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INTEREST-FREE MICROFINANCE MODEL: A PATH TOWARDS SUSTAINABLE DEVELOPMENT

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ABSTRACT

Microfinance means providing financial assistance to poorest of the poor to alleviate poverty. It seems to be the effective tool to poverty alleviation with its social objectives. The moral edge, of the industry enjoys through providing loans to the poorest is rapidly eroded. There is the time need of an effective model which carries the social objectives of microfinance with justified profit motive of both lender and borrower.

This paper is an attempt to understand the key features of microfinance model prevailing in India and developing an overview of major challenges and issues associated with the microfinance model. The purpose of the study is to know the level of satisfaction and perception of the people availing microfinance facilities in India and developing a conceptual promising microfinance model (Interest Free Microfinance Model) to address the challenges of the existing models.

The study is exploratory in nature and based on primary data, collected through the mode of survey by using a semi-structured undisguised questionnaire. The statistical analysis has been conducted to draw meaningful conclusions and suggestions.

KEYWORDS: Interest free, microfinance model, social objectives and poverty alleviation.

INTRODUCTION

Microfinance means providing the small amount loans to the down trodden in order to uplift that class. It started with social objective but lost in profit motive. The inherent conflict between social objectives and profit motives in the MFI industry put it into trouble. The moral edge, the industry enjoys through providing loans to the poorest is being rapidly eroded. The borrowers are often required to pay over a third what they borrow as interest every year. The interest rates are nearly usurious. The framework started with the prosperity theory is a growing threat of social debt in rural India. The worst impact of MFIs is revealed in Andhra Pradesh. Over a 100 borrowers of various microfinance institutions allegedly committed suicide; some women confessed they were forced into prostitution by other group member (of Self Help Group) to fulfil weekly payments obligations. There is a need to rethink about the structure of microfinance in India.

EVOLUTION OF MICROFINANCE IN INDIA

Microfinance seems to be an effective tool introduced in 1980s to address the poor masses of India in order to create resonance with the slogan echoing in political premises " garibi hatao" led by Smt. Indira Gandhi. The poor masses exploited with sahukars (traditional money lenders). Many initiatives have been taken such as Chakbandi, aboilation of Zaminari system, cooperative farming after independence. These initiatives had limited success. The social activists and reformers are in search of methodology for alround development of the Bottom of the Pyramid (BoP).

The development of Microfinance can be categorized into three phase since 1980's [1][Sriram(2010)]

The first phase was when people who were working in the development sector discovered the methodology of reaching micro-loans to the poor through a methodology that was mastered by Grameen Bank. When the tradition system had serious costs (usurious rate of interest) and chit funds ran the risk of collapsing in defaults, Microfinance was the promising alternative that offered funds at the doorstep of the poor. This system ensured very low defaults as lending in groups provides an ability to self regulate (the other members of group exert pressure on a potential defaulter).

The second phase came in when the first generation organizations reached scale and sought methods to morph into for-profit commercial organizations.

Thus, there was a natural push for microfinance organizations to move into the commercial space. Unfortunately for the operators of microfinance, the move into the commercial space was not going to be simple. The options available in the commercial space to carry out microfinance activities were three:

1. Move the operations to a non-banking finance company [NBFC]

2. Move the operations to a co-operative format

3. Set up a local area bank

Each of these options had their own barriers from the perspective of the wave 1 microfinance organizations. Setting up of a local area bank [which BASIX did after much scrutiny and delays in obtaining a licence] was a painful and arduous route. The Reserve Bank was careful and miserly in granting licences for banks, its area of operations were to be restricted to three contiguous districts and the capitalization required was Rs.5 crores, a significantly steep hurdle for the players operating at that time. The regulations also prescribed divestment of the equity

[1] M.S. Sriram, "Commercialization of Microfinance in India", Research & Publication, IIIMA, India, W.P. No-2010-03-04

stake in a specific time frame and diversification of ownership, with cap on voting rights irrespective of investments. All these did not make the prospect attractive for anybody to pursue.

While several initiatives took off on the co-operative format, the design of co-operatives dictate it to be user-member based and therefore posed a challenge of continuously raising capital from the members, a much more difficult, slow and arduous route.

This actually left the players with only one option of setting up of an NBFC. While BASIX had set up its operations in the for-profit space right from the beginning – through a complex structuring of softer loans obtained from patient investors like Ford Foundation and the Swiss Development Co-operation in a highly leveraged holding company and down streamed as equity in an operating company, it was not possible for the others to replicate the model.

The third phase is when mainstream commercial institutions like L&T finance, Equitas and the private equity players started looking at microfinance as an interesting business. The commercial institutions surpass the social objectives of Microfinance which leads to Present Crisis of Microfinance.

LITERATURE REVIEW

PROVIDERS AND MODELS OF MICROFINANCE

MIX defines an MFI as "an organisation that offers financial services to the very poor." (MIX, 2005). According to the UNCDF (2004) there are approximately 10,000 MFIs in the world but they only reach four percent of potential clients, about 30 million people. On the other hand, according to the Microcredit Summit Campaign Report (Microcredit Summit, 2004) as of December 31st 2003, the 2,931 microcredit institutions that they have data on, have reported reaching "80,868,343 clients, 54,785,433 of whom were the poorest when they took their first loan". Even though they refer to microcredit institutions, they explain that they include "programs that provide credit for self-employment and other financial and business services to very poor persons" (Microcredit Summit, 2004). There are the three microfinance models

ROTATING SAVINGS AND CREDIT ASSOCIATIONS

These are formed when a group of people come together to make regular cyclical contributions to a common fund, which is then given as a lump sum to one member of the group in each cycle (Grameen Bank, 2000a). According to Harper (2002), this model is a very common form of savings and credit. He states that the members of the group are usually neighbours and friends, and the group provides an opportunity for social interaction and are very popular with women. They are also called merry-gorounds

or Self-Help Groups (Fisher and Sriram, 2002).

