AN ANALYSIS OF THE ROLE OF MICROFINANCE PROGRAMS IN PROMOTING FINANCIAL INCLUSION IN INDIA

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NATIONAL UNIVERSITY OF SINGAPORE

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AN ANALYSIS OF THE ROLE OF MICROFINANCE PROGRAMS IN
PROMOTING FINANCIAL INCLUSION IN INDIA¹

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¹ The rupee exchange rate is approximately Rs. 45.50 to a US Dollar (February 14, 2011).
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While all the above have contributed to the thesis, the usual caveat that I am responsible for errors, applies here too.

Savita Shankar

February 16, 2011
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Thesis Abstract

The thesis defines financial inclusion as ongoing access to a range of financial services in an affordable and convenient manner. As low income groups are often among those lacking such access, microfinance programmes providing financial services to them have emerged as a public policy instrument to promote financial inclusion. This thesis evaluates the contribution of microfinance programs in promotion of financial inclusion in India.

The research framework and research questions in the thesis were informed by the relevant literature, particularly relating to microfinance, financial inclusion and their links with broader development goals. The research questions relate to how the two major microfinance models in India, the self help group bank linkage program (the SBLP) and the microfinance institution (MFI) model, address barriers to financial inclusion, and facilitate expected outcomes.

To sustain financial inclusion, group microfinance members should graduate to individual financial services. The thesis therefore also explores the environment in which such graduation could take place.

A research design based on case studies and qualitative research methods was adopted. The lines of enquiry followed were at the sector level, at the microfinance provider level and at the microfinance member level. For the provider and member levels, primary data were collected in the State of Tamil Nadu. At the provider level, one organization associated with each model was studied, including interviews of senior officials and 103 MFI field staff. At the member level, 34 low income women
were interviewed. The enquiry enabled the development of an explanatory framework for financial inclusion through microfinance.

The research at the sector level led to understanding of the following: factors influencing microfinance penetration; requirement for improving availability of financial services other than microcredit; need for creating a sector wide credit bureau; benefits of unique identification numbers for residents to facilitate development of credit histories for microfinance members; and the importance of a systematic approach to graduation of group members to individual financial services.

The findings from provider and member level research included barriers to microfinance membership; the requirement for a wider range of financial services particularly savings services; and the need for enhanced financial literacy and financial management skills among members. Distinct categories of MFI and SBLP members also emerged. “Effective utilizers” who build up individual repayment capability during group membership, enabling them to graduate to individual loans later, were common to both models. In addition, in MFIs, there were “ineffective utilizers” who fail to adequately build up repayment capacity. In the SBLP, there were “cashflow smoothers” and “consistent savers’. While the first do not receive adequate finance in order to invest substantially in their enterprises, the second group uses the SBLP primarily to save.

The thesis analyzed appropriate regulatory framework for the microfinance sector. The study has implications for policymakers at the national and state level, microfinance providers, members and funding agencies. The thesis findings also suggest that there is considerable scope for policy relevant empirical research on microfinance in India.
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<td>AP</td>
<td>Andhra Pradesh</td>
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<tr>
<td>ATM</td>
<td>Automated Teller Machine</td>
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<td>BC</td>
<td>Banking Correspondent</td>
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<tr>
<td>BRI</td>
<td>Bank Rakyat Indonesia</td>
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<td>CCE</td>
<td>Citizen Centre Enterprises</td>
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<td>CGAP</td>
<td>Consultative Group to Assist the Poor</td>
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<td>CRA</td>
<td>Community Reinvestment Act</td>
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<td>DFI</td>
<td>Development Finance Institution</td>
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<td>ERR</td>
<td>Effective Rate of Return</td>
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<td>FINCA</td>
<td>Foundation for International Community Assistance</td>
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<td>FIPB</td>
<td>Foreign Investment Promotion Board</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GPS</td>
<td>Grameen Pension Scheme</td>
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<td>GRT</td>
<td>Group Recognition Test</td>
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<td>GVMFL</td>
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<td>HIH</td>
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<td>IFAD</td>
<td>International Fund for Agricultural Development</td>
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<td>Index of Financial Inclusion</td>
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<td>IRDA</td>
<td>Insurance Regulatory and Development Authority</td>
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<td>IRDP</td>
<td>Integrated Rural Development Program</td>
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<td>IRR</td>
<td>Internal Rate of Return</td>
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<td>IT</td>
<td>Information Technology</td>
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<td>KYC</td>
<td>Know Your Customer</td>
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<td>MACs</td>
<td>Mutually Aided Cooperative Society</td>
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<td>MFI</td>
<td>Microfinance Institution</td>
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<td>Microfinance Organisation</td>
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<td>Micro Finance Provider</td>
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<td>NABARD</td>
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<td>Non-banking finance company</td>
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<td>NBFI</td>
<td>Non Bank Financial Institution</td>
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<td>NGO</td>
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<td>Self Help Group</td>
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1. Introduction

Microfinance refers to the provision of a broad range of financial services such as deposits, loans, money transfers, and insurance to poor and low income households and their microenterprises\(^1\). Provision of microcredit, namely loans for the poor, has however dominated the microfinance sector globally.

The growth of microfinance has been described as a revolution (Robinson, 2001). Yunus (1998) has described it, perhaps somewhat exaggeratedly, as a “revolutionary way to reduce poverty”\(^2\). The first Microcredit Summit held in Washington D.C., in 1997, brought together over three thousand people from 137 countries. It was organized by RESULTS\(^3\) Educational Fund. The Summit launched a nine year campaign to reach over 100 million of the world’s poorest families\(^4\). The year 2005 was designated by the United Nations (UN) as the “International year of microcredit”. In 2006, the Nobel Peace Prize was awarded to Muhammad Yunus, the founder of Grameen Bank, one of the earliest and

\(^1\) Definition from Asian Development Bank web site (www.adb.org, accessed on November 1, 2008). Microenterprises here are assumed to be non-financial in nature.

\(^2\) Rigorous evaluation studies have however yet to establish conclusively the link between microfinance and poverty reduction. Refer Chapter 2 for a detailed review of studies on microfinance impact.

\(^3\) RESULTS (not an acronym) is a grassroots based advocacy group headquartered in the USA.

\(^4\) The goal is reported to have been reached by year 2007, when a new goal of reaching 175 million poorest families and lifting 100 million families above the threshold of US$ 1 a day by 2015 was adopted by the Summit (Daley-Harris, 2009).
perhaps the best known microfinance institution (MFI). These milestone events have drawn international attention to the microfinance sector.

One of the most important potential contributions of microfinance is financial inclusion, namely enabling access of financial services to underserviced individuals.

This chapter explains the rationale for the thesis and the research questions. It also provides an overview of the concept of financial inclusion and its link with microfinance. Section 1.1 explains the rationale for the study. Section 1.2 introduces the concept of financial inclusion while Section 1.3, 1.4 and 1.5 provide an international overview of measures of financial inclusion, barriers to financial inclusion and policies for the promotion of financial inclusion, respectively. Section 1.5.1 discusses financial inclusion policy in India. Section 1.6 specifies the research questions and finally Section 1.7 describes the organization of the thesis.

1.1 Motivation for the Thesis

In India, financial inclusion (discussed in greater detail in Section 1.2) has been on the policy agenda since financial year 2004-2005, after being highlighted in the annual policy review of the country’s central bank, the Reserve Bank of India (RBI). According to the “All India debt and investment survey”, (2003), the share of institutional debt for rural households in India in 2002 was 57 percent, declining from 64 percent in 1991.\(^5\)

\(^5\) The share of institutional sources had earlier increased from 29 percent in 1971 to 61 percent in 1981 with expansion in the network of state owned banks and further to 64 percent in 1991.
(NSSO, 2005). In 2005, assuming one savings account per person, 59 percent of the adult population in India had bank savings accounts. The number of loan accounts, on the other hand, constituted only 14 percent of the adult population (Thorat, 2007).

An inclusive financial system implies availability of a continuum of financial services for all income groups. Financial inclusion policies of most countries typically focus on encouraging banks to open affordable savings accounts for the financially excluded. The assumption is that once this is achieved, access to other financial services becomes easier. However in the Indian context, it is observed that such accounts, even when opened are not widely used and substantive financial inclusion therefore remains limited.

Various studies indicate that low income acts as a significant barrier to financial inclusion, both from the demand and the supply side. This makes provision of financial services to low income segments of the population particularly challenging. Microfinance specifically addresses this very segment, making such programs very useful in promoting

6 The term “continuum” is used to imply that there are no gaps in provision of financial services. To illustrate with an example regarding loans, if MFIs provide loans up to a certain amount, loans just above that threshold need to be provided by another kind of institution. There should not be a gap between the upper threshold of the MFI and the lower threshold of the institution providing the next larger loan.

7 The term “financially excluded” implies individuals who are unable to access financial services due to the presence of barriers. This is the sense in which the term is largely used in the financial inclusion literature. There is no normative implication attached to the term.

8 This aspect is discussed in detail in Section 1.5.1.

9 Section 1.4 discusses this aspect in detail.
financial inclusion. As Rhyne (2010) puts it “financial inclusion is like a jigsaw puzzle, for which microfinance has many of the pieces”\textsuperscript{10}.

With the rapid growth of the microfinance sector in India, there were 70 million microfinance accounts by 2009, indicating an annual growth rate of 25 percent. The sector is attracting finance from a variety of sources and hence is growing at a rapid pace. As microfinance programs in India typically cater to low income financially excluded households, it is fast emerging as a possible means to expand access.

An understanding of the contribution of microfinance programs and their service gaps from the financial inclusion perspective can indicate additional facilitative and supportive roles required of the Government and other stakeholders. As detailed in \textbf{Chapter 2}, many studies on microfinance tend to focus on its possible impact in enhancing various socially desirable objectives, such as poverty mitigation and female empowerment. The results of these studies have mostly been inconclusive. While there is consensus on microfinance’s utility in providing financial services, there is no in-depth analysis on this aspect.

An important gap in the literature concerns the examination of the question whether microfinance adequately addresses demand and supply side barriers, mentioned in the literature on financial inclusion. Conroy (2006) and Jayasheela et al. (2010) suggest that microfinance can be a useful means of increasing financial inclusion in the

\textsuperscript{10} This was mentioned in her article urging MFIs to focus on financial inclusion by expanding the range of financial services offered by them, as their current over-emphasis on expanding the scale of their lending operations has led to concerns regarding multiple lending and repayment problems in a number of countries.
context of the Pacific Islands and India respectively, but not on the basis of detailed studies. Further, while there is considerable literature on financial development and economic growth at the macro level\textsuperscript{11}, no other study examines if outcomes expected of financial inclusion are provided by microfinance at the individual level. Similarly, no other study analyzes whether group membership subsequently enables graduation of microfinance members to financial services on an individual basis.

The thesis attempts to evaluate the contribution of microfinance programs to financial inclusion based on primary data collected in the state of Tamil Nadu in India. The microfinance sector in this state is at a mature level, though there is scope for further progress. Not all states in India exhibit a mature microfinance sector, nevertheless the results of a study focused on Tamil Nadu could provide an indication of typical issues that are likely to arise in other states as microfinance access grows. An important finding, which is likely to be relevant for the rest of the country, is the need to develop an appropriate regulatory framework for the microfinance sector. A suggested framework for the country as a whole is articulated in the thesis as state level regulation could be dysfunctional, creating distortions in the spread of microfinance services.

\textsuperscript{11} These studies are described in Section 1.2.
1.2 Financial Inclusion

There is recognition that in countries at all income levels, there are population groups that are not adequately serviced by the formal financial system. Financial inclusion involves expanding their access to the financial system at an affordable cost.

Early definitions of financial exclusion viewed it in the larger context of social exclusion. Leyshon and Thrift (1995) define financial exclusion processes as those which serve to prevent certain social groups and individuals from gaining access to the formal financial system. More recently, financial inclusion has been defined by the World Bank (2008), as the absence of price and non-price barriers in the use of financial services.

The UN report (2006) entitled, “Building inclusive financial sectors for development” (referred to sometimes as the “blue book”) played a significant role in bringing international attention on this issue. The publication was a follow-up to the Monterrey Consensus in 2002, under which heads of State resolved to address the challenges of financing for development.

The U.N. Report defines an inclusive financial system as one which provides credit to all “bankable” individuals and firms; insurance to all insurable individuals and firms; and savings and payment services for everyone. Financial inclusion does not imply that everyone will use all available financial services, rather everyone has the option to use them. An important distinction made in the U.N. Report is between “inclusive

finance” and microfinance. While the former refers to a broader concept of a continuum of financial service providers, the latter represents only one type of financial sector organization. Building inclusive sectors hence includes, but is not limited to, strengthening microfinance. A continuum of financial services needs to be made accessible to individuals as they improve their standard of living.

Often small and medium enterprises which have outgrown microfinance are unable to access and use mainstream financial products. These enterprises are usually unable to find financiers to cater to their requirement, a gap known as the “missing middle”\(^\text{13}\). While the UN Report advocates a vision for financial inclusion, it does not provide specific policy prescriptions. However it does emphasize that within a country, multiple stakeholders need to work together in a coordinated manner if progress towards financial inclusion is to be made (Page 40, Executive Summary of the UN Report).

**Expected Outcomes of Financial Inclusion**

The importance of financial inclusion stems from various factors. First, an inability to access financial services could lead financially excluded entities to deal mostly in cash, with its attendant problems of safe-keeping. Second, the lack of access to safe and formal saving avenues could reduce their incentives to save. When saving occurs, safety and interest rate benefits may not be adequate to the extent available in the formal system. Inadequate savings could lead households to depend on external sources of funds, in times of need. Often these sources are unregulated and with high interest

\(^{13}\) The gap is supposed to have first been identified by a commission headed by Harold MacMillan in the United Kingdom in the 1930s (Burgess, 2010).
rates. High interest rates increase the risk of default by borrowers. Third, the lack of credit products means inability to make investments and significantly improve their livelihoods. As a result, small entrepreneurs often lack an enabling financial environment to grow. Fourth, the lack of remittance products leads to money transfers being cumbersome and high risk. Fifth, the lack of insurance products means lack of opportunities for risk management and wealth smoothening\footnote{Assuming individuals are risk averse, insurance increases total utility by serving as a wealth smoothening mechanism. The reduction in wealth due to payment of an insurance premium in a “no-loss” scenario is more than offset by the saving due to insurance in a “loss” scenario, particularly as the marginal utility of money diminishes with increase in wealth.}.

Access to an organized financial system implies availability of standardized financial products from regulated institutions. Savings products, small value remittances, insurance products and purchases on credit make financial planning easier. Savings products enable consumption smoothing over time. Remittance products are safer than cash payments, not only to prevent theft, but also to document proof of payment. More importantly, credit histories are built which enable borrowing at more favorable terms in the future. With increasing automation, financial service providers rely on existing databases rather than personal interaction in order to make offers to customers. This puts financially excluded individuals at a distinct disadvantage as they are unlikely to feature in such databases. (Leyshon et.al., 1998).

It is commonly argued that the economy as a whole benefits through financial inclusion (Mohan, 2006). First, it could be an important tool to reduce income inequality in the economy. Low income individuals are often those not accessing financial services. Once access is provided, these individuals have greater potential to improve their income..
levels. Second, more financial resources become available for efficient intermediation and allocation. Third, greater financial stability may be expected if financial activity moves from unregulated to regulated institutions. Fourth, access to finance promotes more start-up enterprises\(^\text{15}\), who often contribute to risk taking, employment and processes of creative destruction\(^\text{16}\) (Schumpeter, 1942).

As financial inclusion by definition implies increasing the coverage of the formal financial system, it may be expected to contribute to the development of a financial system. The relationship between financial development and growth has been studied by a number of economists. There is an agreement that the two are related, but there is a lack of consensus on the direction of causality (Fitzgerald, 2006). A number of empirical studies however suggest, that development of the financial system spurs growth in an economy (King and Levine, 1993; Aghion, Howitt and Mayer-Foulkes, 2003 and Rajan and Zingales, 2003).

A study using data on 109 developing and developed countries by Calderon and Liu (2003) showed that the direction of causality was generally from financial development to economic growth. Moreover, economic growth is likely to be beneficial to the poorest segment of the population, as indicated by the results of a study by Beck, Demirguc-Kunt and Levine (2007). They use data from a sample of 72 developed and

\(^{15}\) In addition, to promoting more start-ups, transaction costs of starting and closing businesses are also important. This needs to be addressed too in the case of India, as is apparent from the 2011 overall rank of 134 with regard to “ease of doing business” (www.doingbusiness.org). Other areas on which India needs to improve are enforcement of contracts, payment of taxes and dealing with construction permits.

\(^{16}\) Creative destruction refers to the process of entry by new entrepreneurs by creating value through innovations, in the process eroding the value of older firms who may lose out as a consequence.
developing countries for the period 1960-2005 and find a positive relationship between financial depth [as measured by the ratio of private sector credit to gross domestic product (GDP)] and the change in the share of the lowest quintile in total national personal income\textsuperscript{17}.

Similar results have been obtained by Burgess and Pande (2005) who studied the effect of the rural bank branch expansion which took place in India during the period 1977 to 1990, as a result of a specific rule. The rule was that a bank could open a branch in an area with other existing bank branches, only if it also opens branches in four other areas with no bank branches. It was found that there was a significant fall in rural poverty and increase in non-agricultural output\textsuperscript{18}.

1.3 Measures of Financial Inclusion

Measuring financial inclusion is a challenge due to the difficulties in differentiating between voluntary and non-voluntary financial exclusion\textsuperscript{19}. The former refers to the population that has the ability to access financial services, but does not voluntarily do so. This segment of the population needs to be excluded from estimations of financial exclusion, posing measurement challenges. A census or household survey

\textsuperscript{17}The study uses a dynamic panel estimator to control for endogeneity and obtains the result at a 5 percent level of significance

\textsuperscript{18}The study builds a linear trend break model and uses state level panel data on the number of bank branches, rural credit and saving shares and poverty outcomes.

\textsuperscript{19}While there have been a number of studies regarding financial development and growth, they usually use aggregated indicators of financial depth rather than that of access. Typical indicators used are ratio of credit availed by the private sector to GDP, the turnover of shares relative to stock market capitalisation and the spread between lending and deposit interest rates (World Bank, 2008).
may be the only way to obtain such data but very few such surveys on use of financial services are available\textsuperscript{20}.

Researchers therefore focus on measures of use of financial services. A basic measure used is the number of credit and deposit accounts (per thousand adult persons). This measure however has limitations, as there may be individuals or firms with multiple accounts. There also may be accounts which exist on paper but are inactive for long periods. Beck, Demirguc-Kunt and Martinez Peria (2007) compile bank loan and deposit data for a cross section of 57 countries through surveys of bank regulators. Both loan and deposit data show wide variations among countries\textsuperscript{21}. While the ratio of deposit and loan accounts relative to the population increases with increase in per capita income, the average deposit or loan account balance relative to income per capita decreases with income, indicating that poor people and small enterprises are better able to make use of these accounts in high income countries.

Another proxy measure is the number of bank branches either per million people or as a proportion to the total area. This measure provides an approximate indicator of the average distance from a household to a bank branch, representing the physical barrier to access. Such measures are discussed under barriers to financial inclusion in \textbf{Section 1.4}.

\textsuperscript{20} In fact, such data are available only in the case of around 44 countries, half of which are in the European Union (Honohan, 2008).

\textsuperscript{21} In Greece there are 776 loan accounts per 1000 persons while in Albania there are only 4 for every 1000 persons. In Austria, there are more than 3 deposit accounts per individual, while in Madagascar there are only 14 for every 1000 individuals. The data set does not include India.
Each of the indicators mentioned above provides partial information on the inclusiveness of the banking system. Sarma (2008) proposes an index of financial inclusion (IFI) which takes into account three dimensions. These are the banking penetration (measured by the number of bank accounts as a proportion of the total population); availability of banking services (measured by number of bank branches per 1,000 persons) and the usage of the banking system, (measured by the volume of credit and deposit as a proportion of the country’s GDP)\(^2\).

As there may be other providers of financial services besides banks, some studies (Christen, Jayadeva and Rosenberg, 2004; Peachey and Roe, 2006) used information on access to alternate financial institutions. Examples for this are microfinance institutions, postal savings banks, and credit unions to ascertain the extent of access to financial services from these sources in selected countries.

Honohan (2008) uses aggregated data obtained from respective country regulators and survey data (in cases where available), to build a model. More precisely, using data on accounts in various financial institutions as a proportion of the population, and an average account size as a proportion of GDP per capita as regressors, he estimates a non-linear relationship between these variables and the actual share of households with a financial account obtained from the survey data. This regression is then used to generate predicted values where survey data is not available. Based on this, Honohan (2008) has developed a composite data set to measure financial services access for 160 countries,

\(^{22}\) Sarma calculated the index designed to be a number between 0 and 1 (with 1 signifying highest possible financial inclusion) for 55 countries using 2004 data and found a range of variation from Spain (0.737) to Madagascar (0.011). Among the 55 countries, India ranks 31\(^{st}\) with an IFI value of 0.155.
which is a “synthetic headline indicator” of access, measuring the percentage of adult population with access to an account with a financial intermediary. The results show a wide variation in financial access across countries, ranging from 100 percent in Netherlands to five percent in Tanzania and Nigeria. The measure for India is 48 percent.

1.4 Barriers to Financial Inclusion

Collins et al. (2009) study more than 250 financial diaries of low income individuals in Bangladesh, India and South Africa. Their findings show that each household uses at least four types of informal financial instruments (such as interest free loans and informal savings clubs) in a year, with the average being just under ten. The cash turnover through these instruments (i.e. the gross amounts routed through them) was large (77 percent to 300 percent), relative to the net income of the households. This suggests that low income individuals do need access to financial services, and the existence of barriers that prevent their use of formal sector services.

There are many complex factors that prevent rapid progress towards the goal of financial inclusion. In the UK, the Financial Inclusion task force (which monitors access to basic banking services) has differentiated between supply and demand side factors of financial exclusion, in its action plan for 2008-2011. The supply side factors include non-—

23 Honohan’s dataset has a number of limitations. These include non-comparability of data from different countries with regard to the time period of collection and varying practices with regard to multiple account holding (some institutions consolidate them and some do not). Moreover, some surveys used the individual as the unit of study while others used the household.
availability of suitable products, physical barriers and non-eligibility on account of documentation issues. On the demand side, financial literacy and financial capability are regarded as important factors by the task force. While financial literacy refers to the basic understanding of financial concepts, financial capability refers to the ability and motivation to plan financials, seek out information and advice and apply these to personal circumstances.

Low and irregular income is often the primary reason that contributes to financial exclusion on both supply and demand sides. The reasoning is that it leads to lack of availability of suitable financial products, as well as lack of motivation to open accounts due to inability of the individuals to save. Studies in the UK context have also found that the lowest income group is twice as likely to not be accessing financial services (Kempson, 2006).

**Supply Side Factors**

On the supply side, lack of appropriate financial products is an important barrier. Often, the terms and conditions of banks are not suitable to low income groups. Minimum balances required to open accounts are at times found to be too high, and accounts are closed by some banks due to infrequent use. In the UK context, where substantial research on financial inclusion has been carried out, the fact that overdrawing on conventional current accounts, resulting in account closure, has been identified as a reason for persisting financial exclusion (Kempson, 2006). Safeguards to prevent cases of over-drawing can be useful in ensuring that financial inclusion, when it is achieved, is not temporary.
Another common supply side barrier to financial inclusion is the physical barrier stemming from distance to bank branch or automated teller machine (ATM). Inability to provide documentation such as identity proof required by formal financial institutions is another frequently faced barrier. Banks are required by regulators to conduct sufficient identity checks before opening accounts. These regulations sometimes result in lack of access to genuine customers.

**Demand Side Factors**

One of the demand side factors is financial literacy, which is a prerequisite for first time users of financial services. Another demand side factor is financial capability which is important in view of increasing complexity of financial products. The need for financial capability development is important throughout people’s lives, as financial markets and personal circumstances change (Mitton, 2008). Finally, there are the demand side factors of psychological and cultural barriers which stem from mistrust of banks, either due to negative experiences or negative perceptions. These factors lead to self exclusion from formal financial services.

**Indicators of Access Barriers**

Based on a survey of up to five large banks in 99 countries, Beck, Demirguc-Kunt and Martinez Peria (2007a) developed indicators of access barriers to loans, savings, and payments services of banks. It includes indicators of physical barriers such as geographic
branch penetration and ATM penetration per population\textsuperscript{24}. In addition, documents required for account opening, minimum account balances required to be maintained on accounts and annual fees charged are also included. Beck et al. present the last two indicators relative to the respective country’s per capita GDP in order to provide a sense of the affordability of the products.

As may be expected, the results relating to geographic and demographic penetration show wide variations in access barriers across countries\textsuperscript{25}. The number of documents required to open a savings account varied from one in the case of 13 countries, to more than four in the case of Bangladesh and Zimbabwe. In India, it was more than two but less than four. However an important point to be noted is that the survey by Beck et al. was conducted during the period 2004-2005. In November 2005, RBI introduced the concept of no-frills accounts in India. Hence subsequent to the survey, the number of documents required may be expected to have reduced in India\textsuperscript{26}. Minimum account balances in the case of savings account was zero in 18 countries, though it was as high as 74 percent of per capita GDP in the case of Nepal. In India, it was five percent of per capita GDP. This too is expected to have become close to zero subsequent to the survey, as a result of introduction of no-frills accounts.

\textsuperscript{24} Number of bank branches and ATMs per 1,000 kilometers; and bank branches and ATMs per 100,000 people

\textsuperscript{25} Geographic branch penetration varies from 0.11 in Namibia to 636 in Singapore (India: 22.5) while geographic ATM penetration varies from 0.07 in Nepal to 2642 in Singapore (data not available for India). Demographic branch penetration varies from 0.41 in Ethiopia to 95 in Spain (India: 6.3) while demographic ATM penetration varies from 0.06 in Bangladesh to 135 in Canada (data not available for India).

\textsuperscript{26} However even to open no-frills accounts, both identity and residence proof are required, which is a challenge for many low income individuals, particularly migrant workers. The proposed issue of unique identification number to Indian residents (discussed in Chapter 4, Section 4.6.2) is expected to help in this matter.
Indicators of access barriers show a negative correlation with actual use of financial services confirming that they can exclude individuals from using bank services (Beck et al., 2007a). **Figure 1** summarizes the barriers to financial inclusion.
1.5 Policies to promote Financial Inclusion: An International Overview

While there is considerable variation in degrees of financial inclusion across the world, there is not much data on what determines the inclusiveness of the financial system in a particular country. In general, countries with lower levels of income inequality tend to have higher levels of financial inclusion (Kempson, 2006). Financial inclusion is also observed to be higher in countries such as Germany and France where local savings banks and/or post offices are important players in the provision of banking
services. Account holding also tends to be higher in countries such as Australia, where payment of social security benefits and pensions are made directly into bank accounts\textsuperscript{27}.

There are specific problems regarding access in different country contexts. In Australia, concerns have been expressed that some segments of the population who have an account may be under banked, meaning that they have a bank account but make little use of it. In Britain, a segment of the population has access to very limited banking services. In France, a key problem is some individuals not having access to cheques; while in Sweden, where internet banking is very well developed, individuals without access to a computer face difficulties and higher costs. In countries, such as Sweden and Germany which have near universal access, the financially excluded are mainly those with bad credit histories, which is likely to be the reason for exclusion (Kempson, 2006).

A number of countries have implemented policies to promote financial inclusion. Even countries such as the USA and the UK having a relatively high degree of financial inclusion\textsuperscript{28}, are emphasizing measures to universalize financial inclusion. This is because in these economies, use of transactional banking services is so widespread that financial exclusion has immensely high costs.

Two broad policy responses have been attempted to address financial exclusion (Mohan, 2006). The first is introducing codes of practice for commercial banks, requiring them to open affordable accounts with minimal facilities. The other is passing legislation

\textsuperscript{27} In India, in 2009, the Government announced that payments to workers in schemes promoted under the “National Rural Employment Guarantee Act” (discussed in \textbf{Section 1.5.1}) will be made through bank or post office accounts, which could similarly increase account holding.

\textsuperscript{28} 91 percent access in both countries according to Honohan (2008).
on the right to a bank account. Voluntary charters and codes developed by banks themselves through their trade association to make no-frills bank accounts available have been used in Belgium and Germany. In UK and Australia voluntary arrangements have been used, though no formal charters have been developed. In UK, additionally a financial inclusion fund and a task force\(^{29}\) to monitor financial inclusion have also been established. Sweden, Canada, Belgium and France are some of the countries which have passed legislations on the right to a bank account.

In USA, UK and Australia, matched savings programs and financial literacy programs have been introduced as part of the effort towards financial inclusion. In the USA, the Community Reinvestment Act (CRA) was introduced in 1977 to address concerns regarding “redlining” a term used to refer to the practice of banks not lending to creditworthy applicants in neighborhoods where funds were raised, due to non-business criteria (such as racial and ethnic discrimination). Banks are rated by federal regulators on the extent of their compliance with CRA and the ratings are taken into account when regulatory permissions are sought by them for new bank branches or mergers and acquisitions. Since the 1980s, most banks have tried to obtain at least satisfactory ratings on this account (Kempson et.al, 2000).

In low income countries, where a majority of the population is financially excluded, the challenges are different. The importance of providing access to financial

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\(^{29}\) The Financial Inclusion Task Force is an independent body appointed in 2005 to advise the UK Treasury on financial inclusion. The Financial Inclusion Fund of GBP 120 million was also set up by the UK Government in 2005 to help bring about financial inclusion. The fund has three priority areas- access to free money advice, access to banking services and access to affordable credit. The web link is: [http://www.citizensadvice.org.uk/index/partnerships/financialskillsforlife/fsfl_projects/fsfl_projects_fif.htm](http://www.citizensadvice.org.uk/index/partnerships/financialskillsforlife/fsfl_projects/fsfl_projects_fif.htm) [accessed on 9 December 2009].
services is equally important for these countries to enable wider participation in economic growth. However, the scale of the problem being larger, there is a need for solutions that vary from the approach taken by developed countries.

Mere legislation on the right to a bank account is unlikely to help without appropriate products being introduced. Whether required by legislation, or voluntarily proposed by associations of banks, introduction of accounts to unbanked individuals needs to be monitored not by the measures themselves but by tracking of actual increase in number of accounts and their utilization. This is particularly important for developing countries where demand side barriers of lack of financial literacy and psychological and cultural barriers tend to be significant. This has been observed in India (See Section 1.5.1), where though a large number of basic “no-frills” accounts\(^\text{30}\) have been opened, the usage is low.

The most cost effective means for financial inclusion needs to be evolved depending on the culture as well as the institutional and legal infrastructure in the country. For instance, matched savings programs have been tried in Australia and USA. However such programs require high budgetary resources and may not be a feasible option in the case of many low income countries.

\(^{30}\) No-frills accounts are savings bank accounts with nil or very low minimum balance requirements. They usually do not have overdraft facility and sometimes check-drawing facility.
1.5.1 Financial inclusion Policy in India

The link between poverty and finance has been articulated by Indian policy makers since 1954\textsuperscript{31}. Successive national plans of the Government continued to emphasize the importance of financial access to the poor, the majority of whom were in rural areas\textsuperscript{32}. In the mid 1970s, Government owned regional rural banks (RRBs) were set-up with a clear mandate to lend to the rural poor. However, RRBs came under political pressure and often did not follow prudent financial practices, resulting in accumulated losses exceeding Rs. 30 billion by March 1999 (Chakrabarti, 2004)\textsuperscript{33}. RRBs also catered more to the richer segments of the rural population (Basu,2006). A number of committees\textsuperscript{34} examined the causes of the financial woes of RRBs. As part of the financial sector reforms, RRBs were restructured in the late 1990s, which led to a financial turnaround of many of these entities. Unfortunately, most of the turnaround came from a shift to investment in Government bonds and lending even more to the non-poor (Bose, 2005). At present, there is still debate regarding the best way for RRBs to balance viability and outreach to the rural poor.

\textsuperscript{31} The RBI report on the All India Rural Credit Survey 1951-52 (RBI,1955).

\textsuperscript{32} Poverty headcount in rural areas is higher than in urban ones, for instance in 2004-05 it was 28.3 percent as compared to the national average of 27.5 percent while in 1973-74 it was 56.44 percent above the national average of 55 percent (www.pib.nic.in). These figures are based on India’s national poverty line which varies from the World Bank poverty line.

\textsuperscript{33} There was however variation in performance among the RRBs which was studied by Misra (2006) who found that the financial health of the RRB’s sponsor (each RBB had a commercial bank as sponsor) was an important factor. Another study by Sinha et.al.(2003) found that most of the better performing RRBs were in the Southern states.

\textsuperscript{34} Some of these include the Kelkar Committee (1984), Thingalaya Committee (1997) and the Sardesai Committee (2005).
Another important attempt at providing credit to the rural poor was the Government sponsored “Integrated Rural Development Program (IRDP)” in 1980. IRDP was one of the world’s largest microcredit programs involving provision of 56 million loans. The aim was to enable the rural poor to acquire income generating assets. However, the program was plagued by a high default rate, with repayment rate being around 31 percent by the year 2000 (Meyer, 2002). The lack of technical training, as well as, lack of linkages with markets as part of the program contributed to the high default rate (Mahajan, 2007). Eventually, most of the loans were written off. A further shortcoming of the program was, that it did not reach the truly poor (Dreze, 1990).

In 1982, the National Bank for Agriculture and Rural Development (NABARD) was established with a mission to promote equitable rural prosperity through credit and other initiatives. It was set up as an apex institution in the field of credit for agriculture and other economic activities in rural areas. Various initiatives were taken by NABARD to increase the flow of credit to low income groups. The “Kisan (Farmer’s) Credit Card (KCC) Scheme” was launched in 1988-89 to meet credit needs of farmers. The self help group (SHG) bank linkage program (SBLP) was launched in 1991-92 to enable credit to be made available to low income women (this model will be discussed in detail in Chapter 4).

However, the goal of expanding access to the payments systems, to financially excluded individuals began to be emphasized from 2005 onwards. In November 2005, 

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35 This allows farmers to avail credit facilities for purchase of inputs such as seeds and fertilizers on a seasonal basis without going through the credit screening process repeatedly. The card is valid for three years subject to annual renewals. Loans can be rescheduled when there are losses on account of a bad season. Banks which offer agricultural loans offer KCCs.
banks were advised by the RBI to open basic no-frills accounts. In order to ease account opening for low income groups, the “know your customer (KYC) norms” of banks were simplified for those with account balances less than Rs. 50,000 and credits less than Rs. 100,000 per year. Banks were encouraged to provide revolving overdraft facilities up to Rs. 25,000 in rural and semi-urban branches without insistence on collateral. Banks were also advised by the RBI to consider the use of the services of MFIs and non-government organizations (NGOs) to provide financial services. It may be noted here, that banks were viewed as the main channel to expand outreach of financial services in India, even though the Indian postal system (called “India Post”) has a larger network of branches and also offers financial services. The reason for this was that India Post has not substantially upgraded its technology and has lacked customer service orientation in provision of financial services. However, in 2010, a report of an expert committee examined the prospect of restructuring India Post so as to enable it to contribute to the financial inclusion objective. India Post’s potential in contributing to financial inclusion is discussed in Box 1.1.

In 2006, the Government of India appointed a committee under the chairmanship of C. Rangarajan, former Governor of RBI, to recommend a strategy to promote financial inclusion in the country. The committee defined financial inclusion as “the process of ensuring access to financial services; timely and adequate credit where needed by vulnerable groups such as weaker sections; and low income groups at an affordable cost”.

The report submitted in January 2008, recommended a national level plan for financial inclusion with detailed targets at various levels (block, district and state) for bank branches. In addition, the report proposed the setting up of two funds\(^{37}\) for financial inclusion. The committee took note of the potential role of the SBLP\(^{38}\) as well as MFIs and recommended that appropriate regulation be enacted to enable them to play a more useful role.

Subsequently, there has been progress reported on some of the relevant indicators by banks, though studies have raised questions regarding the substantive impact. For example, between 2005 and 2009, banks are estimated to have opened 33 million no-frills accounts but the usage of these accounts remains low (Ramji, 2009; Srinivasan, 2009). In 2009, RBI had urged the banks to go beyond merely opening no-frill accounts and take steps for more substantive financial inclusion\(^{39}\).

A study by Kochhar (2009) estimated that between April 1, 2007 and May 30, 2009, 25 million no-frills accounts were opened; of which only around 11 percent were operational. The study indicates that many of the accounts were opened by bank branches mainly to achieve financial inclusion targets. Furthermore, no guidance was given to the individuals opening the account on how to use them. In some cases, individuals were

\(^{37}\) The Financial Inclusion Promotion and Development Fund and the Financial Inclusion Technology Fund.

\(^{38}\) A program promoted by the National Bank for Agriculture and Rural Development (NABARD) under which commercial banks provide credit to SHGs, with NGOs playing a facilitative role.

\(^{39}\) RBI circular dated January 22, 2009
enticed to open accounts with promises of future benefits in the form of subsidies. Many other accounts were opened as a result of the government notification in January 2008 that all payments under the “Mahatma Gandhi National Rural Employment Guarantee Act (NREGA)” will be made through accounts in banks and post offices. NREGA is discussed in Box 1.2.

Based on a study of 28 pilot projects and one scaled-up project, Kochhar (2009) provides detailed estimates to show that the transaction costs of no-frills accounts for banks were high, making them an unviable option. This acts as a further disincentive for banks to open no-frills accounts and encourage their ongoing use. There are also high transaction costs for the user in visiting a bank branch (which are often at a distance) and operating the account which leads to low usage.

In a number of geographic areas, financial inclusion targets have been reported as being met but questions have been raised on the veracity of this reporting. A study by Thyagarajan and Venkatesan, (2009) showed that in Cuddalore district in Tamil Nadu where 100 percent financial inclusion was reported to be achieved by the State Level

40 For instance in Bhamasha in Rajasthan, account holders were promised a credit of Rs.1500 and health and life insurance, however after the change of Government in Rajasthan, the scheme has not progressed.

41 An act introduced in India in 2005, which guarantees 100 days of employment to a rural household whose adults are willing to do unskilled manual work.

42 The viability gap per account at the end of 2 years, using plastic card (photo identity card) technology, which is presently being used is estimated by the study to vary between Rs. 26 to Rs.73 depending on the location (The government of Andhra Pradesh pays the banks 2 percent charge and hence the gap in the case of no-frills accounts in that state is around Rs. 26 though in other cases it is Rs. 76). Costs could lower if mobile based technologies are adopted.
Bankers’ Committee (SLBC)\textsuperscript{43}, 25 percent of the households remained financially excluded\textsuperscript{44}.

1.6 Research Questions

The purpose of the thesis is to assess the two models of microfinance prevalent in India, the SBLP Model and the MFI model from the perspective of their contribution to financial inclusion. While it is likely that there are gaps in respective contributions, it is important to know what these gaps are and how they can be addressed. Based on the above reasoning, the thesis research questions have been articulated.

The following questions guide the analysis of the role of microfinance in financial inclusion in the thesis (I) How do the two major microfinance models in India, the SBLP and the MFI models, address financial inclusion? (II) Why are there gaps and how best can they addressed by the sector, policy makers and other stakeholders?

The first research question leads to three sub-questions which form the basis of the analysis. These are:

$I(i)$ Are the barriers to financial inclusion\textsuperscript{45} adequately addressed by microfinance providers?

\textsuperscript{43} A group of bankers and government officials that meets on a quarterly basis to review banking developments at the state level. A similar structure exists at the district level and is called the “District Level Bankers’ Committee”. Every state has its own SLBC.

\textsuperscript{44} The need for “truthful organizations” where information flows both from top-to-bottom and from bottom-up are of reasonable quality and timely is evident from this example (Asher, 2011).

\textsuperscript{45} These are described in Section 1.4.
I(ii) To what extent are the expected outcomes of financial inclusion available to microfinance members?

I(iii) What are the conditions under which group membership enables members to subsequently access financial services on an individual basis?

Analysis relating to the second question will be based on the gaps identified by addressing the above three questions.

1.7 Organization of the thesis

This introductory chapter has focused on the rationale for the thesis, provided an overview of the financial inclusion concept and indicated the research questions analyzed in the thesis. Chapter 2 provides an overview of the debates concerning microfinance. The central debate revolves around the issue of the trade-off between the social and commercial goals of MFIs. This debate in turn leads to another important debate regarding the level of interest rates charged by MFIs. As the thesis links microfinance and financial inclusion, a framework to analyze financial inclusion is presented in Chapter 3. The details of the research methodology adopted in the thesis are also presented in the same chapter. Chapter 4 discusses in detail the SBLP and the MFI models and also provides an overview of microfinance in the state of Tamil Nadu where the study was conducted. Thereafter the results of the sector level enquiry are presented. The microfinance penetration in different states in the country is analyzed and contrasted with the availability of banking services in the states. The range of microfinance products available is reviewed. Finally the development of credit histories by microfinance
members and graduation of group microfinance members to individual financial services are discussed. **Chapter 5** discusses the results of the empirical study of microfinance providers and microfinance members. An important finding from the empirical study is the need for a wider range of microfinance services, particularly savings. Provision of savings products by MFIs requires the Government to regulate them so that the savings of low income individuals are safeguarded. At present however, India has not introduced microfinance regulation. **Chapter 6** suggests a framework for regulating microfinance in India. **Chapter 7** presents the conclusions of the study, the implications for Indian policymakers, sector participants and other stakeholders, and directions for future research.
## Box 1.1: India Post: Avenue for Provision of Financial Services

The Indian postal network (India Post) has 155,000 branches across the country and hence has an outreach which is nearly twice as large as that of the banking network. In addition to postal services, India Post provides financial services and hence may be viewed as one of the agencies to expand financial inclusion.

India Post offers eight different kinds of savings products including savings accounts, recurring deposit accounts and time deposit accounts. Another important financial product India Post offers is the money order service for transfer of cash from one individual to another. In addition, a postal life insurance scheme is available which is open to certain categories of Government employees. Finally, mutual funds are marketed in designated post offices in large cities.

Despite the large network, the savings bank of India Post is reported to cater to only 160 million individuals with cumulative savings of Rs. 3,454 billion as on March 31, 2008 (equivalent to 11 percent of aggregate bank deposits and 8 percent of GDP as on the same date). This is a small proportion of the population particularly in view of the postal network’s outreach. There are a number of reasons for this unsatisfactory outcome. First, the low level of technology currently adopted by the postal network means that many tasks are carried out manually resulting in low accuracy and efficiency. Second, typically customers face long wait times while completing their transactions, perhaps due to the staff often having to handle dual responsibilities for postal as well as financial services. The staff is also not trained to have a customer service orientation. Finally, it is reported that at times there is lack of liquidity in post offices which results in customers having to wait for a few days before withdrawing their savings (Linder, 2010).

