Conceptual framework of microfinance institution in India

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Indian public policy for rural finance from 1950s to till date mirrors the patterns observed worldwide. Increasing access to credit for the poor has always remained at the core of Indian planning in fight against poverty. The assumption behind expanding outreach of financial services, mainly credit was that the welfare costs of exclusion from the banking sector, especially for rural poor are very high. Starting late 1960s, India was home to one of largest state intervention in rural credit market and has been euphemistically referred to as 'Social Banking' phase. Between 1950 and 1970, the Indian Government focused on reaching out to the unbanked with subsidized agricultural credit and small loans. It also launched many initiatives including the Lead Bank Scheme, Priority Sector Advances and PMRY (Prime Minister Rural Employment Scheme) to benefit unbanked and underdevelopment regions; however, these did not penetrate as deeply as intended. In order to address this issue, the Government proposed the introduction of MFIs, to be regulated and supervised by the RBI, which would lend to the poor at subscribed interest rates. This paved the way for the entry of MFIs in the 1980s. In time, micro enterprise credit organizations - financing small businesses run by women – evolved into Non-Government Organizations, and in the 1990s transformed themselves into formal financial institutions with the express goal of creating inclusion. The World Bank says that MFIs serve around 160 million people in developing countries. India has approx. 350 million people living below the Poverty Line, most of whom are unable to avail of Government benefits because of collateral documentation and legal stipulations. In the late 1990s, institutions such as SIDBI and NABARD entered the area to assist the ailing microfinance business.

Table - 1

Emergence of Microfinance Institutions (MFIs) in India

Year	No. MFIs in India
1995	02
1996	03
1997	03
1998	08
1999	09
2000	11
2001	11
2002	13
2003	39
2004	87
2005	93
2006	106
2007	79
2008	100
2009	118
2010	119
2011	108

Table – 1 shows the no. of microfinance from 1995 to 2011 in India. MFIs in 1995 were 02 only whereas up to 13 were raised after seven years (2002). In 2003, MFIs became three times (39) as compared to the no. of 2002. While the earliest MFI, Shri Mahila SEWA (Self-Employed Women's Association) Sahakari Bank (SEWA Bank) was set up in 1974, rapid growth in the number of MFIs took place mainly after 2002. The early MFIs were set up as cooperative banks, societies or trusts. As the profitability of microcredit became established, some of them started transforming themselves into non-banking finance companies (NBFCs), so that they could access equity in order to leverage the funds increasingly becoming available from the banking system. A majority of MFIs use group-based models of lending.

Objectives of the Study

In India so many micro lending services to the poor and hence many delivery models institutions are working. Some are in very good condition have been developed over a period of time in terms of lending, training to their clients for saving. Some are in bad condition a human right. The present study is increasing their outreach has always been an important conducted to know the following things related to MFIs. The present paper discusses conceptual framework of a microfinance institution in India. The successes and failures of various microfinance institutions around the world have been evaluated and lessons learnt have been incorporated in a model microfinance institutional mechanism for India.

Role of NGOs for Promoting Microfinance in India

The idea of microfinance is promoted by NGOs with the help of self help groups. Self help groups formed in groups of three or five people generate their own savings. Finally, it is stated that for many NGOs, microfinance is a way to financial sustainability. Especially for the medium to large NGOs that are able to access bulk funds for on-lending. For example from SIDBI, the interest rate spread could be an attractive source of revenue than revenue generated from an uncertain highly increasing and competitive donor funding. Microfinance has shown positive results than the other projects. Most microfinance schemes led by NGO are for the rural women who are given access to small loans to meet their emergency needs. NGOs have played a huge role in promoting microfinance by partnering with influential so called actors for microfinance. This included the National Bank for Agricultural and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), Friends of Women's World Banking (FWWB), Rashtriya Mahila Kosh (RMK), Council for Advancements of People's Action and Rural Technologies (CAPART), Rashtriya Gramin Vikas Nidhi (RGVN). Additionally the other donor funded programs included International Fund for Agricultural Development (IFAD), United Nations Development Program (UNDP), World Bank and Department for International Development in UK and recently even the commercial banks have been added to the idea pull. Induced by the worldwide focus on microfinance, donor NGOs too have been funding microfinance projects therefore this can be called as a supply push.