THE GRAMEEN SOLIDARITY GROUP MODEL

This model is based on group peer pressure whereby loans are made to individuals in groups of four to seven (Berenbach and Guzman, 1994). Group members collectively guarantee loan repayment, and access to subsequent loans is dependent on successful repayment by all group members. Payments are usually made weekly (Ledgerwood, 1999). According to Berenbach and Guzman (1994), solidarity groups have proved effective in deterring defaults as evidenced by loan repayment rates attained by organizations such as the Grameen Bank, who use this type of microfinance model

VILLAGE BANKING MODEL

Village banks are community-managed credit and savings associations established by NGOs to provide access to financial services, build community self-help groups, and help members accumulate savings (Holt, 1994). They have been in existence since the mid-1980s. They usually have 25 to 50 members who are low-income individuals seeking to improve their lives through self-employment activities. These members run the bank, elect their own officers, establish their own by-laws, distribute loans to individuals and collect payments and services (Grameen Bank, 2000a). The loans are backed by moral collateral; the promise that the group stands behind each loan (Global Development Research Centre, 2005).

MICROFINANCE AND ITS IMPACT IN DEVELOPMENT

Microfinance has a very important role to play in development according to proponents of microfinance. UNCDF (2004) states that studies have shown that microfinance plays three key roles in development.

It:

- helps very poor households meet basic needs and protects against risks,
- is associated with improvements in household economic welfare,
- helps to empower women by supporting women's economic participation and so promotes gender equity.

THE IMPACT OF MICROFINANCE ON POVERTY

Hulme and Mosley (1996, p.109) in a comprehensive study on the use of microfinance to combat poverty, argue that well-designed programmes can improve the incomes of the poor and can move them out of poverty. They state that "there is clear evidence that the impact of a loan on a borrower's income is related to the level of income" as those with higher incomes have a greater range of investment opportunities and so credit schemes are more likely to benefit the "middle and upper poor" (1996, pp109-112). However, they also show that when MFIs such as the Grameen Bank and BRAC provided credit to very poor households, those households were able to raise their incomes and their assets (1996, p.118).

LIVELIHOOD SECURITY AND MICROFINANCE

A livelihood security approach according to Concern (2003) aims for a holistic analysis and understanding of the root causes of poverty and how people cope with poverty. They identify livelihood shocks such as natural disasters and drought, the social, political and economic context, and people's livelihood resources such as education and local infrastructure as factors affecting people's livelihood security (ibid.). Therefore, when analyzing the impact microfinance is having on livelihood security, as is the objective of this dissertation, an holistic analysis of people's livelihood security must be conducted, rather than just focusing on the material/economic impact microfinance is having on the livelihoods of the poor.

SOCIAL IMPACT ANALYSIS

McGregor et al. (2000, p.3) states that wider social and economic impacts can occur through the labor market, the capital market, the market for goods consumed by poor people, through production linkages and through clients participation in social and political processes.

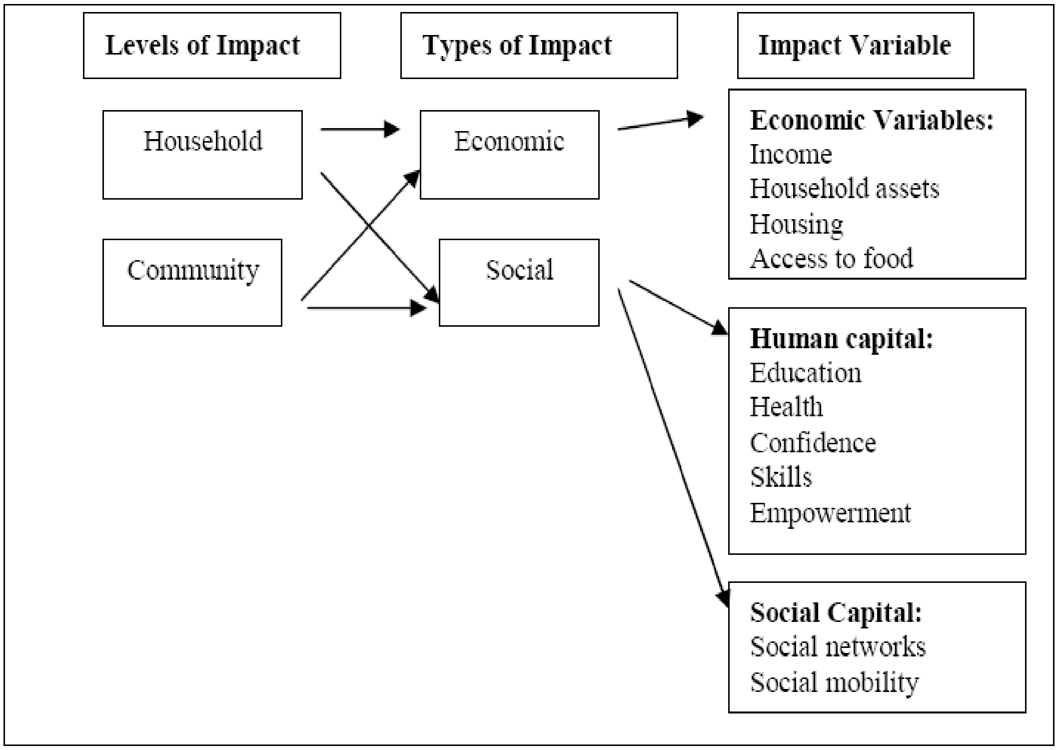
A. IMPACTS AT A HOUSEHOLD LEVEL

Robinson (2001) in a study of 16 different MFIs from all over the world shows that having access to microfinance services has led to an enhancement in the quality of life of clients, an increase in their self-confidence, and has helped them to diversify their livelihood security strategies and thereby increase their income

B. EMPOWERING WOMEN

Murduch and Hashemi (2003, p.4) state that access to MFIs can empower women to become more confident, more assertive, more likely to take part in family and community decisions and better able to confront gender inequities. Hulme and Mosley (1996) state that microfinance projects can reduce the isolation of women as when they come together in groups they have an opportunity to share information and discuss ideas and develop a bond that wasn't there previously

Fig. 1. Potential impact of microfinance at a household and community level:



Source: Eoin Wrenn for Trócaire, 2005.