With decline in revenue from postal services on account of the advent of email and mobile phones, the share of financial services in India Post’s total revenue is around 45 percent and a need to expand its share has been recognized. The Shah Committee Report (2010) suggests how India Post’s network can be harnessed for financial inclusion. The recommendations of the committee which submitted its report in June 2010 revolved around upgrading technology so as to make it possible for India Post to offer account to account transfers thereby enabling it to provide remittance services including “Government to person” payments under Government programs. The committee suggests that India Post establishes contractual arrangements with multiple information technology (IT) vendors for providing application programming interface. It also suggests setting up data centers and IT systems on a public private partnership basis, with an open architecture to enable opening up the interface in a fee based manner to MFIs and other financial service companies and telecom companies desirous of reaching financially excluded sections of the population.

Restructuring of India Post on the above basis will be a huge exercise and will involve considerable effort and outlay. It will also require managing organizational change of India Post, a task which is made even more difficult by the entrenched public sector work culture. Additionally, the current mismatch in available skills and the needs of the organization will also pose a major challenge.

Box 1.2: The National Rural Employment Guarantee Act (NREGA)

The NREGA act (later renamed the Mahatma Gandhi National Rural Employment Guarantee Act) which was introduced in India in 2005, guarantees 100 days of employment in every financial year to a rural household whose adults are willing to do unskilled manual work. The Act aims to directly address poverty and put purchasing power in the hands of the poor. It also aims to address rural to urban migration. Schemes under the Act were initially introduced in 130 districts but in 2008 it was expanded to all 626 districts in the country (http://nrega.nic.in).

State Governments are encouraged to implement local public works projects called “NREGA schemes” such as those for minor irrigation, water conservation, flood control, de-silting of tanks, land development and rural roads. Employment in one such project is to be provided on demand by an individual within a period of 15 days. If employment is not provided, an unemployment allowance is to be paid. While the central Government pays the wages of those employed, 75 percent of material costs and some administrative costs, state Governments pay the balance 25 percent of the material costs, some administrative costs and the unemployment allowance. The payment of unemployment allowance by the state Government is designed to incentivize it to provide employment. The minimum wage under NREGA is at present Rs.100 per day and is automatically indexed to the Consumer Price Index for agricultural labor. In 2008, it was decided to dovetail NREGA with other social sector programs. Convergence of NREGA funds with funds from other sources for creation of durable assets was also permitted in 2008.

The main advantage of NREGA is that it is self targeting. Moreover there are provisions to ensure transparency such as public disbursal of wages, maintenance of workers’ job cards (enabling them to check their payments at any time) and regular social audits. Despite these measures, implementation problems have been reported in some states. Some examples are delay in payment of wages and non adherence by Government officials to conditions such as payment of unemployment allowance (Adhikari and Bhatia, 2010). In order to address these issues in 2009 it was announced that payments under NREGA will be made through accounts in banks and post offices so as to bring in greater transparency and better record keeping to the scheme whilst also bringing more individuals into the banking system.

Some analysts have pointed out that as NREGA has introduced a relatively high wage rate with automatic indexation to inflation for rural labor, it could result in encouraging substitution of capital for labor in agriculture; and in increasing the operating cost of small and medium farmers, contributing eventually to increases in food prices. The macro-economic and inter-sectoral implications of the NREGA have been given insufficient attention in its design and implementation.
2. Microfinance: Evolution, Current Debates and Selected Issues

The evolution of the microfinance sector was unplanned and entrepreneurial, and began with small initiatives in different parts of the developing world. The starting point for the growth of the sector can be traced to the challenges in providing credit to low income groups, which fundamentally motivated the early initiatives. Section 2.1 describes these challenges and the methods that have been used to address them. The development of microfinance is also described here. As microcredit was the starting point for microfinance, much of the literature relates to it, with other microfinance services being of relatively recent origin. Section 2.2 identifies three waves in the microfinance sector’s growth commencing with “outreach focused growth”, moving on to “sustainability focused growth” and finally to “profit focused growth”. Section 2.3 discusses the typical features of microcredit including group lending, dynamic incentives, frequent repayment of installments, targeting women, reaching the appropriate customer base and high administrative costs.

A central debate in the microfinance literature is the possibility of a trade-off between poverty reduction and sustainability objectives of MFIs, which more recently have manifested itself as the “profit versus social objective” debate. This debate is reviewed in Section 2.4. A controversial issue in microfinance operations concerns interest rates charged on microcredit loans. Section 2.4.1 provides an assessment of this
issue. Section 2.5 focuses on the evaluation of MFIs, within which Section 2.5.1 discusses sustainability evaluations and Section 2.5.2 reviews impact evaluations. Section 2.6 and 2.7 review the literature with regard to graduation of group microfinance customers and regulation of MFIs, two important focus areas of this thesis. Section 2.8 provides concluding remarks.

2.1. Challenges in providing credit to low income groups

Policy interventions in developing countries for providing credit to low income segments of the population have been attempted since the 1930s. The motivation for these interventions was to help them break out of the “vicious cycle of poverty.”

Provision of credit enables investment in assets, which in turn results in an increase in the individual’s income. Many other socially desirable public policy initiatives such as supplementary feeding, employment generation programs and investment in primary health and education do not enable the poor to acquire tangible capital assets. As the poor usually do not have retained profits or sufficient current income, credit is the only means for them to acquire assets. The infeasibility of suitable land reform in most countries further underlines the utility of credit in building assets for the poor.

As pointed out by Aghion and Morduch (2005), enterprises of the poor are typically under-capitalized. When capitalized they should be able to generate higher

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46 This refers to the observation that poverty once started continues from generation to generation unless there is outside intervention.

47 Atkins (1988) examines this aspect in detail.
returns compared to enterprises that are already adequately capitalized. This implies that they should attract more capital. However, when one compares enterprises promoted by the poor with other enterprises, a number of factors such as lack of education and technology often work against the poor, reducing their rates of return. Hence in practice the poor do not attract capital.

Even if banks want to fund the poor, they face the problem of asymmetric information when dealing with the market due to lack of credit histories, collateral and insurance. Even if the poor have built some assets, as De Soto\textsuperscript{48} (2000) has shown, land tenure and land titling deficiencies often prevent them from collateralizing these assets. The asymmetry in information results in differences in credit quality among borrowers being unobservable, which in turn affects market efficiency (Akerlof, 1970; Rothschild and Stiglitz, 1976). The high interest rates called for could cause low risk borrowers to drop out of the applicant pool causing an adverse selection problem for banks. At times, equilibrium in the credit market can be consistent with credit rationing, as lenders do not react to excess demand by increasing interest rates, because of the adverse selection effect (Stiglitz and Weiss, 1981). Bester (1985) argues that rationing stems from restrictions on the instruments available to lenders to screen loan applicants, such as collateral. Moreover, in the absence of collateral, there is also a problem in incentivizing repayment and enforcing loan contracts. The lenders cannot observe, without incurring considerable costs, either the effort made by the borrower or the

\textsuperscript{48}De Soto in an interview on February 15, 2010 pointed out that in the case of India, in addition to residential property titling, registration of small and micro businesses and individual identities also need to be addressed in order for the measure to be effective (www.livemint.com accessed on June 20, 2010).
realization of project returns. These are respectively referred to as ex-ante and ex-post moral hazard (Aghion and Morduch, 2005).

The result of the adverse selection and moral hazard problems is that interest rates in credit markets for the poor become exceedingly high or the markets may simply not exist. More often, the result is a market consisting of a small group of oligopolistic suppliers at high rates of interest (moneylenders).

However, local mechanisms for providing loans without collateral may exist, which have developed indigenously in a number of countries. The most common among them are rotating savings and credit associations (ROSCAs) and credit cooperatives. ROSCAs are groups of individuals that agree voluntarily to contribute to a common “pot” that is allocated to one member in each time period. They are particularly useful when individuals want to make lumpy purchases. Their underlying principle is that of social collateral. ROSCAs are found to be popular in various parts of Asia, Latin America and Africa. Credit cooperatives (or credit unions) are considered an improvement over ROSCAs as they permit some members to mainly save and others to mainly borrow (Aghion and Morduch, 2005). The earliest credit cooperatives were said to be promoted in Germany in the 1850s by a village mayor, Raiffeisen. They later spread to India and present day Bangladesh.

The limitations of ROSCAs and credit cooperatives were that they essentially circulated local funds and did not provide access to outside funds. Moreover, their size and operations were limited by their managerial capacity which was often not high

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49 Social collateral refers to the fact that default may result in social penalties.
(Aghion and Morduch, 2005). The problem of addressing market failure in credit markets remained an important challenge.

Hoff and Stiglitz (1990) identified direct and indirect mechanisms by which market failure in credit markets can be addressed. Direct mechanisms rely on lenders expending resources to service applicants and enforce loans, a good example being development financial institutions. Indirect mechanisms rely on designing contracts with borrowers so as to influence behavior in credit markets, a good example being micro finance institutions.

**Direct Mechanisms - Development Finance Institutions**

Development finance institutions (DFIs) are usually sponsored by national governments and agencies to fill the gap in the credit market. Some of these are sectoral or regional in focus while others are aimed more generally at the rural poor. As explained above, transaction costs of lending to poor communities are typically high due to high screening, monitoring and enforcement costs. These in turn can translate into high borrowing costs in the absence of subsidies. Hence most DFIs rely on government subsidies.

Questions regarding the efficiency of DFIs began to be raised in the mid 1970s, when the World Bank Agricultural Sector Policy paper (World Bank, 1975) reported that out of a sample of 44 DFIs, over half had arrear rates of more than 50 percent. In 1973, USAID’s Spring Review of Agricultural Credit also raised similar questions.

The arguments against DFIs were strengthened by a group of economists at Ohio State University (known as the Ohio School) who gave the movement its theoretical
underpinning. The notable members of the group include Dale Adams, Claudio Gonzalez-Vega and J.D. Von Pischke. The Ohio School’s ideas were accepted by the World Bank and were reflected in the Bank’s operational practice.

The Ohio School viewed credit as playing a facilitating, not a leading role, in the process of economic development (Adams and Von Pischke, 1992). They argued that informal financial institutions in developing countries such as money lenders, ROSCAs and occasional sources such as suppliers, traders, relatives and friends were likely to be more cost efficient than DFIs (Von Pischke et al., 1983). Moreover, they argued that DFIs are likely to write-off loans of powerful borrowers due to political pressures (Adams et al., 1984). For these reasons, the Ohio School was opposed to any kind of subsidies for DFIs. Their views seemed to echo the general preference for market over state action, including the assumption that rent seeking behavior due to difficulties in principal-agent relationships in the public sector would prevent it from out-performing the private sector.

Hulme and Mosley (1996) pointed out the lack of statistical evidence for many of the Ohio School’s arguments particularly concerning the claim that informal sources of credit offer a cheaper and more efficient service than DFIs. More fundamentally, they questioned the Ohio School’s implicit assumptions that informal financial markets in developing countries are characterized by perfect competition and that producers able to use credit productively are able to reap the advantages of such competition. As

Principal – Agent relationship refers to the arrangement that exists when one entity acts on behalf of another. Principal-agent problems typically occur when there is a conflict between the principal’s interest and the agent’s interest. Various mechanisms are used to align the interest of both. The public sector has often not been found to be successful in aligning its interest (as the principal) with that of its employees (as its agents).
discussed earlier in Section 2.1, in practice, these markets are often oligopolistic and sometimes do not exist at all.

**Indirect mechanisms- The Emergence of Microfinance institutions (MFIs)**

The 1990s witnessed the growth of new kinds of innovative financial institutions which provided credit to low income and often financially under-serviced communities. In order to lend, they used indirect mechanisms to offer varied solutions to the access, screening and enforcement problems usually faced in lending to the poor. These institutions designed contracts with borrowers, such that there was an incentive for them to use their local information on co-borrowers to the advantage of the bank. This in effect addressed the information asymmetry problem, even though the bank does not itself acquire more information on borrowers.

Mutua et al. (1996) studied three of these new kinds of institutions, BancoSol in Bolivia, the Kenya Rural Enterprise Program in Kenya and Thailand’s Bank for Agriculture and Agricultural Cooperatives. They found that these institutions represented a paradigm shift in viewing the poor not as beneficiaries of subsidies, but as customers of financial institutions designed to address their demands for various financial products, particularly for credit. Moreover, they shifted the focus in rural credit from agriculture to ‘non-farm enterprises’ such as making handicrafts, raising livestock and running small stores.

The term “microcredit” was used as the loan sizes offered by these institutions were small in relation to other loans. The promoters of these institutions were typically not-for-profit entities with a mission to facilitate access to loan funds to low income
groups who did not have collateral. The small loan size made it easier for the users to service the loans and was also prudent from a risk management viewpoint. Moreover, it helped restrict access to only poor borrowers\textsuperscript{51}, encouraging self selection.

A broader term of “microfinance” came to be used interchangeably with microcredit. The recent literature, however, explicitly recognizes that the latter denotes provision of only credit while the former denotes provision of a wider range of financial services including savings and insurance (Aghion and Morduch, 2005).

2.2 The Microfinance sector growth: Three Waves

The best known of the early microcredit models was that of Bangladesh’s Grameen Bank. Its group lending model was developed by Muhammad Yunus, in the mid 1970s through field experiments. Once these experiments proved successful, he accessed funds from the Bangladesh Bank (central bank), to expand outreach. Further non-commercial funding from the International Fund for Agriculture and Development (IFAD), the Ford Foundation and the governments of Bangladesh, Sweden, Norway and the Netherlands permitted rapid expansion, resulting in Grameen Bank’s nationwide presence in Bangladesh. At around the same time, in Latin America, ACCION International\textsuperscript{52} supported the development of solidarity group lending to urban vendors and Fundacion Carvajal developed a credit and training system for individual micro

\textsuperscript{51} The borrowers of MFIs are typically referred to as “members” by MFIs.

\textsuperscript{52} ACCION, not an acronym, is an NGO founded in 1961 in the USA to reduce poverty in Latin America.
entrepreneurs (Ledgerwood, 1999). Another early microfinance model was the “village bank” model developed by FINCA\textsuperscript{53} (the Foundation for International Community Assistance), a United States based not-for-profit microfinance organization which was set up in 1984. The model is implemented by its affiliates in different parts of the world, including Latin America, Africa, Eastern Europe and Central Asia. These developments, representing the first wave in microfinance growth, may be described as “outreach focused” growth.

In the late 1980s and 1990s, there occurred what Robinson (1995) termed a “paradigm shift” from government and donor-funded subsidized credit to sustainable\textsuperscript{54} financial intermediation. A frequently cited example is that of Bank Rakyat Indonesia (BRI), a state owned rural bank in Indonesia\textsuperscript{55}, which moved away from providing subsidized credit and converted its micro-banking unit into a commercially sustainable unit offering credit and savings services. The underlying reasoning for this was that the large demand for institutionalized microcredit could not be met by subsidized funding\textsuperscript{56}. A sustainable model on the other hand could cater to more number of customers over a

\textsuperscript{53} www.finca.org accessed on 1 October 2010.

\textsuperscript{54} A sustainable MFI is one which covers its costs and hence is not dependent on donor funds for its survival. The concept is discussed in greater detail in Section 2.5.

\textsuperscript{55} Subsequently in 2003, the Government of Indonesia divested 30 percent of its ownership in BRI through a public issue. Presently 43 percent of BRI’s shares are held by the public and are actively traded in the stock market [www.bri.co.id accessed on 10 December 2010].

\textsuperscript{56} Rosengard et al. (2001) analyzed BRI’s micro-banking services and found that it was the exclusive service provider for more than half of the respondents who had viable enterprises and availed credit/savings services. The study also found that though BRI was active in every sub-district of Indonesia and had 2.8 million microcredit loans outstanding and 27.3 million small savings accounts, there was considerable scope for expansion.
longer time period and could be replicated even in situations where there was no subsidized funding available. Within two years of commercial operations, the BRI unit broke even (Robinson, 1995). BRI developed its own unique individual lending model using voluntary savings mobilization as a source of funds and a transparent set of incentives for savers, borrowers and staff\(^{57}\).

While BRI, a formal institution, fine-tuned its microfinance activities based on sustainability, some microfinance not-for-profit entities tried to transform themselves into formal financial institutions once more with sustainability as a major objective. In Latin America, for example, PRODEM\(^{58}\) converted into a private commercial bank (BancoSolidario or BancoSol) in 1992. While PRODEM had to depend on donors and foundations, BancoSol was able to collect savings from the public and borrow from the central bank. This enabled greater outreach and a wider range of financial services. Many of these developments which occurred in the 1990s, may be termed the second wave of growth in microfinance, which saw both downscaling of some formal institutions and up-scaling of some informal institutions. This wave may be characterized as “sustainability focused” growth.

Finally, the third wave of growth in microfinance became evident after 2007, when the listing of equity shares of a well known microfinance institution, resulted in

\(^{57}\) Incentives to savers included differentiated interest rates to encourage larger savings balances. Savers were also entitled to participate in a lottery scheme with the number of lottery coupons increasing with the savings balance. Besides the promise of higher loan amounts in subsequent loan cycles, a “prepaid incentive for prompt payment” which was built into the monthly repayment schedules of borrowers, was returned to them if their payments were on time. For staff, 10 percent of a unit’s profit was distributed to staff in proportion to their salaries on a semi-annual basis (Maurer, 1999).

\(^{58}\) Not an acronym
supernormal profits for its investors. This is the case of Compartamos, a Mexican MFI discussed further in Box 2.1. The event drew attention to microfinance as an “asset class” and lead to the entry of commercially oriented funds, further fueling the sectors growth. Gonzalez (2007) found that microfinance portfolios show high degree of resilience to economic shocks, suggesting that microfinance investments were also attractive from a viewpoint of diversification of portfolio risk. This third wave of microfinance development maybe referred to as “profit focused” growth.

The three waves in microfinance development mentioned above, correspond broadly to the “three waves of action” identified by Sriram (2010). In the first wave came the discovery of the Grameen Bank model. In the second wave the first wave organizations achieved scale and transformed themselves into for-profit entities. Finally in the third wave, mainstream financial institutions commenced microfinance activity.

The above discussion of the three waves is not meant to indicate that the microfinance sector in any given country does not include MFIs having characteristics of different waves. Indeed, an evolving and dynamic microfinance sector may be expected to have a wide diversity of market participants.

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59 Earlier Patten, Rosengard and Johnston (2001) have documented the strong repayment performance of BRI’s microenterprise borrowers compared to small, medium and large enterprise borrowers during the East Asian crisis.
2.3 **Features of Microcredit**

Most microcredit models involved a number of innovations in designing contracts so as to circumvent some of the typical problems faced in lending to the poor. These innovations are briefly discussed below:

**Group Lending**

Group lending refers to arrangements by which individuals without collateral are encouraged to form into groups, with the aim of providing loans on group responsibility (sometimes called joint liability) basis. It has been described as microcredit’s most “celebrated innovation” (Morduch, 1999). Group lending is credited with results of high repayment rates (upwards of 98 percent) on microcredit in spite of the loans being collateral free (Cull et al., 2009).

While economies of scale initially motivated Grameen Bank to make use of groups, the bank later realized that requesting borrowers to organize themselves into groups also had the advantage of reducing costs of screening, monitoring and enforcement (Aghion and Morduch, 2005). Often information on other borrowers can be obtained from group members. For first time users of financial services, the group also offers the comfort of companionship. Moreover, the use of the group model in the Bangladesh context, enabled promotion of social messages through repetition of verbal oaths (called sixteen decisions) regarding matters such as education of girl children and
abstention from dowry practices. However, in 2002, the bank did away with joint liability when it introduced changes to its lending methodology called “Grameen II”. The objective of Grameen II was to make the model more flexible, primarily to enable restructuring of loans of borrowers who found it hard to repay. After the 1998 flood in Bangladesh, Grameen Bank had provided additional loans to borrowers to rebuild their houses, which resulted in many of them having unsustainable levels of debt. Even though the joint liability mechanism was discontinued, Grameen Bank continued its regimen of group meetings.

The group sizes vary from one MFI to the other. In the case of Grameen Bank, each group has five members, while in the case of BancoSol, it has three members. In the case of groups promoted by Foundation for International Community Assistance (FINCA), it has 15-30 members. The optimal size of groups in terms of number of members has been studied both through theoretical models and empirical studies. Ghatak and Guinnane (1999) attempted to relate the theory on joint liability lending to practice. They pointed out that theoretically, a larger group size can have two countervailing effects. On one hand, if project returns of members are not correlated, larger group size can help repayment. On the other hand, larger group sizes also limit the extent to which members are able to screen and monitor each other. However their review of empirical studies suggests that large groups typically experience coordination and at times free rider problems. They suggested that Grameen Bank’s group size of five, which was

\[ M. Yunus during an interaction on November 2, 2007 at the Lee Kuan Yew School of Public Policy, National University of Singapore. \]

\[ www.grameen-info.org (accessed on 10 November 2009) \]
arrived at on the basis of trial and error, may be a good balance between the two opposite effects that larger group sizes may have. However, research by Buckley (1996) in Malawi found that groups as large as 10 or more also work effectively.

Groups are usually formed by self-selection. The potential borrowers use relevant information to form groups with individuals who have similar risk characteristics. This also ensures that safe borrowers do not have to cross-subsidize risky ones. Ghatak (1999) shows analytically that risky borrowers cannot adequately compensate safe ones to induce safe ones to join mixed groups. This does not however mean that risky groups always default; risky borrowers can potentially generate higher return than safe ones due to the positive relationship between risk and return. Hence they can cross-subsidize their unlucky risky partners, unless all of them are unlucky at the same time (Aghion and Morduch, 2005).

To reinforce the group responsibility concept, Grameen Bank had a system of 2:2:1 staggered disbursement whereby two members of each five member group received disbursement at first. If all installments were paid on time, four to six weeks later another two members received disbursement and finally the group leader got the disbursement.

Groups meet regularly, most commonly on a weekly basis. A loan officer from the MFI conducts the meeting. All loan disbursement and repayments are made at the group meetings, making these processes transparent and public. This has advantages for the lender as it heightens the impact of social stigma in case of default by borrowers. It

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62 In 2002, Grameen Bank, did away with joint liability and discontinued staggered disbursement when it introduced “Grameen II” mentioned in the second paragraph under “Group lending”.

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also reduces opportunities for fraud by MFI officials, making it easier to enforce internal controls. Group meetings are also sometimes used by MFIs to communicate social messages\textsuperscript{63}.

Group meetings are held in the borrowers’ neighborhood making it convenient for the borrower. Minor problems such as missing documents or a cash shortfall are addressed on the spot due to proximity from borrower residences.

Different aspects of group lending have been studied both analytically and in different contexts, mainly to isolate the determinants of repayment in group contracts.

Stiglitz (1990) was one of the earliest researchers to show analytically that a group lending contract induces borrowers to monitor each others’ choice of projects and to penalize those who choose highly risky projects. This addresses “ex-ante” moral hazard. Besley and Coate (1995), show that the possibility of imposing social sanctions improves repayment. Aghion and Morduch (2005) show that “ex-post” moral hazard, namely the concern that even when returns are earned, repayments are not made, is also addressed by the model.

The importance of social ties among group members in determining repayment of group loans has been studied by various researchers and there is wide variation in the results obtained. In a lab setting, Abbink, Irlensbusch and Renner (2002) show that groups of strangers do as well as friends, a result similar to that obtained by Wydick, (1999) based on a field study in Guatemala. The latter finds that social cohesion (as

\textsuperscript{63} Broadly two kinds of MFIs are observed: “Minimalist” MFIs which focus on financial services and “Integrated” MFIs which additionally offer other services (eg. enterprise development services such as business training and marketing or social services such as health and education) as a means to improving the ability of their members to utilize financial services (Ledgerwood, 1999).
proxied by living in the same neighborhood or knowing each other prior to joining the microfinance group) helps repayment, though friendship creates tensions.

Karlan (2003) uses a situation in FINCA, Peru where groups of 30 were formed on a random basis, to study the relationship between social capital and repayment. The FINCA program involved broadcasting the intent to create village banks and then signing up borrowers as they join. Each time the list reaches 30, a group is formed. Karlan defines social capital as the links between customers that are foundations of trust and cooperation. He proxies social capital by considering cultural similarity as indicated by language, hair and attire (kind of dress and hat worn), as well as considering geographical proximity. He finds that greater social capital aids repayment. Moreover, he finds that while default usually leads to dropping out of members from the program, this effect is less so when there is high social capital. This implies that when default is due to circumstances beyond control, the borrower is not forced to drop-out when social ties are strong. The study however is unable to pinpoint if the results are because of greater trust or simply due to greater ease in monitoring. Wenner (1995) and Gomez and Santor (2003) through studies in Costa Rica and Canada respectively arrive at similar results. Ahlin and Townsend (2002) find from a study in Thailand that strong social ties help repayment in the poorer regions but are associated with weaker repayment in wealthier regions.

While there are contradictory results, it is possible that though social capital may lead to better repayment, in some cases too much social capital could translate into collusion. Sadoulet and Carpenter (2001) point out that if diversity in groups translates
into less correlated incomes, it could improve repayment, as shown by a study in the Guatemala context.

A number of studies have found that alternative options for borrowing are an important influence on repayment (Ahlin and Townsend, 2002, Wenner 1995, Sharma and Zeller, 1996). Khandker, Khalily and Khan (1995) however found that both drop-outs and repayments were higher in wealthier villages, which had better business opportunities as well as more options for borrowing.

It is apparent from the above that the success of group lending depends on various factors, many of which are contextual so simple generalizations are unwarranted.

**Dynamic Incentives**

One of the main incentives for MFI borrowers to repay is the threat that the MFI will deny access to further loans, to those who do not repay on time. On the other hand, if repayments are made promptly, borrowers are offered a larger loan in the next “loan cycle” (a loan cycle extends from loan disbursement to repayment of the final installment). This acts as an important dynamic incentive prompting on-time repayment of groups. It also enables the lender to conservatively increase exposure to the customer so as to screen out the worst performers before expanding scale (Ghosh and Ray, 1997).

In cases where there are rumors of failures of MFIs, these dynamic incentives no longer work and could lead to a spurt of defaults (Bond and Rai, 2002) 64. Dynamic incentives can also weaken when alternative lenders enter the market, if the borrower has

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64 This study was in the Ecuador context.
the option to borrow from them instead. This problem can be addressed by putting in place a mechanism by which microfinance providers share information on defaulters, either informally through industry associations or by means of a credit bureau.

**Frequent Repayment of Installments**

Regular, frequent (usually weekly) group meetings to collect installments are an important feature of microfinance. The weekly repayment in fact, usually starts a week or two after disbursement. This seems to imply that there is no gestational period for the investment to start generating returns. This may be true in the case of some projects, such as purchase of livestock. More often, it is assumed that repayment of the early installments comes from other sources of household income (Churchill, 1999).

MFIs benefit from the frequency of repayments as they act as an early warning system in case of defaults. Moreover, the weekly meetings ensure that loan officers are in close touch with borrowers, ensuring better monitoring. Second, it helps borrowers who have difficulty in holding on to their income on account of multiple demands on it. These include demands from relatives, spouses and others. In fact, this aspect motivates some customers who do not have access to safe saving avenues, to use microcredit as a means of converting small amounts of money available during the year into a lump sum at the

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65 Jain and Manusri (2003) theoretically show that if MFIs assume dependence on moneylenders for the early installments, it implies that only those who are capable of accessing funds from them borrow from MFIs. In other words, MFIs use these informal lenders for screening potential borrowers. No empirical evidence has been observed in favor of this argument.
start (Rutherford, 2001) \(^{66}\). But this comes at a cost, as interest charges have to be paid on microcredit.

A number of studies have shown that delinquencies tend to rise when frequency of installments is reduced (Gonzalez Vega et al., 1997, Silwal, 2003) \(^{67}\). The experience of BRAC, a leading MFI in Bangladesh, also indicates similar results (Aghion and Morduch, 2005). However, Field and Pande (2008) used randomized assignment and found no significant difference in delinquency and default between customers assigned weekly and monthly repayment schedules in India.

While it is generally believed that regular frequent installments help reduces default risk in microfinance, in view of the absence of collateral, it also dramatically increases MFI transaction costs. Moreover weekly installments are unviable in low population density areas. This is the reason why PRODEM, a rural lender in Bolivia, uses monthly installments (Gonzalez Vega et al., 1997).

In cases of monthly as well as weekly repayments, the installment amounts tend to be uniform making it hard for borrowers involved in highly seasonal occupations, such as agriculture to repay. The system evolved by Grameen Bank in 2002 (Grameen II) tries to partially address this problem by permitting loan officers to vary the size of weekly installments according to the season.

\[^{66}\] Rutherford (2001) refers to such a mechanism as “saving down”.

\[^{67}\] In the Latin American and Nepal contexts.
Targeting Women

Most microfinance institutions primarily serve women, for a number of reasons.

First, women are less mobile and more likely to be susceptible to peer pressure, making them more conservative in their investments and consequently less risky borrowers. This fact is particularly important as loans are collateral free. A number of studies have shown that women are better borrowers than men (Khandker, Khalily and Khan, 1995; Kevane and Wydick, 2001)\(^{68}\).

Second, from the societal viewpoint, providing resources to women is expected to have better developmental impacts. Women tend to expend more resources on children’s health and education as compared to men (Blumberg, 1989). Further, in a number of developing countries women are often oppressed even within the household due to prevailing social norms and lower literacy levels. Microfinance is often viewed as a means of female empowerment. Browning and Chiappori (1998) develop a model in which a woman’s intra-household bargaining power is determined by her ability to credibly threaten to leave the household. Access to microfinance can enhance this ability.

However, even though 71 percent of microfinance customers are women\(^{69}\), there are concerns regarding “pipelining” of loans to male family members. Goetz and Gupta (1996) found in a study in Bangladesh that 39 percent of the women had little or no control over their loans. Todd (1996) carried out an ethnographic study of 64 women borrowers of the Grameen Bank who were members for 8 to 10 years and found various

\(^{68}\) In Bangladesh and Guatemala contexts respectively.

\(^{69}\) As on December 31, 2007 according to State of the Microcredit Summit Campaign Report 2009 (Daley Harris, 2009).
positive impacts on borrowers. She however found that a quarter of them were pipelining their loans and found that these were the most marginalized women in her sample. However other studies (quoted in Goetz and Gupta, 1996) indicate that even if women pipeline the loan, they are better off with microfinance than without. Similarly, studies have arrived at varying conclusions on the relative returns of micro enterprises promoted by men and women (Goldberg, 2005).

**Reaching the appropriate customer base**

Microfinance has been primarily represented as a way to reduce poverty by providing income generating loans. In the words of Grameen Bank’s Yunus (1998), the traditional circle of “low income, low saving, low investment” needs to be transformed into a virtuous circle of “low income, injection of credit, investment, more income, more savings, more investment, more income” as represented in Figure 2.1 and Figure 2.2.
Figure 2.1  Vicious Cycle of Poverty

(Source: Author)

Figure 2.2  How Microcredit can break the vicious cycle

(Source: Author)
It therefore follows that to a large extent, the impact of microfinance rests on the degree to which the poor are able to access it and use it productively.

“The poor” are not however a homogenous group. Hulme and Mosley (1996) analytically differentiate between the core poor, who have not yet crossed the economic threshold\textsuperscript{70} and others who have crossed it. While the core poor need financial services such as micro savings and contingency loans that are protection focused; others may have a need for promotional credit.

Based on field experience, Robinson (2000) found that the above definition of the core poor includes a very large segment of the population in developing countries. She instead differentiates between the economically active poor and the extremely poor. While the former have some form of employment, the latter tend to be severely food-deficient or destitute. She argues that credit is particularly useful for the economically active poor, who are not severely food-deficient or destitute. The extremely poor on the other hand need more importantly, tools such as food, shelter, medicines, skills training and employment. However the extremely poor may indirectly benefit through microfinance through the labor market, to the extent that there is employment generation through microenterprises (Robinson, 2000).

\textsuperscript{70} The economic threshold is defined as existence of a reliable income, freedom from pressing debt, sufficient health to avoid incapacitating illness, freedom from imminent contingencies and adequate resources to cope with problems as they arise.
Based on a study, Hulme and Mosley (1996) too found that microfinance has a greater effect on the less poor due to their higher risk taking capacity. This indicates that there is a limit beyond which it is impossible to reduce poverty and increase impact simultaneously. Hulme and Mosley call this the “impact possibility frontier”. MFIs can aim to be at particular points on the impact possibility frontier by choosing the proportion of poor to non poor they would like to serve. Reducing operating costs is an important way to push the frontier outward. Improving the risk management mechanisms available to the poor through provision of insurance products would serve to change the nature of the relationship over time; so that it becomes possible to decrease poverty and increase impact simultaneously.

Christen et al. (1995) studied 11 successful microfinance programs in three continents and concluded that the trade-off is not inevitable. Gibbons and Meehan (1999) show with the help of three case studies that the key to serving the poorest sustainably is to increase cost effectiveness so that interest rate charged to borrowers can be minimized.

Reaching the poorest of the poor has therefore continued to be viewed as a goal of microfinance. The Microcredit Summit Campaign (a not-for-profit group of those involved with microfinance activities around the world), was launched in 1997 with the objective of reaching at least 100 million of the poorest people in the world. This objective was reported to have been met by 2007 and a new goal of reaching 175 million

71 The study involved twelve MFIs in seven countries and found that there was a positive relationship between borrowers’ pre-loan incomes and the increases in income they experienced as a result of microfinance.

72 Defined as those who live in households with incomes that place them in the bottom 50 percent of the poverty group as defined officially in each country.
poorest families and lifting 100 million families above the threshold of US$ 1 a day, by 2015 has been adopted (Daley-Harris, 2009).

However, there are studies that suggest that microfinance does not often reach the poorest of the poor (Amin et al., 2001 and Akula, 2004). This may be due to an inability to understand and cater to their needs and preferences (Arun and Hulme, 2008) or due to the higher costs involved in doing so.

In practice, MFIs try to restrict access to the poor through small loan size (that may not interest the elite) and loan conditions that the rich are not likely to agree to (such as compulsory attendance at group meetings). Moreover, as the interest rates charged are market related, there is no incentive for local elites to attempt to garner the loans. Individual MFIs decide on the sub-group they choose to target and do so by evolving appropriate eligibility criteria. Appraisal of potential borrowers is based on MFI specific eligibility criteria, through personal interviews, neighbor references as well as visits to the borrowers’ residence.

To summarize, the literature indicates that there are diverse views regarding the segment within the poor that MFIs should target. There is also lack of clarity regarding the segment it actually serves, as data on this aspect is not recorded.

**High Administrative costs**

In general, the cost of lending comprises of funds cost, cost of provisions for loan defaults, and administrative costs. The latter includes the costs of identifying and screening the borrower, processing the loan application, completing the documentation,
disbursing the loan, maintaining the accounts, collecting repayments and following up on nonpayment.

Unlike lending costs and provisioning costs, administrative costs are not proportional to the amount lent. Due to average microfinance loan size being smaller than most other loans, the operating cost on a percent basis for a microfinance loan tends to be higher\(^3\). Moreover, the group lending model necessitates other specific costs such as costs of group formation and frequent collection of installments. These costs show wide variation across MFIs and also between branches of the same MFI as they are a function of the context in which microfinance is delivered (Shankar, 2007)\(^4\).

As a result of the above, effective interest rates to borrowers are usually higher than the subsidized rates charged by DFIs and also when compared to most other loans in the country\(^5\).

### 2.4 Main Debates in the Microfinance Literature

As described earlier, microfinance has its roots in attempts to deliver credit to low income groups and is frequently viewed as a “poverty alleviation” initiative. However as seen in [Section 2.2](#), as it grew, it first embraced the “sustainability” objective and later, at

\(^3\) Lending $100,000 in 1000 loans of $100 each costs much more in terms of staff salaries than one loan of $100,000 particularly when the lending methodology is “high touch” (CGAP, 2009).

\(^4\) A study of three MFIs in India revealed that group formation, training, administration and monitoring costs in the first year of lending to a group, varied within the range 3.2 percent to 11.3 percent of the amount of the loan.

\(^5\) However, Government subsidized loans at times carry hidden transaction costs for borrowers, due to long wait times and side payments expected by Government officials. Such costs increase the effective interest rate for borrowers.
least to some extent, the “profitability” objective. As may be expected, these developments have lead to questions concerning potential conflicts with the original poverty focus. A corollary of this debate is on how interest rates in microfinance should be set. Both debates are reviewed below.

2.4.1 The “Sustainability versus Poverty Impact” debate and the “Profit versus Social Objective” debate

The latter half of the 1990s was marked by a debate between two approaches to microfinance, the “financial systems” approach and the “poverty lending” approach (Robinson, 2001). While the former emphasized institutional sustainability, the latter emphasized poverty reduction. Rhyne (1998) described poverty and sustainability as the “yin and yang” of microfinance, implying that they are two sides of a whole, each incomplete without the other. She pointed out that ultimately members of both camps had the same objective, namely that of increasing outreach. The former viewed sustainability with its attendant benefit of access to private funds as a means to the goal.

Schicks (2007) studied the cases of BancoSol and Grameen Bank as exemplifying the “sustainable” and “charitable” goals respectively and concludes that there is a case for coexistence of both organizations. While the former enables greater breadth of outreach, the latter enables greater depth of outreach as it able to reach poorer individuals. She does however point out that the two could potentially harm each other. The former may prevent the latter from using cross-subsidizing strategies by catering to the more well off customers; the latter could price their products at less than sustainable levels, forcing the former out of the market.
Arun and Hulme (2008) suggest that the trend of downscaling of some large banks and up-scaling of some small MFIs since the 1990s (as described in the second wave of microfinance development in Section 2.2 above), has led to the resolution of the debate in favor of the “financial systems” approach.

Even earlier, Gibbons and Meehan (1999) pointed out that while the need for sustainability has been by and large accepted, there is less clarity on how to approach it without losing sight of the poverty reduction goal. This issue was brought into sharper focus when post-2007, MFIs began to raise equity from commercial sources. This is the third wave of microfinance development described in Section 2.2.

As MFIs are typically under-capitalized, raising equity enables them to access higher amounts of loan funds and consequently increase their outreach. However, as commercial investors are by definition profit oriented, their involvement in the ownership of the MFI raises the prospect of changing its focus from social to commercial objectives, commonly referred to as “mission drift”\textsuperscript{*}. Rosengard (2004) views the debate on profit versus social value added in MFIs, as part of the larger debate on similar issues in social entrepreneurship.

Yunus (2007b) advocates that MFIs follow a “social business” model by which he means that the business should either be owned by low income individuals or else the investors in the business should be prepared to only receive the amount invested from the business and not other benefits such as dividends. However such a model may not be able

\textsuperscript{*} Mission drift may manifest itself in various ways such as by MFIs serving more well-off segments of the population or by MFIs charging higher rates of interest.
to generate much funding as not many social investors may be ready to entirely forego returns on their investment.

Schmidt (2010) argues for a “consciously cautious approach” by MFIs wanting to take advantage of lower cost funds from the capital market without compromising on their social agenda. He advocates that MFIs should not approach capital markets in a naïve manner but put in place in advance, a binding commitment on the orientation of their MFI after infusion of funds from the market. For example, they could decide on their profit level or interest rate levels. Schmidt further suggests that MFIs sell non voting rights in order to retain their original distribution of voting rights and maintain the binding commitment entered into as above. While these are practical suggestions that can be adopted, these measures could well mean (as Schmidt himself points out) that the valuation of the MFI shares is lowered due to the advance commitment and the non-voting nature of the shares. Hence, only promoters who have a very high level of determination to adhere to their social goals may consider this route. Moreover, the commitments need to be carefully considered. A cap on profits for example could breed inefficiency.

The most obvious conflict between social and commercial objectives occurs on the issue of setting of interest rates on microfinance loans. While a social objective would imply setting an interest rate just enough to be sustainable, a profit objective would imply setting an interest rate as high as the market would accept. An important offshoot of the above debate is therefore regarding “how should microfinance interest rates be determined”.
2.4.2 How should microfinance interest rates be determined?

Sustainability implies setting interest rates for borrowers such that MFI costs are covered. As explained in Section 2.3 above, high loan administration costs are a feature of microcredit, resulting from two main driving forces, the peculiar loan delivery mechanism used and the unusually small size of the loan. To quote an example from Helms and Reille (2004), a sustainable Indian MFI which has a cost of only US$ 0.25 per customer interaction has an operating cost of 25 percent of average loan portfolio while a commercial bank in India typically has operating expenses in the range of 5 – 7 percent p.a. A cost covering (sustainable) interest rate for the MFI hence has to be in excess of 25 percent p.a. Such interest rates appear exploitative when compared to interest rates on most other loans.

The unusually high interest rates lead at times to questions regarding MFIs’ commitment to helping the poor. The result in some countries is political pressure on MFIs to reduce interest rates. There are also frequent suggestions that the government enforce interest rate ceilings on microfinance loans.

Helms and Reille (2004) identify three types of interest rate ceilings. These include: interest rate controls on banks imposed by the central bank of the country; usury laws forming part of the civil code aimed at private and consumer lending (which usually affect NGO MFIs); and finally de-facto ceilings which are not codified into law, but are brought about by political pressure and the need to compete with large subsidized government lending programs.

Nominal interest rate ceilings can have adverse impacts. First, they could lead to the exclusion of customers whose profiles call for interest rates in excess of the cap.
Often these customers are likely to be the more needy ones. Second, a uniform interest rate would create incentives for MFIs to move away from difficult and new geographies where transaction costs are higher. Third, as a result of the interest rate cap, MFIs may be encouraged to repackage loan contracts by varying fees, charges and other aspects such that effective interest rates remain the same. For a numerical example see Appendix 6.1 in Chapter 6. Fourth, interest rate caps could also be detrimental in attracting capital to the sector. Attracting capital to the sector is critical so that the MFIs build scale and thereby reduce lending costs. Fifth, there is a risk that existing players are driven out of the market and new players do not come in, reducing the outreach. In specific cases, the impact of the ceiling depends on its level and the extent to which it is enforced. If ceilings lead to state subsidy, opportunity costs of the subsidy need to be taken into account. The rate ceilings are prone to populist political pressures.

Government policy fostering innovation, competition and transparency in the sector has often been suggested as a more effective policy to bring down interest rates. A study by Porteous (2006) of three mature microfinance markets highlights that regulations requiring MFIs to quote interest rates in a uniform manner, contribute to reduction of interest rates over time.

A number of arguments have been advanced to justify the rates of interest charged by MFIs, other than the fact that they are a result of high transaction costs. First, the poor

77 This has been observed in the Armenia and Nicaragua contexts where interest rate caps were imposed (Helms and Reille, 2004).