Guidelines for regulating Microfinance in India

The typical precedent in regulation for micro-credit is banking sector regulation, which has a focus on protecting the rights of the depositor. As a result, microfinance regulation tends to differentiate between deposit and non-deposit taking MFIs, with a lot of the banking sector regulation applied to the deposit-taking MFIs. This does not quite apply in the case of the Indian micro-credit sector, where MFIs offer credit while deposit-taking has remained a distinctly uncertain future possibility. To add to the complexity, banking regulation cannot readily translate into a framework to accommodate the heterogeneity of legal structures that the typical microfinance sector is based on. If regulation has to be created for the microfinance industry, it would need to be uniform across these different forms so that the industry does not get fragmented across regulatory lines. Internationally, there is some precedent for this approach. For instance, the Basel Committee on Banking Supervision has developed guidelines for prudential regulation of deposit-taking institutions in the microfinance space. Several recommendations for expansion of the financial inclusion agenda have made a case for the establishment of small-banks which would be permitted to take deposits from the rural poor. But, so far, these have not had much traction in policy **(CFSR, 2008)**. **Shankar and Asher (2010)** offer a mandate for Indian micro finance regulation that falls within the domain of the deposit-taking MFIs. They propose that RBI regulate deposit-taking MFIs by eventually making them MFI banks, along with an independent oversight board (under the purview of RBI) to regulate the non-prudential aspects of the remainder of the micro- finance business. A more general framework is that presented in **Christen, Lyman, and Rosenberg (2003),** which details guiding principles of microfinance regulation across both the forms. The dichotomy caused by these two regulatory approaches has been the source of much confusion in the industry. Two key efforts in proposing a framework for the Indian microfinance industry are the **(Ministry of Finance, 2010)** which was actually proposed by the industry after the 2005 Krishna crisis, and the **Malegam (2011)** report which was proposed after the 2010 legislation was passed. Both these focus heavily on prudential norms, and corporate governance issues. However, they fall short of a tangible effort at tackling the issues of ensuring better credit processes.

Key Consideration of Microfinance for Indian Economy

Micro-finance and Poverty Eradication

Over the last ten years, however, successful experiences in providing finance to small entrepreneur and producers demonstrate that poor people, when given access to responsive and timely financial services at market rates, repay their loans and use the proceeds to increase their income and assets. This is not surprising since the only realistic alternative for them is to borrow from informal market at an interest much higher than market rates. Community banks, NGOs and grass root savings and credit groups around the world have shown that these microenterprise loans can be profitable for borrowers and for the lenders, making microfinance one of the most effective poverty reducing strategies. Microfinance institutions can broaden their resource base by mobilizing savings, accessing capital markets, loan funds and effective institutional development support. A logical way to tap capital market is securitization through a corporation that purchases loans made by microenterprise institutions with the funds raised through the bonds issuance on the capital market. Once microfinance institutions are engaged in deposit taking in order to mobilize household savings, they become financial intermediaries. Consequently, prudential financial regulations become necessary to ensure the solvency and financial soundness of the institution and to protect the depositors. However, excessive regulations that do not consider the nature of microfinance institution and their operation can hamper their viability. In view of small loan size, microfinance institutions should be subjected to a minimum capital requirement which is lower than that applicable to commercial banks. On the other hand, a more stringent capital adequacy rate (the ratio between capital and risk assets) should be maintained because microfinance institutions provide uncollateralized loans.

Governments should provide an enabling legal and regulatory framework which encourages the development of a range of institutions and allows them to operate as recognized financial intermediaries subject to simple supervisory and reporting requirements. Usury laws should be repelled or relaxed and microfinance institutions should be given freedom of setting interest rates and fees in order to cover operating and finance costs from interest revenues within a reasonable amount of time. Government could also facilitate the process of transition to a sustainable level of operation by providing support to the lending institutions in their early stage of development through credit enhancement mechanisms or subsidies. Therefore, formal sector finance institutions could form a joint venture with informal sector institutions in which the former provide funds in the form of equity and the later extends savings and loan facilities to the urban poor. Another form of partnership can involve the formal sector institutions refinancing loans made by the informal sector lenders. Under these settings, the informal sector institutions are able to tap additional resources as well as having an incentive to exercise greater financial discipline in their management.

