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AN INTRODUCTORY OVERVIEW OF MICROFINANCE IN INDIA: AN ENQUIRY INTO FUTURE PROSPECTS

DR. VINITA K. PIMPALE*

*Assistant Professor,
R. A. Podar College of Commerce & Economics.

ABSTRACT

Although much progress has been made, the problem has not been solved yet, and the overwhelming majority of people who earn less than $1 a day, especially in the rural areas, continue to have no practical access to formal finance sector. Microfinance has been growing rapidly with $25Bn currently at work in microfinance loans. Although much progress has been made, the problem has not been solved yet, and the overwhelming majority of people who earn less than $1 a day, especially in the rural areas, continue to have no practical access to formal finance sector. Microfinance has been growing rapidly with $25Bn currently at work in microfinance loans. With controversial results, both supporting and not the assumption that microfinance can promote income generate activities, this paper attempts an enquiry into the recent developments in microfinance.

KEYWORDS: microfinance, Micro-finance institutions (MFIs).

INTRODUCTION

Although much progress has been made, the problem has not been solved yet, and the overwhelming majority of people who earn less than $1 a day, especially in the rural areas, continue to have no practical access to formal finance sector. Microfinance has been growing rapidly with $25Bn currently at work in microfinance loans. Microfinance is a general term to describe financial services to low-income individuals or to those who do not have access to typical banking services. Microfinance is a broad category of services including microcredit.
Microcredit is provision of credit services to poor clients. Although microcredit is one of the aspects of microfinance, critics attack microcredit referring to it indiscriminately as either 'microcredit' or 'microfinance'.

This paper will try to explain how microfinance works – by painting a picture of the parties involved and the recent development.

THE HISTORY OF MODERN MICROFINANCE

Credit unions and lending cooperatives have been around hundreds of years. However, the pioneering of modern microfinance is often credited to Dr. Mohammad Yunus, who began experimenting with lending to poor women in the village of Jobra, Bangladesh during his tenure as a professor of economics at Chittagong University in the 1970s. He founded the Grameen Bank in 1983 and won the Nobel Peace Prize in 2006. Grameen Bank (GB) has reversed conventional banking practice by removing the need for collateral and created a banking system based on mutual trust, accountability, participation and creativity. GB provides credit to the poorest of the poor in rural Bangladesh, without any collateral. At GB, credit is a cost effective weapon to fight poverty and it serves as a catalyst in the overall development of socio-economic conditions of the poor who have been kept outside the banking orbit on the ground that they are poor and hence not bankable.

Since then, innovation in microfinance has continued and providers of financial services to the poor continue to evolve. Today, the World Bank estimates that about 160 million people in developing countries are served by microfinance

NEED FOR MICRO FINANCE

There's now plenty of evidence that access to financial services is a critical tool for both economic growth and human development. Meanwhile, global experience also shows clearly that the poor can be reliable clients and institutions that service them right do good business.

Financial inclusion can be defined as a "state in which all people of working age have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients." An inclusive financial system is one that services all clients—not just the relatively well-off. This means reaching out to poor and low-income clients and providing them with affordable financial services tailored to their needs.

In many countries, poor and low-income people don't have access even to basic savings accounts, let alone more advanced financial services that could provide security, predictability and the seeds of economic growth for their household. An inclusive financial sector will support the full participation of lower income households in the financial system.

Financial Inclusion is one of the best tools we have today to alleviate poverty and contribute to the achievement of the development goals because…

- Sustainable access to microfinance services helps poor households meet basic needs such as adequate housing, healthcare, and education for their children.
- Even very small loans can be used to create new businesses, jobs and livelihoods.
- Poor people have proven that they not only repay their loans on time, they can provide profitable business for the loan provider that gives them the chance.
- Poor people use other financial services such as insurance and savings accounts to invest in their families and further secure the future of their households.
- Poor people do not want charity; they want access, and opportunity. Microfinance empowers the poor to participate in decision-making and control their lives.
- Providing services that tap the entrepreneurial spirit of poor people is vital to eradicating poverty.