RESEARCH OBJECTIVE AND METHODOLOGY

The need of the research is to determine the attitude and perception of the focussed group (customers of Microfinance Institutions, common people, and Microfinance Institution's employees) regarding Microfinance in India. It helps to determine the grass root challenges faced by the customers of Microfinance Institutions and Microfinance Institutions. Further the need of alternate model of Microfinance and its model's prototype is also ascertain. The research addresses the present Microfinance Crisis in Andhra Pradesh.

THE RESEARCH OBJECTIVES AND SCOPE

The objectives of the research are -

- To determine the impact of Microfinance on sustainable development.
- To develop an alternative model of Microfinance and alternate financing institutions.

RESEARCH METHODOLOGY

The research design is descriptive research design. The study is based on secondary data which is collected through various sources like annual reports of various MFI's. The model is developed on alternative microfinance model by taking inputs from existing studies on challenges and issues in Microfinance.

THE EXISTING MODELS OF MICROFINANCE IN INDIA

The basic methodology being used in commercial microfinance in India was innovated by Grameen Bank and later improvised by several players. This methodology involved the following elements:

1. Identify the potential customer.

2. Organise the potential customers into groups, so that they could address the issue of information asymmetry and lack of collaterals by transferring what could be an individual liability into a group liability and hold the group morally responsible for repayment – through a process of public oath.

3. Have standardized products, standardized operating systems and enforce discipline; ensure that the exceptions were dealt with severely.

NON GOVERNMENT ORGANISATION (NGO) MODEL: This is the model practiced in the initial phase for social objective. This was emerged as the alternative when local money lenders were charging usurious rate of interest without considering the problems of the individual borrowers and chit funds ran with the risk of collapsing if there were defaults. In this model the utility of the borrower is of prime concern and small groups were formed. The lending was usually based on economic activities rather for consumption. The interest rates were low which caused problem to self sustainability of the NGOs. This model was very similar to Self Help Group (proposed by Mahatma Gandhi).

The model primarily focuses on the social causes rather than economic sustainability. The equilibrium between effort and reward is violated. The effort of poverty alleviation is one sided (from NGO) which leads irresponsible borrowing, large area coverage problem and threat to the self-sustainability of the NGOs

SELF HELP GROUP MODEL (SHG) MODEL: This model is highly influenced by the success of Grameen Bank in Bangladesh. This model is commonly practiced with PSU banks and SHG linkage. PSU banks had Rs. 1000 crore exposure to SHG based loans, lent another 60 crore to MFIs. The SHG concept involves forming groups of 15-20 women who meets regularly, understand each other's problems and bond for a while. They are expected to save a small amount, keep the money in bank and earn interest. A member could borrow if she falls ill and couldn't go for work. She would return the money with 18-24 per cent interest to the group. The recovery is almost certain due to the pressure and bonding with the group. Such groups formation and bonding takes a minimum of six to none months.

The basic problem with this model is long operational time and lending for non-income generating activities. The pressure of repayment creates coercions which lead to multiple borrowing or illegal practices by the group member. The problem arises for the regulation.

JOINT LIABILITY GROUP (JLG MODEL): In this model, agents of MFIs persuade 4-5 women to form a group and each guaranteed the other's loans. Most of the members could not develop the bonding like SHG. The MFIs charge 12-18 per cent in JLG, compared with that of 18-24 percent charged by SHG primarily run by the PSU banks. MFI interest rates are non-transparent and effective rates are over 27 per cent, considering loan processing fees, penalties and hidden charges.

This model primarily focuses on the profitability of MFIs. The repayment rate is also low due to weak bonding among the group members. The credit generation is more than the actual production (economic activities). Though, most of the MFIs claim they have lent for income generating activities, in reality, most lending has been fir consumption purposes – buying a TV, repairing a house, paying for school fees or for serious illness of a family member. Thus indiscriminate lending and irresponsible borrowing is encouraged , leading debt trap and Microfinance Crisis.

MICROFINANCE AND ITS IMPACT IN DEVELOPMENT

CHALLENGES AND ISSUES OF EXISTING MICROFINANCE MODEL

HIGH INTEREST RATE: this is one of the basic problems with the existing model. The MFIs are justifying it with high operational cost. The borrowers are only facing the uncertainties of the failure of their business. The studies reveal that maximum borrowing is for agricultural needs, which is highly risky engagement. If the yield is low so the farmers are caught in one hand debt trap and on other hand starvation. It is difficult to pay weekly payments with such a high interest. The condition becomes miserable if borrowers borrow for non income generating activities.

MULTIPLE LENDING: The Malegam Committee report notes that repayment of old debt accounts for about 25 per cent of new loans taken by JLG/ SHG in Andhra Pradesh, while another 25 per cent goes to income generating activities. The borrowers borrow more than one MFI. They borrow from one MFI to repay loans to another MFI rather focussing on the pace of income generation activities. This causes debt trap and the conditions become same as Sahukar's lending.