The Formal Sector Institutions

The formal sector Banking Institutions in India have been serving only the needs of the commercial sector and providing loans for middle and upper income groups. Similarly, for housing the HFIs have generally not evolved a lending product to serve the needs of the Very LIG primarily because of the perceived risks of lending to this sector. As far as the formal financial institutions are concerned, there are Commercial Banks, Housing Finance Institutions (HFIs), NABARD, Rural Development Banks (RDBs), Land Development Banks Land Development Banks and Co-operative Banks (CBs).

As regards the Co-operative Structures, the Urban Co-op Banks (UCB) or Urban Credit Co-op Societies (UCCS) are the two primary co-operative financial institutions operating in the urban areas. There are about 1400 UCBs with over 3400 branches in India having 14 million members, their total lending outstanding in 1990-91 has been reported at over Rs. 80 billion with deposits worth Rs. 101 billions. Similarly there exist about 32000 credit co-op societies with over 15 million members with their total outstanding lending in 1990-91 being Rs. 20 billion with deposits of Rs 12 billion. The Government has taken several initiatives to strengthen the institutional rural credit system. The rural branch network of commercial banks have been expanded and certain policy prescriptions imposed in order to ensure greater flow of credit to agriculture and other preferred sectors. The commercial banks are required to ensure that 40% of total credit is provided to the priority sectors out of which 18% in the form of direct finance to agriculture and 25% to priority sector in favour of weaker sections besides maintaining a credit deposit ratio of 60% in rural and semi-urban branches.

The Existing Informal financial sources

The informal financial sources generally include funds available from family sources or local money lenders. The local money lenders charge exorbitant rates, generally ranging from 36% to 60% interest due to their monopoly in the absence of any other source of credit for non-conventional needs. Most of the NGOs like SHARAN in Delhi, FEDERATION OF THRIFT AND CREDIT ASSOCIATION (FTCA) in Hyderabad or SPARC in Bombay have adopted the first model where they initiate the groups and provide the necessary management support. Others like SEWA in Ahmedabad or BARODA CITIZEN's COUNCIL in Baroda pertain to the second model. The experience of these informal intermediaries shows that although the savings of group members, small in nature do not attract high returns, it is still practiced due to security reasons and for getting loans at lower rates compared to that available from money lenders. These are short term loans meant for crisis, consumption and income generation needs of the members. The interest rates on such credit are not subsidized and generally range between 12 to 36%. Most of the loans are unsecured. In few cases personal or group guarantees or other collaterals like jewellery is offered as security.

Credit Mechanisms Adopted by HDFC

HDFC has been making continuous and sustained efforts to reach the lower income groups of society, especially the economically weaker sections, thus enabling them to realize their dreams of possessing a house of their own.

HDFCs' response to the need for better housing and living environment for the poor, both, in the urban and rural sectors materialized in its collaboration with Kreditanstalt fur Wiederaufbau (KfW), a German Development bank. KfW sanctioned DM 55 million to HDFC for low cost housing projects in India. HDFCs' approach to low-income lending has been extremely professional and developmental in nature. Negating the concept of dependence, HDFCs' low cost housing schemes are marked by the emphasis on people's participation and usage of self-help approach wherein the beneficiaries contribute both in terms of cash and labour for construction of their houses. HDFC also ensures that the newly constructed houses are within the affordability of the beneficiaries, and thus promotes the usage of innovative low cost technologies and locally available materials for construction of the houses. For the purpose of actual implementation of the low cost housing projects, HDFC collaborates with organizations, both, Governmental and Non-Governmental. Such organizations act as co-coordinating agencies for the projects involving a collective of individuals belonging to the Economically Weaker Sections. The projects could be either in urban or rural areas.

Strengths of Informal Sector

A synthesis that can be evolved out of the success of NGOs/CBOs engaged in microfinance is based on certain preconditions, institutional and facilitating factors.

