scale as compared to mainstream finance in terms of assets and conditions. The focus was only on lending and deposit mobilization through MFIs was poor.

Reserve Bank of India the apex of Indian banking system has made several provisions in the regulation and one of them is focusing on eradication of poverty in alignment with the broader policy of inclusive growth, RBI has initiated financial inclusion campaign. One of these measure made commercial banks were insisted to directed lending to priority sectors. Several steps in respect of priority sector lending were initiated and implemented by RBI are discussed below.

1. National Credit Council meeting held in July 1968 emphasized the need for lending to agriculture and small scale industries.
2. RBI constituted an informal committee to study the statistics relating to priority sector advances to identify priority sectors and the same was formalized in 1972.
3. In 1974, banks were asked to increase their share of priority sector advances to 33 1/3 percent by March 1979.
4. In March 1980, CEOs of public sector banks with the Union Finance Minister agreed that priority sector advances be made to 40 percent by March 1985 and sub-targets were also specified to sub-sectors.
5. RBI has set up a committee under the Chairmanship of M.V. Nair, to suggest revised guidelines with regard to classification of priority sector lending. As per the recommendations of the committee, priority sector includes the following categories
    i. Agriculture
    ii. Micro and Small Enterprises
    iii. Education
    iv. Housing
    v. Export Credit

vi. Others

On the other hand, National Bank for Agriculture and Rural Development the apex institution for cooperative societies accredited with all matters concerning policy, planning and operations in the fields of credit for agriculture and other economic activities in rural areas in India. NABARD was established in 1982 as a Development Bank, for providing and regulating credit and other facilities for the promotion and development of agriculture, micro and small entrepreneurs in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas and for matters connected therewith or incidental thereto". The corporate mission set by NABARD for making available microfinance services to the very poor envisages the coverage of one third of the rural poor through one million SHGs by the year 2006-07.

## THE GROWTH OF MICROFINANCE IN INDIA

Growth of microfinance institutions can be attributable to the factors like changes in lending methodology such as lending to self help groups of women, change in the supply of financial products to include savings, insurance and remittances etc, rise in suppliers ranging from commercial banks, socially responsible investors apart from NGOs. Despite the efforts, the low penetration of microfinance is due to preference of the poor to turn to informal and unorganized lines of credit from friends, family members, indigenous bankers and money lenders, priority of commercial banks and other micro finance institutions for entrepreneurs of proven success and self-sustainability consciousness of donors.

The bank linkage programme for self help groups has been in operation since 1992 in India had financed about 2.24 million SHGs by 2006. It involved commercial banks, Regional Rural Banks (RRBs) and cooperative banks in its operations. In India, microfinance has passed three stages to find its place in economic development. It was brought into formal lending with pilot project by linking the Self Help Groups with banks in 1992-96 and brought under mainstream banking during 1996-98 and expansion of the sector continued since 1998. In a recent report on microfinance by National Bank for Agriculture and Rural Development (NABARD), the total outreach of MFIs in India stood at 26.6 million people with an outstanding portfolio of $3.48 billion by the end of 2011. The total outreach which stood at 48 million during 2006-07 rose to 83.4 million by 2011-12. Of these, the share of bank self help groups increased from 38 million to 56.6 million while that of MFIs increased from 10 million to 26.8 million. The loan portfolio of MFIs increased from $0.57 billion to $3.48 billion while that of banks self help groups increased from $2.06 billion to $6.05 billion. The most recent data available from the publications of NABARD reveal that the loan portfolio stood at $8.96 billion. This includes $ 6.56 billion pertaining to bank linkage model and $ 2.40 billion to MFI model by the end of FY 2013. There is a clear indication that the growth in the sector has been hampered by regulatory concerns aftermath of AP crisis.