78 Helms and Reille (2004) report that competition lead to lowering of interest rates in Bolivia and Cambodia. In Bolivia, the interest rate charged by BancoSol, a prominent MFI fell from 65 percent p.a. in 1992 to 22 percent p.a. in 2004. In Cambodia, microfinance interest rates are reported to have fallen from 5 percent a month to 3.5 percent a month in 2004 over a span of a few years.
generally consider ongoing access to credit more important than the actual cost of the credit (Christen et. al, 1995). High repayment rate and repeat borrowing evidence the positive value derived by MFI borrowers. Second, usually the return on small enterprises is higher per unit of capital than that of larger ones. Third, even though MFI interest rates appear high they are often significantly lower than that of moneylenders who sometimes charge up to 10 percent per month (Robinson, 2000). Fourth, borrowing from unscrupulous moneylenders carries other risks including the use of abusive collection techniques. Moreover at times, borrowers do not realize the obligations they commit themselves to.

A study by Karlan and Zinman (2008) used randomized trials to assess credit elasticity in the case of a consumer lender focusing on the working poor in South Africa. They found that the demand for credit was relatively flat for a wide range of prices (50-200 percent p.a.). In order to compare outcomes for individuals who avail of a loan at a high interest rate and those who do not, they selected a pool of marginal customers who closely missed qualifying for a loan. Half of the individuals in the group were randomly chosen to receive a loan at 200 percent p.a. The outcomes of these individuals were compared to those in the pool who did not get a loan, on a range of parameters. It was found that there were significant net benefits for borrowers, as compared to the non-borrower group, implying that even highly priced loans could have favorable impacts for borrowers. A possible reason could be that those not given a loan may have availed loans from informal sources at even higher rates of interest.

The interest rate controversy in microfinance was rekindled in April 2007 when shareholders of Compartamos, a Mexican MFI, sold part of their shareholding and
realized high profits amounting to an internal rate of return of 100 percent p.a. on their investment (Rosenberg, 2007). The fact that the MFI charged its borrowers an average interest rate of around 86 percent p.a. made it apparent that the MFI’s objective was not just sustainability but rather profit maximization. Even supporters of the “financial sector approach” such as CGAP79 and Dale Adams of the Ohio School questioned Compartamos’ strategy (Rosenberg, 2007; Arun and Hulme, 2008). Appendix 2.1 provides a brief overview of the Compartamos controversy.

Interest rates charged by most MFIs at present however, are well below that charged by Compartamos, as evidenced by the fact that the median interest income for sustainable MFIs weighted by gross loan portfolio was 26.4 percent of loans outstanding80 (Rosenberg et. al., 2009).

The debate on microcredit interest rates is far from resolved. The fact that there is variation in transaction costs in different locations means that no overall benchmarks for “appropriate” interest rates can be evolved. This leaves room for subjective interpretation on the nature of interest rates in the sector.

2.5 Evaluation of MFIs

MFIs traditionally have been evaluated on a “double bottom line” basis meaning on the basis of both sustainability and development impact.

79 A policy and research centre housed at the World Bank and supported by over 30 development agencies and private foundations (www.cgap.org).

80 Based on data from Microfinance Information Exchange (MIX) (www.mixmarket.org), a non-profit company supported by CGAP and other foundations, which disseminates information on microfinance institutions.
**Sustainability of MFIs**

One of the main attractions of microfinance stems from the belief that microfinance is a sustainable means to achieve developmental impact.

Morduch (1999) however provides evidence to show that the high repayment rates reported by MFIs did not translate into profits and that most programs continued to be subsidized through grants and soft loans from donors. In defining subsidies, Morduch takes into account both explicit and implicit subsidies. Explicit subsidies are easily ascertained, as they are reflected in the revenue accounts of the recipient. Examples of implicit subsidies are soft loans or transfer of resources on non-commercial terms. Their value needs to be calculated based on the difference between the price paid by the recipient and the prevailing market price of the resource\(^{81}\).

Examining sustainability at two levels, operational\(^ {82}\) and financial\(^ {83}\); he concluded that while most programs achieved operational sustainability, few achieved financial sustainability. He finds that financially, broad based programs such as those of BancoSol and BRI did better than programs which focused exclusively on specific income segments.

Subsidy data on MFIs is summarized by the subsidy dependence index, which provides an estimate of the percent increase in lending rate of the MFI that would enable

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81 Implicit subsidies are reflected in the “economic” cost of operation though not in the “accounting” cost.

82 Operational sustainability refers to the ability to generate revenues enough to cover operating costs but not necessarily the full cost of capital.

83 Financial sustainability implies covering all costs including full cost of capital.
it to operate without subsidies (Yaron\textsuperscript{84}, 1992). In the case of Grameen bank in the early 1990s, Morduch (1999) estimates that the average interest rate would have to be increased from less than 20 percent to 32 percent in order to be independent of subsidies.

Hulme and Mosley (1996) argue in favor of subsidies for pioneer MFIs and those experimenting with new program design features, on the grounds that these institutions reduce risks for subsequent lenders.

However, other researchers such as Robinson (2000) argue against dependence on subsidies and donor funds on a number of grounds. First, the availability and amount of subsidies and donor funds often tend to be unpredictable in the long term. Second, dependence on subsidies and donor funding may be a constraining factor for MFIs that have plans to scale up rapidly in future. Third, there is a risk of breeding inefficiency. Fourth, subsidized programs have an added challenge, namely to guard against capture by elites. Finally, the conditions for access to donor funds are expected to become more stringent with the recent global economic crisis which affected many developed countries who have traditionally been donors.

Morduch (2007) suggests that well designed subsidies (referred to as “smart subsidies”) can increase the scale of microfinance outreach, increase access to commercial finance and increase depth of outreach to the poor. He emphasizes subsidies that are transparent, rule-bound, time limited and have potential to “crowd in” other donor funds. He however does concede that such subsidies are not easy to implement.

\textsuperscript{84} Yaron too considers explicit as well as implicit subsidies.
Cull et al. (2009) analyzed a dataset covering 346 MFIs comprising NGOs, Non-bank financial institutions (NBFIs) and banks, cumulatively serving nearly 18 million members, obtained from the Microfinance Information Exchange (MIX)\(^8^5\). They found that the subsidy per microfinance borrower\(^8^6\) for the median NGO was sizeable at US$233 while that for the median NBFI was only US$32 and for banks it was zero. It therefore appears that NBFIs and banks have embraced the goal of sustainability, while NGOs are still dependent on subsidies\(^8^7\).

**Challenges in evaluating impact of Microfinance programs**

While anecdotal evidence on the benefits of microfinance are many, the number of careful impact studies by independent researchers is far fewer. This has led to skepticism on whether the enthusiasm for microfinance has been misplaced (Adams and Raymond, 2008).

Rigorous evaluations need to address the issue of what would have happened if the microfinance program had not existed. In the context of microfinance, this aspect is complicated by the fact that microfinance is expected to have multiple impacts on a household. While an obvious expectation is an “income effect” in terms of increase in

\(^{8^5}\) MIX is a US based not-for-profit organization, founded by CGAP, committed to promoting information exchange in the microfinance industry including through online resources (www.mixmarket.org).

\(^{8^6}\) These are calculated in purchasing power parity adjusted dollar values and approximate the value in local values rather than the costs to the foreign donors. Subsidies include donations from past years, donations to subsidize financial services, in-kind subsidy adjustments and adjustments to the cost of funds.

\(^{8^7}\) A strength of the dataset was that both implicit and explicit subsidies were included. A weakness of the dataset was that participation in the database is voluntary.
household income due to the activity financed, there may also be a “substitution effect” due to the greater amount of time spent on that activity (Aghion and Morduch, 2005). For example, at times some activities pursued earlier may need to be discontinued. In addition, as microfinance targets women, intangible impacts on the influence that women have in household decision-making are also expected. MFIs which combine social initiatives such as in the areas of health and education, along with credit, are expected to have impacts in these areas as well.

A large number of studies have focused on measuring the causal impact of microfinance on borrower income. Due to fungibility issues, ascertaining the precise impact of the loan amount is often a challenge, referred to as the “attribution dilemma” (Ledgerwood, 1999). Researchers therefore attempt to measure the impact of the loan on overall household income and consumption. This too poses a number of challenges.

The first issue is that MFI membership being voluntary, unobservable characteristics may differentiate MFI members from non-members, making them non-comparable even prior to availing microfinance. Studies show that, those who select themselves into MFI programs are on average wealthier (Coleman, 2002; Alexander, 2001) and displayed different attitudes (Hashemi, 1997) from non-members. It is also likely that they may differ on non-measurable factors such as entrepreneurial ability. McKernan (2002) shows that, not controlling for selection bias can overestimate the impact of participation by nearly 100 per cent. Hence a direct comparison between increases in income of members and non-members in a time period is not sufficient to measure impact.
Similarly, direct comparisons between older members and new members also poses problems as members who joined the program earlier are likely to have been significantly different (such as having greater initiative and risk taking ability) from later ones.

Therefore, there is a need for a comparable control group so that differences in income prior to availing microfinance, and at a point in time subsequent to availing it, can be compared (difference-in-difference approach). However care should be taken in not having control and treatment groups located adjacent to each other as there may be spillover effects from the treatment to the control group. For example, there may be impacts through general increases in economic activity or specific impacts through the labor market if MFI members generate employment among non-members.

Control groups are usually therefore selected from areas which do not at present have access to microfinance. This again needs to be done carefully as it could lead to biases in certain kinds of MFIs where program placement is non random. For example, if MFI programs first initiate in more needy areas, there could be a bias. Another possible problem with control groups in microfinance is that sometimes there is considerable attrition bias if an MFI commences operations in the area during the period of the study. This problem arose in the case of an impact study by BRAC (quoted in Goldberg, 2005).

If a village identical to the one selected for treatment is found, except that it lacks a microfinance program, it can be used. Three methods of comparison are possible (Aghion and Morduch, 2005).
The first is to compare the average income in the treatment village, to the average income in the control group. This however yields an estimate of the effect of microfinance access not use.

Second, the actual microfinance participants in the treatment village can be compared with those who signed up for a microfinance program but did not avail of it (used by Coleman, 1999). Finding such a situation where borrowers are identified but disbursement not carried out is difficult.

Third, the actual microfinance participants in the treatment village can be compared to those who sign up when a program is introduced in the control village. In other words, older members can be compared with new members. The problem with this approach is non-random attrition of participants. It may be expected that certain kinds of participants systematically drop out. For example, in some cases, it could be richer ones while in others it may be those who have problems in repayment. An older pool of borrowers, who have experienced attrition and a new set yet to do so, may not therefore be comparable. This aspect was a drawback of the USAID “Assessing the Impact of Microenterprise Services (AIMS)” project which carried out studies of a number of MFIs. Karlan (2001) recommends tracing drop-outs and including them in the sample. This may however be a costly exercise. Another option is to build predictive models using past data on drop outs and apply them to the new group (Aghion and Morduch, 2005).
Selected Microfinance Impact Studies

A much cited early impact study is that carried out by Pitt and Khandker (1998) using cross-sectional data from the period 1991-92 in Bangladesh. They used the fact that all the three microfinance programs being studied, namely that of Grameen Bank, BRAC and the state-run program, used a common eligibility rule namely that only households owning less than one acre were eligible. They then proceeded to compare the increases in income experienced by eligible households in villages with access and those without access. As at that time, these microfinance programs lent to men and women, they also investigated the impact on household consumption of credit received by men vis-a-vis that received by women.

The most notable result from their study is that annual household consumption increased by 18 taka\(^8\), for every one hundred lent to a woman but only 11 taka for every one hundred taka lent to a man. Increases in non-land assets were also more pronounced when borrowing was by women. Increase in schooling of girls was more pronounced when borrowing was by women but only in the case of the Grameen Bank program.

The study however sparked controversy on the methodologies used. Morduch (1998) pointed out that the MFI programs did not follow the eligibility rule very strictly. Hence while the eligibility rule was strictly followed in dividing eligible and ineligible households in the control group, it was not so in the treatment group, leading to bias in the study. He then reanalyzed the data using a simple difference-in-differences approach comparing the eligible to the ineligible in the treatment villages, to the same difference in

\(^8\) Approximately 70 Taka is equal to 1 US$ (www.xe.com as on September 4, 2010).
control villages. He found no significant impact of microfinance exposure. Pitt (1999) pointed out that the difference-in-differences approach fails to take into account non-random program placement. If Grameen Bank were to focus on areas with the greatest inequality between the rich and poor, there would be a downward bias in the results obtained by Morduch.

With availability of further data collected in 1998-99, Khandker (2005) found that the total increase on household consumption from each additional 100 taka of credit to women was 20.5 taka, 4.2 from current borrowing (1998-99) and 16.3 taka from past borrowing (1991-92), showing diminishing marginal returns over time. The returns on the loans availed by men were insignificant presumably because over a period of time these institutions increasingly focused on women, and men lagged behind in loan volumes and membership.

Comparing poverty rates in 1991-92 and 1998-99 Khandker found that moderate poverty headcount in program villages declined by 17 percent; 18 percent in program areas and 13 percent in non program areas. Among program participants who had been members since 1991-92, poverty declined by more than 20 percent, about 3 percent p.a. Khandker estimates that more than half of this reduction is directly attributable to microfinance and found the impact to be greater for extreme poverty than moderate poverty, reduction rates of 2.2 percent p.a. and 1.6 percent p.a. respectively. Further, Khandker showed the impact of microfinance on non-participants, who experienced reduction in poverty of 1 percent and 1.3 percent respectively in the case of the moderately poor and the extreme poor. Based on this data, he concluded that
microfinance accounted for 40 percent of the observed village level poverty reduction in rural Bangladesh.

Using the same data set, Chemin (2008) used the technique of “matching” to compare participants in microfinance with matched individuals in untreated villages. He found that microfinance participants spend on average 3 percent more than similar non-participants.

Roodman and Morduch (2009) revisited the data used by Khandker and found that for all the studies using the data-set, evidence for impact was weak. They concluded that for non-experimental methods to be useful in impact evaluation, the quality of the natural experiment had to be high and demonstrated.

Another important impact study was by Coleman (2002) in the Thailand context which did not find much impact from MFI membership. The study used a design where actual microfinance participants in the treatment village were compared with those who signed up for a microfinance program but did not avail of it, as sign-up preceded disbursement by a year. Coleman himself pointed out that one reason for there not being much of an impact from MFI membership could be that 63 percent of the households already had access to credit from a state-owned financial institution, which provided substantially larger loan amounts than the MFIs.

The USAID “Assessing the Impact of Microenterprise Services (AIMS)” study examined three urban based MFIs (SEWA Bank, India; Zambuko Trust, Zimbabwe; and Mibanco, Peru) in the late 1990s. While it used longitudinal data and large sample sizes and control groups, it suffered from the limitation that its baseline data did not comprise new customers, but customers of varying vintages. Significant impacts on the use of
microfinance were found only in the cases of Sewa Bank and Mibanco. A probable reason for the low impact observed in the case of Zambuko was the fact that the period of the study coincided with a period of unusually high inflation in Zimbabwe. The SEWA Bank study was useful in showing positive impacts in the case of both savers and borrowers, with the latter group experiencing much larger impacts than the former (Goldberg, 2005).

A longitudinal study commissioned by SIDBI\(^{89}\) in India during the period 2001-2007, found that microfinance did not always reach those most in need (SIDBI, 2008). It also did not find much support on the empowerment aspects of microfinance for women. The study involved comparison of baseline data with end-line data for users as well as non-users of microfinance. A limitation of the study was that there was sample attrition to the extent of 34 percent in the case of users and 29 percent in the case of non-users, as compared to the expected attrition rate of 25 percent.

Karlan and Zinman (2009) carried out a randomized evaluation in the Philippines to measure the impact of microcredit, and found that businesses of borrowers shrank though profits at the household level increased through productivity gains. They concluded that microcredit works through risk management and investment at the household level rather than by expansion of the micro-enterprises financed.

Banerjee et al. (2009) carried out a randomized evaluation of the impact of introducing microcredit in a new market in the slums of Hyderabad, India. Fifteen to

\(^{89}\) Small Industries Development Bank of India, a development financial institution which lends and invests in MFIs
eighteen months after lending began in treated areas they found no impact on average monthly expenditure per capita or on measures of health, education or women’s education. However, expenditure on durable goods increased in treated areas and the number of new businesses increased by one third.

Studies on non-income impacts of microfinance such as those on contraceptive use, wages, child nutrition and women’s empowerment have been conducted (Goldberg, 2005). Many of them suggest positive impacts on outcomes, though some studies do not use very rigorous methodologies. Moreover, in the case of outcomes such as empowerment, which involve assessment of subjective factors, there are measurement challenges.

An important issue that underlines all microfinance impact studies is that different variables affect microfinance impact. These include whether the setting is rural or urban, if the MFI is “minimalist” that is focused only on credit delivery or combines other interventions, if it is focused on women alone or not, whether the credit delivery is group based or individual based, if the focus is on the very poor or the moderately poor and whether the interest rates charged are below cost, cost covering or excessive. Moreover, there could be dynamic changes in the impacts over time. This implies that a testable single “microfinance” model does not exist (Goldberg, 2005).

However, rigorous impact analysis is important to develop measures of cost effectiveness of microfinance vis-a-vis other interventions. A good way to progress is to collate the information yielded by the different studies, so that eventually it becomes possible to roughly tabulate particular combinations of factors that yield combinations of outcomes.
2.6 Graduation of Microfinance Group Members to Individual Financial Services

The group mechanism is often considered an integral feature of microfinance. There are however several examples of microfinance institutions which provide financial services on an individual basis. Individual lending is defined by Ledgerwood (1999) as the provision of credit to individuals who are not members of a group that is jointly responsible for loan repayment. The main issue in the case of individual loans in microfinance is the absence of collateral. While group loans too are not based on collateral, the comfort of social collateral is available. This too is lacking when loans are given on an individual basis. Some MFIs, have however devised methods to overcome this problem.

As mentioned in Section 2.2, BRI in 1985 developed a sustainable microfinance program based on its own unique individual lending model using voluntary savings mobilization as a source of funds and a transparent set of incentives for borrowers and staff to encourage timely repayment. While BRI generally requires collateral, it has a flexible approach in this regard, and accepts non-traditional collateral such as original driving licenses, marriage certificates and other documents which are easier for low income individuals to provide. While these documents may not have resale value for the lender, they have considerable value from the point of view of the borrower. The pledge of such collateral consequently indicates the borrower’s commitment and confidence in
raising resources required to repay the loan. This approach to collateral focuses on the “notional” not the expected sale value of collateral (Aghion and Morduch, 2005).

In India, one of the pioneer MFIs, SEWA Bank, has from its inception in 1974 provided financial services on an individual basis at the customer’s doorstep. The model is based on insisting on members saving for at least one year prior to availing a loan. The regular savings record acts as a collateral substitute in this case.

Another approach used to overcome the problem of lack of collateral is the insistence of some MFIs on compulsory savings by borrowers. Grameen Bank for instance requires that even for group loans, borrowers must deposit 5 to 50 taka per week into obligatory personal savings accounts depending on the loan amount. In addition, in most cases 2.5 percent of the loan amount is deducted upfront and placed in the borrower’s saving account and another 2.5 percent is placed in a “special savings account” (Aghion and Morduch, 2005). While the balance in a savings account can be withdrawn, provided the borrower is not in arrears, there are more restrictions on “special savings accounts”90. Moreover, members taking loans in excess of 8,000 taka are required to open Grameen Pension Scheme (GPS) accounts which require a monthly deposit of 50 taka for five to ten years. Accounts in arrears are closed with the amounts returned at reduced interest rates. Compulsory savings may not always serve as an effective collateral substitute as their utility depends on the relative balance in the savings and loan accounts of the borrower at the time of default. Moreover, these savings result in reducing the funds available to borrowers and also carry a “hidden cost” to the borrower,

90 For example, withdrawals are not permitted in the first three years.
as the interest rate received from the MFI on savings is usually lower than the interest rate paid by borrowers on loans.

In countries such as Latin America and Eastern Europe, the individual lending model is frequently used by MFIs though often traditional collateral such as land and livestock is required to be pledged.

Even MFIs which have traditionally used group models are moving gradually toward more individual-oriented methods of lending. Grameen Bank revised its lending model in 2002, weakening the joint liability aspect. The revised model known as “Grameen Bank II” allows borrowers who are unable to repay according to the group schedule to renegotiate the loan by extending the repayment period on an individual basis. Another MFI, BancoSol in Bolivia has also over time developed its individual lending program side by side with its solidarity lending program.

Actual loan appraisal and sanction in the case of individual loans invariably involves visits to the borrower’s residence and place of work and assessment of his or her cash flows. There are conflicting views and reports regarding how the individual model in microfinance compares with the group model in terms of cost to the provider. As the field officer needs to have a better understanding of the borrower’s cash flows and needs to monitor the individual more closely than in the case of group loans (where group members help in the screening and monitoring functions), it may be expected that the operating costs are higher. However, the larger individual loan sizes that are possible in the case of individual lending are likely to improve profitability. It is unclear what the net effect of these two opposing influences is on the profitability of individual lending.
According to the 2009 MicroBanking Bulletin\textsuperscript{91}, out of the 1084 reporting MFIs\textsuperscript{92}, 281 (26 percent) exclusively use the individual lending model. For these MFIs, the median value of loan size was approximately 14 times that of MFIs solely using solidarity groups while the total expenses as a percent of assets were lower (21.9 percent vis-a-vis 27.8 percent). This lead to a higher profit margin vis-a-vis MFIs using solidarity groups (7.3 percent vis-a-vis -0.7 percent). It appears therefore that the individual lenders in the sample catered to a more well off clientele who could service larger loan sizes and were also consequently more profitable. Such a result is also in line with the analysis of Ledgerwood (1999).

A study on Indian MFIs based by Sa-dhan (2008) using data on a sample of 220 MFIs indicated that MFIs using the individual lending model had lower average operating cost ratios but also marginally lower average portfolio yields\textsuperscript{93}. However, a very low number of MFIs using the individual lending model in the sample (11 out of 220) and the fact that the portfolio yield and operating cost ratios were calculated as unweighted averages over the number of MFIs in the sub-sample are significant limitations of the study. In general, the fact that there are very few MFIs in the country which use individual based models makes it hard to draw any firm conclusions regarding the model, in India.

\textsuperscript{91} This is a periodic publication of the MIX (briefly described in \textbf{Section 2.5.1}) aimed at benchmarking the performance of MFIs on a global basis.

\textsuperscript{92} 283 (26 percent) of these are in Asia, of which 63 (6 percent of the total number of MFIs) are from India.

\textsuperscript{93} Operating cost ratio (operating cost as a percent of loans outstanding) was 10 percent for individual lending models compared to 11 percent for SHG models and 19 percent for JLG models. Portfolio yield (total income as percent of loans outstanding) was 17 percent, 18 percent and 24 percent respectively for the three above models.
As mentioned in Section 1.1 in Chapter 1, an important focus area for the thesis is the graduation of group microfinance users to individual financial services. The thesis proposes that it is important that group microfinance users are eventually graduated to individual financial services. Access to group loans does not match up to tailored financial services, especially if the latter are delivered in a flexible way, at a convenient location, without undue transaction costs for customers (Rhyne and Otero, 2006). Group lending can at best be considered as a temporary expedient (Harper, 2007). An important practical limitation of group lending is that joint liability limits the loan size that an individual member can avail. For instance when a group of five members avails a loan of Rs. 5,000 each, the individual liability of each member is Rs. 25,000, as liability of other members is also borne. If loan sizes keep increasing under joint liability the liability of each individual member is likely to soon increase to unacceptable levels. Such a phenomenon may force individual members who have a need for higher loan amounts to seek an outside source for finance, which is likely to be the local moneylender (Babu and Singh, 2007). In an unpublished, informal study of Grameen Bank borrowers, Shahnaz (1992) recommended the setting up of a “Grameen Bank 2” to cater to Grameen Bank members who own a house as well as assets of value greater than 30,000 Taka so that they are able to access more flexible financial services. She also felt that this will keep the original Grameen Bank more focused on acquiring new, poor members.

However though some MFIs use individual based models, group models remain more popular particularly in catering to low income groups. There does not seem to be much evidence of group members being graduated to individual financial services. In the Indian
context, only a few large MFIs such as Basix, Share Microfin and Spandana, selectively graduate their best borrowers to individual loans (Duflo, Jain and Pasheva, 2005). Another leading MFI, Grama Vidiyal Microfinance Limited (GVMFL) provides larger loans on an individual basis to some members, within the group framework itself. Usually graduation to individual loans requires in the minimum, provision of personal guarantees from acceptable individuals though at times post dated checks and collateral may also be required. The ability of members to provide the above is an important limitation to graduation of group members.

Gine and Karlan (2006) conducted a randomized field experiment in the Philippines and found that conversion from group to individual liability did not impact repayment and in fact helped retain borrowers. Rodriguez-Meza (2000) shows that moving to individual lending is particularly important when loan sizes increase. His study uses dynamic programming models and finds that when starting levels of group debt are high and borrowers have different endowments, default is higher in the case of group loans as compared to individual loans. This implies that as loan sizes increase, there should be a process of eventual graduation to individual financial services in order to keep defaults low. Most MFIs in India have a system of fixed progression in group loan amounts after each cycle, subject to prompt repayment of earlier loans. The study implies that such a system, in the absence of graduation to individual loans, could lead to defaults in the

94 Bharatiya Samruddhi Finance Limited (www.basixindia.com), Spandana Sphoorty Financial Limited (www.spandanaindia.com), Share Microfin Limited (www.sharemicrofin.com) and Grama Vidiyal Microfinance Limited (www.gvmfl.com) have individual loan products.

95 Government employees or other salaried employees are preferred though at times guarantees of established businesspeople are also accepted.
future. Lehner (2008) shows analytically that when MFIs’ access to capital markets improve, and competition among MFIs increases, they will tend to offer more individual based loans.

In spite of the above results and the success of some MFIs using individual based models, it generally remains accepted at present in the microfinance sector that individual loans have to provide some additional security to the lender; even in cases where the member has an excellent credit history and demonstrated business aptitude. The additional security provided for these loans may help keep risk levels within limits insisted upon by the MFI’s lenders and investors.

This implies therefore that in order for graduation to individual loans to take place, during group membership, members need to build up the ability to provide additional comfort to lenders, whether it is by being able to convince a third party to guarantee the loan or by raising collateral. This in turn calls for a sustained improvement in family income and assets over the period of group membership. This aspect will be explored during the analysis of the results of the empirical study in Chapter 5. Other challenges in developing individual based models in the Indian microfinance sector include developing the use of non-traditional forms of collateral96, training field officers on the ability to accurately assess cash flows of borrowers97 and developing operational and MIS systems

96 Some examples are original driving licenses, marriage certificates and other documents which may not have sale value for the lender but have considerable value from the point of view of the borrower. As noted, this approach used by Bank Rakyat Indonesia (BRI) focuses on the “notional” not the expected sale value of collateral (Aghion and Morduch, 2005).

97 While cash flow assessment is also undertaken in the case of group loans, the presence of group members enables cross checking of details provided by the member; an advantage not available in the case of individual loans.
to handle the complexities of individually customized loan amounts and repayment schedules.

2.7 The Microfinance Sector: Regulatory Issues and Practices

With the growth of the microfinance sector both in terms of size, scope and number of participants a need for developing a more formal regulatory structure for it has been recognized in a number of countries.

Regulation of the sector however poses unique challenges as the lending models used in microfinance have peculiarities requiring a different approach from bank regulation.

First, in the case of bank regulation, banks are often required to make full provisions for loans without collateral. In the case of MFIs, most loans are collateral free and hence no such measures are possible\(^9\). On-time repayments on microfinance loans however tend to be high, though experience shows that once a loan is overdue, the ultimate collection of the loan is less likely, than in the case of loans that are backed by collateral (Rosenberg, 2008). As a result, provisioning already delinquent loans needs to be more aggressive for microcredit loans as compared to other loans.

Second, while bank failures may be contagious in the sense that the failure of one bank is likely to impact solvency of others due to the interdependent nature of the payments system, the interdependencies between group members in microfinance can

\(^9\) In India therefore, the RBI has clubbed microfinance loans with agricultural loans providing greater flexibility to banks with respect to asset classification norms (RBI circular dated July 1,2010).
lead to a different kind of contagion effect. Widespread defaults can occur either if some members start consistently defaulting or if there are rumors of MFI failures. An important incentive for repayment of collateral free MFI loans is the ability to obtain larger loans in the future. Any event which makes the possibility of future loans reduce considerably, has the potential to trigger widespread defaults. A regulator of MFIs has therefore to be highly sensitive to these realities.

Third, MFI customers are often first time users of financial services and usually have low education. The responsibility on the MFI to offer the right products which suit their members’ needs, as well as provide adequate financial education and training to them is considerable. Regulation needs to necessarily oversee this important element of MFI operations.

Fourth, merely formulating regulation regarding codes of conduct for MFIs and providing channels for dispute resolution regarding MFI practices is not sufficient. MFI customers need to be made aware of them by using appropriate communication. Moreover the channels need to be easily accessible.

Fifth, MFIs may not pose systemic challenges in the sense that it is unlikely that even the largest MFIs are “too big to fail”\(^9\). MFIs however deal with low income groups least likely to bear downside risks; therefore, in a democratic country politically the MFIs may be “too sensitive to fail”. The implicit contingent liabilities are on the State, making their effective regulation in the interest of the government.

\(^9\) For example, the asset size of the largest MFI in India (largest as per a 2009 ranking of “India’s top 50 MFIs” by CRISIL, a credit rating agency, report available on \(www.crisil.com\)). SKS Microfinance Limited in March 2010 was Rs.40.6 billion while that of the largest private sector bank in the country, ICICI Bank, was around Rs.3634 billion, approximately 89.6 times as large (\(www.icicibank.com\) and \(www.sksindia.com\)).
Sixth, the cost that MFIs would incur in complying with regulation needs to be considered, as it may have an impact on their lending rates. Though cost of regulation is probably a consideration when introducing any regulation, it is very important in the case of financial services for low income groups.

As the development of the microfinance sector is a relatively recent phenomenon, its regulation in the case of many countries is still evolving. An early model of regulation was developed in Indonesia and involved the central bank as the regulator, with delegation of supervision to a government owned bank, BRI and some provincial banks (Maegher, 2002). In the Philippines, performance standards have been developed in a collaborative manner by stakeholders in the sector, including representatives from Government, private sector as well as wholesale and retail MFIs. These standards are meant for use as industry benchmarks for all types of MFIs (Almorio et. al., 2006). Though microfinance has a relatively longer history in Bangladesh, regulation of the sector was enacted only in 2006 when a Central Authority to regulate microcredit was set up.

A consultative document issued by BIS (2010) describes the findings of a survey covering 32 countries to identify the range of practice in supervising microfinance activities. It was found that in a vast majority of countries there was no uniform regulation for MFIs but regulation varied based on the MFI’s institutional type. Most of the respondents had depository MFIs of which 90 percent were regulated by the central bank. Half of the MFIs having depository MFIs had specialized microfinance supervision teams of relatively recent origin. The findings indicate that seven low income countries were using a model of delegated supervision which according to BIS could be an
emerging arrangement to deal with the burden of supervising a large number of small institutions.

CGAP (2002) has evolved a set of “Microfinance regulation consensus guidelines” which have been adopted by its donor agencies. These guidelines are general in nature and each country is expected to evolve its own regulatory framework based on considerations of likely effectiveness and cost of supervision.

Chapter 6 will develop a suggested framework for microfinance regulation in India.

2.8 Concluding Remarks

The literature on microfinance mostly relates to microcredit as other microfinance services are of relatively more recent origin. The literature has also primarily focused on trying to assess microfinance’s impact on poverty and to some extent on its sustainability. There have been no detailed studies regarding the contribution of microfinance to financial inclusion.

Cull et.al. (2009) summarize the various controversies in microfinance and add that even though there are diverging views around the possibilities and limits of microfinance, there are areas of shared vision particularly on the need for financial services which can benefit a large number of people without access to banks. This emphasizes the role of MFIs in promoting financial inclusion. This is a very important role, particularly in the context of developing countries where a large proportion of the population is under serviced. Many of these countries cannot afford initiatives involving considerable fiscal
outflows, particularly in view of the extent of the problem, a solution involving MFI merits encouragement.

MFI s have a number of features which make them in some ways appropriate channels for this purpose. In particular, they have the ability to break down some common barriers to financial inclusion. Microfinance can address common supply side barriers such as lack of suitable financial products, physical barriers and inability to meet documentation requirements. First, MFI s provide financial products more or less tailored to the requirements of low income groups. For instance, in the case of MFI loans, collateral is not usually insisted upon and loan repayment amounts are small and frequent. Second, they usually provide convenient forms of delivery of financial services, often by regular visits to the neighborhoods of customers, making physical access particularly easy and attractive. Third, they do not usually have elaborate documentation requirements. Loan officers in MFI s usually rely on address checks and neighbor references rather than documents.

Microfinance can also address demand side barriers to financial inclusion such as cultural and psychological barriers and lack of financial literacy and financial competence. MFI s motivate potential members by explaining the benefits of usage of the financial products. The loan officers of MFI s are drawn from local populations, who usually communicate effectively with potential customers and give them opportunities to obtain clarifications on any concerns they may have. They also provide basic training to first time customers on financial concepts. The group model provides companionship to first time users of financial services. The fact that all transactions are conducted in group meetings ensures a degree of transparency and sense of security to members. All these
design features suggest that microfinance may be a suitable means to promote financial inclusion.

However, just as studies have been conducted regarding the impact of microfinance on poverty, the potential of microfinance with regard to financial inclusion needs to be studied in greater detail. Mere provision of financial services on a one-time basis does not amount to financial inclusion. This thesis therefore defines financial inclusion as “ongoing access to a range of financial services in an affordable and convenient manner”. The definition implies that financial inclusion by microfinance providers needs to also encompass the issue of graduation of group microfinance members. Financial regulation is necessary for these institutions to reliably offer certain kinds of services such as savings and hence this aspect needs to be analyzed.

This thesis proposes to examine these issues in the context of Tamil Nadu, India. The next chapter will describe the research framework and methodology for the study.
Box 2.1: The Compartamos Controversy

Compartamos NGO, a not-for-profit NGO MFI in Mexico, was set up in 1990 with grants and soft loans from international aid agencies and Mexican private sources. In 2000, like many other MFI NGOs, it set up a for-profit finance company, Compartamos. The NGO used grant funds obtained from ACCION (in turn obtained from USAID) to invest in the finance company. The finance company also received equity from socially oriented investors. In 2006, it received a full banking license.

Since commercialization in 2000, Compartamos' book value increased at an average annual rate of 53 percent due to rapid growth and retention of 80 percent of profits. This meant that the initial investment of US$ 6 million by investors in Compartamos was worth US$ 126 million in book value by 2006. In 2007, Compartamos made an initial public offer (IPO) of its shares during which the shareholders sold about 30 percent of their shares mainly to mainstream commercial investors. They received US$ 450 million, more than 12 times the book value of those shares. This implied a market valuation of the company of over US$ 1.5 billion and an internal rate of return of around 100 percent per annum on shareholders’ initial investment compounded over 8 years. While most of the proceeds went to public purpose entities such as IFC, Accion and Compartamos NGO, a third of it went to private shareholders, whose unsold shares amount to US$ 300 million if valued at the IPO price.

Though the IPO price was 40 pesos, on listing the price of shares went up to 70 pesos. Later in January 2008, as a result of the global crisis, the price fell to 38 pesos. In April 2010, the share price once more touched 70 pesos due to robust growth forecasts for Compartamos. though that Compartamos’ interest rate was comparable with interest rates charged by other Mexican MFIs.

(..contd.)
Though such variations are common in equity markets, the fundamental point that high interest rates charged by Compartamos (average return on portfolio was around 86 percent for the year 2005) ultimately contributed to the high returns earned by its investors, led to concerns regarding single minded shareholder profit maximization by MFIs.

Even supporters of MFI sustainability such as CGAP and Prof Dale Adams of the Ohio State University, did not approve of Compartamos’ strategy. Yunus (2007), the founder of Grameen Bank argued that a true microcredit organization should keep its interest rate as close to its cost of funds as possible. He suggested that interest rates should be in the range of 10 percent to 15 percent over the cost of funds.

Due to variation in transaction costs in different contexts, benchmarks with regard to microfinance interest rates may be hard to determine. However the Compartamos IPO brought to the fore issues regarding the ethics of private profits obtained by leveraging funds meant for public purposes as well as how MFIs need to tread the fine line between sustainability and profit maximization.

(Data regarding the IPO was obtained from Rosenberg, 2007).
3. Research Framework and Methodology

The financial inclusion literature reviewed in Chapter 1 highlights the barriers to financial inclusion as well as the expected outcomes of financial inclusion. Based on the literature and an understanding of the important issues in microfinance reviewed in Chapter 2, this chapter develops the research framework and questions; and also explains the methodology adopted to address the research questions.

Section 3.1 describes the research framework while Section 3.2 develops the research questions. The research design and methods are described in Section 3.3 while the data sources and their collection are discussed in Section 3.4. The cases selected for the study at the microfinance provider (MFP) and member levels are described in Sections 3.5 and 3.6 respectively. The details of the study and the data analysis are discussed in Sections 3.7 and 3.8. Limitations of the study are mentioned in Section 3.9. Finally, Section 3.10 provides the concluding observations.

3.1 Framework for analyzing financial inclusion

The thesis has defined financial inclusion as ongoing access to a range of financial services in an affordable\textsuperscript{100} and convenient manner. The definition emphasizes the fact that access to financial services needs to be available on a continuous and not on a one-time basis. This is because while the specific financial services required by an individual

\textsuperscript{100} “Affordability” is used to imply that even for very low income individuals, cost of financial services should not be a barrier to access. This is the sense in which the term is used in the financial inclusion literature.
may vary over time, the option to use financial services needs to be routinely available. A second point emphasized by the definition is that for access to financial services to translate into actual usage, the practical concerns of affordability and convenience need to be considered. As the financially excluded are often low income groups, affordability is important. Convenience is also a desired attribute as if accessing financial services imposes unduly high costs in terms of time and effort (i.e. high economic opportunity costs), the motivation to use them is reduced.

The process of financial inclusion encompassing the breaking of barriers and leading to expected outcomes is illustrated in Figure 3.1.

**Figure 3.1: Process of Financial Inclusion**

<table>
<thead>
<tr>
<th>Barriers to Financial Inclusion:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of suitable Products</td>
</tr>
<tr>
<td>Physical Barriers</td>
</tr>
<tr>
<td>Documentation Problems</td>
</tr>
<tr>
<td>Lack of Financial Literacy and competence</td>
</tr>
<tr>
<td>Motivational, Psychological, cultural Factors</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expected Outcomes of Financial Inclusion:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ongoing access to wide range of affordable products which meet needs for consumption smoothing, investment, risk mitigation and money transfer</td>
</tr>
<tr>
<td>Financial literacy and competence</td>
</tr>
<tr>
<td>Credit histories</td>
</tr>
</tbody>
</table>

(Source: Author)
A framework for financial inclusion developed by Da Silva and Chamberlain (2008) shown in **Figure 3.2** forms the basis of the framework for analyzing financial inclusion, developed in this thesis. The framework considers the potential impact of four dimensions of financial inclusion. On the demand side are access factors that exclude individuals from accessing a financial service, and usage factors that discourage them from using the services. On the supply side are entry and expansion factors with regard to financial service provision to low income groups.

**Figure 3.2: Financial Inclusion Framework**

![Figure 3.2: Financial Inclusion Framework](Source: [www.CENFRI.org](http://www.CENFRI.org) accessed on November 1, 2009)

This thesis seeks to examine the role of microfinance programs in promoting financial inclusion in India and hence in addition to demand and supply side barriers, expected outcomes of financial inclusion at the individual level, are also of interest. This

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101 While the paper is unpublished, the framework is reproduced on the web site of the Centre for Financial Regulation (CENFRI), a South Africa based think tank.
is because one of the objectives of the thesis is to examine if microfinance provides the outcomes generally expected from financial inclusion.

The thesis therefore develops a framework for expected outcomes of financial inclusion shown in Figure 3.3. Each of the outcomes follows from the review of literature in Chapter 1. As mentioned earlier, financial inclusion needs to be accompanied by development of financial literacy and competence. Financial inclusion also implies an ability to manage cash flows (meaning ability to save for lumpy expenditures, emergencies and retirement), ability to transfer liquidity to other locations and individuals (through access to payments systems), mitigate risks (risks to life, health and other risks) and realize economic potential (through availing credit and making investments).

An important result of financial inclusion is the development of credit histories. These enable borrowers to access more favorable credit terms in future. Maintenance of credit history by an independent entity empowers the borrower to leverage her credit history to access a wider range of institutions in future. While it is desirable that a lender through the quality of its services retains customers, it is also important that the option to continue availing of the service should lie with the customer. This would help ensure that customers do not get taken for granted and that the lender continues to strive to maintain customers. The importance of credit histories lies in its ability to enable borrowers to potentially access more favorable credit terms in future.
Combining the two frameworks, a framework for analyzing financial inclusion is developed at **Figure 3.4** which is used for this thesis in developing the research problems, analyzing the data and structuring the implications and conclusions.
The focus is on analyzing two aspects—first, the extent to which microfinance providers (MFPs) lower barriers to financial inclusion, and second, the extent to which expected outcomes of financial inclusion are available to microfinance members.

### 3.2 Research Questions

The primary research questions addressed by the thesis are:
(I) How do the two major microfinance models in India, the SBLP and the MFI models address financial inclusion? (II) Why are there gaps and how best can they addressed by the sector, policy makers and other stakeholders?

As explained in Section 1.6 in Chapter 1, the first primary research question leads us directly to three sub questions,

I(i) Are the barriers to financial inclusion\textsuperscript{102} adequately addressed by microfinance providers?

I(ii) To what extent are the expected outcomes of financial inclusion available to microfinance members?

I(iii) What are the conditions under which group membership enables members to subsequently access financial services on an individual basis?

The third sub-question follows from the discussion in Section 2.6, Chapter 2 regarding the benefits of graduation of group microfinance users to usage of individual financial services. The arguments given there are presented in the form of a roadmap for financial inclusion in Figure 3.5.