1. ***Preconditions to Success:***

Those NGOs/ CBOs have been successful that have installed financial value/ discipline through savings and have demonstrated a matching value themselves before lending. A recovery system based on social intermediation and various options including non-financial mechanisms has proved to be effective. Another important feature has been the community governance. The communities in which households are direct stake holders have successfully demonstrated the success of programs. A precondition for success is to involve community directly in the program. Experience indicates that savings and credit are both critical for success and savings should precede credit. Chances of success more with women: Programs designed with women are more successful.

2. ***Operating Indicators :***

The operational success has been more when interest rates are at or near market rates. The operating indicators show that programs which are designed taking into account the localized and geographical differences have been successful. Effective and responsive accounting and monitoring mechanisms has been an important and critical ingredient for the success of programs. The experience of NGOs/CBOs indicates that low income households are willing to pay market rates. The crucial problem is not the interest rates but access to finance. Eventually in absence of such programs households end up paying much higher rates when borrowing from informal markets. Some NGOs have experimented where members of community decide on interest rates. This is slightly different from Thailand experience where community decides on repayment terms and loan amount. A combination of the three i.e.

interest rates, amount and repayment period if decided by community, the program is most likely to succeed. A program which is able to leverage maximum funds from formal market has been successful. Experience indicates that it is possible to leverage higher funds against deposits.

Betterment in quality of life through better housing or better economic opportunities is a tangible indicator of success. The programs which have been able to demonstrate on some measurable scale that the quality of life has improved have been successful. To be successful the program productivity with outreach should match. The credit mechanism should be flexible meeting multiple credit needs: The programs which have taken care of other needs such as consumption, marriage etc. besides the main shelter, infrastructure or economic needs are successful.

3. *Facilitating Factor*

Another factor that has contributed to the success is the broad environment. A facilitative environment and enabling regulatory regime contributes to the success. The NGOs/CBOs which have been able to leverage funds from formal programs have been successful. An essential factor for success is that all development programs should converge across sectors.

Existing Microfinance Models

One of the most successful models discussed around the world is the Grameen type. The bank has successfully served the rural poor in Bangladesh with no physical collateral relying on group responsibility to replace the collateral requirements. This model, however, has some weaknesses. It involves too much of external subsidy which is not replicable Grameen bank has not oriented itself towards mobilizing peoples' resources. The repayment system of 50 weekly equal installments is not practical because poor do not have a stable job and have to migrate to other places for jobs. If the communities are agrarian during lean seasons it becomes impossible for them to repay the loan. Pressure for high repayment drives members to money lenders. Credit alone cannot alleviate poverty and the Grameen model is based only on credit. Micro-finance is time taking process. Haste can lead to wrong selection of activities and beneficiaries. Most of the existing microfinance institutions are facing problems regarding skilled labour which is not available for local level accounting. Drop out of trained staff is very high. One alternative is automation which is not looked at as yet.

Expected Possible Options

The three options that emerge out of above discussion regarding structure of intermediary institution is discussed below.

Option-I

One possible option is to increase the flow of funds to informal lenders to supplement their own funds. The formal sector will take advantage of the lower transaction costs and risk premia of the informal sector so as to reach the low income group borrowers beyond the profitable reach of the formal sector. As for the beneficiaries, inspite of the transaction cost of the formal and the informal sector being transferred on to them, the cost of borrowing will remain low as compared to what exists through money lenders. Thus this approach of promoting linkages combines the strengths of both sectors to supplement the resources of the informal sector. Here it is imperative to avoid the pitfall of discouraging informal savings by substituting cheaper formal funds for informal lenders. The intermediaries could then lend to groups of beneficiaries. The transaction cost of the formal sector would be transferred on to the intermediaries who would pass on the same to the beneficiaries. In the process, the intermediaries would also charge additional fees to borrowers to cover their costs. It would also aid them in strengthening themselves. However, it would be aimed to make the funds reach the beneficiaries at applicable rates of the two institutions. The intermediaries would accept the savings from groups as collaterals and would transfer the same to the formal sector for getting the deposits serviced better. Thus the two way flow of funds would benefit both the formal and informal sector. The beneficiaries would benefit as the cost of borrowing would be low for them and their savings would be safe and would be serviced better. An analysis of community-based finance systems highlights the high establishment costs of NGOs. They suggest that loan service costs are lower amongst co-operative societies, as compared to NGO-linked CBFIs, because of decentralized loan administration and availability of voluntary staff. The NGO-linked CBFI operations are generally supported by grants from national and international donor agencies.