Sl. No.	Range (Loan size)	Number of loan accounts	Amount of loan Rs.	Average loan amount Rs.
1	Rs. 0 to Rs.500	46,687 (37.3%)	1,72,52,074 (9.7 %)	370
2	Rs. 500-Rs. 1000	37,125 (29.7%)	3,48,79,579 (19.5 %)	940
3	Rs.1000 to Rs. 3000	3,0382 (24.3 %)	6,16,59,704 (34.5%)	2,029
4	Rs. 3000 to Rs. 5000	7591 (6.1 %)	3,39,40,225 (19.0%)	4,471
5	Rs. 5000 to Rs. 7000	1326 (1.1 %)	82,59,600 (4.6 %)	6,229
6	Rs. 7000 to Rs. 10000	1329 (1.1 5)	1,23,93,264 (6.9 %)	9,325
7	Rs. 10,000 to Rs. 15,000	366 (0.3%)	48,61,456 (2.7 %)	13,283
8	Rs. 15,000 and above	229 (0.2 %)	54,74,722 (3.1 %)	23,907
	Total	**1,25,035 (100%)**	**17,87,20,624 (100%)**	1,429

source: MRCP database(2002)

Coercive methods adopted for the repayment of loans: the coercive methods are adopted for the repayment of the loans. The villagers are generally illiterate and weak so they could not resist. The pressure of the group members of JLGs/ SHGs is coercion.

LENDING FOR CONSUMPTION NEED: The lending for consumption needs exceeds which causes the problem of repayment for the borrowers. The consumption needs such illness of the family member, for the payment of the school fees buying electronic appliances such as TV, motor bike, refrigerator etc.

Purpose	% share in number of loan accounts	% Share in loan amount
Consumption	35.27	28.99
Agricultural loans	53.37	57.41
Off-farm enterprises	7.98	10.95
Loans for education	3.38	2.65
	100	100

source: MRCP database(2002)

Low penetration and bureaucratic hurdles in regulations: there is low penetration in the Northern India. There are lots of bureaucratic hurdles in the regulation (such as corruption, commission with groups etc.). The local leader declare “no repayment” to gain the political mileage, but this causes serious problem for MFIs. The illiteracy and unawareness is another challenge for the penetration.

INTEREST FREE MODEL OF MICROFINANCE

SELF EMPLOYED GROUP (SEG) MODEL

The model discussed here is based on profit and loss sharing model. In this model focus is on the purpose of credit generation. The problem of poverty is solved when unemployment is reduced and there should be fair distribution of the production. In the existing model the MFIs are reaping the profits with fixed high returns in the form of high interest whereas the poor becomes poorer and get trapped in debt. The working of this model is like cooperative societies. The group is formed and feasible business of their interest is given which is run under the guidance of MFIs. There are lot of farming and non-farming business opportunities in the rural and sub urban areas of India.

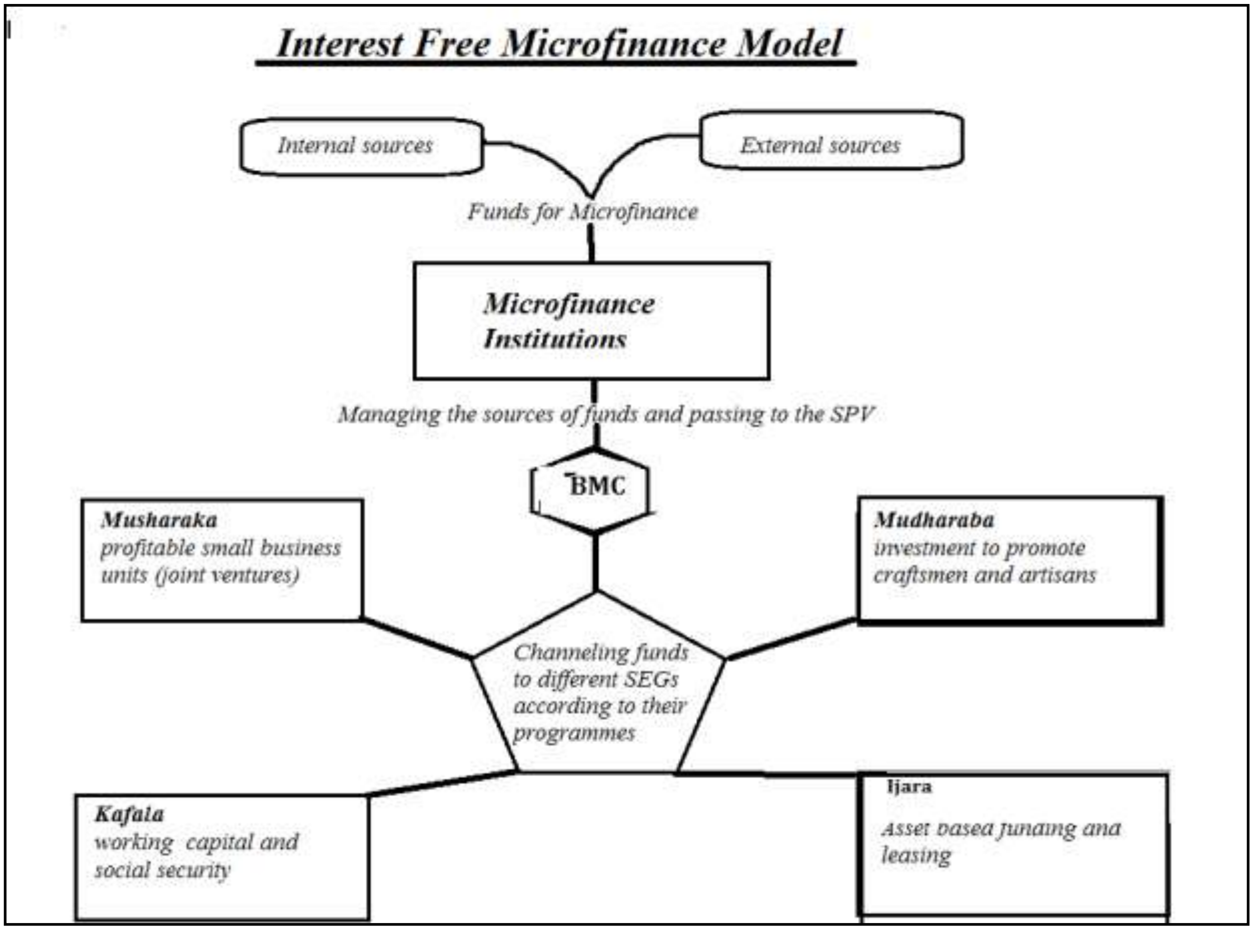
This model addresses the four classes of the villagers