\textsuperscript{102} These are described in Section 1.4.
The three sub-questions arising from the primary research question, regarding barriers to financial inclusion, benefits of financial inclusion and graduation to individual financial services, will guide the analysis in the thesis. The second primary research question will be addressed based on the analysis of the above.
3.3 **Research Design and Method**

The research questions necessitate in-depth coverage of aspects relating to the evaluation of the role of MFPs in promoting financial inclusion, an aspect that is not readily observable. As this necessarily involves complexity, qualitative research suits the research objectives of the thesis. Creswell (2007) advocates use of qualitative methods “when we need a complex, detailed understanding of the issue”. Denzin and Lincoln (2005) define qualitative research as consisting of a set of interpretive, material practices that make the world visible. Qualitative researchers study phenomena in their natural settings, attempting to make sense of, or interpret them, in terms of the meanings people bring to them. These aspects make qualitative research suitable for this thesis. **Box 3.2** highlights typical features of qualitative research vis-a-vis quantitative research.

Creswell (2007) mentions that there is no agreed upon structure for a qualitative study but has identified five qualitative approaches: narrative research, phenomenological research, grounded theory research, ethnographic research and case study research.

Narrative research usually involves focusing on studying one or two individuals and gathering data primarily through their spoken or written text, giving an account of an event (or action) or a series of events (or actions) chronologically connected.

Phenomenological research on the other hand, describes the meaning for several individuals of their lived experiences of a particular concept or a phenomenon, with a view to reducing individual experiences to a universal essence.

Grounded theory research tries to move beyond description and generate or discover a theory, an abstract analytical schema of a process.
Ethnographic research describes and interprets the shared and learned patterns of values, behaviors, beliefs and language of a culture sharing group.

Case study research involves the study of an issue explored through one or more cases within a bounded system (Creswell, 2007). Rossman and Rallis (2003) state that case studies seek to understand a larger phenomenon through intensive examination of one specific instance.

Of the five approaches described above, the case study method fits most closely the objective of the thesis. Narrative or phenomenological research is not appropriate as the research questions do not focus on particular individuals or events. Grounded theory and ethnography too are not suitable as the intention is not to develop theory or focus on particular cultural groups. The objective is however to study an issue or phenomenon (microfinance) by examining specific cases (microfinance programs and their members) which suggest that the case study method is appropriate.

The decision to use case study research is also supported by the insights of Stake (1995) and Yin (2002) who describe situations when case study research may be used. According to Stake (1995), a case study approach is appropriate when the researcher can identify cases with boundaries and seeks to provide an in-depth understanding of the cases or a comparison of several cases. This is true for the thesis as microfinance providers as well as microfinance members, represent at two levels, such cases with boundaries. While Stake (2005) views the decision to do a case study as determined by “what is to be studied” and not a methodological choice; others view it as a strategy of inquiry (Denzin and Lincoln, 2005), a methodology (Merriam, 1998) or a comprehensive research strategy (Yin, 2002).
Yin (2002) states that three conditions should determine the choice of research strategy. These are the type of research questions, the extent of control the researcher has over behavioral events and the degree of focus on contemporary as opposed to historical events. Table 1 summarizes the appropriateness of each research strategy according to Yin (2002).

Table 1: Relevant Situations for Different Research Strategies.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Form of research question</th>
<th>Requires control over behavioural events?</th>
<th>Focus on contemporary events?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experiment</td>
<td>How, why?</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Survey</td>
<td>Who, what, where, how many? How much?</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Archival analysis</td>
<td>Who, what, where, how many, how much?</td>
<td>No</td>
<td>Yes/No</td>
</tr>
<tr>
<td>History</td>
<td>How, why?</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Case study</td>
<td>How, why?</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

(Source: Yin, 2002)

The primary research questions of the thesis are concerned with “how” and “why” questions and these relate to contemporary events, suggesting that the case study method seems appropriate for the study.

The case study has multiple units of analysis, as both MFPs and microfinance members are proposed to be studied. This results in an “embedded case study design”. According to Yin (2002), an embedded case study is an important device for focusing a case study. The sub units can add opportunities for extensive analysis enhancing the insights provided by the case study.
Multiple case studies are proposed to be used at both levels making it a “multiple holistic- multiple embedded” case study design. The use of multiple cases at the MFP level is to obtain insights into both the predominant models of microfinance in the country, namely the SBLP and the MFI model. Hence one typical case of each one is proposed to be studied, making it a multiple case study design at the level of microfinance providers. Within each MFP, a number of MFP members who are at least in the third year of microfinance membership will be studied. The reason for using multiple cases at this level is based on replication logic, to examine if there is a pattern that can be identified through the cases. This replication logic is distinct from the sampling logic used in quantitative studies.

Even though there is a divergence of views among scholars on whether the case study is a method or a strategy, there is agreement that a case study involves in-depth data collection from multiple sources of information relating to a single case or multiple cases. It is therefore proposed to conduct three levels of enquiry as will be described in the following section.

3.4 Data Sources and collection

In qualitative research, data collection is not off-the-shelf; rather it is custom built, revised and “choreographed” (Huberman and Miles, 1994).

According to Creswell (2007), the use of multiple sources of data is an important characteristic of qualitative research. In particular for case studies, he mentions that data collection is typically extensive drawing on multiple sources of information. Yin (2002)
argues that “the use of multiple sources of evidence in case studies allows an investigator to address a broader range of historical, attitudinal, and behavioral issues. However, the most important advantage presented by using multiple sources of evidence is the development of converging lines of inquiry, a process of triangulation.” Accordingly, the thesis collates and assesses evidence on financial inclusion through microfinance, by data triangulation to address the research questions.

In order to facilitate triangulation, three lines of enquiry were followed, which are described below.

3.4.1 Sector level inquiry

The first is at the broader microfinance sector level, drawing on secondary sources of data. As this is the context in which the MFPs as well as MFP members operate, trends at the macro level reflect trends at the meso and micro levels.

The first sub question regarding the barriers to financial inclusion was addressed by examining two aspects: “Are microfinance services uniformly available in all regions of India?” and “Do microfinance programs focus on geographic areas that are not adequately served by the banking sector?” The first question is important to understand if there are physical barriers to microfinance access (just as there are barriers to financial inclusion). The second question enables us to analyze the spread of microfinance services vis-a-vis that of banking services. The relationship will reveal the extent to which microfinance program fill in gaps in banking sector services. The analysis draws on published data sources such as annual “State of the Sector” reports and reports regarding
trend and progress of banking available from the RBI website\textsuperscript{103}. In addition, interviews were held with 19 sector stakeholders from a wide range of organizations including senior executives of microfinance providers (including NGOs, local area banks and non-banking finance companies), financial institutions involved in funding the sector, government organizations overseeing microfinance and an information technology provider for MFIs. These are listed in Appendix 3.1.

The benefits of financial inclusion were studied by examining the financial products that are presently being offered by the sector and the benefits they offer. Graduation to individual financial services was studied through the trends with regard to the share of individual lending at the sector level and discussions with stakeholders regarding their views on offering individual loans to a mature group of microfinance users. The present regulatory structure for microfinance and the gaps therein were also discussed with sector stakeholders. The discussion on the regulatory framework is presented in Chapter 6.

3.4.2 Microfinance Provider level inquiry

The second level of enquiry is at the MFP level. As there are two models of microfinance in India, one MFP of each kind was studied. This is in keeping with the suggestion of Creswell (2007) regarding choosing cases for qualitative research with the objective of showing different perspectives on the problem, process or event being studied; described as “purposeful sampling”.

\textsuperscript{103} \url{www.rbi.org}
In the case of each MFP, data was collected from three sources. First, from the administrative office, brochures and documents relating to the MFP operations were collected. Second, in-depth semi-structured interviews were conducted with the senior MFI executives. Third, short structured interviews were conducted of 103 field staff. Field officers of an MFP are the contact points between the MFP and its members. They perform the critical roles of group formation, training and monitoring, and as such are likely to be well aware of the ground-level realities. In order to tap into this valuable resource, field staff was surveyed.

In addition, the researcher attended two group training sessions and five routine group meetings as an observer to enhance understanding of the processes involved.

3.4.3 Microfinance Member level inquiry

The third level of enquiry is at the microfinance member level. In-depth interviews of microfinance members who were at least in their third year of membership were carried out. Other studies trying to assess the impacts of microfinance in the Indian context have used a similar cut-off (Akula, 2004 and Santiago, 2006).

Here again, members of both models were interviewed with the objective of “purposeful sampling” (as explained in Section 3.4.2). Further, the researcher visited urban, semi-urban and rural branches of one MFP to study members of all three kinds of

104 The number of field officers at the time of the study was around 600, hence around 16.7 percent of the workers were interviewed.
branches. Within the branches however the actual respondents were chosen based on “convenience sampling”. The researcher on some occasions interviewed members who happened to be visiting the branch for a routine activity. At other times she visited nearby neighborhoods, and also accompanied the field staff during routine group meetings and interviewed available members after the meetings. Though the researcher also wanted to interview members who had graduated to individual loans, as well as non-graduates, no specific selection was made on this basis. It was expected that as 7 to 10 percent of the MFI’s portfolio comprised individual loans, there was a high probability that both kinds of members would be interviewed.

In addition to questions directly addressing the three research sub-questions, the interviews aimed at understanding the history of important financial decisions by the members since commencement of MFP membership. The objective was to use this history as additional evidence to analyze some of the research questions. The data sources and the methods of collection are summarized in Table 2.

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105 In convenience sampling, units most conveniently available are selected.

106 At the MFI studied, these individual loans are also given within the group framework with all transactions happening at group meetings, even though liability is individual and not joint.

107 This was in fact the case as 9 of the 31 members interviewed had graduated to individual loans.
<table>
<thead>
<tr>
<th>Level of Enquiry</th>
<th>Data Source</th>
<th>Method of Data Collection</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sector</strong></td>
<td>Published secondary data</td>
<td>Microfinance India State of the Sector Reports (published by Sage Publications), Bharat Quick Microfinance Reports (published by Sa-dhan, the industry association of community development financial institutions in India).</td>
</tr>
<tr>
<td><strong>Microfinance Provider</strong></td>
<td>Brochures and documents</td>
<td>From administrative office of MFI</td>
</tr>
<tr>
<td></td>
<td>Senior executives</td>
<td>In-depth interviews of two senior executives from each model</td>
</tr>
<tr>
<td></td>
<td>Field Officers</td>
<td>Short structured interviews of 103 field officers</td>
</tr>
<tr>
<td></td>
<td>Observation of 2 group training sessions and 5 routine group meetings</td>
<td></td>
</tr>
<tr>
<td><strong>Microfinance Member</strong></td>
<td>Mature members (who are at least in their third year of membership) from each model, Drop-outs, an individual unable to access microfinance.</td>
<td>In-depth interviews of 34 low income women. The interviewees included 8 SBLP members, 23 MFI members (8 from urban areas, 10 from semi-urban areas and 5 from rural areas), 2 drop-outs and 1 individual unable to access microfinance. The interviewees also included 9 members who had graduated to individual financial services.</td>
</tr>
</tbody>
</table>

(Source: Author)
3.5 Cases at Microfinance Provider level

As explained in Section 3.5 above, at the microfinance provider level, two cases, one representing each model was selected. For the MFI Model “Grama Vidiyal Microfinance Limited (GVMFL)”, an MFI using the Grameen model was selected while for the SBLP, “Hand in Hand (HIH)”, an NGO involved with the SBLP model was selected. Both MFIs are important participants in the microfinance sector in Tamil Nadu.

3.5.1 Grama Vidiyal Microfinance Limited (GVMFL)

GVMFL is the largest MFI in Tamil Nadu on the basis of loans outstanding, and the 9th largest in the country. It is headquartered in Tiruchirapalli district in Tamil Nadu and works exclusively with women. It started operations in 1996. As on March 31, 2009, GVMFL had 408,685 members and 154 branches in 27 out of the 30 districts in Tamil Nadu and in the neighbouring union territory of Pondicherry. The loans outstanding stood at Rs. 2 billion. By April 2010, GVMFL had 862,482 members and loans outstanding of Rs. 5.9 billion. GVMFL had also expanded geographically and has 230 branches.

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108 “Grama Vidiyal” means “dawn of the village” in Tamil language.

109 CRISIL (2009), “India’s top 50 MFIs”.

110 As the study was conducted in the period June-August 2009, the figures as on March 31, 2009 have been provided.

111 GVMFL’s rapid growth in the recent past is typical among large MFIs in the Indian microfinance sector, as will be explained in Chapter 4.
GVMFL started operations in 1986 as ASA (Activists for Social Alternatives), a not-for-profit NGO registered as a public charitable trust. It was started by an individual, S.Devaraj, as a charitable activity to promote human rights of lower caste poor people in Tamil Nadu. It was also later involved in drought relief activities. In 1992, it began microfinance activities after studying the models used by Grameen Bank and other Bangladesh-based microcredit organizations. In 1997, with growth in microfinance activities, it was decided to transfer the charitable activities to a different entity, ASA Grama Vidiyal (ASAGV), another trust.

In 2007, like many other MFIs, ASAGV recognized the advantages of having an NBFC organizational form for microfinance activities and incorporated Grama Vidiyal Microfinance Limited (GVMFL). It raised the Rs. 20 million required for the registration as NBFC by raising Rs. 10 million from Grameen Foundation and the balance Rs. 10 million from the America India Foundation (promoted by social venture capitalist Mr. Vinod Khosla). In 2009, GVMFL raised two rounds of equity, one of Rs. 139 million and another of Rs. 218 million from equity funds and venture capitalists.

Around 80 percent of GVMFL’s loan portfolio is comprised of “general loans”, namely loans ranging between Rs. 5,000 to Rs. 15,000 given using the Grameen Bank model. These loans are repaid in weekly group meetings over a year. Another product, seasonal loan, which comprises 7 to 10 percent of its portfolio, is offered to members who are prompt in repaying the general loan, midway through its tenure, to meet seasonal cash flow requirements such as payment of school fees. The amounts range between Rs.1, 000 to Rs. 2,000. The balance 7-10 percent of GVMFL’s portfolio is comprised of individual loans given on a selective basis to members who have completed at least two
years of membership. These range between Rs.25, 000 to Rs. 50,000 and are hence given only after a detailed appraisal to members who have the repayment capacity. In addition, the members have to provide guarantees from two individuals who are in government service or who have an established business. These loans are not guaranteed by the group, though repayments are made in weekly group meetings.

GVMFL has adopted a “Fair Practice Code” which is available on its web site (www.gvmfl.com). The code specifies its policy with regard to members during the stages of admission, loan application, appraisal and disbursement stages. The policies concerning changes in terms and conditions of loans to members and other general policies such as that of non-interference in members’ affairs are also covered by the code.

GVMFL has a board of directors consisting of seven members, two representing the promoters, two representing foreign equity holders and three independent representatives. The details of the board are in Appendix 3.2. GVMFL, in late 2009, had appointed a President, Mr. S. Pattabiraman, an experienced corporate sector executive, to head its operations. The other key management person is Mr. Arjun Muralidharan, Senior Vice President and Chief Strategic Officer who was earlier employed with GE Capital.

GVMFL was chosen for the case study as it represents a typical well established MFI. A study of its MFI customers can be expected as reasonable representation of MFI customers in Tamil Nadu. Moreover, as GVMFL operates in rural, semi-urban and urban areas, it enabled study of borrowers from all these three backgrounds. Finally, as GVMFL has an individual loan program, it provided scope for studying those who graduated to individual loans and those that did not.
3.5.2 Hand in Hand (HIH) India

Hand in Hand is an NGO registered as a public charitable trust, started in 2002 to address the problem of child labor in the silk industry in Kanjeevaram district, Tamil Nadu. The objective was to eliminate child labor and get children back to schools. The founder and chief donor of HIH is Percy Barnevik, former CEO of ABB\(^{112}\), who is also a well known philanthropist. HIH is also supported by the Dutch, Swedish and Indian Governments.

In 2004, HIH perceived that child labour in the areas of its operation had declined significantly and so decided to adopt a broad five pillar approach to development, consisting of microfinance, education, health, citizens’ centre enterprises (CCEs)\(^{113}\) and a clean environment.

As part of its microfinance activities, HIH worked in partnership with the Tamil Nadu Government and was active in promoting self help groups. In 1992, the International Fund for Agricultural Development (IFAD)\(^{114}\), the Government of India and the Government of Tamil Nadu (GOTN) had announced a joint scheme known as the Tamil Nadu Women’s Development Project (known in the local language as “Mahalir Thittam” meaning “Women’s Program”) in certain districts of the state, aimed at improving the economic and social status of women by providing credit to them through self help groups (SHGs). After the IFAD scheme came to an end in 1996, the GOTN

\(^{112}\) ABB, is a multinational company based in Europe, with significant international presence in the power equipment industry.

\(^{113}\) CCEs are equipped with computer, internet access and a small library with newspapers and magazines. SHG members are encouraged to set up a CCE in their village as a social enterprise.

\(^{114}\) A specialized agency of the United Nations.
launched a state wide program using its own funds and HIH became a partner-NGO in the Kancheepuram district of the state. In addition to linking SHGs with commercial banks like other NGOs, HIH also started its own microfinance program by raising funds from various sources for on-lending to SHGs.

By 2009, HIH had a presence in 17 out of the 30 districts in Tamil Nadu and had also extended its reach to Madhya Pradesh, Karnataka and the union territory of Pondicherry. HIH also provides consultancy and training on microfinance-related issues to organizations in South Africa, Afghanistan and Brazil. As on February 2010, HIH had 536,091 SHG members and has helped disburse credit of Rs. 3,322 million of which Rs.1,949 million was from its own sources and the balance sourced by linking SHGs with commercial banks.

The board of directors of HIH India consists of 11 members. The Managing Trustee, Ms. Kalpana Sankar, heads its operations. She was earlier a senior civil servant handling the Tamil Nadu Women’s Development Project, state Government microfinance initiative. The details of the board of directors of HIH India are in Appendix 3.3.

In 2009, HIH incorporated “Belstar Investment and Finance Limited” an NBFC exclusively for microfinance activities. While IFC, a member of the World Bank group has invested US$1.15 million, the Norwegian Microfinance Initiative has invested US$900,000 in the company.
3.6 Cases at microfinance member level

In both MFPs, the members interviewed were women between 18 and 59 years of age, as this is the age group that is eligible for microfinance loans. All the women were low income though not necessarily in the Government list of those “below the poverty line (BPL)” It is found that like many microfinance providers, GVMFL does not use the BPL list to identify members but use their own criteria. HIH however used the BPL list for guidance. The limitations of the BPL list are discussed in Box 3.1.

Interviews were conducted of members who were at least in their third year of membership. In addition drop-outs and individuals unable to access microfinance were also interviewed. In all cases, a basic introduction was provided by the MFP branch staff. The interviews were however conducted privately and not in the presence of the staff. None of the members had prior knowledge about the study but all of them were willing and appeared to be happy to be interviewed by the researcher.

In this manner, at GVMFL, five rural members, eight urban members and ten semi-urban members were interviewed. As some members had been graduated to individual loans, in all three categories, graduates and non graduates were interviewed. In addition, in all branches, the researcher requested to interview drop-outs. However, in most locations it was found that field officers and members were often not aware of the whereabouts or contact details of drop-outs. However, in one semi-urban branch it was possible to interview two drop-outs. One of the drop-outs wanted to rejoin, hence was
cooperative for the interview. The other drop-out did not want to rejoin and agreed for a very short interview.

Similarly, in all branches the researcher requested to meet financially excluded individuals who are unable to access group microfinance. In most cases field officers and members were unable to direct the researcher to any of them. However, after one centre meeting, the researcher happened to meet one such individual who had come to enquire whether she could join a group though her work schedule did not permit regular attendance at group meetings. It was hence possible to interview her.

In total, in-depth interviews of 34 low income women were carried out including eight SBLP members, 23 MFI members, two drop-out members and one low income individual unable to access microfinance. Of the 23 MFI members, eight were from urban areas, ten were from semi-urban areas and five were from rural areas. Among the interviewees, nine had graduated to individual loans, of which four were from urban areas, four from semi-urban areas and one was from a rural area.

At HIH, as only monthly meetings are held, a neighborhood in which members reside was visited and available members who were at least in the third year of their membership were interviewed. Here again, a basic introduction was provided by the field officer though the interviews were conducted in private. 8 interviews were conducted at HIH.
3.7 Research Details

The primary data collection for the thesis took place during the period June to August 2009 in Tamil Nadu in India.

Research sites

In the case of the MFI (GVMFL), the researcher visited 12 branches of the MFI around Tiruchirapalli. The urban branches of Thennur, Srirangam, Kattur and Pudukkottai were visited. The semi-urban branches that were visited were Somarasampettai, Samayapuram, Mathur and Lalgudi. The rural branches that were visited were Annavasal, Keeranur, Thirukattupalli and Nanillam. In addition, visits were conducted to the head office at Tiruchirapally and the administrative office at Chennai.

In the case of the SBLP (HIH), the researcher visited Baluchetty in Kancheepuram District, Tamil Nadu. In addition, the head office at Chennai and the administrative office at Kancheepuram were also visited.

Interviews with senior MFP personnel

The interviews with senior MFP personnel followed a semi-standardized format, which involves having a basic structure, predetermined questions and/or special topics, while retaining the option of follow-up probes, appropriate to the given situation and the central purpose of the investigation (Berg 2001). The interview process attempted to develop, adapt, and generate additional questions based on the interactions during the interview itself. A pilot study was conducted in December 2007 and the questionnaire for
senior MFP personnel was administered at GVMFL. The questionnaire was refined subsequent to the pilot.

The interviews, conducted in English, were sourced through prior appointments. In GVMFL, the Chief Executive Officer and a Director, located respectively in the Chennai administrative office and the head office at Tiruchirapalli were interviewed. In HIH, the Managing Director and Chief Operating Officer located respectively in the head office at Chennai and the administrative office at Kancheepuram were interviewed. A sample set of questions are in Annexure 1. A pilot of the questionnaire was administered to two GVMFL representatives during a visit to Tiruchirapalli in December 2007.

Field officer interviews

The interviews for field officers followed a standardized format which as defined by Berg (2001) as a formally structured schedule of questions. The format used is in Annexure 2. A pilot of this questionnaire was administered to two GVMFL field officers during a visit to Tiruchirapally in December 2007. As 12 branches spanning rural, semi-urban and urban areas were visited, all field officers attached to the branch who were available at the time of the study were interviewed, resulting in 103 interviews. As the study was conducted after obtaining the approval of senior MFI personnel, the MFI branch personnel had been requested by the head office to cooperate with the researcher. As a result, all field officers approached participated in the study.

The interviews were conducted in the local language, Tamil. Due to the limited time available at the MFI and the large sample to be covered, the assistance of a research assistant was taken in interviewing the field officers. No interpreter was required as both
the researcher and the research assistant are fluent in Tamil. Translation of questions was done not literally but in a culturally relevant manner as suggested by Saito, Nomura, Noguchi and Tezuka (1996).

The interviews were conducted at the MFI branch as all field officers report at the branch after finishing their group meetings in the morning. The detailed comments of each field officer were transcribed on individual copies of the question format.

**MFP Member interviews**

The MFP member interviews like the MFP senior personnel interviews also followed a semi-standardized format. The sample questions are in **Annexure 3**. A pilot of the questionnaire was administered to five GVMFL members in December 2007, following which the questionnaire was refined.

For cultural reasons, written consent was not obtained as it may have perturbed interviewees, as many of them are not very well-versed in reading and writing. Verbal consent was however obtained and recorded in field notes. Some of the interviews were tape recorded but the quality of recording was poor as the locations were noisy. However detailed field notes were taken which were later transcribed. The interviews with MFP customers were conducted by the researcher in Tamil. Here again translation was done in a culturally relevant manner

Weiss (1994) points out that an implicit but important element of the interview process is that the participant will not be damaged because of his or her participation in it. Taking this into account, it was decided not to reveal identities of participants while
reporting the results of the study. The names of interviewees were hence replaced with codes.

3.8 Data Analysis

Data analysis in qualitative research consists of preparing and organizing the data for analysis, then reducing the data into themes through a process of coding and condensing the codes, and finally representing the data in figures, tables or a discussion (Creswell, 2007). The organization of data into themes enables the researcher to go beyond the initial research design. The objective is to ensure that data analysis is not driven by the researcher-formulated interview questions preventing the emergence of independent realities that may not correspond with the dominant preoccupations of the researcher (Holliday, 2007). The process of data analysis typically includes data management (into files), reading (generating memos), describing, classifying and interpreting (developing codes and categories) and finally representing and visualizing (into text, tables or figures).

Miles and Huberman (1994) summarize the process by stating that qualitative analysis consists of three concurrent streams of activity: data reduction, data display and conclusion drawing/verification. Data reduction acknowledges the voluminous nature of qualitative data and the need for focusing, simplifying and transforming it into a more manageable form (Berg, 2001). Miles and Huberman (1994) stress that use of appropriate data displays (such as matrices, tables and charts) can help present qualitative data in a manner that enables conclusion drawing. Creswell (2007) states that in case studies, data
analysis needs to also involve case descriptions, identification of issues within a case and looking for common themes that transcend the cases.

The methods suggested above were adopted for analyzing the data collected for the thesis. As described earlier, primary data collection in the thesis was carried out in connection with the second and third lines of enquiry. As the second line of enquiry involved interviews of MFP senior executives as well as MFP field officers, data was collected from three sources. The data analysis method used in each case differed, as it was a function of the nature and volume of data collected.

First, for the in-depth interviews with senior MFP executives in GVMFL and HIH, data analysis involved transcription of interviews, thematic analysis and presentation in the form of a discussion in Chapter 5. As the interviews were only four in number, data reduction was not required. A matrix display showing areas of agreement and disagreement in views of senior executives in both models helped conclusion drawing.

Second, for the field officer interviews, the detailed comments of each field officer were transcribed on individual copies of the question format. As these were 103 in number, numeric codes were assigned to expected responses for each question at the time of framing the questionnaire. When new categories of responses emerged, additional numeric codes were assigned by the researcher. Each questionnaire with the associated codes for each question, was then entered into a Microsoft excel sheet. Using the pivot table function the frequency of each code was counted for each question and the responses were organized into tables. The pivot tables were then summarized and are
presented in Chapter 5. This was the manner in which the processes of data reduction and data display were carried out in this case.

Third, for the in-depth interviews with 34 low income women, data analysis involved transcription of the interviews and thematic analysis. Patterns of behavior were identified across cases which enabled identification of distinct “categories” of members in each model resulting in data reduction. The results are presented in Chapter 5 through data displays in the form of boxes (which highlight particular individual cases) and tables (which provide comparisons across cases).

3.9 Limitations of the Study

The primary limitation of the study is that generalizations based on the results need to be done with caution due to the importance of contextual factors in microfinance. Moreover, the study is limited in that it mostly draws on the primary and secondary data sources as mentioned in the thesis.

3.10 Concluding Remarks

This chapter described the research framework for analyzing financial inclusion to be used in the thesis. The framework involves barriers to financial inclusion, benefits from financial inclusion as well as graduating group microfinance members to individual financial services. The thesis uses three lines of enquiry, at the sector level, the microfinance provider level, and the microfinance member level. While the first enquiry
uses secondary data, a case study method is used for the latter two levels of enquiry. Two MFPs, each representing one of the two prominent models of microfinance in the country were studied. Within each MFP, senior executives were interviewed. Interviews of 103 MFP field officers were conducted. Finally, 34 low income women including members, drop-outs and an individual excluded by MFIs were interviewed. The details of the methods used for data collection and analysis; and limitations of the study were discussed. Chapter 4 will analyze the results of the sector level enquiry while Chapter 5 will do so for the results of the MFP and member level enquiries.
Box 3.1: “The Below Poverty Line (BPL)” List

A poverty line usually refers to the minimum income deemed necessary to meet basic needs. Poverty lines are used to obtain a rough measure of the extent of poverty in a country and the progress made towards reduction in poverty over time. The uses of the line are mainly for academic and benchmarking purposes.

In India, the poverty line has additionally been used to help identify households that are “below the poverty line (BPL)” so as to enable targeting of benefits to them. The approach has lead to unfavorable outcomes due to a number of reasons. First, while poverty lines are useful in providing a rough measure of the extent of poverty and are often painstakingly derived, they are by their very nature somewhat arbitrarily fixed cut-off points. In practice, there is very little difference in the standards of living of households falling just below the poverty lines and those falling just above the line. Second, poverty being a dynamic phenomenon, the list of households is bound to change over time calling for regular updating, posing practical difficulties. In India the lists are based on surveys conducted every 5 years by the NSSO. Third, there has been dissatisfaction in India over the determination of the poverty line itself and even more with the means adopted for identification of households below the poverty line.

The issue of determination of poverty line was addressed by the Tendulkar Committee which was appointed by the Planning Commission (report available on http://planningcommission.nic.in). The Committee has suggested a revised method for estimation of poverty lines. While earlier calorific intake during the last thirty days was the basis of calculation of the lines both in urban and rural areas, this was often found by various surveys to have not resulted in the nutritional outcomes expected. Instead a mixed reference period (MRP) was recommended by the committee with the reference period varying between 365 days for items purchased less often (such as clothing, footwear) and 30 days for items such as food. The committee’s recommendations have been accepted by the Government.

The other issues relating to use of the “BPL” list to target benefits however remain. While some NGOs and microfinance providers use BPL as a criterion for targeting their programs, a majority of microfinance organizations have evolved their own criteria and have found these to be useful in identifying target users. In fact these criteria are often contextually derived. For example, in Bangladesh, the Grameen Bank’s criteria sought out members who owned less than half an acre of land and had total household assets of value less than one acre of average quality land in the area. This was to specifically reach out to the poor who, having little collateral, had no access to commercial credit.

In India, when the early Grameen Bank replicator, Cashpor Financial and Technical Services Private Limited (CFTS) model started operations in Mirzapur, Uttar Pradesh in 1996, it found that it was viewed with suspicion by the people. As a result they were not openly coming out with details about the land and assets they owned. CFTS therefore developed a housing index to help its field officers identify the poor (Gibbons, 1999). Many other MFIs in India have developed their own housing indices relevant to the areas they operate in.

By steering clear of “BPL” lists, MFPs make their services available to low income groups based on households’ current standards of living as observed by MFP field officers, rather than academic or bureaucratic criteria.
Box 3.2 Qualitative Research and Quantitative Research: Major Characteristics

Qualitative research typically begins with a world view and often uses a theoretical lens (Denzin and Lincoln, 2005). Quantitative research on the other hand often begins with a hypothesis and a model that is to be tested.

Qualitative researchers tend to collect data in the field at the site where participants experience the issue (Creswell, 2007). Quantitative researchers often send out instruments for respondents to complete and at times bring respondents into a laboratory setting.

Qualitative researchers usually use multiple sources of data, whereas quantitative researchers may not do so (Creswell, 2007).

Qualitative researchers build patterns, categories and themes from their data through an iterative process working back and forth between the themes and the database (Miles and Huberman, 1994). Quantitative researchers use their data to test their hypotheses and arrive at conclusions.

The research plan of qualitative researchers often undergoes changes during the study itself. The idea is to learn from participants and fine tune the research plan. For example, the questions or the form of data collection may change if the researcher feels that it would help the study. Such changes are not usually expected in quantitative research.

Qualitative researchers try to develop an integrated cross-disciplinary account, identifying many factors involved in a situation and generally sketching the larger picture that emerges. Quantitative studies tend to focus on a pre-determined set of variables or analyze a specific set of relationships.
Appendix 3.1 Sector Stakeholders Interviewed

<table>
<thead>
<tr>
<th>Name</th>
<th>Designation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>NGOs</strong></td>
<td></td>
</tr>
<tr>
<td>1. Mr. M. P. Vasimalai</td>
<td>Executive Director, Dhan Foundation</td>
</tr>
<tr>
<td><strong>Microfinance Institutions</strong></td>
<td></td>
</tr>
<tr>
<td>2. Dr. Jaya Arunachalam</td>
<td>Founder and President, Working Women’s Forum.</td>
</tr>
<tr>
<td>3. Mr. Samit Ghosh</td>
<td>Founder and Managing Director, Ujjivan Financial Services Private Limited.</td>
</tr>
<tr>
<td>4. Dr. Joslin Thambi</td>
<td>Founder and Managing Director, Bullock Cart Workers Development Association.</td>
</tr>
<tr>
<td>5. Mr. S.G. Anil Kumar</td>
<td>CEO, IFMR Trust Holding Company</td>
</tr>
<tr>
<td>6. Mr. Jim Reiff</td>
<td>Managing Director, Growing Opportunity Finance (India) Private Limited.</td>
</tr>
<tr>
<td>7. Mr. Mahesh Ramachandran</td>
<td>Managing Director and</td>
</tr>
</tbody>
</table>

The Representatives of the organizations in which the study was conducted have been excluded from this list.
<table>
<thead>
<tr>
<th>Name</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>CEO, Commonwealth Microfinance (India) Limited.</td>
</tr>
<tr>
<td>8. Mr. E. Varathkanth</td>
<td>Head- New Initiatives, Equitas Microfinance</td>
</tr>
<tr>
<td>9. Mr. R. Selvanathan</td>
<td>General Manager, Sarvodaya Nano Finance Ltd.</td>
</tr>
<tr>
<td></td>
<td>Financial Institutions funding microfinance</td>
</tr>
<tr>
<td>10. Ms. Vijayalakshmi Das</td>
<td>Chief Executive Officer, Friends of Women’s World Banking</td>
</tr>
<tr>
<td>11. Mr. R.M. Nair</td>
<td>General Manager, Small Industries Development Bank of India (SIDBI)</td>
</tr>
<tr>
<td>12. Ms. Uma Gopal</td>
<td>Vice President, Microfinance Group, Citibank N.A.</td>
</tr>
<tr>
<td>13. Mr. Somak Ghosh</td>
<td>Group President, Corporate Finance and Development Banking, Yes Bank.</td>
</tr>
<tr>
<td>14. Mr. A. Nayar</td>
<td>Deputy General Manager, State Bank of India.</td>
</tr>
<tr>
<td>15. Mr. S. Srinivasan</td>
<td>Assistant Branch Manager, Micro Sate Branch, Indian Bank</td>
</tr>
<tr>
<td>Name</td>
<td>Designation</td>
</tr>
<tr>
<td>-------------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>16. Mr. M. Narendranath</td>
<td>Head- Agriculture, Microfinance and Rural Banking, Development Credit Bank.</td>
</tr>
</tbody>
</table>

**Government Organisations Overseeing Microfinance**

<table>
<thead>
<tr>
<th>17. Mr. G. Radha</th>
<th>Additional, Director, Tamil Nadu Corporation for Development of Women Limited</th>
</tr>
</thead>
<tbody>
<tr>
<td>18. Mr. R. Nithyanandam</td>
<td>Deputy General Manager, National Bank for Agriculture and Rural Development (NABARD)</td>
</tr>
</tbody>
</table>

**Other service providers for microfinance**

<table>
<thead>
<tr>
<th>19. Mr. C. V. Prakash</th>
<th>Founder and CEO, Gradatim IT Ventures Limited.</th>
</tr>
</thead>
</table>

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## Appendix 3.2  GVMFL: Details of Board of Directors.

<table>
<thead>
<tr>
<th>Name</th>
<th>Background</th>
</tr>
</thead>
</table>
| 1. Mr. S. Devaraj, Chairman and Managing Director | Promoter of GVMFL  
30 years experience in the development sector.                                                                                                               |
| 2. Ms. D. Shirley, Vice President and Chief Financial Officer | Representative of Promoter  
B.E., M.B.A. Finance.  
Employed earlier with GE Capital.                                                                                                                                  |
| 3. Mr. Chris Brookfield                   | Representative of Unitus Equity Fund  
Managing Director of Elevar Equity.                                                                                                                                 |
| 4. Ms. Kim Totah                          | Representative of venture capitalist, Mr. Vinod Khosla  
Co-founder and Partner, McCabe and Totah, LLP.                                                                                                                       |
<p>| 5. Mr. Pasupathy Gopalan                  | Vice President and Head, Strategic Marketing and Corporate Business Development, Cypress Semiconductor Corporation Group.                                                |
| 6. Mr. Dilip James                        | 25 years general management experience in retail, distribution and                                                                                                    |</p>
<table>
<thead>
<tr>
<th>Name</th>
<th>Background</th>
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<tbody>
<tr>
<td></td>
<td>information technology domains. Presently independent investor and strategic</td>
</tr>
<tr>
<td></td>
<td>consultant to a number of companies</td>
</tr>
<tr>
<td>7. Dr.T.Rajasekar</td>
<td>24 years in academics and research. Teaches at</td>
</tr>
<tr>
<td></td>
<td>Thiagarajar School of Management, Madurai.</td>
</tr>
</tbody>
</table>

(Source: [www.gvmfl.com](http://www.gvmfl.com) )
## Appendix 3.3: HIH India: Details of Board of Directors.

<table>
<thead>
<tr>
<th></th>
<th>Name</th>
<th>Background</th>
</tr>
</thead>
</table>
| 1 | Ms. Kalpana Sankar        | Managing Trustee  
Previous senior Government employee                                                   |
<p>| 2 | Mr. S. Chinnappan         | Long experience in development sector                                                                                                   |
| 3 | Ms. Mangala Ayre          | 30 years experience in education                                                                                                        |
| 4 | Mr. R. Venkat Reddy       | Social worker involved with child labor and education issues                                                                             |
| 5 | Mr. P. Kottaisamy         | Experience in corporate as well as microfinance sectors                                                                                   |
| 6 | Mr. K. P. Kasturi         | Experience in NABARD                                                                                                                      |
| 7 | Mr. A. Nachiappan         | Experience in development sector                                                                                                          |
| 8 | Mr. K. N. Krishnamurthy   | 38 years experience in the corporate sector                                                                                            |
| 9 | Mr. N. Srinivasan         | Long experience in NABARD and author of annual reports on the microfinance sector published by SAGE Publications.                          |
|10 | Mr. P. Shankar            | Retired civil servant who served as “Chief                                                                                               |</p>
<table>
<thead>
<tr>
<th>Name</th>
<th>Background</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Vigilance Commissioner of India&quot; prior to retirement.</td>
</tr>
<tr>
<td>11. Mr. Arun Vasu</td>
<td>Business experience with a prominent business group in South India.</td>
</tr>
</tbody>
</table>
4. Sector Level Enquiry: Microfinance Sector in India

This chapter sets the context in which primary data collection for the study was undertaken by describing the microfinance sector in India. While microfinance loans in India are defined as loans below Rs.50,000 (US$ 1,110) in value, the wide range of organizations providing loans which partly fall in this category leads to challenges in estimating the extent to which they do so. Hence a more narrow definition of microfinance in the country as involving only the two main models in the country, the SBLP and the MFI model, which were briefly mentioned in Chapter 1, is more frequently used. Section 4.1 and Section 4.2 discuss the SBLP and the MFI model respectively\(^\text{116}\). In Section 4.3 the main differences between the SBLP and MFI models are explained. As primary data collection was carried out in the state of Tamil Nadu, Section 4.4 reviews microfinance activities in the state.

The first level of enquiry at the sector level also forms part of this chapter. The main research questions of the thesis relate to how the SHG Bank Linkage Program and the MFI model address issues relating to barriers to financial inclusion, the expected outcomes of financial inclusion and whether group membership enables access to individual financial services in the future. This leads us to three distinct themes based on which the analysis is organized. The first relates to “barriers to financial inclusion”. The second relates to “expected outcomes of financial inclusion” and the third relates to

\(^{116}\) The data on the Indian microfinance sector has been taken from the “Microfinance India State of the Sector Report 2008-09” as this report provides most detailed data on the sector. The report for the year 2009-10 was released in November 2010 when the thesis writing was almost completed and hence the new figures have not been used. However, no substantial changes in trends were reported in 2009-10.
“graduation to individual financial services”. Section 4.5, 4.6 and 4.7 discuss these three themes at the sector level. Section 4.8 draws conclusions from the sector level enquiry.

4.1 The Self Help Group Bank Linkage Program (SBLP) Model

As described in Section 1.5.1 of Chapter 1, the SBLP was introduced as a pilot program in 1991-92 to enable credit availability to low income women. It was based on the findings of an action research project sponsored by NABARD in 1987. The encouraging results of the pilot led to its mainstreaming in 1996 as a normal activity of banks. Subsequently, the country’s central bank, the Reserve Bank of India (RBI) encouraged banks to participate in this activity by reckoning it as part of their lending to weaker sections. This was an important incentive as banks in India are subject to priority sector lending requirements, which means that 40 percent of their net bank credit is to be directed to designated priority sectors, of which 10 percent is to be directed to economically weaker sections\textsuperscript{117}. Making lending to the microfinance sector eligible for meeting this requirement was an important factor in encouraging growth of the sector.

A self help group is usually a voluntary group that comes together with the objective of mutual aid. In the Indian microfinance context, it refers to groups of 12 to 20 low income women who come together to create a pool of savings that can be used for lending to members when the need arises. The women are usually between the ages of 18 years and 59 years and are residents of the same neighborhood. The number of members

\textsuperscript{117} The requirement for foreign banks is 32 percent of net bank credit for priority sector.
of an SHG is capped at 20 to avoid the need for formal registration with the authorities. Often a voluntary agency (NGO) or a Government agency acts as a catalyst in the group formation process and also provides some basic training.

A group leader (called “animator”) and deputy leader are elected by the group. The animator has to attend a compulsory awareness program within the first three months of the group’s formation. The group meets regularly (weekly or monthly) in the same neighborhood and starts saving. The monthly saving ranges between Rs. 20 and Rs. 100, depending on the capacity of the members. The pooled amount is initially kept in a box or in a post office account. Thereafter, a savings account is opened in a nearby bank branch and the amount is deposited. When the balances grow, the group starts giving small amounts (between Rs. 2,000-3,000) as interest bearing loans to individual members. The process continues and a record is maintained by the animator, giving the members experience in assessing individual credit worthiness, monitoring and record keeping. The members also build up credit histories and acquire experience in keeping accounts and adhering to terms and conditions. After a few cycles of mutual savings and credit have been successfully completed, the group approaches an external financial agency, usually a commercial bank\(^\text{118}\) for funding. The group gets two or three times the pooled amount as a loan. A grading system is followed according to which banks assign grades to SHGs based on various criteria such as regularity of group meetings and the

\(^{118}\) While commercial banks are the major players in the SBLP accounting for 55 percent of the number of loans and 64.4 percent of value of loans, RRBs with a share of 26.5 percent in number and value of loans are also active. Cooperative banks also participate in SBLP but to a smaller extent (Srinivasan, 2009).
quality of record keeping by the group. SHGs which obtain more than the minimum score are advanced credit. The borrowing entity is the SHG and not the individual member. The loan taken by the SHG is distributed among the members in a proportion decided by the group, taking into account each member’s need and repayment capacity.

Financial incentives are usually provided by the Government to NGOs for group formation and training. Over a period of time, the NGO reduces its involvement with the group, though some NGOs continue to meet them at least once a month, to monitor their performance and also provide inputs on other matters they consider important for the socio-economic progress of the women, such as health related information.