Traditionally, banks have not provided financial services to clients with little or no cash income. Banks incur substantial costs to manage and maintain a client account, regardless of how small the sums of money involved. The fixed cost of processing loans of any size is considerable as assessment of potential borrowers, their repayment prospects and security; administration of outstanding loans, collecting from delinquent borrowers, etc., has to be done in all cases.

There is a break-even point in providing loans or deposits below which banks lose money on each transaction they make. Poor people usually fall below that breakeven point. A similar equation resists efforts to deliver other financial services to poor people.

In addition, most poor people have few assets that can be secured by a bank as collateral. This means that the bank will have little recourse against defaulting borrowers.

Seen from a broader perspective, the development of a healthy national financial system has long been viewed as a catalyst for the broader goal of national economic development.

Poor people borrowings often rely on relatives or a local moneylender, whose interest rates can be very high.

It is estimated that 76% of moneylender rates exceed 10% pm, including 22% that exceeded 100% pm. While moneylenders are often demonized and accused of usury, their services are convenient and fast, and they can be very flexible when borrowers run into problems.

HOW DOES IT WORK?

Micro-enterprise development is based on sound economic theory, made possible through community banks called micro-finance institutions. Micro-finance institutions (MFIs) work through the same principles as credit unions. They are designed to bring maximum benefits to their customers, with their profits recycled into further loans. Each MFI has an independent board who understands the needs and challenges of the community they are working in.

MFIs provide the funds to get micro-enterprise development started in a community. Then, as loans are paid back with interest, the bank begins to use its own money for further loans. A successful micro-finance institution will see both the funds and the demands for loans grow quickly, so that the benefits are felt by the entire community. Micro-enterprise loans are not designed for the 'poorest of the poor' but towards communities with high unemployment or very low wages.

It is better to consider them clients, whose strong will to succeed helps them to learn new skills, work hard and pay back their loan for long-term business security. By paying interest, they are increasing the value of their community bank and making it possible to provide further loans for themselves and others. Loans are usually small and short-term. An initial loan might be for around US$150 and the timeframe for paying it back 6 to 12 months. Subsequent funds may be a little higher to help the established business expand. The success of the business continues long after the loan is repaid, meaning greater family income for education, healthcare and a better life.

TABLE 1: KEY PERFORMANCE INDICATORS FOR ELEVEN LEADERS IN MICROFINANCE

Name	Country	No. of borrowers(*1000)		Portfolio (USD *million)		Portfolio growth (%)		Number of savers (*1000)		Savings (USD *million)		Expense ratio (%)	
		2005	2007	2005	2007	2005	2007	2005	2007	2005	2007	2005	2007
Compartamos	Mexico	453	839	181	378	44	28	0	0	0	0	44	39
ASA	Bangladesh	4182	5423	255	362	21	16	4059	6664	46	67	9,4	12,6
Mibanco	Peru	155	286	207	501	38	36	57	153	148	280	21,3	22,0
Equity Bank	Kenya	110	393	38	349	-5	70	556	1840	124	495	15,4	11,8
BancoSol	Bolivia	85	121	130	209	16	22	77	170	97	169	14,8	14,7
ACLEDA	Cambodia	141	185	100	315	34	50	92	249	62	345	19,2	13,5

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XacBank	Mongolia	50	61	30	86	46	42	65	103	25	67	18,9	14,9
Al Amana	Morocco	250	481	83	305	40	28	0	0	0	0	18,9	14,6
Share	India	814	990	82	128	51	28	0	0	0	0	23,4	17,2
Card Ngo	Philippines	98	320	9	34	21	52	0	0	0	0	23,3	33,8
Lapo	Nigeria	44	131	3	16	44	52	0	0	0	0	28,1	28,4
		580	**839**	**102**	**244**	**31,9**	**38,5**	**446**	**834**	**46**	**129**	**21,5**	**20,2**
		1163	**1094**	**164**	**338**	**32,1**	**36,3**	**975**	**1212**	**60**	**182**	**21,1**	**19,1**