- Villagers with adequate savings
- Skilful villagers
- Villagers engaged in business required machines and equipments
- Consumption needs of the villagers (group members)

There are four programmes run to cater the needs of each group. Musharaka programme for partnership business, Mudaraba programme for skilful man force, Ijara programme for asset financing or leasing and Kafala programme for consumption needs and social security of the group members.

SOURCES OF THE FUNDS

The internal sources of the funds are the profit share from the programmes and pool funding by the Kafala Programme. The external sources of the funds are equity shares.



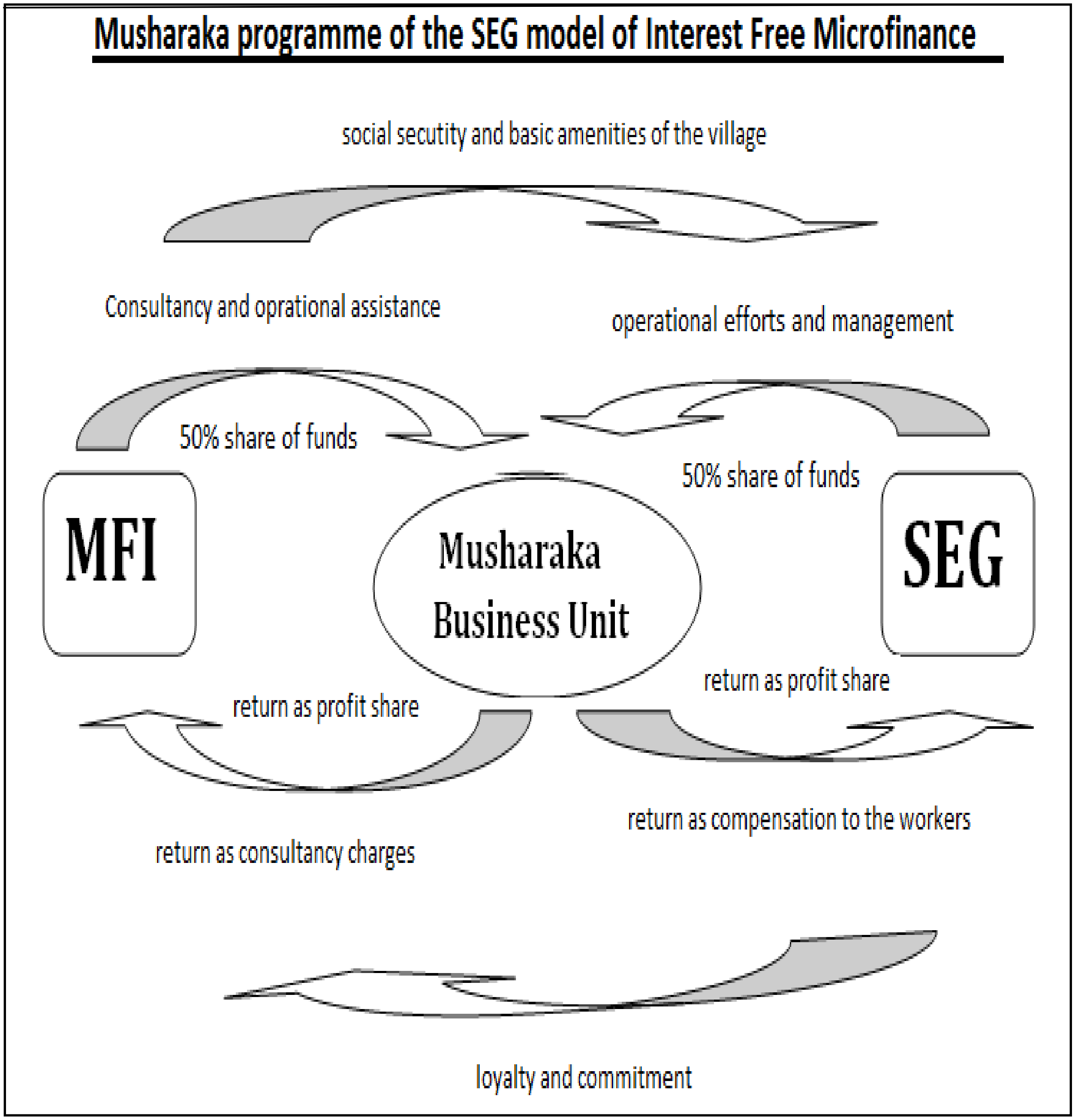
This model is proposed by authors*

BASIC MICROFINANCE CENTRE

These units are meant to control and provide assistance to the SEGs. It comprises the professionals who are compensated with fixed salary and incentives as per the performance of the development programmes. These centres provide necessary trainings and consultancy to the SEGs