With growth of the microfinance sector, a number of NGOs have started microfinance operations. Hence there are fewer NGOs interested in participating in the SBLP. It is estimated that of the new SHGs being formed, only one third are promoted by NGOs (EDA-APMAS, 2006). Government agencies are increasingly stepping in to play the role of NGOs.

**Variants of the typical SBLP model**

A variant of the above model is observed in a small number of cases when the groups are formed by the bank officials themselves. This typically happens in extremely remote areas where there are no NGOs operating. Another variant is when the funding is provided by banks, but by using NGOs as financial intermediaries, i.e. the loan from the bank is given to the NGO which then on-lends it to SHGs. The use of this variant is limited by the capacity of the balance sheet of the NGO to absorb debt.
Structures for a number of SHGs to combine and form larger groups have been attempted since the 1990s by NGOs and state governments. The aim is to create institutions that would enable SHG promoting agencies to withdraw and to create a structure that would enable women to negotiate with other institutions, acting collectively in a manner, not possible for individual SHGs. For instance, typically 10 to 20 SHGs form a village level cluster and around 12 clusters link together to form a federation at the block level and potentially upwards up to district level. These two and three tier structures are called federations. While SHGs are informal organizations, federations are formal organizations and take legal institutional forms. The main advantage of a federation of SHGs is that due to its larger member base, it is in a position to negotiate on behalf of its members. For example, federations can aggregate members’ production and negotiate for better terms from buyers. However, their growth is often constrained by their lack of professional management and administration. At the end of March 2009, there were around 100,000 federations in existence in the country (Srinivasan, 2009).

NABARD is in the process of piloting programs similar to the SBLP for other segments of the financially excluded. For instance, for the mid-segment clients having access to productive assets, NABARD had piloted a Joint Liability Group (JLG) program in 2004-05. A JLG is an informal group comprising four to ten individuals coming together for the purposes of availing bank loan either singly or through the group mechanism, but against a mutual guarantee. Typically, they all engage in similar activities such as share cropping. Unlike SHGs, which follow elaborate procedures for book keeping, the management of the JLG is proposed to be simple with little or no financial administration within the group. The loans also offer more flexibility in terms.
NABARD is yet to fully mainstream the program with commercial banks on a nationwide basis.

Another program being piloted is based on linking SHGs with post offices. This initiative aims to take advantage of the large postal network\(^\text{119}\) which often has a presence in locations that do not have bank branches. After a successful pilot in five districts of Tamil Nadu, the program has been launched in the state of Meghalaya in 2009 for on-lending to SHGs in the hilly regions of the state.

\(^{119}\) There are 153,021 post offices in India as compared to 79,735 branches of scheduled commercial banks in the country (including nationalized banks, foreign banks and private banks) (from web sites of India Post and RBI accessed on September 1, 2010).
Assessment of the SBLP

The SBLP attempts to make more effective use of the existing network of state-owned rural banks to reach the poor. As the transaction cost involved if banks directly deal with the poor is formidable intermediary organizations are needed (Basu, 2006). The existence of a number of well run NGOs in the country, working in diverse areas related to rural development and community-based livelihood programs, seemed to have suggested themselves as a good solution.

Once the SBLP was mainstreamed in 1996, it grew rapidly and NABARD’s target of linking one million SHGs was achieved in 2005, three years ahead of the target date. By March 2009, the membership in the SBLP was 54 million and loans outstanding
under the model stood at Rs. 242 billion (Srinivasan, 2009). The growth in outreach over the years amply demonstrates the popularity of the model. In 2008-09, the SBLP accounted for 70.5 percent of the total outreach of the microfinance sector. However, the rate of growth of its outreach was 14.6 percent, far lower than the growth rate of the MFI model which grew by 60 percent. Moreover, for the first time, the number of incremental customers added by MFIs during the year was more than that added by the SBLP. The rapid growth of the MFI model may be attributed to its ability to attract funding from diverse sources (as explained in Section 4.2) which has lead to large MFIs expanding rapidly. The growth of the SBLP is constrained by the availability of SHG promoting agencies in the country. As mentioned earlier, many NGOs who were earlier active in promoting SHGs have now started their own microfinance programs by raising resources. This may be one factor in the lower rate of growth of SBLP than MFI model in recent years. Moreover, it is possible that due to its longer history as compared to the MFI model, it has already covered many of the areas where it could expand rapidly.

The viability of the SBLP from the perspective of banks is not very clear. A study of seven bank branches\textsuperscript{120} by Siebel and Dave (2002) suggests that the SBLP is profitable for all of them with return on assets ranging from 1.4 percent to 7.5 percent. However, the study is based on a number of assumptions\textsuperscript{121} relating to the costs incurred by the branch on the SBLP. This is because as loans under SBLP are among the many banking

\textsuperscript{120} Branches of one commercial bank, one regional rural bank and one cooperative bank branch were studied.

\textsuperscript{121} For instance in branches which underutilize their personnel, no additional personnel cost is assumed to be spent on the SBLP.
products serviced by the bank branches, separate accounts of expenses relating to them are not maintained.

Kumar and Golait (2009) indicate that the distribution of the SBLP is not favorable to the poorer regions in the country. They call for incentives to encourage spread of SBLP to areas presently lagging.

A detailed study by EDA-APMAS (2006) of 214 SHGs in four states, points out the strengths and limitations of SHGs. The strengths relate to the finding that the membership approximately corresponds to the “below poverty line” sections of the society, within which there is considerable socio-economic diversity of members. Moreover, SHGs cover around 29 percent of their village communities. The limitations include the finding that SHGs tend to exclude some of the poorest individuals in the society due to their highly variable income levels (which does not permit them to save regularly) or because they are forced to migrate to other areas during certain seasons (and cannot attend group meetings). The limitations of many SHGs in account keeping were also highlighted by the study. This has resulted in “Andhra Pradesh Mahila Abivriddhi Society” (APMAS) a knowledge organization that works in the SHG domain, mooting the idea of introducing voluntary standards for SHG accounting and auditing, termed “Sector Own Controls” to improve the functioning of SHGs.

A further disadvantage of the SBLP is that it being a Government supported program, SHGs are at times used to channel resources of poverty alleviation programs of

\[122\] An important limitation of the study is its non-random sample based on selection of SHGs with stories to tell (either positive or negative).
the Government. At the national level, the Swarna Jayanti Swarojgar Yojana\textsuperscript{123} (SGSY), a program launched in 1999, which provides credit and capital subsidy, is implemented through SHGs\textsuperscript{124}. Such measures at times weaken the strengths of the SBLP as availing benefits from the Government becomes the focus of members. If these benefits are delayed or do not materialize, it leads to disenchantment with the program itself\textsuperscript{125}. Moreover, studies have found that the SGSY groups had repayment problems with non performing assets being double the average rate\textsuperscript{126}. The groups are also found to last for a shorter duration. Use of SHGs for provision of Government subsidies could also lead to politicization of the SHG movement if SHGs who have benefited under a particular political party’s regime are expected to further the party’s interests during elections. Such a development could weaken the social objectives and could lead to a different kind of mission drift from “social to political objectives”\textsuperscript{127}.

\textsuperscript{123} Translates as “Golden Jubilee Self Employment Scheme”.

\textsuperscript{124} SGSY groups accounted for 20 percent of the SHGs financed during 2008-09 and 21 percent of the loans disbursed in the same period.

\textsuperscript{125} Based on discussions by the researcher with members and stakeholders during data collection

\textsuperscript{126} 5.72 percent as compared to 2.9 percent (Srinivasan, 2009).

\textsuperscript{127} Such a development is reported with regard to cooperatives using the SHG model, as was discussed at the Microfinance India Summit 2009 and reported in www.microfinancefocus.com.
4.2 The MFI Model

The first private sector initiative in microfinance in India is attributed to Ms. Ela Bhatt who started providing banking services to self-employed women in Ahmedabad, Gujarat. In 1974, the Shri Mahila SEWA (Self Employed Women’s Association) Sahakari Bank was registered as an urban cooperative bank.

The initial impetus for promoting Indian microfinance can however be traced to the 1990s, when as a result of financial sector reforms, the lending of the formal banking sector to the low income groups came down drastically. As a percent of total loans outstanding, lending to these groups dropped from 19 percent in 1993 to 5 percent in 2003 (Mahajan, 2007). However, their requirement for credit remained. By the late 1980s, the group lending model adopted by Grameen Bank in Bangladesh became known and a number of NGOs started examining ways to replicate it in India.

The early MFIs were set up as cooperative banks, societies or trusts. As the profitability of microcredit became established, some of them started transforming into Non Banking Finance Companies (NBFCs)\(^\text{128}\), not-for-profit companies and local area banks, so that they could access equity in order to leverage the funds increasingly becoming available from the banking system. In the mid 1990s, the Mutually Aided Cooperative Societies (MACs) Act was passed which led to a number of cooperatives being registered under the Act (Ghate, 2006).

\(^{128}\) Non banking finance companies need to have a minimum share capital of Rs. 20.0 million and are regulated by the country’s central bank, the Reserve Bank of India.
From the late 1990s onwards however, there has been a steady migration to the non banking financial company (NBFC) form. Such transformations have been observed worldwide for several reasons. First, companies have to meet more stringent disclosure and audit requirements than societies and trusts. While the latter are suited to undertake charitable, welfare and educational activities, the former are more suitable for financial operations. Second, by providing for ownership of capital, there is a stronger sense of ownership among promoters, which is likely to lead to better management and governance. Third, with increasing interest in microfinance as an asset class among social as well as commercial investors, NGOs were able to access the equity required for such transformations (Ghate, 2007).

Due to the diversity of registering authorities, there is no published data on the exact number of MFIs. Sa-dhan, the industry association of the microfinance community has around 250 members. These are the organizations based on which data regarding MFIs in India largely tends to get reported. A recent study conducted by GTZ\textsuperscript{129} aimed at inventorying the smaller microfinance organization who do not report to Sa-dhan. The number was estimated at 786, of which 484 were in the state of Andhra Pradesh (Srinivasan, 2009). This indicates that the total number of MFIs in the country may be around one thousand.

\textsuperscript{129} A German state owned organization working on sustainable development issues in 128 countries

(www.gtz.de accessed on December 1, 2010)
However, the sector is dominated by a few large MFIs. It is estimated that MFIs incorporated as NBFCs, which are around 30 in number, account for 70 percent of MFI loans (Microfinance Insights, 2010).

A majority of MFIs use group based models of lending. Either an adaptation of the Grameen Bank model (called joint liability group model) or the SHG model (explained above) is used. The models are explained below:

**Joint Liability Group (JLG) Model (replication of Grameen Bank model)**

In this model, the MFI raises funds from various sources (donors, equity investors and lenders) and then on lends them directly to groups of low income women living in the same neighborhood. The groups are usually composed of five members, with six to eight groups forming a centre.

The MFI has a team of field officers who form groups and train them. While there is a group leader, she is not required to maintain records for the group as these are maintained by the field officers themselves. Hence no special training for the leader is necessary. After training of members, there is an assessment of the group by the MFI branch manager which involves visits to the residences of the members. This process is called as “group recognition test (GRT)”. Thereafter, the groups meet regularly on a weekly basis in the neighborhood where the members reside. Loans are disbursed soon after the GRT. Savings are not usually insisted upon. Most MFIs (other than those registered as banks or cooperatives) in India are not permitted to collect savings of members.
Loans are given to individual members, though the group as a whole is responsible for repayment. All members in a group usually get the same amount of loan, the tenure of which is around 50 weeks. All disbursements and repayments are made in the weekly centre meetings which typically take place in the early hours of the morning. The meetings are conducted by the MFI field officers who insist on strict discipline to ensure that the meetings take place punctually and are concluded within a particular time frame. All records of transactions of the group are maintained by the field officer. Progressively higher loan amounts are considered by the MFI on successful repayment of loans.

Adaptation of SHG Model

MFIs which evolved from NGOs that had been closely involved with the SHG model make use of the SHG base built up by them as NGOs and superimpose the JLG model of raising funds and then on-lending them to groups. The main difference between this model and the SHG model is that, instead of commercial banks, MFIs themselves lend to SHGs.

Other Models

There are also a handful of MFIs who use individual lending models. Some MFIs graduate their star group borrowers to individual loans, and therefore offer group based as well as individual lending models.
In 2008, a new “branch based” model was introduced by “Kshetriya Gramin Financial Services (KGFS)” by IFMR Trust\textsuperscript{130} in Tamil Nadu and Uttarakhand\textsuperscript{131}. Each KGFS branch services customers within a radius of 3 to 7 km. Customers visit the KGFS branch at their convenience during branch working hours for transactions. Members of a JLG come together to the branch on a weekly basis and make repayments, though no formal meetings are held. Once the group is 6 months old, all members need to come to the branch together only on a monthly basis as the weekly deposit for the group as a whole may be made by a single member. All customers of KGFS are provided with biometric identity cards to prevent any misrepresentation. From the second loan cycle, the repayments can be made on a fortnightly basis. Besides JLG loans, jewel loans, insurance products and wealth management products are offered. Jewel loans are loans offered on the security of jewels which are pledged with the lender. After valuing the jewel, a percent\textsuperscript{132} of the value of the jewel is offered as a loan. For wealth management products, KGFS is offering the option of investment in money market mutual funds to its members. KGFS is also experimenting with providing incentives to its field officers in terms of improvement in households’ net worth rather than in terms of loan disbursements as other MFIs do\textsuperscript{133}.

\textsuperscript{130} A private trust focusing on financial inclusion in India.

\textsuperscript{131} Tamil Nadu is in the South while Uttarakhand is in the North, unlike most other MFIs which expand first into neighboring states KGFS has invested in technology and hence does not foresee difficulty in managing the branches.

\textsuperscript{132} Usually around 75 percent of the value.

\textsuperscript{133} Details regarding KGFS were obtained through an interview with Mr. Anil Kumar, CEO, IFMR Trust Holding Company.
Sources of funding for MFIs

Many of the early MFIs commenced microfinance operations on the basis of grant funds from donors and were later supported by funds from domestic apex financial institutions such as Small Industries Development Bank of India (SIDBI). As in the case of the SBLP, commercial bank lending to MFIs was also eligible for inclusion under priority sector lending requirements and hence they attracted bank funding too, enabling them to grow at a fast pace.

In 1993, the Ministry of Human Resource Development, Government of India set up the Rashtriya Mahila Kosh (RMK) with initial funding of Rs.310 million to act as a provider of wholesale funds for the sector and to develop the sector through capacity building and advocacy. In 1999, the SIDBI Foundation for microcredit was launched to provide both financial and non financial support to MFIs. In 2001, the microfinance development fund of Rs. 1 billion was set up under NABARD to fund various development activities relating to microfinance. It was later in 2005-06, re-designated as the Microfinance Development and Equity Fund with an increased corpus of Rs.2 billion. The Friends of Women’s World Banking\(^{134}\) is another provider of bulk funds for MFIs in India.

In 2002, India’s largest private sector bank, ICICI Bank, initiated an MFI partnership model according to which MFI loans remained on the bank’s balance sheet though the loan origination; monitoring and collection services were performed by the

\(^{134}\) An affiliate of Women’s World Banking, a global network supporting MFIs.
MFI for a fee. The MFI also shared the credit risk up to a specified level. The policy environment largely supported this innovation which considerably increased the pool of funds available for MFIs. In 2006, undesirable practices of some MFIs in Andhra Pradesh lead RBI to initiate new measures\(^{135}\). The RBI urged banks to strengthen their “know-your-customer (KYC)” procedures by ensuring receipt of day-end transaction information, as the loans were on the bank books. This means that the model can be used only in situations where the bank and MFI have the technology necessary to meet the above requirement (Ghate et. al., 2007).

In 2005, NBFCs engaged in microfinance were permitted to obtain foreign equity investment subject to the permission of the Foreign Investment Promotion Board (FIPB)\(^{136}\). The minimum amounts were $0.5 million when investment was less than 51 percent of the total equity; $5 million when it was between 51 and 75 percent of total equity; and $7.5 million when investment was greater than 75 percent of total equity. Many of the large MFIs, primarily those incorporated as NBFCs, have been able to attract equity funding not only from microfinance focused funds\(^{137}\) and social investors but also from mainstream private equity players\(^{138}\). In 2008, IFC, Washington announced an initiative in partnership with KFW\(^{139}\), a German financial institution to provide funds of

\(^{135}\) See Shylendra (2006) for more details regarding the Andhra Pradesh crisis.

\(^{136}\) FIPB is a Government body that provides single window clearance for foreign direct investment proposals not permissible through the automatic route.

\(^{137}\) Lok Capital and Bellwether are two such funds.

\(^{138}\) The largest private equity deal is reported to be the investment of US$75 million in SKS Microfinance by a group of investors led by Sandstone Capital.
between US $ 200 to 500 million to the sector through equity and debt financing of MFIs. The large market potential has motivated the entry of a number of new commercially oriented players with no NGO history. Some NGOs who have transformed into NBFCs have employed professionals with corporate experience to handle day to day operations, with the original NGO promoters taking a back seat. Such a development is reported in the case of SKS Microfinance, the largest MFI in India which is discussed in Box 4.1. The “profit versus social objective” debate discussed in Chapter 2 has as may be expected, also been raised with regard to Indian MFIs.

Since early 2009, a number of MFIs in India have securitized part of their loan portfolios. These loan pools are often bought by banks in order to fulfill their priority sector lending targets. Grameen Capital India, a company set up in order to provide investment banking services for MFIs, has been active in advising MFIs on asset segregation, transaction structuring and pricing aspects. However there are concerns regarding the risks involved in such transactions.

In August 2010, SKS Microfinance, the largest MFI in India became the first MFI to successfully complete an initial public offering (IPO) and raised US$ 352 million. The shares were listed on the Mumbai stock exchange. Other large MFIs in the country are also expected to follow this route in order to access increased funding.

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139 Kreditanstalt fur Wiederaufbau.

140 Set up by the Grameen Foundation, IFMR Trust and Citicorp Finance

141 Rozas and Kothari (2010) provide a discussion on the risks involved.

142 The issue price of the share was Rs.985. Shortly after listing on August 16, 2010, the share price was around Rs. 1160 but had fallen to Rs. 640 by January 14, 2011 on account of concerns regarding loan repayments in Andhra Pradesh.
There are now web sites which offer options for fund raising for the sector. Capital Connect is a portal positioned as an online marketplace that aims to link institutional investors and lenders with social enterprises. Another two portals, Rang De and DhanaX, aim to bring together individual social investors with borrowers\textsuperscript{143}, the former through the medium of NGOs and the latter through SHGs. The model has been pioneered by Kiva\textsuperscript{144} globally.

A related development is a model developed by a social enterprise, United Prosperity (UP) through which the general public can give cash collateral to UP, which in turn uses it to provide guarantees to micro-entrepreneurs through MFIs. Through innovative structuring a guarantee of US$ 1 million can result in microfinance loans of US$ 2 to US$ 5 million. The MFIs are then able to use the guarantees to raise lower cost funds from banks. UP began operations in India in May 2009 in the state of Jharkhand in collaboration with an MFI, Ajiwika.

\textsuperscript{143} The web sites are www.dhanax.com, www.edacapitalconnect.com and www.rangde.org.

\textsuperscript{144} www.kiva.org
Assessment of the MFI Model

According to a ranking of MFIs by Market MIX\textsuperscript{145}, 20 Indian MFIs feature in the list of top 100 MFIs globally. Though cross country comparisons need to be made with caution, the MIX database for 2007, indicates that compared to their counterparts in other countries, Indian MFIs performed well in terms of efficiency. The average microfinance loan size in India was however lower than that in many other countries. Table 3 provides a comparison of Indian MFIs with MFIs in other selected countries. The table compares their performance on the basis of operational self sufficiency\textsuperscript{146}, return on assets, profit margin, average size of loan and yield on gross portfolio. An important limitation of the

\begin{footnotesize}
\begin{enumerate}
\item A not for profit business information provider focused on the microfinance sector (www.themix.org).
\item Operating revenue divided by the sum of financial, operational and loan loss provision expenses.
\end{enumerate}
\end{footnotesize}

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\item A not for profit business information provider focused on the microfinance sector (www.themix.org).
\item Operating revenue divided by the sum of financial, operational and loan loss provision expenses.
\end{enumerate}
\end{footnotesize}
data is that the comparisons are based on MFIs that report to MIX and so the proportion of MFIs that report to MIX in a country will have a bearing on the representativeness of the data for that country.

It is observed that with regard to profitability, Indian MFIs lie somewhere in the middle of the range. While MFIs in Brazil, Mexico and Indonesia are more profitable than those in India; those in Bangladesh, Pakistan and Kenya are less so. It is only with regard to the yield on gross portfolio and average loan size that Indian MFIs significantly lag. It appears therefore that Indian MFIs have low margins and loan sizes, and yet manage to be profitable. With growth of the sector and increasing repayment capacity of members, loan sizes can be expected to go up, leading to greater profitability.

Table 3: Comparison of Indian MFIs with MFIs in select countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Operational Self Sufficiency (OSS)</th>
<th>Return on Assets (ROA) (Percentage)</th>
<th>Profit Margin (Percentage)</th>
<th>Average loan in US</th>
<th>Yield on gross portfolio (Percentage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>106.6</td>
<td>-0.3</td>
<td>-1.2</td>
<td>80</td>
<td>24.3</td>
</tr>
<tr>
<td>Brazil</td>
<td>133.6</td>
<td>6.4</td>
<td>19.4</td>
<td>820</td>
<td>41.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>142.8</td>
<td>3.1</td>
<td>15.4</td>
<td>915</td>
<td>22.5</td>
</tr>
<tr>
<td>India</td>
<td><strong>111.4</strong></td>
<td><strong>0.7</strong></td>
<td><strong>7.9</strong></td>
<td><strong>146</strong></td>
<td><strong>21.2</strong></td>
</tr>
<tr>
<td>Kenya</td>
<td>118.1</td>
<td>-1.0</td>
<td>-0.2</td>
<td>463</td>
<td>31.3</td>
</tr>
<tr>
<td>Mexico</td>
<td>113.2</td>
<td>3.0</td>
<td>10.2</td>
<td>468</td>
<td>62.8</td>
</tr>
<tr>
<td>Pakistan</td>
<td>85.1</td>
<td>-6.6</td>
<td>-47.4</td>
<td>187</td>
<td>27.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>113.0</td>
<td>0.5</td>
<td>6.7</td>
<td>288</td>
<td>38.5</td>
</tr>
<tr>
<td>Uganda</td>
<td>116.1</td>
<td>2.7</td>
<td>9.4</td>
<td>325</td>
<td>53.7</td>
</tr>
</tbody>
</table>

(Source: Srinivasan, 2009)
As on March 31, 2009, 22.6 million individuals were served by the MFI model. Outstanding loans of MFIs increased from Rs.59.50 billion in 2007-08 to Rs. 117.34 billion in 2008-09, a growth rate of 97 percent. This rapid growth on the one hand reflects the ability of the model to attract funding and clientele. On the other hand, it also may be indicative of vulnerabilities arising due to excessive growth of MFIs without adequate systems and safeguards to handle it. In August 2009, there were reports in a leading international daily regarding multiple lending by MFIs in a pocket of the Southern state of Karnataka, which raised fears of a “bubble” (Gokhale, 2009). This lead to concerns regarding whether overstretched institutional capacities of Indian MFIs were resulting in weakening credit discipline and encouraging multiple borrowing by members (Chen et al., 2010).

There are also some positive aspects to the rapid expansion of the MFIs. First, geographic expansion can result in greater availability of microfinance services and choice for the customers. A number of MFIs have expanded into adjoining urban areas and are catering to the urban poor who are also often in need of microfinance.147 Another positive aspect is that larger scale of MFIs enables greater use of technology. A number of MFIs are now computerizing their MIS systems so as to have better control over operations and manage their resources better. In addition, various pilot projects are being carried out on the possibilities of use of mobile banking and smart card based technologies by MFIs to reduce transaction costs (Srinivasan, 2009).

147 Some MFIs exclusively focus on urban areas. Ujjivan, an MFI based in Bengaluru for instance, focuses only on urban locations.
A growing trend of alliances between MFIs and corporate entities is also being observed with MFIs and SHGs becoming channels for marketing various consumer goods and home appliances. While the corporate benefits by reaching a new market, some MFI members benefit by using the opportunity to earn by providing sales and logistics support. The MFI also often earns some fee income. However, there is a strong case for guarding against possible dilution of focus of the MFI on financial services. The dynamics of combining financial and non financial services is still evolving as it is a very recent phenomenon. While on the positive side there may be economies of scope in making such combined offers, on the negative side, it could distort consumer preferences and encourage greater consumption rather than investment expenditure.

A positive development is the initiative of MFIs incorporated as NBFCs\(^\text{148}\) to collaborate and form an organization, the Microfinance Institutions Network (MFIN), in December 2009, for self regulation, creation of a credit bureau, and sector building. MFIN aims to adopt a code of conduct particularly with respect to transparency in interest rates. The credit bureau has subsequently been set up with funding by the Omidyar\(^\text{149}\) group and IFC in collaboration with High Mark Credit Information Services Ltd.\(^\text{150}\). It was reported to be operational in March 2011 and is in the process of collating data from its members. Other activities planned relate to capacity building for MFIs and financial literacy for MFI members.

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\(^{148}\) These number around 31 but account for about 70 percent percent of microfinance loans.

\(^{149}\) Promoters of the on line auction web site, ebay.

\(^{150}\) A Mumbai-based credit risk information services company.
### 4.3 Differences between the SBLP model and the MFI model

There are important differences between the two predominant models, the SBLP and the MFI model, as summarized in Table 4.

**Table 4: Comparison of SBLP Model and MFI Model** *(Source: Author)*

<table>
<thead>
<tr>
<th>SBLP Model</th>
<th>MFI (Grameen) Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Groups of 13-20 members.</td>
<td>5 member groups, with 5 to 7 groups forming a center.</td>
</tr>
<tr>
<td>Group formation and monitoring for some time by NGO, but NGO eventually withdraws.</td>
<td>Group formation and monitoring throughout by MFI.</td>
</tr>
<tr>
<td>Loan advanced by Commercial Bank.</td>
<td>Loan advanced by MFI.</td>
</tr>
<tr>
<td>Group members trained to do record keeping and bank transactions.</td>
<td>MFI staff does record keeping and bank transactions.</td>
</tr>
<tr>
<td>Loans are given to SHGs which on lend to members.</td>
<td>Loans are given to members individually though on joint liability basis.</td>
</tr>
<tr>
<td>Savings for 6 to 12 months needs to precede borrowing.</td>
<td>Loans are given without any prior savings period. In fact savings cannot be collected by MFIs due to regulatory reasons.</td>
</tr>
<tr>
<td>Delivery of microcredit viewed by some NGOs as secondary to goals of female empowerment and social transformation. On an ad hoc basis, Government subsidies are given to SHGs by way of grants equivalent to a part of the loan.</td>
<td>Microcredit is the main focus.</td>
</tr>
<tr>
<td>Average loan size: Rs.3,789 (Sa-dhan, 2010)</td>
<td>There is no direct subsidy element in MFIs.</td>
</tr>
<tr>
<td></td>
<td>Average loan size: Rs.6,519. (Sa-dhan, 2010).</td>
</tr>
</tbody>
</table>

151 However both models receive an implicit subsidy as bank loans to them are considered part of priority sector lending requirements which banks are mandated to meet.
Both the SBLP and the MFI model have over a period of time developed their own strengths and weaknesses. The strengths of the SBLP include its wider social agenda, the training provided to group members, and its emphasis on savings. Moreover SHG meetings are held according to the convenience of members as the presence of NGO field officers is not always necessary. Its primary weakness is that as groups manage themselves after a point, there is wide variation in quality observed between groups (EDA-APMAS, 2006). SHGs may also be vulnerable to politicization, as some of them are beneficiaries of Government subsidies.

The MFI model on the other hand has strengths in the greater uniformity of services provided across groups of a single MFI and the standardized record keeping by MFI employees. The model on an average also offers larger loan sizes, which could be advantageous for members who require and are able to service them. However the sole emphasis on microcredit and the lack of savings services due to regulatory constraints are significant weaknesses.

By March 2009, there were 76.6 million microfinance accounts in India as compared to 61.2 million in the previous year. Of these, 54 million accounts were served by the SHG model while 22.6 million were served by the MFI model. After adjusting for overlaps the net microfinance customer base is estimated at around 70 million. Some studies such as the Intellecap study entitled “Inverting the Pyramid” (2007) estimate

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152 The “Side by Side” report on microfinance in India published by Sa-dhan, the Association of Community Development Finance Institutions in India (2008-09).

153 Intellecap is a social sector advisory firm based in India.
that the potential market may be 245 million individuals, suggesting there is still a lot of scope for the sector to grow.

4.4 Microfinance in Tamil Nadu

The primary data collection as part of the thesis was carried out in the state of Tamil Nadu. Tamil Nadu is in South India and is the sixth most populous state of the country with a population of 62 million (approximately 6 percent of India’s population), of whom around 14.6 million are classified as poor according to Government records. The total area is around 130,000 square kilometres (km.) and the population density is around 480 per km. In Tamil Nadu, there were 987 females to every 1000 males as compared to the national average of 933 in 2001. The literacy rate was 73.5 percent (female literacy of 64.4 percent) as compared to the national average of 64.8 percent (female literacy 53.7 percent) in 2001. Forty seven percent of Tamil Nadu’s population lives in urban areas. Figure 4.3 gives the location of Tamil Nadu within India and Figure 4.4 provides a map of Tamil Nadu. The extent of financial exclusion in the state is estimated to be between 25 to 50 percent.

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As microfinance activities in Tamil Nadu have a sufficiently long history through private as well as public initiatives, it was chosen as the location for the study. Moreover, both the models of microfinance in India namely the SBLP and the MFI model have been widely used in Tamil Nadu. In March 2009, there were 7.46 million SHG members and 2.35 million MFI members in Tamil Nadu (Srinivasan, 2009).
Figure 4.3: Location of Tamil Nadu

Source: [www.mapsofindia.com](http://www.mapsofindia.com)
Figure 4.4: Map of Tamil Nadu

(Source: www.mapsofindia.com)
Microfinance in Tamil Nadu mainly developed during the period 1990-99 when the International Fund for Agricultural Development (IFAD)\(^ {157} \), the Government of India and the Government of Tamil Nadu co-financed the “Tamil Nadu Women’s Development Project” (known in the local language as “Mahallir Thittam”). The project, introduced microfinance schemes through NGOs in each district where the project was implemented. NGOs promoted SHGs, provided them training in saving and maintaining records and later linked them with commercial banks for credit. Incentives were provided to the NGOs for these activities. The program was considered a success and in 1995-96, the Government extended the program using state funds. By 2005, the cumulative membership of these groups had crossed 1.3 million women.

During the latter half of the 1990s, there was also growth in the MFI channel. An early private initiative was the setting up of ‘Working Women’s Forum’ in 1978, a cooperative to provide credit and health interventions to poor, urban women. In 1986, the Bullock Cart Workers’ Development Association (BWDA) registered itself as a society and organized interventions in the fields of health, education, enterprise development and later microfinance. While initially it acted as an NGO, forming and monitoring groups under the SBLP, in the late 1990s, it promoted an NBFC and started raising funds from various banks and institutions for on-lending to SHGs. In 1993, Grama Vidiyal, a registered trust commenced microfinance operations in association with ASA, a well known MFI in Bangladesh. As in the rest of the country, the late 1990s saw a large number of MFIs commencing operations in the state.

\(^ {157} \) A specialized agency of the United Nations.
As both microfinance models have been present in the state for considerable time. The microfinance sector in Tamil Nadu may be described as being in a fairly mature stage. This has facilitated an assessment of the sector’s contribution to financial inclusion.

4.5 Sector Level Enquiry: Barriers to Financial Inclusion

Sector level data is used to shed light on whether microfinance sector has contributed to mitigating physical barriers to financial inclusion by using data on the geographical distribution of microfinance services. Two specific questions are sought to be answered through this enquiry. First, “Are microfinance services uniformly available in all regions of India?” Second, “Do microfinance programs focus on geographic areas that are not adequately served by the banking sector?”

The first question is important because if the microfinance sector is to play a role in providing financial inclusion, it needs to be available in all regions and not only in specific areas. The answer to this question will enable us to understand if there are barriers to microfinance access (like there are barriers to financial inclusion). The second question enables an analysis of the spread of microfinance services vis-a-vis that of banking services. The relationship could help reveal the extent to which microfinance programs fill gaps in banking sector services.

To answer the first question, the Microfinance Penetration Index (MPI) and the Microfinance Poverty Penetration Index (MPPI) which have been reported in the Microfinance India state of the sector report (Srinivasan, 2009) are studied as they
indicate the availability of microfinance in different states in the country. While the MPI compares a state’s share in the total number of microfinance borrowers in the country to its share of the country’s population, MPPI compares the state’s share in the total number of microfinance borrowers to its share of the population of poor in the country.

In order to estimate the indices, first the number of MFI borrowers and SHG members with outstanding loans from banks are computed. Then each state’s share of microfinance customers (including both models) in the country is estimated (MF share). The MPI is computed by dividing the MF share by the state’s share in the population of the country (population share).

\[
\text{MPI} = \frac{\text{MF Share}}{\text{Population Share}}
\]

The MPPI is derived by dividing the MF share by the state’s share in the population of poor in the country (Poverty share).

\[
\text{MPPI} = \frac{\text{MF Share}}{\text{Poverty Share}}
\]

Since MF share is in the numerator in the case of both indices, an MPI value greater than 1 indicates that the state’s share of microfinance borrowers exceeded its share of the population while an MPPI value greater than 1 indicates that the state’s share of microfinance exceeded its share of the population of poor (Srinivasan, 2009). A fall in MPI over time implies that the growth in microfinance was lower than the national rate of growth. An increase in MPI implies that the regional growth was higher than the national rate.

The MPI and MPPI calculation for all the states in India, grouped region wise, is at Table 5.
Table 5: Microfinance Penetration in India

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Northern Region:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Himachal Pradesh</td>
<td>1.21</td>
<td>3.33</td>
<td>1.00</td>
<td>2.75</td>
</tr>
<tr>
<td>2</td>
<td>Rajasthan</td>
<td>0.70</td>
<td>0.88</td>
<td>0.36</td>
<td>0.46</td>
</tr>
<tr>
<td>3</td>
<td>Haryana</td>
<td>0.13</td>
<td>0.26</td>
<td>0.15</td>
<td>0.29</td>
</tr>
<tr>
<td>4</td>
<td>Punjab</td>
<td>0.08</td>
<td>0.27</td>
<td>0.13</td>
<td>0.41</td>
</tr>
<tr>
<td>5</td>
<td>Jammu &amp; Kashmir</td>
<td>0.08</td>
<td>0.41</td>
<td>0.02</td>
<td>0.08</td>
</tr>
<tr>
<td>6</td>
<td>New Delhi</td>
<td>0.04</td>
<td>0.08</td>
<td>0.08</td>
<td>0.16</td>
</tr>
<tr>
<td></td>
<td><strong>Total (A)</strong></td>
<td>0.40</td>
<td>0.71</td>
<td>0.26</td>
<td>0.45</td>
</tr>
<tr>
<td></td>
<td><strong>North Eastern Region:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Assam</td>
<td>1.00</td>
<td>1.39</td>
<td>0.69</td>
<td>0.96</td>
</tr>
<tr>
<td>8</td>
<td>Meghalaya</td>
<td>0.12</td>
<td>0.18</td>
<td>0.21</td>
<td>0.31</td>
</tr>
<tr>
<td>9</td>
<td>Tripura</td>
<td>0.51</td>
<td>0.76</td>
<td>0.92</td>
<td>1.36</td>
</tr>
<tr>
<td>10</td>
<td>Sikkim</td>
<td>0.15</td>
<td>0.18</td>
<td>1.53</td>
<td>1.91</td>
</tr>
<tr>
<td>11</td>
<td>Manipur</td>
<td>0.29</td>
<td>0.46</td>
<td>0.30</td>
<td>0.49</td>
</tr>
<tr>
<td>12</td>
<td>Arunachal Pradesh</td>
<td>0.10</td>
<td>0.16</td>
<td>0.77</td>
<td>1.22</td>
</tr>
<tr>
<td>13</td>
<td>Nagaland</td>
<td>0.14</td>
<td>0.20</td>
<td>0.06</td>
<td>0.09</td>
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<tr>
<td>14</td>
<td>Mizoram</td>
<td>0.60</td>
<td>1.35</td>
<td>0.44</td>
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<tr>
<td></td>
<td><strong>Total (B)</strong></td>
<td>0.78</td>
<td>1.12</td>
<td>0.63</td>
<td>0.91</td>
</tr>
</tbody>
</table>

158 MPI : Microfinance Penetration index
159 MPPI: Microfinance Poverty Penetration Index
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Eastern Region:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Orissa</td>
<td>2.68</td>
<td>1.59</td>
<td>2.13</td>
<td>1.26</td>
</tr>
<tr>
<td>16</td>
<td>Bihar</td>
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<td>0.25</td>
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<tr>
<td>17</td>
<td>Jharkhand</td>
<td>0.43</td>
<td>0.29</td>
<td>0.37</td>
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</tr>
<tr>
<td>18</td>
<td>West Bengal</td>
<td>0.99</td>
<td>1.10</td>
<td>1.45</td>
<td>1.61</td>
</tr>
<tr>
<td></td>
<td>Total (C)</td>
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<td>0.98</td>
<td>0.74</td>
</tr>
<tr>
<td></td>
<td>Central Region:</td>
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<td></td>
</tr>
<tr>
<td>19</td>
<td>Madhya Pradesh</td>
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<td>0.27</td>
<td>0.37</td>
<td>0.26</td>
</tr>
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<td>0.57</td>
<td>0.83</td>
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<tr>
<td>21</td>
<td>Uttar Pradesh</td>
<td>0.37</td>
<td>0.31</td>
<td>0.18</td>
<td>0.15</td>
</tr>
<tr>
<td>22</td>
<td>Uttarakhand</td>
<td>0.69</td>
<td>0.48</td>
<td>2.46</td>
<td>1.71</td>
</tr>
<tr>
<td></td>
<td>Total (D)</td>
<td>0.42</td>
<td>0.33</td>
<td>0.35</td>
<td>0.28</td>
</tr>
<tr>
<td></td>
<td>Western Region:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Gujarat</td>
<td>0.35</td>
<td>0.57</td>
<td>0.16</td>
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<tr>
<td>24</td>
<td>Maharashtra</td>
<td>0.97</td>
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<tr>
<td>25</td>
<td>Goa</td>
<td>0.27</td>
<td>0.50</td>
<td>0.46</td>
<td>0.86</td>
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<tr>
<td></td>
<td>Total (E)</td>
<td>0.75</td>
<td>0.80</td>
<td>0.64</td>
<td>0.69</td>
</tr>
<tr>
<td></td>
<td>Southern Region:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Andhra Pradesh</td>
<td>3.03</td>
<td>5.27</td>
<td>3.84</td>
<td>6.68</td>
</tr>
<tr>
<td>27</td>
<td>Karnataka</td>
<td>2.15</td>
<td>2.37</td>
<td>1.94</td>
<td>2.14</td>
</tr>
<tr>
<td>28</td>
<td>Kerala</td>
<td>1.29</td>
<td>2.36</td>
<td>1.16</td>
<td>2.13</td>
</tr>
<tr>
<td>29</td>
<td>Tamil Nadu</td>
<td>2.18</td>
<td>2.66</td>
<td>2.24</td>
<td>2.73</td>
</tr>
<tr>
<td>30</td>
<td>Puducherry</td>
<td>0.77</td>
<td>0.96</td>
<td>0.73</td>
<td>0.91</td>
</tr>
<tr>
<td>31</td>
<td>Other union territories</td>
<td>0.07</td>
<td>0.07</td>
<td>0.23</td>
<td>0.23</td>
</tr>
</tbody>
</table>
The indices reflect the regional dispersion of microfinance in India, with growth being concentrated in the Southern states of Andhra Pradesh, Tamil Nadu and Karnataka. These are the states where microfinance was first introduced, primarily due to availability of relatively better infrastructure, support from state Governments, and the existence of reputed NGOs. In March 2009, the share of the Southern states in client outreach was 55 percent in the case of the SHG model; while in the MFI model, it was 54 percent (Srinivasan, 2009). In terms of loans outstanding, the share of the Southern states in each of the two models was 69 percent and 58 percent respectively. Even though there has been growth in microfinance in other states, particularly in the Eastern and Northern parts of the country, the dominance of the Southern states has continued. In fact in 2009, the share of the Southern states marginally increased as compared to the share in 2008.

The MPI for the Southern region is 2.32 and 2.55 for the years ended in March 2008 and 2009, indicating that its share of microfinance is more than double its share of population. The MPPI is even higher at 3.22 and 3.54 for the same two periods. The indices are also indicative of the higher microfinance loan sizes in the region which is to be expected in areas where microfinance has a longer history, as borrowers access bigger

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total (F)</td>
<td>2.32</td>
<td>3.22</td>
<td>2.55</td>
<td>3.54</td>
</tr>
<tr>
<td>GRAND TOTAL</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Source: Author based on details in Srinivasan (2009)
loans with increasing duration of membership. This is in itself a welcome development, as for both borrowers and for lending institutions, larger loans are more useful. The former benefit as they are then able to make larger investments while for the latter, larger loan sizes improve profitability. Even within the Southern region, it is found that that MPI and MPPI is unusually high for one particular state, Andhra Pradesh (AP). MPI for the two years ended 2008 and 2009 is 3.03 and 3.84 while MPPI is 5.27 and 6.68. In this state, there are 20 million microfinance accounts (both SBLP and MFI put together) but there are only 16 million households in the state\(^{160}\). This implies that 125 percent of the households have been covered by microfinance. If it is assumed that microfinance only serves the poor (as defined by the Government’s “below poverty line” list), then each poor household in AP would have been financed 8 times as there are only 2 million poor households in AP. There are clear indications of intense competition among microfinance providers and multiple lending\(^{161}\).

The Southern states are followed by the Eastern, Western and North-Eastern regions in terms of microfinance penetration. In these areas, MPI was between 0.5 and 1. In the central and northern parts of the country however, MPI was less than 0.5. MPPI also follows broadly the same trend. The Northern and Central regions however have MPIs and MPPIs lower than 0.5 indicating that these regions are clearly lagging in microfinance penetration.

\(^{160}\) As per figures for 2004-05, Srinivasan (2009).