Source: MicroCapital • August 2009 • www.MicroCapital.org

India is a country with a very large untapped demand for microfinance. The growth percentage has been over 50%, with returns varying significantly. SKS has taken over the market leader position from SHARE. In the period of observation, the market was heavily influenced by the so called "Krishna district collector incident" in March 2006. In Andhra Pradesh, which had been the model state for microcredits in India, the collector of the Krishna district accused several MFIs of charging unfairly high interest rates, taking illegal collateral and using dubious methods of loan recovery. Although no formal interest cap exists in India, various sector players lowered their rates in response to this incident, as is reflected in the financial revenue numbers. Since then the central government - in particular Finance Minister P Chidambaram - has taken a positive stance towards the sector, and gradually more regulation has been introduced.

The Indian market may therefore be currently characterized as having significant expansion possibilities, low interest rates due to informal interest ceilings and a credit-only market (where savings are not allowed). It is, however, open to foreign investors and - due to the fact that this is the largest single market in the world - a lot of innovation and investment has taken place in the last few years.

TABLE 2: PERFORMANCE OF MFIS IN INDIA

Name	**Number of borrowers(*1000)**		**Portfolio (USD *million)**		**Portfolio growth (%)**		**Number of savers (*1000)**		**Savings (USD *million)**		**Expense ratio (%)**	
	2005	2007	2005	2007	2005	2007	2005	2007	2005	2007	2005	2007
Bandhan	150	897	8	82	76,4	63,6	0	0	0	0	20,7	16,5
Basix	143	305	22	56	42,1	43,0	0	0	0	0	22,6	21,1
Share	814	990	82	128	51,0	28,2	0	0	0	0	23,4	17,2
SKS	173	1,629	21	262	63,1	75,8	0	0	0	0	8,1	17,0
Spandana	722	1,189	64	181	14,2	50,5	0	0	0	0	14,7	12,5
Average	**400**	**1,002**	**39**	**142**	**49,4**	**52,2**	**0**	**0**	**0**	**0**	**17,9**	**16,9**
Weighted average	**613**	**1,212**	**60**	**180**	**40,5**	**56,8**	**0**	**0**	**0**	**0**	**18,8**	**16,1**

Source: MicroCapital • August 2009 • www.MicroCapital.org

EVALUATION OF MICROFINANCE

There has been much criticism of the high interest rates upto 24% charged to borrowers. However, annual rates charged to clients are higher, as they also include local inflation and the bad debt expenses of the microfinance institution. The role of donors is also in question. The Consultative Group to Assist the Poor (CGAP) comments that "a large proportion of the money they spend is not effective, either because it gets hung up in unsuccessful and often complicated funding mechanisms or it goes to partners that are not held accountable for performance."

There has also been criticism of microlenders for not taking more responsibility for the working conditions of poor households, particularly when borrowers become quasi-wage labourers, selling crafts or agricultural produce through an organization controlled by the MFI.

Critics maintain that there are few if any rules or standards in these cases governing working hours, holidays, working conditions, safety or child labour, and few inspection regimes to correct abuses.

Microcredit has been blamed for many suicides in India: aggressive lending by microcredit companies in Andhra Pradesh is said to have resulted in over 80 deaths in 2010. http://www.bbc.co.uk/news/world-south-asia-11997571

Milford Bateman, the author of Why Doesn't Microfinance Work?, argues that microcredit offers only an "illusion of poverty reduction". "As in any lottery or game of chance, a few in poverty do manage to establish micro enterprises that produce a decent living," he argues, but "these isolated and often temporary positives are swamped by the largely overlooked negatives."