Considering the performance of the sector, CARE has reported the recent estimates for 2011-13, revealed that the MFIs are increasingly leveraged showing the gearing ratio nearly 3.5 times. The overall profitability has been volatile despite the growth in income is indicated between FY 2012 and 2013. The net interest margin of MFIs showed decline while operating expense ratio also found to be declining. Asset quality deteriorated in 2012 as the Gross NPAs showed an increase from 0.35 to 1 percent against the previous year and could be brought down to 0.20 by the end of FY 2013.

## THE STATUS OF INDIAN MICROFINANCE INSTITUTIONS

From the performance evaluation of 641 microfinance institutions across globe was conducted by Forbes and listed the top 50 in its magazine showed that there 7 microfinance firms have got a place with different overall rankings and varied ranks for performance on four parameters, namely, the scale, efficiency, risk and returns. A comparison of these institutions has been depicted in the table.

**Table 1. State of Indian Microfinance institutes in the top 50 in a survey conducted by Forbes**

| Rank | Name | Scale | Efficiency | Risk | Returns |
|---|---|---|---|---|---|
| 2 | Bandhan (Society and NBFC) | 108 | 42 | 1 | 49 |
| 13 | Microcredit Foundation of India | 75 | 7 | 185 | 142 |
| 15 | Saadhana Microfin Society | 263 | 73 | 1 | 79 |
| 19 | Grameena Koota | 209 | 106 | 156 | 1 |
| 23 | Sharada's Women's Association for Weaker Section | 229 | 55 | 13 | 207 |
| 29 | Asmitha Microfin Ltd. | 80 | 254 | 73 | 111 |
| 44 | SKS Microfinance Private Limited | 61 | 395 | 141 | 1 |
| 20.7 | Average | 146.43 | 133.14 | 81.43 | 84.29 |

On an average, Indian microfinance institutions stood at 21$^{st}$ rank in overall ranking. The average ranking in terms of scale was found to be 146.42. The scale refers to the size of the portfolio. Efficiency is measured in terms of cost to borrowers and operating expenses of the institution, in which the average rank of India was 133.14. Risk refers to quality of assets and Indian microfinance institutions have an average ranking of 81.42. In terms of returns, Indian institutions have an average ranking of 84.28. These figures indicate that there is a need and scope for improvement in the performance of MFIs in all respect. It is worth noting that Bandhan society has made remarkable achievement in its operations setting an example for others. India is trailing to Bangladesh in several aspects with regard to microfinance. The successful models adopted by Bangladeshi firms need to studied and adopted to the Indian market after considering their applicability.

One of the compelling reasons for sharp increase in microfinance it attributable to the initiative of RBI for financial inclusion through which as the regulator of banking activity in the country, insisted commercial banks to focus on underprivileged sections of society to get into organized banking since 2007. Financial inclusion has been defined by RBI as the provision of affordable financial services to those who have been covered by any formal banking or financial service system. These financial services include payments and remittance facilities, savings, loan and insurance services. Micro finance has been looked upon as an important means of financial inclusion in India (RBI, 2006). Most public sector banks have actively involved into the sector encouraging the small borrowers through self help groups. The results are evident that nearly three-fourth of the growth in the sector was contributed by commercial banks.

Unlike many other nations discussed before, Indian banks have been offering diversified loan products like savings, payments, pension and insurance to the poor at affordable prices. Innovation in the sector is well appreciated and several banks are competing to attract the mass segment. On the other hand, several reports on exploitation of clients by some non-banking microfinance institutions made the central bank to regulate the growth of microfinance sponsored by them. This motive has certainly hindered the growth but streamlining of the sector for social justice is ensured with the same. There is ample of scope for strengthening the sector by regulating the deposit taking activities. On the other hand, industry initiated codes of conduct are being observed to ensure safety of funds and proof against the unlawful exploitation of clients. Balancing the financial and social objectives have ever been challenging for MFIs in India due to illiteracy, ever increasing demands for consumption and growth in income levels. Opportunities for growth are often threatened with the policies of free trade and allowing the giants into certain markets. The scope for growth in small entrepreneurship is unclear in the wake of policy shifts.