MUSHARAKA PROGRAMME

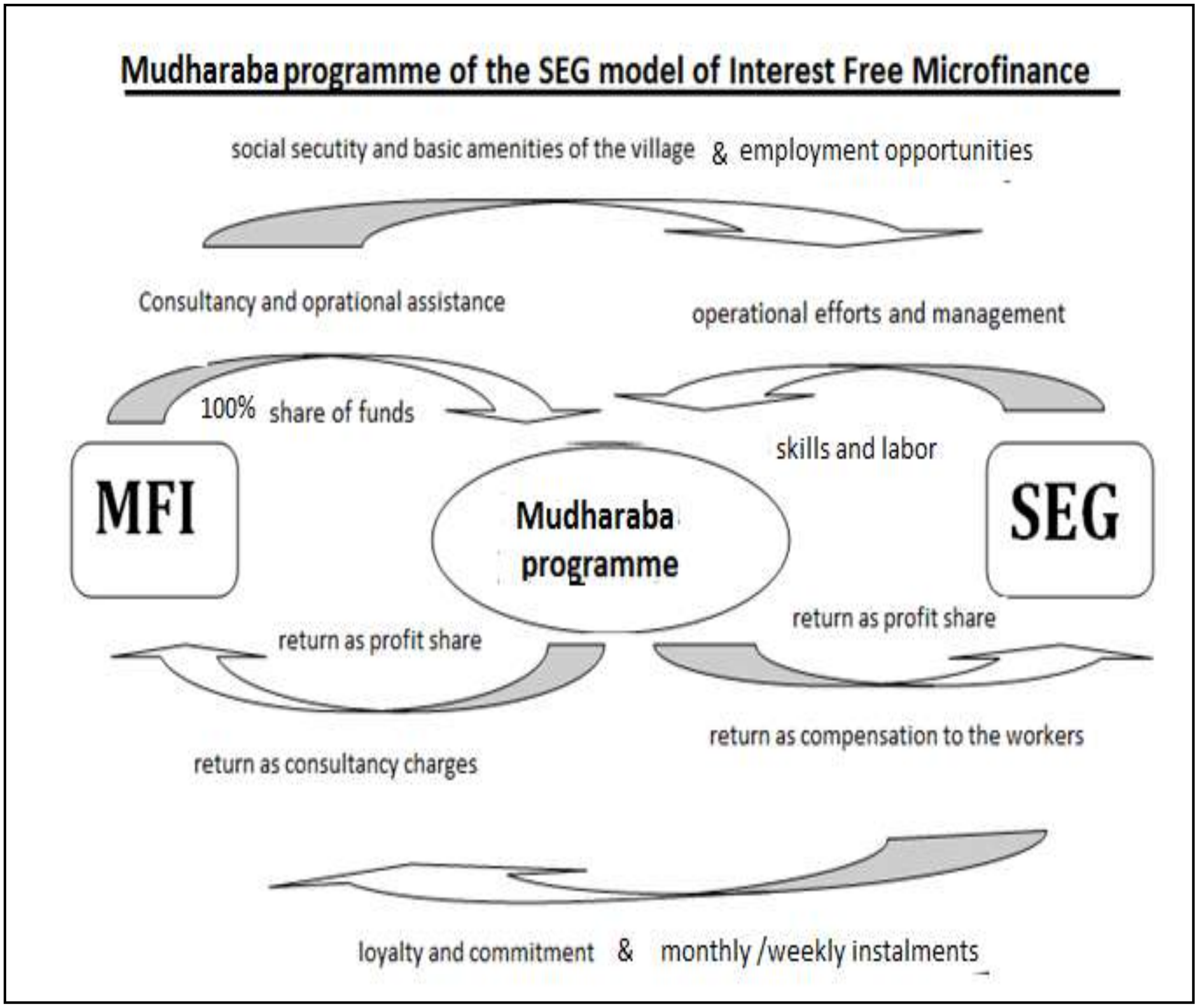
In this programme, MFIs promote entrepreneurship on profit and loss sharing basis. It is intended to make the villagers leverage their savings. In this system, both MFI and SEG members contribute in the musharaka business unit like dairy farm, poultry farm etc. and in return both will enjoys the profit share. The SEG members are further compensated for their operational efforts whereas MFIs for their consultancy and operational assistance. The MFIs may take the help of the National Small Industry Corporation (NSIC), a Government organisation which promote small scale industries. The various project schemes and project profiles are attached in Appendix I.



This model is proposed by authors*

MUDARABA PROGRAMME

In this programme, the MFI invest 100 per cent whereas the group members use their skills and labour. This programme will provide abundant employment opportunities to the villagers. Basic Microfinance centres (BMC) provide training to unskilled man force so that the funds are utilized for the economic activities.