\(^{161}\) In the neighboring Southern state of Karnataka, which does not have such high MPI or MPPI levels as AP, there have been news reports of a potential “bubble” in certain pockets (Gokhale, 2009) due to multiple lending. In the absence of a credit bureau, there is no way for MFIs to ascertain the indebtedness of individuals applying for loans. As mentioned, efforts are underway to create a credit bureau for the microfinance sector in India.
Even within each region, some states are exceptions to their region in terms of microfinance penetration. For example, within the Northern and Central regions (which show low penetration) there are exceptions such as Himachal Pradesh (North) and Uttarakhand (Central region) with MPIs and MPPIs in excess of 1.0. Similarly, within the Eastern and North East regions (which show high penetration), Bihar in the East and Nagaland in the North East have MPIs equal to or less than 0.25.

It is clear that the conditions for microfinance activities are not perceived to be uniformly conducive in all parts of the country. While in some states, the penetration of microfinance is assuming exceedingly high levels leading to fears over multiple lending; in other states vast sections of the low income households are underserviced. The availability of better infrastructure and governance is likely to be one feature which differentiates states that have achieved considerable outreach and those that have not. Moreover, it appears that risk levels are usually perceived to be lower in states in which successful NGOs and MFIs have demonstrated that conditions conducive to microfinance activity exist, as compared to states in which there are no such examples. There certainly seems to be a case for policymakers to examine and address the skewed geographic growth of microfinance in the country. There is a need to make underserved areas more attractive for microfinance providers. There is an equally great need to monitor microfinance growth in areas where it has already reached near-saturation levels. While the latter is likely to benefit from the ongoing initiative to set up a credit bureau in the country, the former needs intervention from policy makers.

To answer the second question, it is proposed to examine if areas not adequately served by microfinance are adequately served by the mainstream financial sector. A study
on similar lines by Kumar and Golait (2009) examined only one model of microfinance, the SBLP. The study found that the latter was prevalent in areas where the banking sector was also prevalent. This conclusion may have been expected as bank branches play an important role in the SBLP.

Using the MPIs which summarize availability of both predominant models of microfinance, it is attempted to identify if areas not adequately served by microfinance are served adequately by the mainstream banks. The reason for choosing MPI over MPPI, as the key measure of microfinance penetration is that (as explained in Chapter 3 Appendix 3.1), MFIs in India does not use the “BPL” list to guide them in choosing their customers. Moreover, as pointed out by Robinson (2001), microfinance may be more useful for the better off among the poor who may in fact be slightly above the poverty line. As at present there is no measure available which measures the microfinance penetration as a proportion of this segment within each state, the MPI which measures microfinance penetration as a proportion of the population of the state seems to be the best available option.

For banking penetration, the average population served per bank branch in each state is used. As explained in Chapter 1, this is a frequently used measure of financial inclusion with regard to banking services. This measure for all the states in the country, grouped region-wise is displayed in Table 6.

The results from Table 5 and Table 6 are summarized and displayed in the form of a matrix (Table 7) which is obtained by cross-tabulating microfinance availability with banking access. Microfinance availability of regions is classified into two categories; those with an MPI in excess of “0.5” are described as “high microfinance coverage”.

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Regions with MPI equal to or lower than “0.5” are considered as having “low microfinance coverage”. As the MPI by definition should be around 1.0 for the state to be represented in the proportion of its population, a ratio of 0.5 indicates that 50 percent progress has been made. In the case of average population per bank branch, as “15” is the national average, regions having higher than average figures can be considered as having “low banking coverage” while those having lower than average figures can be considered as having “high banking coverage”.
### Table 6: Population per Bank Branch in Indian States

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Region/State/ Union Territory</th>
<th>Number of branches as on June 30,</th>
<th>Average population (in '000) per bank branch as at end-June</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2008</td>
<td>2009</td>
</tr>
<tr>
<td>ALL INDIA</td>
<td></td>
<td>76,891</td>
<td>80,369</td>
</tr>
<tr>
<td>1</td>
<td>NORTHERN REGION</td>
<td>13,175</td>
<td>13,800</td>
</tr>
<tr>
<td></td>
<td>Chandigarh</td>
<td>246</td>
<td>261</td>
</tr>
<tr>
<td></td>
<td>Delhi</td>
<td>2,072</td>
<td>2,186</td>
</tr>
<tr>
<td></td>
<td>Haryana</td>
<td>2,044</td>
<td>2,183</td>
</tr>
<tr>
<td></td>
<td>Himachal Pradesh</td>
<td>907</td>
<td>954</td>
</tr>
<tr>
<td></td>
<td>Jammu and Kashmir</td>
<td>957</td>
<td>976</td>
</tr>
<tr>
<td></td>
<td>Punjab</td>
<td>3,147</td>
<td>3,318</td>
</tr>
<tr>
<td></td>
<td>Rajasthan</td>
<td>3,802</td>
<td>3,922</td>
</tr>
<tr>
<td>2</td>
<td>NORTH-EASTERN REGION</td>
<td>2,051</td>
<td>2,133</td>
</tr>
<tr>
<td></td>
<td>Arunachal Pradesh</td>
<td>73</td>
<td>76</td>
</tr>
<tr>
<td></td>
<td>Assam</td>
<td>1,331</td>
<td>1,382</td>
</tr>
<tr>
<td></td>
<td>Manipur</td>
<td>77</td>
<td>80</td>
</tr>
<tr>
<td></td>
<td>Meghalaya</td>
<td>190</td>
<td>201</td>
</tr>
<tr>
<td></td>
<td>Mizoram</td>
<td>91</td>
<td>93</td>
</tr>
<tr>
<td></td>
<td>Nagaland</td>
<td>82</td>
<td>86</td>
</tr>
<tr>
<td></td>
<td>Tripura</td>
<td>207</td>
<td>215</td>
</tr>
<tr>
<td>3</td>
<td>EASTERN REGION</td>
<td>13,017</td>
<td>13,406</td>
</tr>
<tr>
<td></td>
<td>Andaman and Nicobar Islands</td>
<td>37</td>
<td>37</td>
</tr>
<tr>
<td></td>
<td>Bihar</td>
<td>3,735</td>
<td>3,835</td>
</tr>
<tr>
<td></td>
<td>Jharkhand</td>
<td>1,646</td>
<td>1,717</td>
</tr>
<tr>
<td></td>
<td>Orissa</td>
<td>2,600</td>
<td>2,708</td>
</tr>
<tr>
<td></td>
<td>Sikkim</td>
<td>71</td>
<td>72</td>
</tr>
<tr>
<td></td>
<td>West Bengal</td>
<td>4,928</td>
<td>5,037</td>
</tr>
<tr>
<td>4</td>
<td>CENTRAL REGION</td>
<td>15,328</td>
<td>16,027</td>
</tr>
<tr>
<td></td>
<td>Chhatisgarh</td>
<td>1,158</td>
<td>1,225</td>
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<td></td>
<td>Madhya Pradesh</td>
<td>3,785</td>
<td>3,991</td>
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<td></td>
<td>Uttar Pradesh</td>
<td>9,340</td>
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<td>Uttarakhand</td>
<td>1,045</td>
<td>1,088</td>
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<td>5</td>
<td>WESTERN REGION</td>
<td>11,839</td>
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<td></td>
<td>Dadra and Nagar Haveli</td>
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<td>24</td>
</tr>
<tr>
<td></td>
<td>Daman and Diu</td>
<td>18</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>Goa</td>
<td>395</td>
<td>410</td>
</tr>
<tr>
<td></td>
<td>Gujarat</td>
<td>4,203</td>
<td>4,374</td>
</tr>
<tr>
<td></td>
<td>Maharashtra</td>
<td>7,202</td>
<td>7,613</td>
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<tr>
<td>6</td>
<td>SOUTHERN REGION</td>
<td>21,481</td>
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<td></td>
<td>Andhra Pradesh</td>
<td>6,244</td>
<td>6,601</td>
</tr>
<tr>
<td></td>
<td>Karnataka</td>
<td>5,566</td>
<td>5,803</td>
</tr>
<tr>
<td></td>
<td>Kerala</td>
<td>3,952</td>
<td>4,086</td>
</tr>
<tr>
<td>Sr. No.</td>
<td>Region/State/ Union Territory</td>
<td>Number of branches as on June 30,</td>
<td>Average population (in ‘000) per bank branch as at end-June</td>
</tr>
<tr>
<td>---------</td>
<td>--------------------------------</td>
<td>---------------------------------</td>
<td>-----------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2008</td>
<td>2009</td>
</tr>
<tr>
<td>Lakshadweep</td>
<td></td>
<td>10</td>
<td>11</td>
</tr>
<tr>
<td>Puducherry</td>
<td></td>
<td>109</td>
<td>125</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td></td>
<td>5,600</td>
<td>5,937</td>
</tr>
</tbody>
</table>

– : Nil/Negligible.

Source: RBI Master Office File on commercial banks

(Source: Author)

Table 7: Matrix on Availability of Microfinance and Banking Services

<table>
<thead>
<tr>
<th>Low Availability of Microfinance</th>
<th>High Availability of Microfinance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central Region</td>
<td>North Eastern Region</td>
</tr>
<tr>
<td>North Eastern Region</td>
<td>Eastern Region</td>
</tr>
<tr>
<td>Northern Region</td>
<td>Southern Region</td>
</tr>
<tr>
<td>Southern Region</td>
<td>Western Region</td>
</tr>
</tbody>
</table>

(Source: Author)

162 Only states showing “extreme” high or low access to microfinance or banking appear.
The matrix in Table 7 leads to the following observations:

1. In the North Eastern and Eastern regions of the country where the number of bank branches relative to the population is low, microfinance has made considerable progress in increasing access to financial services.
2. In the Northern region, where bank branches relative to the population is high, microfinance access is low.
3. The Southern and Western regions of the country have higher than average number of bank branches to their population and have also seen high access to microfinance.
4. The Central region seems to have lower access to both bank branches and microfinance. An examination of the intra-regional figures however suggests that within the Central region, Uttarakhand is greatly favored by both the banking and microfinance sectors\textsuperscript{163}. Chhattisgrah also has substantial microfinance access as reflected by its MPI of 0.83 though its banking coverage is low at 20,000 persons per bank branch. Uttar Pradesh and Madhya Pradesh on the other hand have not exhibited adequate bank branch or microfinance coverage\textsuperscript{164}. Figure 4.5 displays the information contained in the matrix in the form of a map showing regions differing in availability of banking and microfinance services.

\textsuperscript{163} Average population to bank branch is 9,000 and MPI is 2.46.

\textsuperscript{164} Average population per bank branch is 18,000 and 20,000 respectively.
Figure 4.5: Distribution of Microfinance and Banking Penetration across states in India
4.6 Sector Level Enquiry: Outcomes of Financial Inclusion

The outcomes of financial inclusion are ongoing access to a wide range of products, creation of credit histories and development of financial literacy. While the sector and microfinance provider level enquiry focused on the first two aspects, the third aspect was examined at the member level.

4.6.1 Range of Products

The first outcome is studied at the sector level by examining the financial products that are presently being offered by the sector. While microcredit has been the
mainstay of Indian microfinance, increasingly microfinance providers are also beginning to offer insurance, pensions and remittance services often by tying up with mainstream providers. There are also initiatives in micro-housing. This broadening of the range of microfinance services is desirable as like other segments of the population, low income individuals too often have diverse financial goals and accordingly need services that enable them to achieve them. Moreover, as Rhyne (2010) has pointed out, recent concerns relating to multiple lending and inadequate monitoring by microfinance institutions in some countries\textsuperscript{165} indicate that merely increasing the scale of MFI lending may no longer be desirable. Instead, expanding the scope of microfinance services to provide full financial inclusion may be a more desirable objective.

This section will briefly review the other financial services being offered by the microfinance sector.

A. Microinsurance

The need for microinsurance stems from the vulnerability of low income groups to risks of various kinds. Microinsurance enables this household level risk to be exported to better capitalized and diversified, external risk carriers. CGAP (2003) has ranked different kinds of microinsurance schemes on the basis of complexity. At the lowest level are credit-insurance products, which are offered by many Indian MFIs. This means that for a small percentage fee, the lender writes off any balance outstanding on the loan in

\textsuperscript{165} Bosnia and Herzegovina, Nicaragua and India (in the state of Karnataka).
case of death of the member. This is usually more beneficial for lenders than borrowers as the pool of funds insures them against the default risk on account of death of a borrower.

Next in complexity is life insurance, followed by asset, health and crop insurance. MFIs often partner with a mainstream insurance company to offer these products. Such partnerships are useful as MFIs usually lack expertise in complex financial products. As is illustrated by the example Centre for Agriculture and Rural Development (CARD), a Philippines based MFI’s experience with regard to insurance, developing financial products without expertise or a partnership with a formal provider, can have consequences that can even threaten the existence of the institution (McCord and Buczkowski, 2004).

The importance of microinsurance in the Indian context stems from the low level of insurance coverage in the country, as observed in the table at Appendix 4.1 which compares insurance density\textsuperscript{166} and insurance penetration\textsuperscript{167} in India with that in some other countries. In order to extend insurance coverage, the insurance regulator in India, the Insurance Regulatory and Development Authority (IRDA) mandated private life and non-life insurance companies entering the insurance sector of rural and social sector\textsuperscript{168} obligations. While such a move can help boost distribution of policies, efforts to develop

\textsuperscript{166} Ratio of premium paid in US$ divided by total population reflecting the insurance industry’s revenues relative to the population of the country.

\textsuperscript{167} Ratio of premium paid to Gross Domestic Product (GDP) reflecting roughly the insurance industry’s revenues relative to the GDP of the country.

\textsuperscript{168} Refers to unorganized sector, those below the poverty line and those with disabilities.
insurance products that specifically cater to the requirement of low income groups, called microinsurance products, are also essential. Such products are usually characterized by low premiums which usually also implies that the risks covered may be fewer than in standard policies.

The IRDA has defined microinsurance products as insurance products with a maximum cover of Rs.30,000 for most categories of insurance\textsuperscript{169}. It has also issued guidelines relating to these products, which permit NGOs, MFIs and SHGs to act as microinsurance agents.

The largest segment of the Indian microinsurance industry is micro life insurance. \textbf{Table 8} provides a snapshot of this, through premia collected and number of policies. It can be seen that the bulk of the micro life insurance policies and premiums come from group schemes. These are often marketed by MFIs or NGOs. However, the premia collected on micro life insurance products amount to only 0.1 percent of total life insurance premiums collected in the country in 2008-09 (IRDA, 2009). In terms of the number of lives covered, only 14.6 million lives have been covered which amounts to only 21 percent of the total estimated coverage of the microfinance sector in India. The figures show that the most popular microinsurance product is far behind microcredit in terms of scale. The micro non-life insurance segment is reported to be lagging even

\textsuperscript{169} Only for death due to accident the maximum cover is Rs. 50,000.
further behind\textsuperscript{170}. Other important segments of the microinsurance industry are health, livestock, crop and weather insurance. Finally there are integrated social security schemes. Appendix 4.2 reviews the developments with regard to microinsurance in India.

Table 8: Selected Indicators of Microinsurance in India (Data for the year 2008-09)

<table>
<thead>
<tr>
<th>Premium collected on Individual schemes (in Rs. Million)</th>
<th>366</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium collected on group schemes (in Rs. Million)</td>
<td>2060</td>
</tr>
<tr>
<td>Number of lives covered through individual schemes</td>
<td>2</td>
</tr>
<tr>
<td>(in million)</td>
<td></td>
</tr>
<tr>
<td>Number of lives covered through group schemes (in million)</td>
<td>12.6</td>
</tr>
<tr>
<td>Number of agents</td>
<td>7250</td>
</tr>
</tbody>
</table>

(Source: Author based on IRDA, 2009)

\textsuperscript{170} No aggregate figures for this segment are available but one public sector non life insurance company, United India Insurance, has reported premium of Rs.850 million in 2008-09 from microinsurance, an increase of 28 percent percent over a two year period (Srinivasan, 2009).
Assessment of growth of microinsurance

From Appendix 4.2 it is clear that while there has been considerable innovation concerning microinsurance design and products scaling up these initiatives appear to be a challenge. For example, health insurance seems to be characterized by small custom-made programs in small pockets of the country. However, improving the availability of health infrastructure in some geographic locations needs to precede increasing distribution of health insurance. In livestock insurance too, there is innovation, but the market needs to be expanded through increasing awareness about the product. Weather insurance has shown some mainstreaming efforts, by entry of several large players, but for further expansion, customers will need to be educated about the mechanics of the products.

An integrated product involving bundling of various kinds of insurance required by microfinance members (such as Sewa Bank’s VimoSEWA) would provide convenience to members, and avoid the need for them to keep track of multiple policies. However, the product needs to offer a certain degree of customization to provide for differences in interpersonal needs. Such a product would be demanding on MFI staff as they need to be able to effectively explain the various features of the product to members. It will involve additional administrative responsibilities for the MFI staff as they may need to coordinate with multiple insurance companies. Efficient and professional management at the MFI-end is imperative for such policies to be viable.

In general, for the microinsurance sector to grow faster there has to be a focused effort to build adequate databases to enable insurers to have a basis for pricing products. Product development needs to be undertaken through piloting and feedback from the
field, as is evident from the experiences with regard to development of livestock and rainfall insurance products. While scale economies are important, a certain degree of product customization could be useful as in the case of ICICI Lombard’s weather insurance product for orange growers in Rajasthan. Moreover, the procedures need to be simple and the precise nature of the perils that will be covered needs to be explained adequately to the insured.

With the geographic spread of microfinance services, an increase in distribution of policies may be expected. But servicing the policies through claim payment in a timely manner is crucial and is likely to be the factor driving rates of growth in future. Models in which MFIs initially pay out claim values with subsequent reimbursement from the insurer are likely to work better.

Cole et al., (2009) based on field experiments on take-up of a rainfall insurance product in Andhra Pradesh and Gujarat in India, point to some key barriers to household participation in risk management products. First, households’ purchases of these products tend to be price-elastic implying that reduction in operational costs of insurance companies and competition in the sector are important to increase insurance penetration. Second, sudden liquidity constraints are an important barrier to participation and so loans may be required to bridge the shortfalls in premium payment by the insured. Third, trust and financial literacy are important determinants of household participation.

B. Micro savings

As pointed out by Robinson (2001), for very poor individuals, savings products may be even more valuable than deposit services. However savings products for low income
groups need to cater to their specific requirements. As the poor typically have multiple demands on their scarce resources, savings which are targeted in nature or are specifically aimed at an event, could motivate them to save more, at least in the relevant instrument. Field studies indicate that there is a preference for small, frequent contributions that are collected at their doorstep (Rutherford, 2008). Features designed for limited duration of illiquidity that discourage withdrawals by members, could also help raise savings (Ashraf et al. 2006).

In India, while MFIs incorporated as local areas banks and cooperatives, are permitted to offer savings services, most other kinds of MFIs are not permitted to do so. Not-for-profit companies, trusts and societies are permitted to function as business correspondents of commercial banks. However, the largest MFIs in the country, which cumulatively account for 70 percent of the sector in terms of portfolio outstanding are non-banking finance companies (NBFCs), who are unable to accept savings deposits. In order to do so, NBFCs need to obtain investment grade rating from a credit rating institution, which is difficult for MFIs as their loan portfolios are collateral free. A number of studies have stressed the importance of savings for the poor (Rutherford, 2001). Many MFI members simultaneously both borrow and save. The lack of saving services results in their saving in less convenient, riskier and often lower yielding ways such as through purchase of ornaments. For the MFIs, this lack of access to deposits implies that they tend to be highly leveraged. The introduction of savings services by MFIs has to be preceded by putting in place a framework for their prudential regulation for MFIs. As the issue is to be addressed by regulatory changes, it will be addressed in Chapter 6 which suggests a regulatory framework for microfinance in India.
C. Remittance Products

At times, in the case of low income families, members are forced to migrate to other geographic locations for extended time periods in order to earn a living. These migrant workers need to remit their earnings periodically to family members in their home towns, and therefore need remittance services. Typically, such workers send remittances through risky means such as acquaintances, at times resulting in losses. There are also informal couriers who are often used for domestic remittances, who charge 3 to 5 percent of the remittance amount and are also at times unreliable with regard to the time of delivery (Garg et al., 2009).

Even though there are reliable avenues such as money orders (through the postal service) and bank demand drafts that are available for small value transactions, these are not always used by low income individuals as they are often perceived as inconvenient due to their locations and working hours. As in the case of banking services, here too there is a need for products offering lower cost and greater convenience for low income segments of the population. A study by Pande and Shukla (2009) suggests considerable potential for a service for remittances of amounts between Rs.2,500 to Rs.7,500.

With growth in the number of mobile phone subscribers in the country171, there is scope for using this medium to offer remittance services. Some banks have started offering mobile based services to customers including mobile payments, which implies

171 As on September 30, 2010, there were around 688 million subscribers in India though only 70 percent (483 million) were active according to Telecom Regulatory Authority of India (TRAI) www.trai.gov.in accessed on December 15, 2010).
debit or credit of funds in a customer’s account based on instructions received over mobile phones. As per RBI guidelines issued in July 2008, this service can be offered only by banks which are licensed and supervised in India and have a physical presence in the country. However, in August 2009, RBI has permitted entities other than banks to issue mobile phone based payment instruments of maximum value Rs. 5,000 subject to RBI approval, though the facility is to be used only for purchase of goods and not for person to person transfer.

In India, as only banks and approved money transfer companies like Western Union are permitted to offer remittance products, MFIs can only act as business correspondents\(^\text{172}\) of banks or agents of approved institutions. A number of MFIs have tied up with Western Union to offer such products for international remittances, particularly targeting MFI members who have family members employed in the Middle East region.

In order to offer cash-less payment and money transfer services to low income groups, the Commonwealth Business Council, which aims to improve financial inclusion in underserved regions of the world has launched in 2009, a “financial inclusion card” in India. This card is issued in partnership with commercial banks in India which act as the custodian of the card holder’s funds. The card is serviced through a network of agents and business correspondents. With a minimum balance of Rs.100, a card can be obtained, which can be used to make payments to a network of merchant establishments including

\[^{172}\] Only certain institutional forms are permitted to become business correspondents. This aspect is discussed further in Chapter 6 on regulation.
provision stores, fertilizer and seed sellers, hotels and restaurants. There is also a provision for card to card transfer of funds, making it possible for card holders to transfer money to family members in different locations, provided they are also card holders. The card is also expected to be useful for those who are exposed to considerable risk of theft as it enables value to be stored without holding cash. The charge for the card is Rs. 1 per day, which appears to be on the higher side considering that the value of transactions is likely to be small. Over a period of time there are plans to make it possible for card holders to access other services such as health insurance and term deposits through the card.\footnote{Based on discussions with the Managing Director and CEO of Commonwealth Microfinance Ltd., Mr. Mahesh Ramachandran on June 25, 2009.}

D. Micro-pensions\footnote{This section draws partly from Shankar and Asher (2011) forthcoming.}

Micro-pensions refer to long term savings by relatively low income informal sector workers, with the objective of obtaining income security during old age. Though informal sector workers may not “retire” in the formal sense like employees in the organized sector, they need to provide for the reduction in income earning capacity during old age, particularly due to ill health.\footnote{Additionally as even microcredit is not provided to those above 59 years (upper limit for membership in most MFIs) the lack of availability of funding even for working capital is likely to also constrain enterprise income. With India’s rapid ageing increasing this limit to 65 years merits consideration.} Micro-pensions therefore aim to provide a flow of income to coincide with this decline in earning capacity.

\begin{footnotesize}
\begin{enumerate}
\item\footnote{Based on discussions with the Managing Director and CEO of Commonwealth Microfinance Ltd., Mr. Mahesh Ramachandran on June 25, 2009.}
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\end{enumerate}
\end{footnotesize}
A number of studies have illustrated that the poor understand the value of saving for retirement (Todd, 1996; Rutherford, 2008). Indeed, some low income households resort to borrowing to acquire assets which they hope will provide financial security during old age. There are also instances when the poor are willing to accept negative interest rates from deposit collectors for the service of collecting their small deposits over a period of time and returning it to them as a lump sum at a later period to ensure financial discipline (Rutherford, 1999).

The need for micro-pensions in India is particularly important due to the demographic transition leading to lower total fertility rate, increased life expectancy and consequent increase in the proportion of the aged in the population. The share of the elderly (or persons aged 65 years and above) in India’s population is expected to rise from 4.6 percent in 2000 to 9 percent in 2030. In absolute terms, the number of those above the age of 60 will rise from 87.5 million in 2005 to 330 million in 2050 (Asher and Bali, 2010). Presently, only about a quarter of its elderly benefit from at least one of the components of India’s social security system.

A micro-pension scheme is typically designed as a defined contribution scheme. The scheme essentially operates on the principle of voluntary savings, but with features designed to sustain savings discipline, accumulated over a long period. Ideally, these savings are intermediated through financial and capital markets by a professional fund manager. At an agreed upon withdrawal age (usually 58 or 60 years), the accumulated balances can be withdrawn in a lump-sum, a phased withdrawal, annuity or some combination of these methods. Hence, a micro-pension plan has a distinct accumulation phase as well as a pay-out phase. During the accumulation phase, a member contributes
towards accumulating balances. The value of such accumulation depends on the amount of contributions less pre-retirement withdrawals plus returns (net of investment management expenses) obtained from the investment of funds less applicable taxes. It is usual for administrative expenses to be borne by the members collectively. These however need to be transparent and benchmarked. The accumulation phase is followed by the pay-out phase which commences usually after a particular age, usually 60 years. But this will need to be gradually increased with increasing life expectancy. During this phase, the member receives income from the pension fund either in lump sum or in a phased manner, or a combination of both. A lump-sum only is not recommended as it increases the responsibility of a member to invest it, or use it in small amounts over 15-20 years. Findings from behavioral finance suggest that a phased withdrawal decision committed at the beginning of the payout phase is more likely to create the desired discipline (Mitchell and Utkus, 2003).

In India, in April 2009, a universal voluntary pension scheme called the New Pension Scheme (NPS) was launched by the Pension Fund Regulatory and Development Authority (PFRDA). This scheme is open to all citizens and can be accessed through 23 point of presence entities which includes licensed banks, insurance companies, mutual funds and financial distribution firms.

In July 2010, NPS-Lite, a scheme specifically targeted at economically disadvantaged sections of the society was introduced as part of the NPS architecture. The scheme is proposed to work on a group basis and is to be made available through aggregators. Aggregators are responsible for undertaking “know your customer” verifications and a number of subscriber interface functions. A feature that makes NPS-
lite particularly suitable for low income groups is the waiver of minimum amount of annual contribution\textsuperscript{176}. Moreover, 12 free transactions are permitted per subscriber per year after which a transaction fee of Rs. 5 is charged\textsuperscript{177}. A further advantage is that portability of accounts is incorporated. The success of the scheme will depend on the availability of willing and capable aggregators. Two other micro-pension schemes are in existence in India which are discussed in \textbf{Appendix 4.3}.

\textit{Managing Micro-pension Risks}

In the pay-out phase, longevity, investment and inflation risks need to be addressed. In addition, survivors’ benefits and disability insurance are also essential. Survivors’ benefits in the case of male members are particularly important in India as life-time labor force participation of women is relatively low. Even when they do participate, women as a group earn less than men, and therefore require more years of support. Uneven property rights and social status of women, particularly of widows, are additional reasons to provide survivors’ insurance benefits. Hence more systematic consideration of these issues, informed by international experiences and analytical insights is needed.

The longevity risk concerns the fact that while each person is certain to die, the age, the cause, and the place of death are not known. Some may die within a short period after retirement; while others may live for a much longer period. The latter category of

\textsuperscript{176} There is a minimum contribution of Rs. 100 at the time of registration.

\textsuperscript{177} The fee is proposed to be reduced to Rs. 4 and then to Rs. 3 on reaching threshold of 1.5 million and 3 million subscribers.
persons may find their financial resources exhausted, while those dying early in retirement may not face this challenge. The earlier the age at which final withdrawal is permitted, the longer the period for which the accumulated balances will be required to be used to finance old-age. As noted, India’s demographic trends suggest that there will be considerable lengthening of the pay-out phase over time, with considerable variations among different income groups.

Investment risk refers to the risk of return from the portfolio that the pension fund invests in. In the risk-return continuum, a lower degree of risk is desirable for micro-pension plans due to the lower risk bearing capacity of the low income population. In order to ensure adequate rate of return on the small deposits, the transaction costs involved need to be kept low. This is a challenge which must be met through technology based solutions and conscious attempts to realize economies of scale and scope.

Inflation risks are important keeping in view the long time horizon that micro-pensions entail, particularly in view of the limited resources of the poor. In Africa, inflation risk is one of the main reasons for old age savings being primarily in kind such as investments in land, housing and livestock (Moulick et al., 2005). Until providers develop the ability to invest the funds in inflation-safe vehicles, limiting the term length as in the case of the Grameen Bank’s Grameen Pension Scheme (GPS) is one way to mitigate inflation risk.

Most importantly, micro-pensions represent a long term financial contract with potential for significant agency problems. Due to the political sensitivity associated with low-income groups, the contingent liability of micro-pension schemes are likely to be
borne by the Government. There is therefore a strong case for regulation of micro-pensions.

E. Micro-housing

In general, MFIs in India have been wary of housing loans due to the higher loan amounts and longer time durations they usually entail. Moreover, the risk is also higher due to other reasons. First, the loan does not finance an income generating activity and hence will necessarily have to be paid out of surplus income from existing activities of the borrower. Second, the loan has to be to an individual and hence the comfort of a group guarantee is not available. Third, the houses may not always have documents perfectly in order. Four, ease of saleability of the houses financed even if possessed by the lender, may not be well proven through experience unlike in the case of middle income and high income housing. A leading MFI, Basix, offers housing loans but usually insists on personal guarantees in addition to the deposit of title deeds, as it has observed defaults to be higher than in the case of other microfinance loans. While usually default rates are lower than 1 percent, it is around 2 percent for housing loans (Choudhary, 2009). Other large MFIs such as SKS Microfinance are also experimenting with housing loans to understand the risks better as the need for such loans is apparent.

There is also increasing interest from real estate companies in promoting affordable housing projects as the market for them is estimated at around Rs. 3,000 billion (Knight Frank, 2010). A number of real estate developers are launching such projects in peri-urban areas and tying up with MFIs, as banks are not usually willing to lend to their

\[^{178}\text{Such areas border urban areas}\]
customers. Micro Housing Finance Corp established in 2008 is an MFI that focuses on such lending and provides loans between Rs. 0.3 million to Rs.0.5 million. Due to the higher loan amounts, the focus is on the more well off segments of the poor, particularly salaried workers such as drivers who have excess income to invest.

**Range of products of MFIs: Concluding Observations**

Financial services other than microcredit for low income groups are developing though many of them are yet to be mainstreamed. A number of concerns arise when examining the option to use MFIs to expand availability of these services.

First, while economies of scale and scope may be expected to exist when an MFI also offers other financial services, because microcredit loans are of short duration, with a one year term being the most common, when longer duration products such as micro-housing and micro-pensions are offered by MFIs; the two services may not integrate entirely. To this extent cost savings may also be limited. Moreover, while bundling of savings based long duration products such as micro-pensions with credit products, is desirable to reduce transaction costs, individual members may fear that that in case of default, the savings schemes may be adversely affected. MFIs need to be transparent and clarify these issues at the outset. A provision to avail loans against savings can be considered.

Second, in the case of financial services such as micro-pensions involving asset management and investment functions, these will need to be outsourced by most MFIs as they do not have in-house capacity to handle these functions. For long term savings, the potential risks for providers and consumers tend to increase, calling for professional fund
management. Specialized fund managers are likely to develop as micro-pensions become more widespread. MFIs however, will need to be adept at negotiating and formulating contracts for these services in a manner that best serves the interests of their members.

Third, as group loans account for a large proportion of microfinance in India, record keeping by MFIs is often on a group basis, and detailed individual customer level data are not maintained. Other products such as micro-pension schemes may require individual record keeping and to that extent may require investment in building individual level records.

Fourth, even though MFIs are experienced in record keeping, most of them at present deal with a single product. Offering a range of products will be demanding on their MIS systems and the skills of their field staff, as payments intended for different services need to be appropriately recorded. Moreover, record keeping in the case of microcredit is relatively simple as loan amounts are usually the same for all group members and the collection is also by way of equated installments. Hence uniform amounts are disbursed and collected from all members in a group. Partial payments are not encouraged. In the case of products such as micro-pensions, contributions may show considerable variance both between individuals and for an individual in different time periods.

These challenges may require MFIs to upgrade to information systems that support multi-product financial operations with embedded tools which enable field officers to handle the range of products seamlessly. They may also need to train their field officers to handle the more complex record keeping responsibilities.
Fifth, when introducing new products to microfinance customers, the product features should be kept simple to enable even those with low financial literacy to understand and monitor them. Moreover, field officers of MFIs need to be trained to explain them to potential users. For instance, in the case of a long time horizon product, such as micro-pensions, offering fixed interest rates may be difficult, as flexible interest rates are more appropriate. The concept of flexible interest rate may however be hard to explain to customers with low financial literacy. It is however incumbent upon institutions to effectively explain the product to customers (WWB, 2003). It is important that the potential customers be equipped with enough knowledge to explain the products to their family members. Training on financial planning for MFI customers needs to precede marketing for certain products, such as pension schemes in order to enable them to fully appreciate their utility. This may require initiatives from NGOs and/or Government agencies if MFIs are not willing to incur costs on this account.

Sixth, only established MFIs can effectively market long duration schemes such as micro-housing or micro-pension schemes. The first product usually involves deposit of title documents over a long period, while the second involves payouts over a long period. While customers may be willing to avail micro-credit from less established institutions, they may not be willing to place their land titles and long term savings with them. Hence to that extent, the use of the MFI channel may be limited by the capacity of large MFIs to service the target market. Regulation of the microfinance sector, which will increase the confidence of customers, will therefore be an integral factor in development of these services. Long duration products may also require portability in view of probable geographical mobility of users over time.
In spite of these challenges, MFIs have formidable competitive strengths in providing other financial services to low income groups as their field officers know the cash flows of member households and would to an extent be in a position to judge which product would suit a particular household. Moreover, they visit the neighborhoods of the potential users on a regular basis enabling transactions to be made at the customer’s doorstep. MFIs have also incurred establishment costs in various locations, including remote rural areas.

4.6.2 Development of Credit Histories

The second outcome, importance of building up credit histories, lies in its ability to empower borrowers by enabling them to leverage their past credit history to access more favorable credit terms and a wider range of institutions in the future. While it is desirable that an MFI through the quality of its services retains customers, it is important that the option to continue availing a service should lie with the customer. This would help ensure that customers do not get taken for granted and that the MFI continues to strive to retain customers.

In the case of SHGs, loans are provided by banks to the SHG. It is the SHG which on-lends the funds to its members. Hence, the bank only maintains the credit history of the SHG. The bank passbook is also issued in the name of the SHG. No passbooks are given to individual members. Records of individual members’ transactions are maintained at the SHG level, through registers maintained by the group. The credit history of the borrower is therefore not available to other lenders or to the members themselves. At best, it can be transmitted through word-of-mouth by other SHG members.
In the case of MFIs, credit histories of individual microfinance members are maintained by the MFI, as loans are given to individual group members and not to the group as a whole. Pass books are usually given to members when a loan is provided and entries are made on a weekly basis confirming the repayment of each installment. An individual member’s credit history is available in loan passbooks of the member, and registers maintained by the field officer. The register relating to the group which is retained by the field officer is also updated similarly on a weekly basis. While some MFIs have IT systems that capture and record individual credit histories, others have systems where only group level data are captured.

When the loan is fully repaid, the pass book is returned to the MFI. Usually, another loan is taken for which a fresh pass book is issued and similarly updated regularly. The new pass book does not provide details of earlier loans taken and successfully repaid. This implies that the individual’s credit history is created only within the MFI. The credit history is not available to other lenders or to the members themselves. This does not enable the member to borrow at better terms over time on the basis of credit history unless the microfinance provider itself reduces rates for older borrowers. Most MFIs charge a uniform interest rate for all borrowers to avoid providing opportunities for arbitrage\(^{179}\) and also to keep the MIS simple.

As mentioned earlier, there is an initiative in the microfinance sector to start a credit bureau. Microfinance Institutions Network (MFIN) a self regulatory body of 31 NBFC-

\(^{179}\) This refers to situation where older members borrow at lower rates and on-lend to newer members or non-members, who may have to pay higher rates.
MFIs accounting for 70 percent of microfinance loans has announced plans to start a credit bureau in December 2009. MFIN has invested in Alpha Micro Finance Consultants Private Limited (Alpha), which in turn has invested Rs. 20.0 million towards setting up a credit bureau. Alpha is working in collaboration with Credit Information Bureau (India) Limited (known as CIBIL), a repository of credit information on corporate and consumer borrowers operating since 2004 and another credit bureau, High Mark, which is expected to be launching credit scoring for borrowers in India. The credit bureau is to be supported additionally by the Omidyar\textsuperscript{180} group and IFC, Washington.

The objective of MFIN in facilitating the launch of a credit bureau for microfinance is to prevent the problems that could be caused by multiple borrowing by MFI members, leading to over-indebtedness and consequent delinquencies. In other words, the credit bureau is viewed mainly as a risk management mechanism that could prevent problems and also provide reassurance to investors and lenders to MFIs. This is an important objective particularly as evidenced by problems observed in the recent past in at least four\textsuperscript{181} microfinance markets where high growth was followed by a repayment crisis due to multiple lending (Chen et.al., 2010). However, from the borrowers’ perspective credit bureaus are important as it enables the creation of credit histories that can be used to improve terms of borrowing in future. While presently credit histories are also created, they are only available with the particular provider of microfinance. Hence the customer

\textsuperscript{180} Promoters of the on line auction web site, ebay (www.ebay.com).

\textsuperscript{181} Nicaragua, Morocco, Bosnia & Herzegovina and Pakistan
is unable to use past credit history to obtain facilities from other lenders. It also gives the particular provider undue power in constraining the borrower’s choices.

A drawback of the MFIN initiative is that it only covers MFI NBFCs which account for 70 percent of microfinance loans. This excludes not just MFIs accounting for the balance 30 percent loans but also the entire SHG Bank Linkage Program (SBLP). This means that only partial information will be captured by the credit bureau. This works to the disadvantage of both microfinance providers and customers. The former will be unable to have a true picture of indebtedness of the borrowers. In fact, in two of the four countries which saw repayment problems in the recent past, credit bureaus were in existence but did not cover the sector as a whole\(^\text{182}\) (Chen et al., 2010). The latter will have only partial credit histories. Customers served only by the SBLP, will not be empowered through credit history creation.

Another limitation of any credit bureau in India is that at present there is no national identification number for citizens of India. This makes it hard for lenders to uniquely identify borrowers particularly if they change their residential addresses. The Government of India has in January 2009 constituted the “Unique Identification Authority of India (UIDAI)\(^\text{183}\)” under the aegis of the Planning Commission, with the responsibility of implementing a scheme to issue a unique identification number\(^\text{184}\) to all residents of the country. The number will be linked to the person’s demographic and

\(^{182}\) In Nicaragua, there was separation of credit bureaus for regulated and unregulated MFIs while in Pakistan only microfinance banks submitted data to the credit bureau and NGOs did not.

\(^{183}\) Details obtained from [www.uidai.gov.in](http://www.uidai.gov.in).

\(^{184}\) It is proposed to be a 12 digit number under the brand name “Aadhaar” which means “foundation” or “support”
biometric information stored in a centralized database that can be accessed in an online
cost effective manner. UIDAI is also responsible for operating, maintaining and updating
the database.¹⁸⁵  UIDAI commenced issue of identification numbers in September 2010
and had issued one million numbers by January 2011. It is expected to issue another 600
million numbers over the next four years. Prior to issue of identification numbers, UIDAI
conducts verification of identities of individuals. For individuals with no existing identity
documents, other registered individuals can act as introducers. It is hoped that with issue
of unique identity numbers (UIDs), it will be easier for individuals to meet “know your
customer (KYC)” norms of banks and open accounts enabling greater financial inclusion.
In the context of this study, the UIDs could also help individuals in building up credit
histories, as credit bureau information can be stored more uniquely and accessed more
widely.

To summarize, while there is an initiative to help microfinance customers build credit
histories, the effort is partial and addresses only a sub-set of microfinance customers and
providers. In order to be effective for both customers and providers, it needs to cover the
sector as a whole. This may require intervention by the Government, through introducing
registration for microfinance providers and making it mandatory for registered providers
to submit information to the credit bureau. This aspect will be addressed further in
Chapter 5 on regulation. The issue of UIDs to Indian residents will greatly benefit the
process of building up credit histories of microfinance members.

¹⁸⁵ UIDAI is headed by Mr. Nandan Nilekani, who was earlier Chief Executive Officer of Infosys Ltd., one
of India’s largest information technology companies.
Graduation to individual financial services is studied by examining the trends with regard to the share of individual lending at the sector level, and if there is indication that individual loans are made available to mature group microfinance users.

The primary model of microfinance in India is the group model. The SBLP is entirely based on group model and majority of MFIs also use group lending, either through SHGs or JLGs as explained in Section 4.1 and 4.2. In a study by Sa-dhan, out of a sample of 220 MFIs, only 11 used individual lending methods solely (Sa-dhan, 2008).

As discussed in Chapter 2, group lending through the joint liability mechanism addresses a number of problems associated with lending with the poor which is why it is rightly considered an important innovation that has enabled the growth of microfinance. However, as put forth in Chapter 3, it would be desirable for borrowers if group finance users are eventually able to access individual financial services. In fact, even MFIs could benefit through individual loans as it usually becomes possible to give larger loans. In the case of joint liability lending, all members have to be given the same loan size and so the maximum loan amount for the group is the amount that the weakest member can comfortably repay. As larger loans imply greater profitability, it could be beneficial to the MFI.

While a few MFIs graduate their star borrowers to individual financial services, this cannot be described as a widespread phenomenon. A number of reasons underline the focus on group lending by MFIs. First and most important, is the higher risk that
individual loans entail particularly in the absence of collateral. Hence even MFIs who do offer individual loans, base it on collateral or guarantees of persons who are salaried or have established businesses. A cash flow based assessment of repayment capacity is also undertaken, though it often does not form the sole basis of approval of loan. Assessment of borrower cash flows could also be limited by the capacity of the MFI staff. Second, MFI MIS systems tend to be geared towards standardized loan amounts and installments. Individual loans would require their MIS systems to be able to handle a large variety of differing loan amounts with consequent differences in interest and installment payments. Third, there is a lack of clarity on whether individual loans entail higher or lower profitability. While on the one hand, they enable larger loan amounts to be given, on the other hand the operational costs can be higher as group loans offer the advantage of economies of scale by enabling handling of more number of borrowers at one time.