RECENT DEVELOPMENTS

Less than a year ago, in August 2010, SKS was riding high, having become the first microfinance institution, or MFI, to go in for an initial public offering which was received with much enthusiasm and oversubscribed nearly 14 times. Yet its fourth quarter results, for the year 2010/2011, report a loss of Rs 70 crore. Worse, its reputation, along with that of the entire microfinance sector, has taken a battering; following suicides by poor borrowers in Andhra Pradesh allegedly due to coercive loan recovery methods resorted to by some MFIs, who had begun to resemble the very village moneylenders they sought to replace. The common view seems to be that though SKS was flush with funds following the IPO, what needs to be seen is the way its balance sheet will look three to four years from now. Of the total gross loan portfolio of Rs 4,111 crore, the share of Andhra Pradesh (including the overdues) is Rs 1,285 crore. Even accounting for the 10.3 per cent recoveries continuing in the state, the company's balance sheet will take a huge hit if SKS writes off such a large amount in the next three to four years. It is these fears that seem to be reflecting on the bourses with the SKS scrip dipping by around 70 per cent since October 2010, when the Andhra government ordinance came in.

In wake of the suicide deaths and to regulate the functioning of the MFIs, the AP government issued the 'Andhra Pradesh MFI Ordinance' in Oct 2010. The ordinance, applicable from immediate effect, required MFIs to specify the area of their operations, the rate of interest, the system of operation and recovery.

The Registering Authority may, at any time, either suo moto or upon receipt of complaints by Self-Help Groups (SHGs) or general public cancels the registration of the MFIs after assigning sufficient reasons.

The MFIs should not seek security from a borrower by way of pawn or any other security and they should also display the rates of interest rates charged by them prominently in their offices. The ordinance makes it clear that the amount of interest should not be in excess of the principal amount. The MFIs should not extend a second loan unless the first loan is cleared,.

The MFIs must scrupulously maintain their accounts and submit a monthly statement to the Authority giving the list of loanees, the loan given to them and the amount of interest. In the wake of complaints that rowdy elements go to recover the loan amounts, the Ordinance mandates that only those staff with identity cards should go for recovery which should be done in a public place.

The loanees can complain to the Registering Authority in case of any problems and they can also call the grievance cell with toll free number: 15532.

The state government would establish fast track courts after consultation with the High Court for settlement of disputes of civil nature. All those connected with the MFI would be liable for punishment of imprisonment for upto three years or fine upto Rs 1 lakh or both if they resort to any coercive measures.

RBI appointed a committee under YH Malegam to study the ills of the Microfinance sector.

- The report was released in Jan 2011 and aimed to rein in MFIs & subject micro-credit to norms and disciplines with RBI as the MFI regulator.
- The report has recommended that MFIs charge no more than 24% on loans and that the margins they make be also no more than 10%.
- The report has said disallowed more than two microfinance companies to lend to one borrower.
- It recommended setting up of a microfinance credit information bureau and recommended a priority status on loans to micro lenders.
- The committee proposed to set up an ombudsman for the MFI sector. It also called for the Reserve Bank of India to draft a customer protection code for MFIs
- The committee has said that NBFCs with microfinance operations should be classified as an NBFC-MFI, and said that bank loans to these NBFC-MFI should be included in the priority sector.
- An NBFC-MFI will be a company that provides loans largely to low-income borrowers and gives small amount, short-term loans on unsecured basis. The report says that an NBFC MFIs cannot give more than Rs 25,000 as loan to single borrower and can provide loans only to families with income less than Rs 50,000.

SUMMARY

Over the past centuries practical visionaries, from the Franciscan monks who founded the community-oriented pawnshops of the 15th century, to the founders of the European credit union movement in the 19th century and the founders of the microcredit movement in the 1970s (Muhammad Yunus) have tested practices and built institutions designed to bring the kinds of opportunities and risk-management tools that financial services can provide to the doorsteps of poor people.

While the success of the Grameen Bank (which now serves over 7 million poor Bangladeshi women) has inspired the world, it has proved difficult to replicate this success.

Although much progress has been made, the problem has not been solved yet, and the overwhelming majority of people who earn less than $1 a day, especially in the rural areas, continue to have no practical access to formal finance sector. Microfinance has been growing rapidly with $25Bn currently at work in microfinance loans. It is estimated that the industry needs $250Bn to get capital to all the poor people who need it.

The industry has been growing rapidly, and concerns have arisen that the rate of capital flowing into microfinance is a potential risk unless managed well.

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