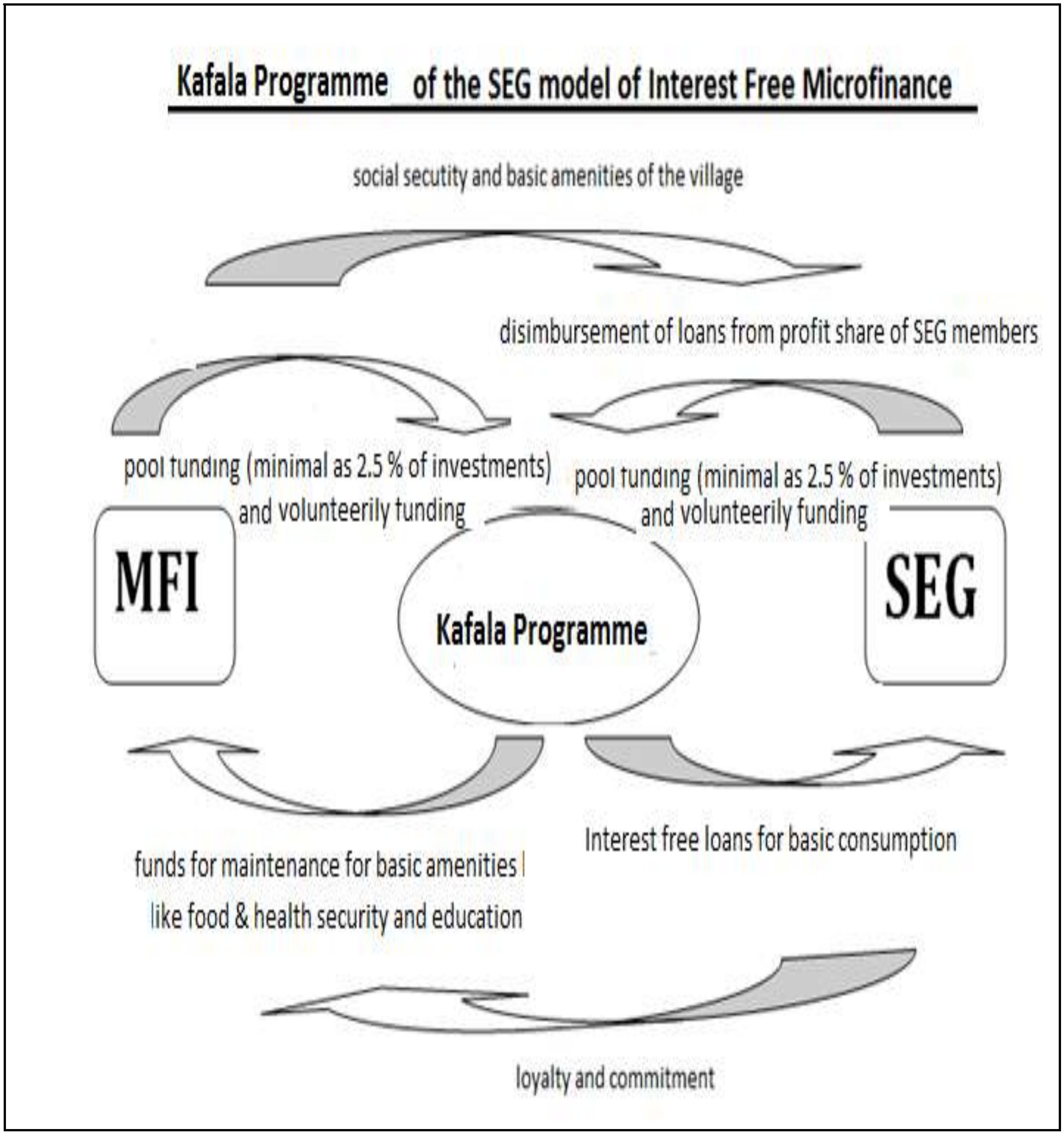


This model is proposed by authors*

The SEG group members have to pay weekly or monthly payments of the instalments. The district polytechnic colleges may be utilised for providing training and skills. The various skilled work forces is generated wit this programme for the SMEs like dairy farming, poultry farming, food processing etc. or for independent services like auto mechanic, barber, tailor etc.

KAFALA PROGRAMME

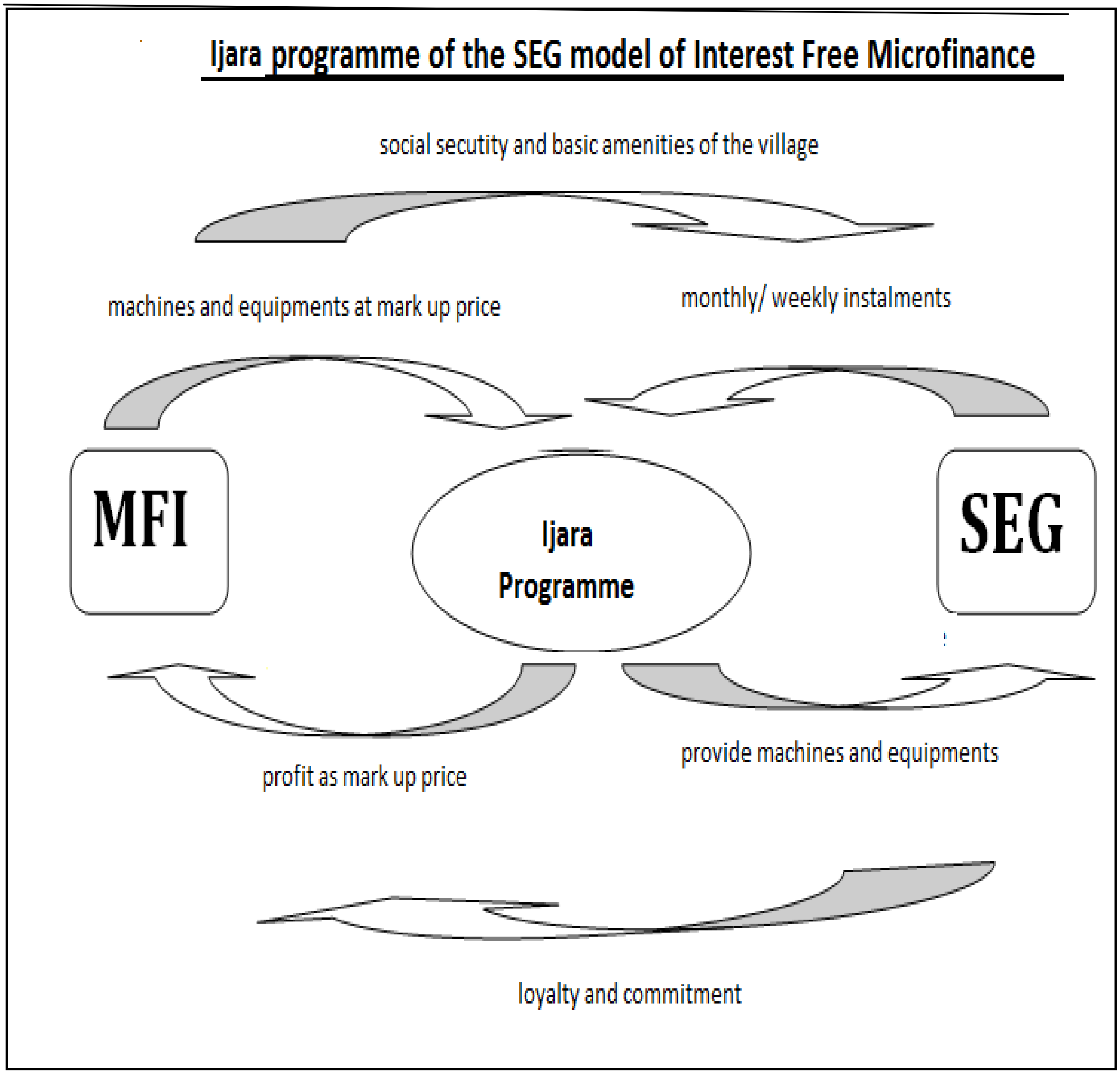
In this programme, the MFIs focus on the consumption needs and Social security of villagers along with provision of basic amenities of the villages such as food and health security, education, electrification, hygienic conditions etc. This will increase the loyalty, trust and commitment of the villagers as a whole. This programme is meant for the social objectives of the MFIs for the sustainable development of the country. This programme is run by the compulsory 2.5 per cent of investments of both MFIs and group members and voluntarily pool funding of both.