A study by Sa-dhan in 2008, suggests that the operational cost ratio\(^{186}\) for individual lending was 10 percent as compared to 19 and 11 percent in the JLG and SHG models respectively (Sa-dhan, 2008). This seems to suggest that individual lending is beneficial for the MFI. However, as pointed out by Panikkal et al. (2010), individual lending products should be introduced by MFIs only after careful consideration of design and implementation issues.

As such individual lending is still a small niche segment of the Indian MFI sector, and systems for MFIs to handle it still need to be fully developed and availability broadened.

\(^{186}\) Total costs of operation including financial costs as percent of loans outstanding
4.8 Concluding Remarks

The microfinance sector in India has seen rapid growth. Two predominant models, namely the SBLP and the MFI models have emerged. Both the SBLP and the MFI model have their own strengths and weaknesses.

The strengths of the SBLP include its broader social objectives that go beyond mere provision of credit, its focus on training of group leaders and members and its emphasis on savings. Moreover, the model offers greater flexibility in terms of procedures as SHG meetings can be held according to the convenience of members, as the presence of NGO staff is necessary only in the initial stages. Its primary weakness is the quality heterogeneity in groups that invariably results as groups manage themselves after a point. The quality of training received from the NGO, the capability of group leaders and the dynamics among members are all factors that could impact the handling of SHG affairs. This in turn is reflected in the accuracy of group records and the satisfaction levels of group members and eventually on the time period for which the group is in existence. Another serious threat to the SBLP with increase in membership of SHGs is that of politicization. With SHGs being used to channel benefits to low income segments, the motivation to provide benefits to them with political objectives, particularly during election times can be expected to be high. If over a period of time SHGs become political vehicles, availability of funds from commercial banks may reduce.

The MFI model on the other hand has strengths in the greater uniformity of services provided across groups of a single MFI and the standardized record keeping by MFI employees. The model on an average also offers larger loan sizes, which could be
advantageous for members who require and are able to service them. However the sole emphasis on microcredit and the lack of savings services due to regulatory constraints are significant weaknesses. Moreover, with extremely rapid growth, the MFIs need to strengthen their institutional capabilities.

With the MFI model growing at a more rapid pace than the SBLP, efforts must be taken to strengthen the SBLP as there is a case for its coexistence with the MFI model to provide a continuum of options for low income groups to access financial services.

The results of the sector level enquiry on the research questions were presented in this chapter. The barriers to financial inclusion addressed by the microfinance sector were examined. This was carried out first, by examining the dispersion of microfinance services in the country and later by comparing the availability of microfinance and banking services in different regions in India. The analysis revealed that microfinance penetration in the country was non-uniform with state specific contextual factors playing a major role in driving microfinance growth. Comparing the spread of microfinance services with that of banking services, it was found that four distinct categories of regions emerged. While the Southern and Western regions were characterized by widespread availability of both kinds of services; the Central region had low availability of both kinds of services. The Eastern and North Eastern regions showed high availability of microfinance but not banking services, while the Northern region showed high availability of banking but not microfinance services. Even within each region there were exceptions, with some states showing trends with respect to microfinance and banking different from their region.
Adequate availability of both kinds of services across the country is required to enable development of a continuum of financial services catering to the diverse requirements of the population. However, microfinance growth in a state seems to be driven by a number of contextual factors including cultural and political ones. This seems to indicate that state specific policies need to be evolved to encourage their development. A recommendation that follows is that policymakers need to fine tune incentives for microfinance as it is clear that these incentives are required more in certain geographical areas than in others. Moreover, research on how microfinance has made inroads into states such as Assam and Tripura, inadequately served by the mainstream financial sector needs to be carried out. Similarly, research is needed to examine why in states such as Jammu and Kashmir and Uttar Pradesh, even though there appear to be adequate banking coverage, microfinance services have not made significant progress, as there likely to be an unaddressed need for microfinance services by some segments of the population. The reasons for the lack of interest by microfinance providers need to be researched and addressed.

The sector level enquiry also considered if the outcomes of financial inclusion by way of a range of financial services and build-up of credit histories was available to Indian microfinance members. Developments with regard to microinsurance, micro savings, remittances, micro-pensions and micro-housing were reviewed. The challenges and advantages in using MFIs to propagate these services were discussed. Ultimately, as Prahalad (2009) has persuasively argued, in offering standard middle and high income products to those at the “bottom of the pyramid”, social entrepreneurship (along with social responsibility) which radically reduces transaction costs and results in genuine
resource cost savings without compromising on quality is essential. This is the direction which development of financial services for low income groups should take. With innovation in products in categories other than microcredit, microfinance will enable access to a more complete range of financial services. To reduce transaction costs further, MFPs can consider incurring some overhead costs on technology jointly and sharing the resources to reduce costs. In the case of micro-pensions, such a method has been used by different providers partnering with Invest India Micro-pension Services Limited (IIMPSL), a company set up by a group of NGOs to provide services for design and implementation of sustainable and scalable micro-pension and microinsurance schemes for low income groups. Collaborating with IIMPSL, enables MFIs to access better technologies than each of them would have individually been able to afford, due to sharing of overhead costs.

Further, the use of automated payment technologies such as mobile phones, automated teller machines (ATMs), internet payment processors and smart cards are promising developments. Finally, differentiated products need to be developed for different income segments even within low income groups with higher degree of flexibility being offered to the poorest segments.

The outcomes relating to development of credit histories too is available only partially to members in that these credit histories are developed only at the MFI level and cannot be easily leveraged to access financial services from other providers. The setting up of the credit bureau by MFIs incorporated as NBFCs, is a useful first step though a credit bureau with wider participation by sector participants will be more beneficial to members as well as providers. The project for providing unique identification numbers
for residents of the country holds considerable promise for financial inclusion, as well as building up uniquely identifiable credit histories for individuals such as migrant workers who lack documents to prove identity.

Individual lending is at present a small segment within the Indian MFI sector. While the SBLP is completely group based and does not provide for graduation, even in MFIs, graduation to individual financial services of group microfinance customers does not yet appear to be systematized. MFIs need to develop the capability to handle diligent monitoring and greater customization of loans that individual loans necessarily entail, before considering their introduction.

In the next chapter, enquiries at the microfinance provider and member levels will analyze the role of microfinance with respect to financial inclusion.
Box 4.1: The SKS Story

Swayam Krishi Sangam (SKS Society) was started by an individual, Mr. Vikram Akula, with funding of around US$ 2,000 raised from 357 associates and friends. It started as an NGO in 1997, beginning microfinance operations in Medak district in Andhra Pradesh in India, with a special focus on exclusively reaching the poor. It used the "Grameen Bank" group lending model.

One of its first achievements was a pilot project for introducing smart cards at the village level, which won it a CGAP award in 2000. In 2003, SKS Microfinance Private Ltd. (SKS) was incorporated which later became a non-banking finance company in 2005, moving gradually to a for-profit structure. Since then, the focus of SKS has been on developing a model that could scale up rapidly so that the large demand for microcredit in India could be met. This was achieved by investment in technology which enabled standardization of processes. The SKS model is often described as borrowing from the practices of McDonald's or Starbucks. To meet the high demand for capital that a high growth strategy entails, it raised capital from various sources including commercial ones, becoming the first Indian MFI to raise purely commercial capital.

The result of the above strategy was that between March 2006 and September 2009, its compound annual growth rate in terms of borrowers was 263 percent and in terms of branches was 233 percent, making it India’s largest MFI. In September 2009, it had a borrower base of 5.3 million amounting to around 20 percent of all MFI customers in India. While Grameen Bank took 30 years to reach 6 million borrowers, SKS reached 5.3 million borrowers in 6 years.

In the last quarter of 2009, SKS announced plans to raise equity by means of an initial public offer (IPO) and eventually to list its shares. The announcement lead to a rekindling of controversies regarding the benefits and dangers associated with MFIs raising money through IPOs.

(contd.)
Mr. Muhammad Yunus of Grameen Bank was critical of such a move as it emphasized the “profit motive” which is likely to lead MFIs away from the social mission. However others such as Mr. Vijay Mahajan, a pioneer in the microfinance sector in India, argued that once an MFI grew beyond a certain stage, an IPO was inevitable. A large portfolio requires sufficient capital to meet capital adequacy requirements. Capital availability from private sources may be insufficient, necessitating an IPO. Other observers have pointed out that the legal framework in India which does not enable MFIs to accept deposits compels them to largely depend on external finance. This has prevented use of the “Social Business” model adopted by the Grameen Bank in Bangladesh. As the “Social Business” model advocated by Yunus (2007b) implies that investors only recoup the amounts invested and not receive any returns on their investment, the amount that can be raised in this manner may be limited and not sufficient to fund the growth of Indian MFIs.

In spite of the controversy surrounding its decision to initiate an IPO, SKS has nevertheless been successful in introducing a new business model to the international microfinance sector. Its story of rapid growth and innovation through technology and standardization of processes hold lessons for other Indian MFIs.

(The financial details were obtained from Kumar and Rozas, 2010).
Appendix 4.1

Insurance Density\textsuperscript{187} and Insurance Penetration\textsuperscript{188} of Select countries.

(Source: Author; Based on data from IRDA Handbook on Indian Insurance Statistics, 2008-09)

\textsuperscript{187} Ratio of premium paid in US$ divided by total population.

\textsuperscript{188} Ratio of premium paid to Gross Domestic Product (GDP).
Appendix 4.2

Microinsurance Schemes in India

Life Insurance

In India, insurance companies need to get their products approved by IRDA before offering them. At present there are around 19 different microinsurance life products available, with the market leader being “Aam admi bima yojna”, a product of the public sector insurance company, Life Insurance Corporation (LIC) with 4.26 million policy holders (Srinivasan, 2009). The product is subsidised and offered only to earning members of rural, landless families. An add-on feature of the product is an educational scholarship for two children of the insured. Another scheme, “SBI Grameen Shakti”, launched in 2009 by State Bank of India (SBI) is expected to reach large sections of the population through the wide reach of SBI and its subsidiaries. An interesting product “Max Vijay” of a private sector company, Max New York Life, requires a relatively high initial premium but offers great flexibility in premium payment thereafter. Table 9 lists the features of key micro life insurance schemes.

Health Insurance

189 The Scheme details have been obtained from Srinivasan (2009) unless otherwise stated.

190 Translates as “Common man’s insurance scheme”.

Table 9

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The need for health insurance is apparent as health shocks often severely impact low income groups. The expenses on medical treatment combined with the loss of income during the period hurt them simultaneously. While there are national health insurance schemes of the Government of India, these are often not marketed well as the features are not explained adequately to potential users. Moreover, the schemes do not have a committed distribution network. Hence schemes distributed and marketed by micro finance providers have potential to meet the need for such insurance.

Most health insurance interventions of MFIs and NGOs fall into one of two categories. One is a self funded scheme where the participants pool their premium payments and insure each other. Such schemes are usually found to be unviable as the risks faced by members in the same geographic area often tend to be closely correlated, particularly in cases of epidemics. The largest such scheme Yashaswini, is co-funded by the Government of Karnataka which has kept it stable. The linkage of the scheme with a network of 135 hospitals increases its attractiveness. Other prominent mutual insurance schemes are PREM in Orissa, Uplift India in Maharashtra and Dhan Foundation in Tamil Nadu.

Sri Kshetra Dharmasthala Rural Development Project (SKDRDP), Karnataka has a unique model. While it is also a mutual scheme, a part of the premium collected by it is passed on to an insurance company to diversify risk. The premium retained by SKDRDP is used to settle claims by members considered reasonable by SKDRP but rejected by the insurance company. The Karuna Trust also in Karnataka is another health insurance
scheme which is unique because it focuses on increasing the utilization of public health facilities\textsuperscript{191}. Brief features of the schemes are summarized in Table 9. It is apparent that while several small initiatives are having a positive impact there does not appear to be an effort to scale these up. Many of the schemes seem to be operational in only one particular state, Karnataka.

Dror et al.\textsuperscript{(2009)} studied three micro health schemes in India and concluded that very low premiums and low caps on payouts, designed to attract members and make the schemes viable, greatly limited their ability to provide adequate coverage and retain members. It appears that schemes will need to consider an appropriate trade-off between objectives of viability of the scheme and adequacy of coverage for members. The study also recognized the need to cater to different income levels among the poor by offering a variety of schemes. In particular it found through surveys that people were willing to pay between 1.12 and 2.64 percent of their income for health insurance premiums. Further, there was a distinct preference for schemes that provided for use of private as opposed to public health facilities.

\textit{Livestock insurance}

Livestock being an important asset for the poor in India, its insurance is important as death of an income generating animal is likely to result in a sudden fall in household income. The Kshetriya Gramin Financial Services\textsuperscript{192} (KGFS) and HDFC ERGO General

\textsuperscript{191} It is found that in some places public health facilities are underutilized because of the consumer preference for private facilities. Improving these facilities and creating a reputation for reliability and customer focus in public health facilities is essential for such initiatives to succeed.

\textsuperscript{192} A financial institution promoted by the IFMR Trust.
Insurance Company in 2007-08 pioneered a livestock insurance scheme in Tamil Nadu. When a farmer requests cattle insurance, an accredited veterinarian tags the animal with a radio frequency identification (RFID) tag. The details regarding the cattle are then entered using a laptop and sent on a real time basis to the insurance company. A policy note is issued on-the spot after payment of premium. Vaccines and de-worming medicines for the period of coverage are also given to the farmer on the same day. Loans are also provided by KGFS toward payment of premium. Claims under the policy are settled within 72 hours by KGFS and later reimbursed by the insurance company. Once the operations relating to the product stabilized, the premium charged was reduced by 30 percent. After the scheme’s success in Tamil Nadu where it was first introduced, it has been introduced in 2009-10 in Orissa and Uttarakhand.

_Crop Insurance_

Crop insurance is offered by the Government owned Agricultural Insurance Corporation of India (AIC), incorporated in 2002, which is the main provider of this kind of insurance. Crop insurance is essential for farmers who avail agricultural loans from banks. Studies have shown that the schemes of AIC are not usually marketed or distributed adequately. Moreover, as the unit for crop damage is at the block level which spans over 100 villages, localized crop damage is not compensated. The failure to settle such claims has led to disenchantment with the scheme. However, in two states (Gujarat

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193 This is an example of a product that was developed by trial and error on the field. Initially, the RFID tags were placed on the ear of the animal, which resulted in some cases of moral hazard, with some farmers selling the animal but claiming the insurance by cutting off the animal’s ear. Thereafter, the procedure was modified and tags were placed on the animal’s body.
and Rajasthan) the scheme is reported to be functioning well due to specific localized factors. In the former case, the insured had a high level of awareness and took good advantage of the product while in the latter case, due to the frequent dry spells encountered in the state the availability of insurance is found to be advantageous to the farmers (Srinivasan, 2008).

A promising development for crop insurance is the use of NDVI (Normalized Difference Vegetative Index) which taps on satellite imagery to estimate production yields in landholdings. This enables accurate assessment of actual yields, resulting in the development of a more effective microinsurance product. Such methods are in use in USA, Canada and Spain. The method has been launched in India by ICICI Lombard in the state of Punjab and by AIC in Haryana in the year 2009. If successful, more widespread use of the method is expected.

**Weather/ Rainfall Insurance**

The livelihoods of many low income groups in India depend on weather conditions. In the case of some households such as those dependent on farming, this is a major risk which needs to be insured.

Weather index based rainfall insurance was pioneered in 2003 by an MFI, Basix in collaboration with ICICI Lombard. Starting with a pilot, the product was gradually improved based on feedback from field officers and customers. This innovation by the private sector motivated the public sector AIC to also introduce a weather insurance product in 2004. In 2006, it is reported that 300,000 weather insurance policies were sold with a few other insurance companies also introducing such products (Skees, 2008).
Weather insurance is now also being marketed to non-farm enterprises affected by weather risks such as salt processors and brick makers. While in most cases policies have been sold without any subsidy element, the Government of Rajasthan provided a subsidy to a scheme customized by ICICI Lombard for orange growers in Rajasthan\(^{194}\) (Srinivasan, 2008).

While the weather insurance product in general has shown growth in India, some problems were reported, as farmers who had bought drought policies protested as their claims due to losses on account of excessive rainfall were declined. This highlights the need for proper explanation of product features to the customer at the time of marketing. In this case for instance, it needs to be explained that while crop yields could be affected due to various weather conditions and pest infestation, only some events are covered by the policy (Skees, 2008).

**Integrated Social Security Schemes**

In 2003, SEWA Bank, one of the oldest MFIs in India introduced an integrated insurance product called VimoSEWA. The product bundles together different kinds of insurance relevant to the needs of the typical SEWA member, a working low income woman. The product offers coverage for the death of an insured woman and her husband, hospitalization and asset loss. Health cover is optionally available to the husband and children of the insured woman. Asset loss covers natural disasters as well as manmade

\(^{194}\) Three significant perils were identified, adequacy of rainfall, its regularity and occurrence of consecutive dry days during the initial flowering period. A premium of Rs. 990 per acre was payable to cover all 3 perils and the sum assured was Rs.15,000.
ones such as riots. Members are encouraged to open fixed deposits with interest income to cover the premium payment. At present there are 70,000 members in the scheme and 90,000 lives have been insured.

SEWA has tied up with various insurance companies (LIC, New India Assurance, ICICI Lombard and AVIVA) for different components of the bundled insurance product. A positive feature of the product is that claims are processed in-house by VimoSEWA without referring to the insurance companies. The program still had a renewal rate of only 42 percent in 2005, which was incidentally higher than renewal rates in earlier periods (Sinha, 2006). The main reasons for drop-out from the scheme were lack of sufficient understanding of the product and absence of adequate field contact by the SEWA Bank staff. The scheme has moreover been found to be unviable, with the deficit being funded by donors. Efforts to reduce administrative costs and increase enrolment and renewal of members, need to be undertaken.
Table 9: Features of Microinsurance schemes in India (Source: Srinivasan, 2009)

<table>
<thead>
<tr>
<th>Micro Insurance Scheme</th>
<th>Eligibility</th>
<th>Cover</th>
<th>Premium</th>
<th>Add-on features</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Life:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LIC Aam Admi Bima Yojana</td>
<td>Earning members of Rural, landless families of age 18-59 years</td>
<td>Rs.30,000 on death (Rs. 75,000 in case of disability)</td>
<td>Rs. 200 annually</td>
<td>Subsidized, 50 percent by state and 50 percent by centre. Scholarship of Rs. 100 per month for 2 children studying in 9th to 12th standard.</td>
</tr>
<tr>
<td>SBI Grameen Shakti</td>
<td>Members of SHGs between 18-50 years</td>
<td>Rs. 30,000</td>
<td>Rs.361 annually</td>
<td>Close ended for 5 years If insured survives, after 5 years, 50 percent of premiums paid returned.</td>
</tr>
<tr>
<td>Max Vijay</td>
<td>10-50 years</td>
<td>5 times premium paid subject to maximum of Rs. 50,000/ Rs.75,000/ Rs.100,000</td>
<td>First premium -Rs.1000/ Rs.1500/ Rs.2500 Thereafter minimum Rs.10; maximum Rs.2500 per policy per day</td>
<td>Flexibility in timing of premium payments. No lapsation of policy for 10 years as long as account covers some basic charges. Partial withdrawals after 3rd year.</td>
</tr>
<tr>
<td>3 variations:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rajat/ Swarna/ Heera</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scheme</td>
<td>Number of members</td>
<td>Cover</td>
<td>Premium</td>
<td>Add-on features</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>-------------------</td>
<td>--------------------------------------------</td>
<td>--------------------------------</td>
<td>---------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Yashaswini in Karnataka</td>
<td>3.05 million</td>
<td>Rs.0.2 million</td>
<td>Rs.140 per person p.a. and 15% discount for family of 5</td>
<td>Co-funded by Government of Karnataka. Linked to 135 hospitals.</td>
</tr>
<tr>
<td>PREM in Orissa</td>
<td>0.15 million</td>
<td>Rs.5,000 for hospitalization and 50% of cost of medicines</td>
<td>Rs.30 per person p.a. (entire family has to enrol to address adverse selection)</td>
<td></td>
</tr>
<tr>
<td>Uplift in Maharashtra</td>
<td>62,000</td>
<td>Rs.15,000 for hospitalisation expenses in public facilities</td>
<td>Rs.100 per person p.a.</td>
<td>6 NGO/MFI partners</td>
</tr>
<tr>
<td>Kadamalai Federation, Dhan Foundation</td>
<td>15,000</td>
<td>Rs.10,000 per family</td>
<td>Rs.250 per family or Rs.200 per person</td>
<td>Cashless treatment facility; Wage loss compensation</td>
</tr>
<tr>
<td>SKDRDP, Karnataka</td>
<td>1.09 million</td>
<td>Rs.25,000 per family</td>
<td>Rs.800 per family</td>
<td>Rs.25,000 also for accidental death cover and disability cover</td>
</tr>
<tr>
<td>Karuna Trust, Karnataka</td>
<td>15,000</td>
<td>Rs.25,000 per person in Govt facilities</td>
<td>Rs.20 per person p.a.</td>
<td>Primary health facilities of Government</td>
</tr>
</tbody>
</table>
Appendix 4.3

Micro-pension plans in India

The first micro-pension plan in India was launched by a mutual fund, UTI Asset Management Company (AMC) in 2006. The majority shareholding in UTI AMC is held by public sector financial entities. But in January 2010, 26 percent of its shareholding was acquired by T.Rowe Price, a U.S. based investment management institution. UTI’s asset under management (AUM) were Rs. 653 billion in December 2010\(^{195}\).

The UTI micro-pension is based on small value of deposits (ranging from Rs. 50 to Rs. 200 per month); flexibility in payments (monthly or yearly contributions are not mandatory), and presence of a third party, such as a cooperative, SHG, MFI or an NGO. The non-mandatory nature of the contributions is an important departure from traditional pension plans. The contributions must typically be made until age 55 and the pension payments begin after age 58, with nomination facility being available on death of the person.

The third party acts as partner and its roles include, being a locus for generating a large number of members having common characteristics; undertaking certain administrative functions; and acting as a channel of communication. If instead the traditional agent model is used to obtain members, costs of customer acquisition and costs of servicing the account will be significantly higher. The value of micro-pension accounts being small, these costs on a proportionate basis could impact the viability of micro-pensions. The third party assists in reducing transactions costs involved by

\(^{195}\) As on December 31, 2010 (Source: [www.amfiindia.com](http://www.amfiindia.com))
identifying members, collecting contributions and record-keeping. The savings from members are pooled and transferred to UTI for funds management. Records are maintained on an individual basis and each member receives a unique account number.

The first scheme was launched in partnership with an urban cooperative bank, SEWA (Self Employed Women’s Association) Bank. SEWA Bank which works exclusively with low income working women in Ahmedabad, follows a philosophy of designing its products based on its members’ life cycle needs. It realized the need for a pension product for its members to plan for their old age. But it was constrained in offering the product as a bank in India was not able to provide savings products for a term longer than 10 years. It therefore decided to tie-up with UTI for the pension product.

Other partners that UTI has been given a mandate for micro-pensions, by COMPFED, are-a federation formed by milk producers in Bihar; Paradip Port and Dock Mazdoor Union (a labor union), self help groups of REPCO Bank, Union Bank of India and Bank of India and an MFI, SHEPHERD (Self Help Promotion for Health and Rural Development).

It is essential that the third party commands trust and confidence of the members as well as is competent in administration and financial management. Moreover both the trust and the competence must be sustained over a long period. In the case of SEWA Bank, as it is a cooperative bank, its members are also its shareholders and elect the bank’s board members, infusing greater trust among members. Increasing supply of such third parties is therefore critical to expanding the reach of micro-pensions.

While the micro-pension product offered by UTI through all these organizations is broadly the same, there are differences in operational formalities at the level of each
provider. For example, in the case of SEWA bank, as each member already has a savings account, all transactions are routed through it. Members are required to set on a yearly basis a target amount of contribution which is then transferred through monthly standing instructions to the pension account subject to availability of funds. However there are no penalties for not making the contribution on time (Gianadda, 2007). Other providers who are not incorporated as banks do not have the benefit of such a mechanism, and need to necessarily collect cash from members.

The fund management is undertaken by UTI. A maximum of 40 percent of the balances is invested in equity and the balance is invested in debt. Actual investment in equity is however around 20 percent. The target appears to be an annual return of 10 to 12 percent after all expenses. As core inflation has been in the range of 6 to 7 percent, if the target return is achieved, it would provide comfortably positive real returns, though it will still be below the recent rates of real GDP growth of 6 to 8 percent.

UTI AMC has made only minor adjustments in their usual charges levied for managing regular pension funds. The management fees range from 1.75 percent to 2.5 percent of assets depending on the assets under management. There are however, no empirical studies available as yet to estimate such costs as a percent of contributions and of assets and their behavior over time.

Unlike in the case of regular pension plans, there is no entry load. But exit load of 1 percent is levied if amounts are withdrawn before the agreed upon retirement age. The exit load appears to be harsh given the fact that economic and financial uncertainties, and liquidity and credit access constraints, loom large for the members of micro-pension schemes. Perhaps zero exit loads after suitable period of membership could be
considered. Alternatively provision of loans against deposited amounts may be offered, though this will reduce the power of compound interest, and lessen savings discipline.

The structure of the pay-out phase in the UTI AMC’s micro-pension plans appears to have received less attention. A phased or systematic withdrawal plan has been proposed after retirement until the amounts are exhausted. Till then, the amount will continue to be invested as in the accumulation phase. Instead, a gradually reducing level of risk exposure may be advisable after retirement. Moreover, other ways to structure phased withdrawals can be examined. Greater attention to this design issue is warranted, including the costs to the members of different types of options.

In savings-based micro-pension schemes, investment, macroeconomic and other risks are borne by the individual. Risk-sharing arrangements have therefore been often advocated. Some have argued for co-contributions by the government at the accumulation stage for participants in micro-pensions. Other options include risk sharing by the society (through government) at the pay-out phase. These could be in the form of special bonds or bank deposits with higher interest rates for senior citizens (with a cap on total investment) which vary according to market interest rates on long-term government bonds. This can be combined with well-targeted and reasonably funded old age assistance schemes financed from general budgetary revenue, for the elderly to address longevity risks.

More research is needed in the Indian context before designing risk-sharing options. In particular, design of options should aim to minimize the probability that populist policies may trump financial and economic sustainability.
The issue of who should bear the costs of the services of the third parties needs to be considered. If full costs are charged to members, micro-pension schemes may become financially unviable. Rigorous research efforts are needed to separate accounting and financial costs on the one hand from economic costs, which involve costing all the resources, used in delivering micro-pension services. Once these costs are identified, then cost-sharing arrangements among different stakeholders in both accumulation and pay-out phases can be further investigated.

In addition to design changes concerning exit load suggested earlier, the fund management fees will need to be substantially lowered. In the case of the NPS, the fund management fees based on competitive bidding is 0.009 percent. This is far lower than the 1.75 to 2.25 percent charged by the UTI AMC for micro-pensions. Admittedly, the two costs are not directly comparable. Nevertheless, they suggest possibilities for reducing costs. However, these will not come about automatically. The financial industry in general, and microfinance institutions in particular, will need to be innovative. Minor modifications to existing schemes, while useful as a beginning, would be insufficient if volumes are to be increased substantially.

For the back end operations and the MIS required for the scheme, SEWA has entered into collaboration with Invest India Micro-pension Services Limited (IIMPSL), a company set up with investment by SEWA Bank and UTI, to provide services for design and implementation of sustainable and scalable micro-pension and microinsurance schemes for low income groups. Collaborating with IIMPSL, enables MFIs to access better technologies than each of them would have individually been able to afford, due to sharing of overhead costs.
The UTI AMC is an example of provision of micro-pension through collaboration of MFIs with professional fund managers. The use of shared overhead costs by partnership with IIMPSL improves the viability of the scheme.

In the first year (2006-07), the UTI SEWA initiative fulfilled 35 percent of its target of 100,000 members\(^\text{196}\). SEWA has identified that typically low income women live on a day-to-day basis and hence it is hard for them to plan for the future. In order to help them change their mindset, SEWA conducts financial literacy programs for its members using videos and other visual aids. This enables them to communicate concepts to even illiterate members.

The other collaborations of UTI for the micro-pension product are more recent and information regarding the progress of the schemes is not yet available.

**Rajasthan Vishwakarma Unorganized Sector Workers (Motivational) Contributory Pension Scheme 2007 (RVPS)**

The other micro-pension scheme in the country is the Rajasthan Vishwakarma Unorganized Sector Workers (Motivational) Contributory Pension Scheme, launched in August 2008. This scheme is being jointly implemented by the Rajasthan state government and IIMPSL.

The scheme is open to resident workers of the state between the ages of 18 and 60 years belonging to 20 identified occupations. It targets those who are not members of any pension or provident fund scheme. Individual retirement accounts with unique

\(^{196}\) Source: [www.swwb.org](http://www.swwb.org).
identification numbers are opened and maintained under a central server with IIMPSL as the record keeping agency. The accounts are portable across the state.

The minimum contribution for the scheme is Rs. 100 at one time. The scheme is a co-contributory one with the Rajasthan State Government having committed to add a matching contribution to the members’ savings subject to a maximum of Rs. 1000 per annum per worker. As the co-contribution by the Government reduces the cost of retirement savings by the member, it acts as an excise subsidy on savings. Low income individuals are not liable to personal income tax. So income tax exemption does not benefit them. Co-contributions by the governments may therefore act as a useful incentive, similar to tax exemption for middle and higher income groups.

The government is paying an interest of 8 percent per annum on the total contributions in the retirement account. It is examining the possibility of investing the funds of the scheme with a fund manager regulated by the PFRDA. Upon reaching the age of 60 years, the member will receive a pension based on the sum total of member contributions, government contributions and interest generated.

As of March 2010, membership in the scheme was 50,000. IIMPSL estimates that in India, there are 80 million workers capable of saving for retirement. They also estimate the size of untapped annual savings to be as high as Rs.110 billion.\(^{197}\)

While sound architecture of the scheme is essential there is also a need for specific strategies to popularize it. In this context, there is a role for NGOs and other such organizations to provide the financial education required in order for these individuals to

\[\text{---------------------}\]

\(^{197}\) Source: [www.micro-pensions.com](http://www.micro-pensions.com).
understand the value of a pension plan. As identified by SEWA bank, initiation to the concept of micro-pensions needs to be preceded by a change in mindset, from day-to-day to long term planning. This in turn requires appropriate communication on a sustained basis in the least in the form of a short term financial education course. While schemes distributed through MFIs such as the UTI scheme may use the MFI as a channel to provide this service, other schemes such as the RVPS will need to involve NGOs or Government agencies to do so.

RVPS is an interesting experiment though the contribution by the government will impose a fiscal cost on the state. India’s fiscal deficit is already higher than 10 percent of its GDP and its internal debt to GDP ratio at 80 percent is well above the 60 percent considered fiscally sustainable (RBI, 2009). There is therefore a need to carefully consider the costs and benefits of different forms of state interventions including micro-pensions. A further challenge is that the pension funds need to be professionally managed. Considering the long time horizon, maintenance of returns at the fixed interest rate being offered, may need considerable financial expertise.
5. Microfinance Provider and Member Level Enquiries: An Analysis of Results of Empirical Study

The analysis of the results of the enquiries at the microfinance provider level and microfinance member level are presented in this chapter.

Section 5.1 provides details regarding the respondents. As in Chapter 4, the analysis is organized thematically. The three themes underlying the thesis, “Barriers to financial inclusion”, “Expected outcomes of financial inclusion” and “Graduation to individual financial services” are discussed in Sections 5.2, 5.3 and 5.4. In each section the responses obtained during interviews are summarized. Section 5.5 analyzes the findings with respect to the two cases at the microfinance provider level while Section 5.6 analyzes the findings at the microfinance member level. Section 5.7 integrates the findings under each theme from the three lines of enquiry and builds an explanatory framework for analyzing the role of microfinance in financial inclusion. Section 5.8 concludes the chapter.

5.1 Profile of respondents

Senior Management

The senior management interviews at GVMFL were held with the Chief Executive Officer and the Director (Operations). The senior management interviews at HIH were held with the Managing Trustee and the Program Director. In both cases one senior executive interviewed was female.

Field officers
Of the 103 field officers in 12 branches of GVMFL who were interviewed, 22 were women. There was no significant difference observed in responses of male and female field officers and hence these are not being separately reported. The average number of years of “microfinance” experience of the field officers was a little over 2 years. As the microfinance sector in India is relatively young, GVMFL as it expanded recruited field officers with various backgrounds. Some had been studying prior to joining the MFI while others had accounting or marketing experience in other businesses prior to doing so. The typical educational qualification of the field officers was a Bachelor’s degree or a diploma.

**Low Income Individuals**

The broad composition of the 34 low income individuals interviewed is given at Table 10. The demographic profile of the 34 women interviewed is displayed in the form of a matrix at Appendix 5.1. As mentioned in Chapter 3, the names of the participants have been replaced by alphabetic codes to ensure confidentiality. The median age of the women interviewed was a little above 38 years, while the range was between 27 and 59 years. The mode was 45 years. While one interviewee had studied till graduation and four interviewees had studied up to the 12th grade; the others had discontinued their studies midway through school.

The professions of the interviewees varied greatly. Many engaged in more than one activity. All of them were married, though three were widows. Except for one interviewee, they all had children. The median household income level was around Rs.8,350 per month while the range varied from Rs.2,400 to Rs. 20,000. The mode was Rs. 8,000 per month. This shows the diversity of participants in microfinance program.
At GVMFL, the median household income for urban interviewees (eight in number) was Rs.9, 250; for semi-urban interviewees (ten in number) it was Rs. 11,125 while for rural interviewees (five in number) it was significantly lower at Rs. 6,000. At HIH, interviewees (eight in number) were all from semi-urban areas and their median household income was Rs. 8,200. The members themselves however had lower incomes and their income ranged from nil to Rs. 11,500\(^{198}\). A few high income ones increased the average to around Rs. 2,300, though the mode was Rs. 500.

Those interviewed at GVML had been members for three to seven years while those interviewed at HIH were members for four to five years. 13 of the 25 GVMFL members interviewed (52 percent) were members in other microfinance organizations as well. However, only one out of the eight HIH interviewees mentioned that they were members of another microfinance organization\(^{199}\) (12.5 percent). As GVMFL also offered individual loans within the group framework to eligible members, nine of the 23 interviewees at GVMFL had graduated to these individual loans. As mentioned in \textbf{Chapter 3}, two drop-outs and an individual unable to access microfinance were also interviewed.

\(^{198}\) This particular member had invested her microfinance loans in a computer centre run by her sister for which she got investment income of Rs. 10,000 every month in addition to her own earnings of Rs. 1,500.

\(^{199}\) This could be because HIH more overtly discourages membership in multiple microfinance organizations resulting in interviewees not making full disclosures.
TABLE 10: COMPOSITION OF INTERVIEWEES AT MEMBER LEVEL

<table>
<thead>
<tr>
<th>Composition of Interviewees</th>
<th>Number of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>GVMFL Members:</td>
<td></td>
</tr>
<tr>
<td>Urban</td>
<td>8</td>
</tr>
<tr>
<td>Semi-Urban</td>
<td>10</td>
</tr>
<tr>
<td>Rural</td>
<td>5</td>
</tr>
<tr>
<td>HIH Members (Semi-urban)</td>
<td>8</td>
</tr>
<tr>
<td>Drop-outs (Semi-urban)</td>
<td>2</td>
</tr>
<tr>
<td>Individual unable to access microfinance (Semi-Urban)</td>
<td>1</td>
</tr>
<tr>
<td>TOTAL</td>
<td>34</td>
</tr>
</tbody>
</table>

(Source: Author)

5.2 Barriers to financial inclusion

While the sector level enquiry essentially focused on physical barriers to access by analyzing geographic trends in availability of microfinance services, the provider and member level enquiries tried to identify the practical barriers observed at the ground level even in areas where microfinance is well established.

5.2.1 Microfinance Provider level enquiry

Senior Management Interviews

The questionnaire used for the interviews is at Annexure 1. The questions that pertain to this theme are: “Q1. To what extent do MFPs cover financially excluded segments of the population in their areas of operation? Do you have data, aggregate or branch wise? Q2. Are there any financially excluded segments of the population that you
do not cover? If so, what are the reasons? Q3. What mechanisms are required to provide access to these segments?"

In the case of each of the two organizations, GVMFL and HIH India, it was found that though interviews with both executives were held separately, the responses were very similar. Hence, their responses are consolidated and presented as the views of senior management of the particular organization.

The senior management of GVMFL was aware that it did not reach all women who do not presently have access to financial services, even in the areas in which it operated. GVMFL branches, which were set up based on market studies by GVMFL managers, typically had a target to reach 4,000 families in a radius of five kilometers in rural areas and ten kilometers in urban areas. Usually only poor women who had an ability to engage in an income generating activity were selected. Data regarding the coverage of financially excluded population covered was not collected by the MFPs. But both MFPs mentioned that almost all their customers did not have bank accounts and hence were financially excluded.

GVMFL used a set of intuitive criteria to assess if an individual was low income and did not use the Government of India’s list of “below poverty line” families. The method of operation of GVMFL requiring members to attend training initially and regular meetings thereafter itself worked as a screening mechanism that prevented the “non-low income” from joining. Moreover, the meetings required all members to sit on the floor in a public place, often by the side of a road or a temple, which too acted as a disincentive.
There were instances when a non-low income individual\textsuperscript{200} attempted to join GVMFL attracted by the possibility of a loan. However, when the detailed procedures involved were explained to them, they backed out, without needing to be pressurized to do so.

GVMFL executives mentioned that a number of studies conducted by them had shown that borrowers benefited by their association with GVMFL. Their focus now was on replicating their model in other areas. Hence GVMFL was expanding geographically. GVMFL’s growth strategy did not specifically involve trying to cover other individuals not having access to financial services in the areas they were already operating in.

The senior management of HIH felt that as they (and other NGOs) drew their field officers from the communities with which they worked, they are able to identify and reach out to a large number of potential members. HIH used the Government provided BPL lists to identify customers but did not confine its members to the list. As the field officers of the NGO were themselves from low income groups, they made a special effort to include most of those who could be potential members. However, HIH representatives observed that despite the advantage that NGOs had, it was the MFI model that seemed to be growing faster, indicating that it was able to achieve larger operational scale. It was for this reason that HIH was in the process of setting up an MFI incorporated as an NBFC.

\textit{The above suggests that microfinance providers tried to reach low income women in areas surrounding their branches who were able to engage in an income

\textsuperscript{200} There was one instance when a lawyer’s wife wanted to join and another when a police inspector’s wife wanted to join (Discussions with GVMFL senior executives).}
generating activity and comply with the requirements of the group lending model. All financially excluded individuals were not expected to be covered. The focus was on quality of loan portfolio. Moreover, once branches reached the benchmark number of members, they focused on maintenance of portfolio by gradually increasing loan amounts and replacing members who dropped out. Further growth of MFPs to concentrate on geographic outreach and not through continuously increasing penetration in areas already covered. This focus of increase in geographic coverage enables rapid increases in outreach within a short span, perhaps enabling the MFP to attract the attention of potential investors and lenders.

Field officer Interviews

The questionnaire is available at Annexure 3. The questions relating to this theme were:

“Q1: Have you come across a situation where a financially excluded member could not access group microcredit?

Q2: If yes, approximately how frequently do you come across such cases?

Q3: What are the main reasons? Please rank them

Q7: What are the main reasons why members drop out of groups?”

101 out of 103 field officers interviewed mentioned that they do regularly come across individuals who want to join the group, but are not able to for various reasons. While the second question asked the field officers also attempted to obtain a

\[201\] It is quite likely that the 2 who said they had not come across such situations were overcautious in trying to play safe and not say anything that could possibly show their employer in negative light.
quantification of the average number of individuals excluded during each group formation exercise, it was found that most field officers were unable to estimate these numbers. This is because during the group formation stage, the focus of field officers is solely on forming groups. The officers have not been encouraged to collect information regarding those who do not successfully join the group. This could possibly be because as the market for microfinance so far has been largely untapped, branches are able to achieve the required targets without being forced to give much thought to these aspects.

The field officers were then asked to list out the main reasons why they are usually unable to do so. The first three reasons mentioned by each field officer were tabulated and the frequency with which each reason featured in the responses was calculated. Responses obtained in urban, semi-urban and rural areas were grouped and analyzed as the location of the member may have an impact on these factors. Table 11 summarizes the results relating to this question.

Table 11: Field officers’ Responses: Main reasons for Individuals not being able to join microfinance groups

<table>
<thead>
<tr>
<th>REGION</th>
<th>Reasons for not being able to join Microfinance groups</th>
<th>Percentage of Field officer responses that referred to the reason.</th>
</tr>
</thead>
<tbody>
<tr>
<td>URBAN</td>
<td>Inability to attend weekly group meetings</td>
<td>35%</td>
</tr>
<tr>
<td></td>
<td>Lack of address proof</td>
<td>28%</td>
</tr>
<tr>
<td></td>
<td>No economic activity to engage in</td>
<td>16%</td>
</tr>
<tr>
<td>SEMI-URBAN</td>
<td>Inability to attend weekly group meetings</td>
<td>38%</td>
</tr>
<tr>
<td></td>
<td>Lack of address proof</td>
<td>28%</td>
</tr>
<tr>
<td></td>
<td>No economic activity to engage in</td>
<td>20%</td>
</tr>
</tbody>
</table>
Table 11 indicates that the same three reasons were cited in urban, semi-urban and rural areas as the main reasons for lack of access to microfinance. These were inability to attend weekly group meetings, lack of address proof and not having an economic activity to engage in. In rural areas, “lack of address proof” ranked highest while in urban and semi-urban areas “inability to attend weekly meetings” emerged as the most important reason.

With regard to the first reason, it was mentioned by field officers that the nature of the work of some low income women such as day laborers who worked at distant locations (such as factories or construction sites) required them to leave for work early in the morning much before group meetings are usually held. This meant that these women had to lose their daily income if they wanted to join a group.

On the second reason regarding lack of address proof, it was mentioned that at times women did not have an address proof when they move into a village after marriage. They also hesitate to go through the processes required to obtain it, as they often are

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202 Group meetings typically start around 6.30 or 7.00 a.m. These workers leave their homes by 6 a.m.
afraid to go by themselves to Government offices. This issue appears to be particularly important in rural areas\textsuperscript{203}.

For the third reason, on lack of economic activity, field officers gave examples of low income women who are rag-pickers who sometimes approach MFIs for loans. As they do not have a particular income generating activity into which they can invest the loan funds, MFI field officers as well as other group members are hesitant to include them in groups.

The researcher found while discussing with branch managers that there were also many instances of members dropping out of groups. Most MFIs including GVMFL do not specifically track this figure, as usually a member who drops out is replaced with a new member.