Option-II

Since it is now being felt that the existing structures are inadequate to meet the housing and economic credit needs of the participating community, an Institution that would combine the strengths of an NGO and the expertise of a financial institution, with participation from the community will be appropriate. Thus, the concept of Development Association for Savings and Credit (DASC) could be utilized to address the issue of providing better access to housing finance and economic loans for the participating community in the project area. The DASC is built on the strength of the informal groups to create and improve access to skills, resources and markets. These Groups mobilize savings from their constituent members and other formal/informal sources. The funds mobilized are thus used for meeting the credit needs of the members. The DASC is proposed to be a registered company which will affiliate the Groups based on affiliation criteria and have community representation on its decision making body.

Option-III

As mentioned before, a review of the cooperatives and NGOs illustrates a wide variety of arrangements as well as different stages of development of community-based financial institutions. In all cases, the strength of the community based systems is their close rapport and linkages with the community and its members. The broad arrangement involves a bulk loan from the Formal Financial Institution to the Community Based Financial Institution (CBFI) with specified terms and conditions for lending to households. The CBFI will have the responsibility for loan origination and servicing and therefore would also bear the credit risk. In terms of specific arrangements, two forms of intermediation are envisaged by the strategy. The multi-tiered structure is one in which the bulk loans from the Formal Sector are routed through a Federation or Apex Agency or an NGO, which in turn lends to a primary CBFI. In the single-tiered structure, the Formal Sector Institution deals directly with the CBFI. It is felt that the administrative costs incurred with lending through the multi-tiered model are much higher than under the single-tier model. In promoting these linkages between the Formal Institutions and CBFIs, directly or through the NGO, it is important that basic financial principles are developed for giving bulk credit to community-based financial institutions. The purpose of the loan, credit terms and underwriting criteria should be clearly defined for the bulk credit that is provided to the CBFI. It is essential that a delinquency risk fund (DRF) be placed as a deposit with the Formal Institution to cover delinquency risk which may draw against the DRF if the CBFI fails to make a regularly scheduled loan payment. In order to meet the DRF requirement, CBFIs should be encouraged to start a savings scheme. An appropriate legal status for the CBFI to be able to receive the bulk credit is essential. This may involve a simple registration under the Societies Act. The legal form should permit the receipt of bulk credit for on lending to the individual members.

Conclusion

The micro-finance industry has seen tremendous growth in the last half decade and it should be appreciated for its innovative ways to cater to the marginalized poor people. However, its current region-centric growth leaves a huge scope for MFI to grow in other parts of India. Moreover, it can achieve tremendous growth if it follows a customer-centric flexible model instead of the current standardized product and service model, which acts as a barrier to expand in unknown territories. However, in order to achieve this growth, the expert believes that MFIs should be run only by profit organizations as there has been enough proof of this concept in the past. Also, MFIs should work with the government to gain the support of people and should not treat state actors as competitors. It is also believed that the industry is adequately regulated and there is no need to bring any new regulation. Instead the regulators should monitor the industry in an effective manner. The expert also believes that the MFIs will come out as mature players after the current crisis. Some valuable lessons can be drawn from the experience of successful Microfinance operation. First of all, the poor repay their loans and are willing to pay for higher interest rates than commercial banks provided that access to credit is provided. The solidarity group pressure and sequential lending provide strong repayment motivation and produce extremely low default rates. Secondly, the poor save and hence microfinance should provide both savings and loan facilities. These two findings imply that banking on the poor can be a profitable business. A main conclusion of this paper is that microfinance can contribute to solving the problem of inadequate housing and urban services as an integral part of poverty eradication programs. The challenge lies in finding the level of flexibility in the credit instrument that could make it match the multiple credit requirements of the low income borrowers without imposing unbearably high cost of monitoring its end-use upon the lenders. A promising solution is to provide multi-purpose loans or composite credit for income generation, housing improvement and consumption support.

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