This model is proposed by authors*

IJARA PROGRAMME (LEASING FINANCE)

This programme is run for providing necessary machines and equipments for farming and non-farming activities. Under this programme machines and equipments like tractors, thresher, harvester, grinding machines etc are provided either on lease or selling on credit with mark up price so that these machines are affordable for the villagers.



This model is proposed by authors*

FEASIBILITY OF THE MODEL

The Model is feasible as it gives high return and risk is shared by both MFIs and SEG group members. In the existing models the risk is not shared whereas both the models (SHG and JLG) are the extremes as one talk about the social objective which is a threat for self sustainable MFIs and talk for profit motive only which neglects social concern of the villagers which leads to coercion and disloyalty of the customers. This model is self-regulatory and intended for sustainable growth rather to make credit slaves. The model addresses all the groups of the village. It focus on the basic amenities of the village too which enhance the commitment, trust and loyalty of the villagers.

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APPENDIX –I : THE LIST OF SCHEMES PROVIDED BY NSIC [2]

1. AGRI WASTE UTILISATION

Plant Growth Promoter and Vermi Composting

2. AGRO PROCESSING INDUSTRIES

Bleached And Unbleached Ginger	Coconut Products	Spices Grinding
Defibering Unit	Crude Edible Oil Expeller	Turmeric
Cattle And Poultry Feed	Compounded Asafetida	Wheat Milling

[2] http://www.nsic.co.in/

Agro Seed Processing Plant,	Dehulled Sesame Seed	Quick Aging Of New Paddy
Desiccated Coconut	Garlic Powder	Rice Flakes
Flour Mill Unit	Groundnut Decorticator	Spices Grinding
Karamcha Processing	Mini Rice Mill	Pulse Milling
Mustard Powder	Oil Mill	

3. COIR AND JUTE PRODUCTS

Automatic Coir Yarn Spinning	Coir Pith Block Making Unit	Jute And Mestha Products
Sisal Fibre Handicrafts	Rubberised Coir Unit	Semi Automatic Coir loom
Curled Coir	Motorised Ratts Spinning	

4. DEMAND BASED UNITS

Agarbathi Manufacturing	Clay Bricks Manufacturing	Fly Ash Bricks
Agricultural Implements	Clinical Laboratory	General Engineering Workshop
Automobile Service Unit	Computer Training Institute	Gummed Paper Tape
Brass And Bronze Casting	Corrugated Boxes	Hawai Chappals
Card Board Boxes	Cyber Cafe	Hollow And Cement Concrete Bricks
Cement Based Products	Dairy Farming	Leather Bags Making
Charcoal Making	Fish And Prawn Feed	Note Books
Packaged Drinking Water	Readymade Garments	Washing Soap And Detergent
Pencils	Repairing And Hiring Of Pumpset And Oil Engines	Wax Candles
Photography Studio	Soft Toys Making	Weigh Bridge

Polythene (LEPE) Bags	Steel Furniture	Wire Baskets Manufacturing
Pottery On Wheel	Tent House	Wooden Furniture
Powerlooms Unit	Tyre Retreading Unit	Wooden Switch Boards

5. FOOD PROCESSING

Biscuits	Milk Packing And Selling	Spice Oil
Bread	Mixed Nut Snacks	Stabilised Rice Bran
Cashew Processing	Papad Making	Tomato Products
Frozen Vegetables & Cold Storage	Pasta Products	Tomato Sauce And Ketchup
Ginger And Garlic Paste	Pickles Making	Instant Pickle
Ice Candy	Potato Banana Wafers	Mango Jelly
Soya Sauce	Preservation Of Eggs	

6. FOREST BASED UNITS

Bamboo Products	Herbal Deodorant Detergent	Seedless Tamarind Cake
Beedi Manufacturing	Cashewnut Decorticator	Sisal Fibre Unit
Brooms Making	Honey Bee Keeping	Soapnut Powder
Cashew Shell Nut Liquid	Honey Processing	Tamarind Powder
Herbal Mosquito Repellent Coil	Hand Made Paper- Mestha Based	Herbal And Ayurvedic Medicines
Gum Processing	Leaf Cups And Plates	Milk Products
Honey-Based Beverages	Mat Weaving	