Certain common impediments for growth in the sector across the world are observed by the research. These include

1. Cost constraints and the Application of Technology
2. Cost Savings needed to expand MFIs' Outreach: To extend their outreach, MFIs need to improve their performance.
3. Improving productivity and efficiency for MFIs
4. Understanding the clients' needs and putting them into practice
5. Being proactive

Except for well established banks, many cooperatives societies and MFIs have difficulty in adopting the technology as many of most of them are not in a position to afford for. A solution for the problem can be initiated by software giants, but the training the existing employees in these organization is a tough task for reason that they are much ignorant and technically non-inclusive. On the other hand these institutions cannot afford technically well literate employees for their operations and cannot attract urban youth towards rural employment.

Many of them are small and operate in small territory and confine to small scale operations and are not able to utilize the advanced technology for cost savings. Performance of these institutions has a bearing on the growth of the sector. At many instances the service operations are institutionally dominant and attention towards customer needs is not well perceived for the growth of the business. On the other hand, even though some institutions recognized the fact, they cannot afford offering diversified products with limited resources.

## CONCERNS

Efforts to alleviate poverty through microfinance institutions and self help groups are hampered by increasing non-performing assets in the sector. According to NABARD's reports, the gross NPAs of commercial banks against SHGs were found to be 4.74 percent at the end of March 2011 increased to 6.83 percent by the end of March 2012. The gross NPAs of commercial banks against loans to MFIs were found at 2.17 percent by the end of March 2012 and that of regional rural banks were at 3.55 percent and that of cooperative banks at

2.19 percent. The aggregate gross NPAs in loans to MFIs was found at 2.22 percent. The trend in rising NPAs is equally affecting both the banks and non banking microfinance institutions prompting a serious concern. Credit evaluation of borrowers is much complex in the sector as most of the advanced methods are based on evaluation of credit worthiness of individual borrowers who have a history of account with bank and proof of records of their earnings. Since majority of the clients are new to a bank account, it is difficult to obtain their past credit history. The financial conduct of the group forms the main source of information for evaluation of credit worthiness of the group. New models are to be innovated for the same to apply and implement the evaluation practices of the banks like for corporate and retail borrowers of the main stream bank finance.

## POLICY INITIATIVES

Policy initiatives to assist the growth are the need of the hour. One, the artisans and small formers and micro entrepreneurs make the majority and the women members in self help groups. The needs of the members vary as well as the income trends. Most of them have uneven income patterns. Necessary financial education need to be encouraged by the banks to make the groups of individuals with diversified income patterns that afford planning for repayment. Subsidized interest rates may be offered to SHGs apart from continuing them continued as part of priority sector lending. New models to be developed for credit allocation, evaluation and control to check the non-performing assets. Banks need to recognize it as a strategic business segment in the course of time as it offers ample scope for expansion and growth vis-à-vis assisting the objectives of banking sector as financial intermediary and agents for economic growth. Specific needs of micro borrowers are to be identified and innovative loan products are to be designed to cater the needs. Use of business correspondent model may need to be enhanced to develop strategy and make effort to formulate groups from individuals on mutual agreement with other members. Performance evaluation mechanism for microfinance institutions need to be effectively implemented by organizing campaigns for providing necessary training to the staff on credit management and designing the loan products and services. Necessary standards are insisted on non-banking microfinance institutions for strengthening their role in the sector.

## CONCLUDING SUMMARY

Microfinance began as social initiative and a movement. Commercialization of the concept undoubtedly supported the movement. Many third world countries have adopted and experienced the outcomes of the sector with varied levels of performance. The financial legislation and the approach of the nations differs along with the impediments cause such variations. India along with Bangladesh has been keen on promoting the sector and rapid commercialization has shown unhealthy signs in certain aspects which may be detrimental to furtherance of the growth. A corrective and suggestive regulation, providing necessary knowledge on the application of the concept both to the microfinance institutions and the beneficiaries are to be considered by the successful banks and other financial institutions apart from the regulation and monitoring. If effectively organized, the sector can help in poverty alleviation and propel the ongoing drive for financial inclusion.

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