As these drop-out members are unable to access microfinance in an ongoing manner, information regarding the main reasons for members dropping out was gathered and Q7 was added to the questionnaire for field officers. Table 12 summarizes the findings in this regard.

\textsuperscript{203} The national unique identity number initiative discussed in Chapter 4 would be useful in addressing this issue.
TABLE 12: Field officers’ Responses: Main reasons causing members to drop out.

<table>
<thead>
<tr>
<th>REGION</th>
<th>REASONS DROPPING OUT</th>
<th>FOR Percentage of Field officer responses that referred to the reason.</th>
</tr>
</thead>
<tbody>
<tr>
<td>URBAN</td>
<td>Migration</td>
<td>38%</td>
</tr>
<tr>
<td></td>
<td>Inability to attend centre meetings</td>
<td>23%</td>
</tr>
<tr>
<td></td>
<td>Default</td>
<td>16%</td>
</tr>
<tr>
<td></td>
<td>Migration</td>
<td>32%</td>
</tr>
<tr>
<td></td>
<td>Marriage</td>
<td>18%</td>
</tr>
<tr>
<td>SEMI-URBAN</td>
<td>Migration</td>
<td>32%</td>
</tr>
<tr>
<td></td>
<td>Marriage</td>
<td>18%</td>
</tr>
<tr>
<td></td>
<td>Inability to attend centre meetings; Default</td>
<td>15%;15%</td>
</tr>
<tr>
<td></td>
<td>Default</td>
<td>29%</td>
</tr>
<tr>
<td></td>
<td>Migration</td>
<td>24%</td>
</tr>
<tr>
<td></td>
<td>Marriage</td>
<td>21%</td>
</tr>
<tr>
<td>RURAL</td>
<td>Default</td>
<td>29%</td>
</tr>
<tr>
<td></td>
<td>Migration</td>
<td>24%</td>
</tr>
<tr>
<td></td>
<td>Marriage</td>
<td>21%</td>
</tr>
</tbody>
</table>

(Source: Author)

It seems that migration, marriage, default on the loan and inability to attend centre meetings are the main reasons why members are forced to drop out. When families migrate, there is no provision for members to transfer their account to the new location, even if the MFI has a presence there. This implies that members have no choice but to drop-out. On moving to the new location, they have to once more commence the process of forming a group, providing address proof and undergoing training before they are able to access microcredit. When women get married, as they typically move to the area where their husbands reside, they have to again drop-out of their existing MFI. If they want to access microcredit in the new location, they have to again go through the membership process. “Default on the loan” refers to a situation when a member either is unable to repay a part of the loan or repays it with considerable difficulty. Such members usually drop-out before the next loan cycle. “Inability to attend centre meetings” refers to situations when circumstances change and a member is no longer able to attend centre meetings.
meetings. Usually this is due to change in job location such as, when members decide to take up jobs in nearby cities requiring them to leave house early in the morning. As they are no longer able to attend the centre meetings, they drop-out of the MFI.

These findings indicate that there are individuals who may want to access microfinance but are not able to do so due to a number of reasons. First is the requirement to regularly attend weekly group meetings in the mornings. Second, even though documentation requirements of microfinance institutions are minimal, there are some individuals who are not able to comply with them. Typically, they do not have a proof of address. While field officers state that such individuals can visit the local Government officials and obtain a letter of proof fairly easily if they are residents of the place; it appears that a number of them are hesitant or lack the resources to do the needful. Third, the lack of an economic activity is a significant barrier to accessing microcredit. There is perhaps need for such individuals to obtain some skill training prior to joining a microfinance group.

The findings also indicate that current access to microfinance services does not necessarily imply ongoing access to financial services as in a number of cases it is found that the access is purely temporary as members drop-out. There is a need for greater portability of microfinance accounts in order to address drop-outs due to migration and marriage. To address the drop-outs due to default on loans, access to savings services would be useful to enable such members to continue their use of financial services and prepare for contingencies. This is particularly important as they no longer have access to loans. Drop-outs on account of inability to attend centre
meetings need to be addressed perhaps by offering these members the option to avail branch based services.

5.2.2 Member level enquiry

The questionnaire for members is available at Annexure 3. The question relating to this theme is “Q9: Have you come across a situation where a financially excluded individual could not access group microcredit? If yes, what are the reasons?” All the interviewees uniformly mentioned that only those unable to meet the MFI’s conditions regarding meeting attendance or weekly repayment refrained from joining. Box 5.1 has a summary of an interview conducted by the researcher of one such individual.

As dropping out of a group implies that microfinance access is temporary, two members who had dropped out of their groups were also interviewed to understand the motivations for their decisions which are discussed in Box 5.2. One of the drop-outs, chose to discontinue her membership because she no longer had a need to borrow, while the other was forced to do so due to temporary migration to another geographic location. As credit is the only service\(^\text{204}\) provided by the MFI, continuous membership for a long time implies continuous borrowing by the member. This may not in itself be undesirable as enterprises have working capital requirements, for which some short term borrowing may be required periodically. However, borrowing continuously on behalf of various family members may prevent a member from saving for her old age as is illustrated in

\(^{204}\) Though insurance is also provided, it is an add-on service provided to its borrowers and is not viewed as a stand-alone product.
Box 5.3 by the case of a seven-year MFI member whose continuous membership may not necessarily be to her personal advantage.

The findings provide further examples of the situations described by field officers when members are unable to access microfinance as well as the reasons why members drop-out. There are cases when individuals are not able to join microfinance groups due to their inability to comply with the requirements of group lending. The lack of portability of microfinance account may cause members to drop out when they relocate. As credit is the only service provided by MFIs at present, continuous borrowing becomes a condition for membership. Members may therefore drop out if they no longer need to borrow. Consequently, continuous MFI membership implies continuous borrowing. While borrowing periodically on a continuous basis for enterprise working capital may be understandable, borrowing for other family members continuously may prevent members from saving for their retirement.

5.3 Outcomes of financial inclusion

5.3.1 Microfinance Provider level enquiry

Senior Management Interviews

This theme is addressed by the following questions in the interview format at Annexure 1.

“Q4. Are there any financial services that you feel you should offer but are not doing so right now? If so, what are the constraints preventing the launch of these products?

Q6. Is the financial training they receive at the time of joining sufficient to enable them to handle individual loans in future?
Q7. If a member wants to stop borrowing but would like to avail other financial services such as insurance for example, is it possible? If no, why not? If yes, how many such members do you have so far?

Q8. Do members build up individual credit histories when they avail loans from your organization? How is it recorded? Can they take advantage of it to avail financial services from elsewhere in future?”

GVMFL representatives stated that the only financial service that is focused on is lending, primarily due to regulatory reasons preventing them from offering savings services. Though insurance is also provided, it is an add-on service provided to its borrowers and is not viewed as a stand-alone product.

Even though the Government had introduced the “business correspondent” model by which an MFI (other than an NBFC) could act as a business correspondent of a bank, the model was not attractive. This aspect will be discussed further in Chapter 6.

HIH representatives emphasized savings, particularly when an SHG was first formed. After six months of regular savings only was a loan considered for an SHG. As explained in Chapter 4, internal loans are given within the SHG once the savings of a group reached a reasonable amount. However, often the loans given as part of the SBLP were not sufficient for members. This was one of the reasons why HIH also had its own microfinance program, though this will soon be discontinued once the NBFC incorporated by HIH is operational.

On creation of credit histories, both GVMFL and HIH maintained individual records of members of a group and so at the MFP level, credit histories were created. The member however does not have any documentary proof of their credit history. In the case
of GVMFL, though each member has an individual passbook, these are collected back by the MFI once a loan is repaid. In the case of HIH, record keeping is in the books of the SHG and again the individual does not have proof that they could show anyone. For credit histories to be created and be useful to members in increasing access to various financial sources, a credit bureau is required. Both GVMFL and HIH representatives mentioned that the credit bureau initiative was being considered by MFIs though it was not certain how successful it would be. In particular there were concerns regarding sharing customer data directly with competitors.

With regard to the training on financial literacy for members, GVMFL representatives mentioned that while group leaders were trained regularly, it was hard to train each individual member due to capacity constraints. HIH representatives mentioned that the leader and the deputy leader of every SHG attended a training which enabled them to maintain the SHG’s records and accounts. Moreover other specific skill development trainings such as embroidery and making handicrafts are also organized by NGOs, including HIH from time to time which are open to interested members. The members are also provided with a daily allowance when attending workshops to compensate them for the daily wages they have to forego on account of the training. However, discussions with members revealed that these trainings, though useful, are not sufficient to enable them to start a business. The members opine that if the NGO can

205 It was only later that MFIN finalized the plan as mentioned in Chapter 4.

206 The cost of maintaining the database is also likely to be a disincentive due to the small value and high frequency of transactions in microfinance. However, maintenance of the database through frequent updating is an important determinant of its usefulness. MFIN will probably need to cover the costs through fees collected from member MFIs.
arrange for internships in similar successful enterprises in other nearby locations it could be more useful.

*The findings show that the SBLP model focuses on savings as well as credit while the MFI model focuses only on credit, primarily due to regulatory reasons. However the MFI model seems to offer larger loan sizes and greater scalability for providers. With regard to credit histories, microfinance providers maintain credit histories of individual members, though at present these are not shared with any outside party. While providers agree that a credit bureau would be useful for the sector as a whole, there are concerns regarding sharing customer data with competitors. It therefore appears that an initiative to establish a credit bureau will need to address these concerns by involvement of a professional third party in its administration*\(^{207}\). Both models provide training on their respective products though SBLP additionally trains leaders and deputy leaders on maintaining records. Training specifically on financial concepts and financial planning does not appear to be a regular feature of microfinance programs.

**Field officer Interviews**

“Q4: Are there any financial products which are currently not being offered but which members ask that you should offer?” relates to this theme. All the field officers answered this in the positive. They were then asked to list what they were. The first three products mentioned by each field officer were tabulated and the frequency with which

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\(^{207}\) The MFIN initiative to establish a credit bureau (described in Chapter 4) addresses these concerns by involving a professional third party.
each product featured in the responses was calculated. Responses obtained in urban, semi-urban and rural areas were grouped and analyzed as the location of the member may have an impact on the products requested. **Table 12** summarizes the results relating to this question. It was found that the same requests namely that for higher loan amounts, housing loans and education loans featured on the case of all three regions. However, in the case of urban areas, nominee insurance, which means insurance of the life of the nominee (usually the husband), was also requested. As typically wives tend to be younger than husbands, they often outlive them. As the husbands of most of these women are not part of a pension scheme and their lives are also not insured, widows have to contend with a sharp drop in household income after their death; hence the request for nominee insurance.

**Table 13: Main products requested by members**

<table>
<thead>
<tr>
<th>REGION</th>
<th>PRODUCT REQUESTED BY MEMBERS</th>
<th>Percentage of Field officer responses that referred to the reason.</th>
</tr>
</thead>
<tbody>
<tr>
<td>URBAN</td>
<td>Higher Loan amounts</td>
<td>22%</td>
</tr>
<tr>
<td></td>
<td>Housing Loan; Education Loan</td>
<td>19%;19%</td>
</tr>
<tr>
<td></td>
<td>Savings; Nominee Insurance</td>
<td>14%;14%</td>
</tr>
<tr>
<td>SEMI-URBAN</td>
<td>Housing Loan</td>
<td>33%</td>
</tr>
<tr>
<td></td>
<td>Higher loan amounts</td>
<td>32%</td>
</tr>
<tr>
<td>RURAL</td>
<td>Education Loan</td>
<td>14%</td>
</tr>
<tr>
<td></td>
<td>Higher loan amounts</td>
<td>41%</td>
</tr>
<tr>
<td></td>
<td>Housing Loan</td>
<td>28%</td>
</tr>
<tr>
<td></td>
<td>Savings; Education Loan</td>
<td>14%;14%</td>
</tr>
</tbody>
</table>

(Source: Author)

*The field officers’ interviews indicate that members’ need for loans has perhaps still not been fully met and hence higher loan amounts are demanded. On the other*
hand, it could also be that since members are aware that the main business of the MFI is provision of loans, more of the same was requested. Savings, though required, may not have always been specifically requested as most members are aware that it is not permitted as per regulation. Instead, higher loans may be sought so that part of it could be put away in the form of savings in kind such as ornaments which could come in handy in times of emergencies. The need for housing loans reflects the need to build assets for security in future. Education loans again are sought to improve income earning capacities of children. The greater awareness in urban areas perhaps lead additionally to request for nominee insurance which could be very useful due to lack of social security or insurance for husbands.

5.3.2 Member Level Enquiry

This was addressed by asking a number of questions (Q 1 to 5 as well as Q7 and Q10 of the questionnaire at Annexure 3).

“Q1. What are the sources of your family income and how much does each source contribute? Are there any fluctuations in the income during the year? What were the sources when you joined the MFP? What were the fluctuations then? “

Q2. Financial decisions

a. Savings-

Where are you saving your money and why?

Jewelry/ safe/ bank / others;

Reason for saving;

b. Loans
Trace out the history of the different loans availed in the last three years and the utilization by your family. What is the interest rate on the different loans?

How many times have you had to borrow from the money lender in the last 3 years, when and why? What is the interest rate you paid?

If another MFP were to offer you a loan, how would you decide if you should take the loan from them or from your existing MFP?

Are you able to repay installments of the loans comfortably? If not, why? If yes, how do you manage?

Q3. At any stage did you think you needed any financial products which you could not access? If so, details?

Q4. Do you know which other MFPs operate in this area? Do you know what terms they offer? How many MFPs have you dealt with? Are you happy with the services you got?

Q5. Financial Planning

What are-

a. Your costs to produce/ work per week?

b. The expenses of your family per month;

c. The incomes of your family per month;

d. Your capacity to save money?

e. Are there any major expenses for your family in the next few years? How do you plan to meet them?

f. How do you plan your day-to-day finances? Has there been any difference in the way you plan them after becoming an MFI member?
Q7. Have you planned what to do with your next loan? How long do you plan to keep borrowing?

Q10. What are your suggestions for the MFP?”

The questions were posed in order to understand the financial position of the household, how it has changed since microfinance membership, the manner of utilization of the loans and whether the member demonstrates understanding of financial concepts and financial planning. Finally there was also a question that seeks to understand if there is a need for any financial service that is not being met at present.

The responses under this head are organized thematically and not question wise. The findings for the group of 31 microfinance members as a whole are discussed. If there are any specific differences observed between urban, rural and semi-urban members; between MFI and SBLP members or between graduates and non graduates, these are highlighted.

Sources of Family income

The share of the 31 microfinance members in their household income varied from 100 percent to zero percent, while the average share was 26 percent. Only in five out of the 31 cases (16 percent), the member’s share in household income was 50 percent or more, of which in three cases microfinance members had a joint business with their husband and their share was assumed to be 50 percent. The two cases where members’

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While 34 interviews were conducted, 31 were of microfinance members, two were of drop-outs and one was of an individual unable to avail microfinance.
shares were greater than 50 percent and two cases where members were not contributing to family income are discussed in Box 5.4.

Seven of the 31 members (22.5 percent) derived some part of their income from agriculture, which showed variation in returns from year to year. Their typical land holding was between one to two acres, and hence they had to supplement their agricultural income with income from other sources. Another five had household income from professions (such as photography or spray painting) where the returns varied on a seasonal basis. In all, 12 out of the 31 cases (39 percent), the household income showed variation of some kind. The members did not have any particular mechanism or instrument for handling the variability. However, most of them had multiple sources of income so that some minimum income continued throughout the year. Some of them worked as day laborers during periods when their regular activity was not in season.

It appears that the share of microfinance members to household income varies greatly and except in a minority of cases, their share is often less than half. Many of the members’ household incomes are characterized by variations of different kinds.

Change in household position since microfinance membership

As those interviewed had been microfinance members for three years or more, most of them could not recollect precisely the details of their household income when they joined\textsuperscript{209}, though they recalled how they had utilized each loan. The MFI also did not

\textsuperscript{209} The tendency was to use vague terms such as “it was very low”.

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precisely record household income details earlier, though recently they have commenced doing so.

When all loans taken by the members from the microfinance provider (GVMFL or HIH as the case may be) since commencement of membership are considered, the percentage used for the member’s own or joint\textsuperscript{210} business was on average 34 percent though the range of variation was from 0 percent (in eight cases) to 100 percent (in seven cases). In the case of five of the 31 MFI members, it was observed that the early loans of smaller value were utilized for the member’s own activity but as the loan progressively became larger, they were deployed for the husband’s activity. It appeared that the tiny enterprises of the members were unable to absorb the larger loans offered at later stages and hence these were usefully deployed in the husband’s enterprise.

In 19 of the 23 cases (83 percent), utilization of microfinance loans had resulted in enhancement of income earning capacity as a new line of activity was commenced (by the member or a member of her household) or an existing line of activity was expanded. While there may be occasions when some part of a microfinance loan had gone towards consumption smoothing, the majority of the loans had gone towards the business activity. This however cannot be termed as the impact of microfinance as it is hard to decide if access to microfinance loans was solely responsible for the outcome as other factors too may have contributed to the enhancement of income\textsuperscript{211}. In the absence of the microfinance loan, the household could well have accessed loans from other sources.

\textsuperscript{210} The share in the case of joint business with the husband is taken as 50 percent.

\textsuperscript{211} This is one of the challenges in measuring the impact of microfinance referred to in Chapter 2.
(though perhaps at a higher rate of interest) and initiated or expanded the activity. In any case, these members may be termed as “effective utilizers”.

The other four members\textsuperscript{212} had consistently utilized the microfinance loan for repaying existing high cost loans and consumption expenditure (such as payment of school fees, hospital expenses, repayment of other loans, gifts for relatives and household expenses). In these cases too, the microfinance loan is likely to have benefited the member as in its absence the member would probably have still incurred these expenses by availing higher cost loans from other sources. However, these members can be termed as “ineffective utilizers” who consistently use the microfinance loan funds in a manner that does not substantially impact long run household income. Moreover, accessing progressively higher amounts of loan as is the practice in microfinance too may not be in their interest as it may lead to considerable strain on their finances over time. This is because the increasingly high interest amounts have to be serviced from existing income sources. At the same time, a plateau in loan amounts may cause disinterest in the member possibly causing them to lose interest and drop out.

As against this the “effective utilizers” utilize the funds in a manner that leads to potential increase in household income, even though they may not always be entrepreneurs. This could be by investment in a husband, son or daughter’s enterprise (by way of working capital or capital expenditure)\textsuperscript{213}.

\textsuperscript{212} Members P, W, X and Z.

\textsuperscript{213} It is not very clear if the case of “L” discussed in Box 5.4 whose investment in her cousin’s enterprise provides her regular investment income is desirable. It can be argued that in some ways this amounts to arbitrage by on-lending borrowed funds at higher interest rates.
There were also differences observed among SBLP members in their loan utilization. Here too there are “effective utilizers” who use the SBLP loans for income generation activities. The second are the “cash flow smoothers” \(^\text{214}\) who do not avail large or long term loans as the other group members do not think they can repay them, but keep borrowing and returning small value loans taken through the internal lending mechanism. Unlike in the case of the MFI where the MFI field officer decides the loan amount for each member, in the SBLP the group members decide how much loan each member can avail. While even the access to internal loans of the SHG helps them in managing their cash flows, these members cannot be expected to improve their income levels substantially over time. This is because the lack of access to larger loans can prevent them from making larger investments that may be required in order to do so. It is also possible however that some of these cash flow smoothers could have been “ineffective utilizers” much like the ineffective utilizers in the MFI model. The other SHG members knowing their group members well may be allocating the funds to those who can utilize it productively. One last category was noticed, “the consistent savers”. Though among the interviewees only one\(^\text{215}\) (BB) displayed these characteristics, according to other members and HIH personnel, there are other similar cases of those who use the SBLP mainly to park their excess funds. The attractive rate of return of 24 percent on internal loans of the SHG is a contributory factor. While they may earn higher returns as moneylenders, there has been a fall in demand for these funds subsequent to increase in

\(^{214}\) Members, AA, FF, GG and HH.

\(^{215}\) Member, BB
microfinance availability. The existence of “consistent savers” is itself not an issue and is in fact desirable as these individuals enable greater fund availability to other SHG members. The only issue that arises is that when the SHG avails “state subsidies”\textsuperscript{216}, these individuals who have cash surplus are also likely to be included among the beneficiaries. This is because they typically have substantial clout within the SHG and would insist on their share of these subsidies\textsuperscript{217}.

The phenomenon of “pipelining” of the loans to other members of the family observed by Todd (1996) in the Bangladesh context was also observed in the study. In fact on average the utilization of the loan for the member’s own businesses seems to less than half. However, pipelining has not worked negatively for the members and it is observed that it helped their household members (husbands, sons or daughters) establish and run businesses which contributed substantially to family income.

To the extent that for the recipients, microfinance loans are cheaper than loans from most outside sources, they are beneficial to all members who would have contracted more expensive loans in their absence. However, when tangible benefits in improving income earning capacities of members are examined, two distinct categories of MFI members can be identified, “the effective utilizers” and “the ineffective utilizers”. The former are more likely to improve their income levels substantially over time. The latter have to be careful in keeping their borrowing within tight limits so as to avoid straining

\textsuperscript{216} As mentioned in Chapter 4, SHGs are often channels for state funded poverty alleviation programs.

\textsuperscript{217} The study by EDA-APMAS(2006) has also pointed out the non homogeneity in SHG membership which often translates into inequalities within the group.
their financial position unduly. They need to look for other means to improve their income levels over time such as skill development and vocational training. Even though all of them are not the poorest individuals in the group, the high interest rates paid on MFI loans is likely to prove to be a financial burden over time, if not utilized appropriately in income generating activities. Three different kinds of SBLP members are observed, “the effective utilizers”. “the cash flow smoothers” and “the consistent savers”. The “cash flow smoothers” are not able to avail larger loans as they typically lack the required group support though they keep availing and repaying smaller value loans in order to smooth their cash flows. This category of individuals is unable to make the investments required to substantially increase their incomes over time. The final category of SBLP members observed are “consistent savers”. These individuals help increase availability of funds for the SHG though this may result in their availing state subsidies even though they may not be part of the target group.

Financial Instruments Used

Out of the 31 microfinance members, 23 (74 percent) reported that they saved regularly. In four cases, the savings were in excess of Rs. 1,000 per month. The “mode” for monthly savings was Rs. 100, usually with their self help group\(^{218}\) which 17 interviewees used. Other savings instruments used were insurance policies of the Life Insurance Corporation of India (LIC)\(^{219}\) (used by six interviewees), post office accounts

\(^{218}\) SHGs usually insist on a minimum regular monthly saving and hence this saving may in fact not been entirely voluntary.

\(^{219}\) LIC policies are often viewed as a long term savings instrument in India
(used by five interviewees) and chit funds (used by five interviewees\textsuperscript{220}). Four interviewees mentioned that they had a bank account though when asked if they used it regularly they replied in the negative, citing inconvenience of location associated with high transaction costs as an issue. The most commonly stated reasons for saving were children’s higher education, daughter’s marriage and old age.

\textit{As also observed by Rutherford (2001), this study too suggests that low income individuals see value in saving. The instruments that they seem to be comfortable using are savings with SHGs, insurance policies, post office accounts and chit funds. As the interviewees do not seem to actively use bank accounts, it seems that microfinance does typically reach those excluded by banks.}

\textbf{Financial planning and awareness of financial concepts}

Only four of the 31 members (13 percent) interviewed said they planned their finances. The others said they that just managed on a day to day basis. Some typical cash flows of members interviewed are at \textbf{Appendix 5.2}.

In order to examine the level of awareness about the terms of microfinance loans, the interviewees were questioned regarding the rate of interest they paid on it. Nine of the 31 (29 percent) members said they were not sure of the interest rate charged by the MFI. Of the nine four of them were MFI group leaders. When questioned about the fact that the interest rate is repeatedly mentioned by the MFI during the initial training session, all of

\textsuperscript{220} A chit fund is a kind of “rotating savings and credit association” popular in India. Subscribers to a chit regularly contribute to a pot which is auctioned to the highest bidder at the end of each time period. A foreman usually conducts the scheme for which he/ she earns a commission.
them replied that they later forgot about it. It appeared that loans are taken repeatedly by members without analyzing if the returns from the investment of the loan justify the interest rates paid on them. It was noted however that all the members of the SBLP interviewed were aware of the interest rate they paid. This could be because of the fact that book keeping in this model is handled by the SHG members themselves.

It was observed that the members of the MFI also displayed a lack of awareness regarding financial concepts as a number of interviewees mentioned that the MFI of which they were members was cheaper than others because all the installments are not of equal size as they are structured to reduce in size over the period of the loan. Front ending of installments actually results in a higher effective cost of the loan, particularly as interest rate in this case is calculated not on a declining but on a flat basis. While the MFI was very transparent in sharing its method of interest rate calculation with the researcher, they said that the lack of awareness of the members prompted them to use techniques such as front ending of the installments to keep them satisfied.

Some members who had multiple MFI memberships justified their decision to borrow repeatedly based on a comparison of the interest rate charged by the MFI with that charged by moneylenders. None of them seem to have assessed their ability to service debt.

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221 This means that in calculation of interest, the loan installments repaid are not taken into account. Appendix 6.2 of Chapter 6 provides an illustration of the difference between flat and declining interest rates.

222 Members L and Q.
The study findings indicate that awareness regarding financial concepts and financial management needs to be nurtured more specifically in microfinance members. SBLP members displayed higher degree of awareness regarding interest rates, perhaps as book keeping is done by group members\textsuperscript{223}. Inability of the member to assess their repayment ability (taking into account all their liabilities) could be a serious risk factor when loan sizes and access to loans increase over time, not just for the member but the MFI as well.

Financial Needs not presently met

The experiences of MFI members (23 in number) and SBLP members (eight in number) are discussed separately here as the nature of financial services accessed in both cases differ.

Need for Savings Services for MFI members

Seven of the 23 MFI members (30 percent) felt the need for savings services, not presently offered. Some of the members in fact used or planned to use MFI loans as a means to save as illustrated by the examples in Box 5.5\textsuperscript{224}. Such practices have been noted by Rutherford (2001) and Collin et.al. (2009). Banerjee and Duflo (2010) argue that while microcredit may serve a useful purpose as a commitment to save, it may not be

\textsuperscript{223} Though the leader and assistant leader are the ones carrying out book keeping tasks, other members probably keep a broad check to ensure that the books are in order as they are not “professionals” unlike in the case of the MFI Model.

\textsuperscript{224} Such instances are termed as “saving down” by Rutherford in his essay on “The poor and their money” (Rutherford, 2001).
the best way to save, as saving in a more direct form is clearly superior as it involves receiving rather than paying interest.

The SBLP offers savings products and hence also caters to those looking for an avenue to channel savings. The case of one member who joined the SBLP primarily to save is discussed in Box 5.6.

Inflexibility regarding disbursement of MFI loans

The method of operation of the MFI involves the group as a whole availing a loan, repaying it over a 50 week period and once more applying for another round of loans. This means that loans are available to members of a particular group at only at a certain time during the year when one lending cycle is completed. While this shortcoming in financial services was not articulated by the interviewees, it was observed by the researcher. Based on two cases of MFI members interviewed, when there was a timing mismatch between the need of a member and the availability of the loan. Often when there are shortfalls, members mentioned that moneylenders’ funds are used to bridge the gap temporarily. Two cases in which this inflexibility worked to the disadvantage of members are described in Box 5.7.

Need for Educational Loans for both MFI and SBLP members

Four out of the 31 interviewees (13 percent) had used large amounts (in excess of Rs. 10,000) towards payment of fees for professional/ vocational courses for their children. The repayment schedule of microfinance loans as it is at present is however not suitable for educational loans as these require a longer repayment schedule. However as there is
no alternative, members use the loans for this purpose even though it often puts a severe
strain on their finances. Often there is a regular dependence on moneylender loans to
bridge the cash flow gap till they obtain the disbursement of the next loan.

Need for individual loans for SBLP members

All the SBLP members had access to savings, however three out of the eight
members felt the need for larger loans than what was presently offered, out of which two
mentioned that they would like a loan on an individual basis. An example of one such
case is at Box 5.8.

The findings indicate the need for savings services for MFI customers and individual
loans for SBLP members. Both kinds of members also appear to need educational
loans. The variation in income observed in a large number of members’ cases also
underlines the need for savings services. The need for greater flexibility with regard to
timing in availing MFI loans could also benefit members considerably. Moreover,
when MFIs introduce individual loans, members need to be assisted on how to fulfill
formalities. While MFI field staff is usually available to answer queries, members may
not be in a position to ask the right questions and hence personalized guidance may be
required.

5.4 Graduation to individual financial services

5.4.1 Microfinance Provider level enquiry

Senior Management Interviews
In the sample questionnaire in Annexure 1, the following questions correspond to this theme.

“Q5. What do you envision as the future of group microfinance members? Do you think they should be graduated out of groups? What are the reasons?

Q7. If a member wants to stop borrowing but would like to avail other financial services such as insurance for example, is it possible?

If no, why not?

If yes, how many such members do you have so far?”

As mentioned in Chapter 4, GVML has already introduced individual loans for members who have completed at least two years of membership and who were able to produce guarantees from two individuals who are in Government service or who have an established business. Even though these loans are not covered by joint liability, the member continues to be part of the group and repayments of the loan are made in group meetings. Representatives of GVMFL believe that being in the group helps give the woman an identity. It also provides them with support to enable them to actively engage in an issue of social or personal importance if they wish to do so. GVMFL believes that women may be very vulnerable in the absence of group members.

HIH representatives also felt that the group mechanism was important for women. For members showing exceptional enterprise, HIH sometimes considers providing a recommendation to the bank for an individual loan. Some bank managers were open to such recommendations and were looking to increase their customer base in this manner. However others may be more risk averse. HIH representatives mentioned that even if she obtains an individual loan, being in the group gives the women strength. The model of
some SHG federations (discussed in Chapter 4), which over a period of time were able to run themselves, enabling the concerned NGO to withdraw, was quoted as an example of graduation of members and not graduation to individual loans.

Field officer Interviews

The following questions in the interview format in Annexure 2 relate to this second theme:

“Q5. In your experience, have group microcredit members expressed a desire to move out of groups into individual financial services?

Yes □  No □

How many of your borrowers have asked you about this aspect:

Fewer than 10 10-50 More than 50 More than 100
□ □ □ □

Q6. In your opinion do you think, group micro finance members can handle individual financial services?

Yes □  No □

Why?”

Sixty two percent of the field officers said that there was a demand for individual loans, out of the group mechanism. The field officers who mentioned that there was no
demand for individual loans, when asked for the reason for it, mentioned that as the
group concept was always emphasized by the MFI no one would think of asking for loans
outside the group. Except for two field officers, all others felt that the group members
would not be able to handle loans on an individual basis outside the group mechanism.

The findings indicate that more than half of the field officers recognize that demand
for individual loans exists. However the majority of field officers do not think that
members can cope with individual loans outside the group mechanism. This could be
because the members have not been trained on basic financial concepts and planning
that could enable them to manage on an individual basis.

5.4.2 Member level enquiry

Questions 6 and 8 of the interview format available at Annexure 3 are about “Theme 3”.
“Q6. What do you envision for yourself going forward?

Q8. Do you want to avail individual financial services in future? What are the reasons?”

It was found that nearly half (ie. 15 of the 31) of the interviewees defined their
goals in terms of their children, either in terms of the education they wanted them to
receive or in terms of the profession they wanted to “settle” them in. Typical examples
were “I want my children to study professional courses” or “I want to set up a carpentry
shop for my son”. Seven of them wanted to grow their own or their husband’s businesses
while another three of them wanted to reduce their level of debt. Three interviewees
wanted to buy their own house so that they save on rent.
When asked if they would like to avail individual loans outside the group mechanism, only four out of the 31 members wanted to do so. The reasons for this could be a sense of loyalty to the existing group, a kind of affirmation that the group they were currently in had no conflicts. The other reason could also be that the member lacks the confidence to handle a financial transaction on an individual basis as they are unfamiliar with the concept. The cases of the four members who wanted loans on an individual basis are discussed in Box 5.8.

While the above discussion referred to graduation out of the group mechanism, it is useful to examine the cases within GVMFL where members have graduated from group to individual loans within the group system.

A comparison of the graduates and the non graduates clearly showed that the graduates have higher household incomes. The average income of all the 31 members was Rs. 10,275 while that of graduates is Rs. 13,757. As the MFI examines at household cash flows in order to assess the repayment capacity of the household, a successful business of either spouse or both of them is a characteristic of all graduates\(^\text{225}\). Ultimately individual loan require adequate repayment capacity.

GVMFL has taken a conservative approach in providing individual loans, which seems to be working as it continues to have healthy repayment rate on its loan portfolio\(^\text{226}\). Repayment capacity needs to be built up by the member by investment in a

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\(^{225}\) Except for “A” whose husband is employed in Saudi Arabia and remits money regularly to her.

\(^{226}\) The repayment rate is 99.99 percent as on April 2010 (www.gvmfl.com). Though segment wise repayment rates are not provided discussions with branch managers during the research visit revealed that in particular the individual loan portfolio had a near 100 percent repayment rate.
household enterprise as the other graduates have done. This seems to indicate that the issue of graduation is closely related to the issues regarding utilization of loans that were discussed in Section 5.3.2. “Effective utilizers” are more likely to graduate than ineffective utilizers, though the time taken in order to do so may vary from member to member as it depends on a number of factors. Banerjee and Mullainathan (2009) argue that if the marginal utility of consumption and “temptation” goods that are valued by the member in the current period falls faster than that of goods which provide benefits over a period of time, there will be demand for “savings transformation” and microfinance borrowing amounts to savings over time. If these amounts saved are invested in productive assets, the household’s income increases over time. The important of asset building for the poor has been emphasized in the American context by Sherraden (2001) and Schreiner and Sherraden (2007). It appears that in the Indian microfinance context too asset building appears to be relevant though it has not been emphasized much.

The above shows that graduation to individual loans is not actively sought by microfinance group members of both models unless they feel the need for larger loan sizes. Moreover they need to be informed and trained on individual financial services so that they have the confidence to use such services if offered to them. Graduation ultimately depends on repayment ability of the member which typically is low when members join microfinance groups but needs to increase over time by appropriate utilization of the loan. While cash flow management constraints facing members will result in some microfinance loans (or some parts of them) being used for non-business

227 Except for “A” who was fortunate in receiving monthly remittances
purposes, on a long term basis, members need to be building up their business and ultimately their repayment capacity over time. This requires envisioning growth of their business enterprise which is seen in only half of the members interviewed. Training on this aspect too may be required for members to more consciously look at moving beyond their current capacities. As regards the “ineffective utilizers” in the MFI model and the “cash flow smoothers” in the SBLP model, special efforts need to be made to help these individuals develop skills required to engage in a productive enterprise that would enable increase in income over time.

5.5 Analysis of Cases at Microfinance Provider Level

5.5.1 GVMFL

GVMFL’s strategy for growth is two-fold. On the one hand it is expanding geographically by setting up branches in other locations. On the other hand, it has started providing larger value individual loans to those who are assessed to have sufficient repayment capacity.

Though GVMFL tries to cover as many borrowers as possible in its area of operation, its standardized lending model does not permit it to make exceptions to cater to the requirements of all financially excluded individuals in a particular area. Such exception would entail higher costs both on account of the cost of a customized transaction as compared to one using the group mechanism and due to the greater monitoring that would be required from the MFI in the absence of group members. The
low incomes that many of these workers typically have\textsuperscript{228}, too perhaps act as a disincentive as it means that the loan values are likely to remain at low levels. GVMFL has to be careful in choosing only customers who are involved in a steady economic activity that would enable repayment of the loan particularly, because in the case of microfinance loans repayment commences within a week of disbursement\textsuperscript{229}. Hence it is only a sub-set of the financially excluded individuals that GVMFL services.

The range of services is limited by regulatory constraints to providing only loans and insurance products. Borrowing is more or less a condition for membership as in the case of many other MFIs in the country. The financial training provided by the MFI is adequate for its purposes but is not enough to have an impact on the member’s financial planning habits and cannot be termed as improving “financial literacy” adequately. Individual credit histories are recorded and maintained by GVMFL though it is not in the public domain. Customers can leverage their credit history in GVMFL but only within GVMFL. Moreover the process of retrieval of old customer credit histories is cumbersome as the customer’s loan card is collected back after repayment and is not available for customers to show in the future.

\textsuperscript{228} The flower picker who was unable to join the MFI for instance had one of the lowest household incomes among those interviewed.

\textsuperscript{229} Most corporate loans on the other hand offer a moratorium period during which only interest on the loan needs to be serviced. Principal repayment commences after an appropriate time period during which the enterprise stabilizes its operations.
5.5.2 **Hand in Hand India (HIH)**

HIH’s strategy for growth appears to hinge on promotion of an MFI. Even though HIH plans to continue to be part of the SBLP, it is clear that it considers it important to also participate in the MFI model. HIH too covers only a section of the financially excluded individuals as only those who can save regularly can be part of the SBLP.

The financial training provided by the HIH is adequate for its purposes, and also promotes awareness regarding the manner in which interest rates are calculated. However, it is not enough to have an impact on the member’s financial planning habits and cannot be termed as improving “financial literacy” adequately. Individual credit histories are recorded in the SHG books, and the book keeping is overseen by HIH’s field officers, though it is not in the public domain. Customers can leverage their credit history only within the SHG. At best HIH can use its contacts with commercial banks to enable members to obtain an individual loan. However the members have to meet the assessment criteria of bank managers, which are often understood to be non-uniform and unpredictable.

As HIH uses the SBLP both savings and loans are provided which enables even financially excluded individuals requiring savings services.
5.6 Analysis of cases at the member level.

The study revealed that among MFI members two broad categories can be identified: “effective utilizers” who utilize the funds in a manner that leads to an increase in household income. Even if they themselves are not entrepreneurs, by investing the MFI loans in a husband, son or daughter’s enterprise, their household income goes up. The other category are “the ineffective utilizers” who consistently use the microfinance loan funds in a manner that does not impact long run household income substantially (such as by using it for hospital expenses, school fees, repayment of other loans, gifts for relatives and household expenses). These members are also in a sense benefiting from microfinance loans to the extent that in its absence they would have availed higher cost loan funds but cannot be expected to improve their income earning capacity substantially over time. Moreover, accessing progressively higher amounts of loan, as is the practice in microfinance, may not be in their interest as it may lead to considerable strain on their finances over time. This is because increasingly high interest amounts have to be serviced from existing income sources. At the same time, a plateau in loan amounts may cause disinterest in the member, possibly causing them to lose interest and drop out.

Three different kinds of SBLP members were observed, “the effective utilizers”, “the cash flow smoothers” and “the consistent savers”. The “cash flow smoothers” are not able to avail larger loans as they typically lack the required group support\(^{230}\), though they

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\(^{230}\) As pointed out by EDA-APMAS, at the group level SHG membership reveals diversity in income levels. While this is observed in MFI groups as well, it is not much of an issue as MFI groups are subject to uniform MFI procedures by the field officer, unlike in the case of the SHG where the members determine issues such as individual loan amounts, and therefore has a bearing in equity within the group.
keep availing and repaying smaller value loans in order to smooth their cash flows. This category of individuals is unable to make the investments required to substantially increase their incomes over time. The final category of SBLP members observed is “consistent savers”. These individuals help increase availability of funds for the SHG, though this may result in their availing state subsidies even though they may not be part of the target group.
5.7 Building a framework for financial Inclusion through Microfinance

Figure 5.1: Explanatory Framework for financial Inclusion through Microfinance

(Source: Author)

*Microfinance implies: Either only credit (MFI Model) or credit and savings (SBLP). Both have in-built inflexibilities and are preceded by basic financial product training and result in development of credit history at the provider level.
Based on the findings of the empirical study, an explanatory framework for financial inclusion through microfinance is developed. The model shows that access to microfinance is itself a function of the state in which the individual resides and whether the individual has an economic activity and is able to provide proof of address and comply with group requirements such as regular attendance in group meetings. Access to microfinance implies access to either credit only or credit and savings depending on the model accessed. In the case of the MFI Model, loan sizes increase after each loan cycle lasting for a year until a limit is reached which depends on the repayment capacity of the member. In the SBLP model, loan sizes depend on the SHG’s grade as assessed by the commercial assessment of other members of the SHG.

Once access is achieved, two kinds of outcomes are possible. Those who effectively utilize the loan by building up a household enterprise establish individual repayment capacity and are able to access loans on an individual basis later. Those who do not effectively utilize the loan stay within the group framework. If loan sizes keep increasing, they may find it hard to service the loan and may drop-out. If loan sizes do not increase, there is a possibility again of drop-out due to loss of interest.

In the SBLP three kinds of members were observed, “effective utilizers”, “cash flow smoothers” and “consistent savers”. However, “cash flow smoothers” may be viewed as ineffective utilizers (though the difference may be that they may not have a choice in this respect as the SHG does not give them high enough loan amounts). “Consistent savers” though they raise some issues are a small segment and are not included in the framework.
5.8 Concluding Remarks

This chapter presented the findings of the empirical study conducted through microfinance provider level and member level enquiries. The study identifies two distinct categories of MFI members, “effective utilizers” and “ineffective utilizers”. The former individuals build up individual repayment capability during group membership, which enables them to graduate to individual loans later. The ineffective utilizers consistently use their loans to meet consumption related expenses and hence do not build up repayment capacity. Three kinds of SBLP members were also observed, “effective utilizers”, “cash flow smoothers” and “consistent savers”. The second category does not receive adequate finance from the group in order to develop their enterprise, while the final category uses the SBLP exclusively to save.

The three levels of enquiry enabled development of an explanatory framework for financial inclusion through microfinance. The framework points to the various factors that can contribute first to financial inclusion through microfinance and second to the factors that could enable graduation of group microfinance members. The study additionally highlights drawbacks that arise due to inflexibilities and limitations of the financial products accessed by microfinance members of both models and the need for more comprehensive financial training for microfinance members.
Box 5.1 Reasons for not being able to join a Microfinance Group

“U” was unable to join the MFI because her work as a flower picker required her to work in the early hours of the morning. She has been engaged in this activity for at least 20 years with the same employer, who has a flower stall in the city. She earns Rs. 500 per month from this activity. Moreover, as she is free after 10 a.m. she can engage in agricultural labor whenever she is able to supplement her income further, which on average yields her Rs. 2,000 per month. Her work schedule does not permit her to attend the MFI group meeting which is held in the early morning hours in her area. If given a loan by the MFI, she and her daughter (who has discontinued studies and is not working) can commence some economic activity such as keeping livestock. She is confident of being able to repay by working as a laborer for as many days as required to make the repayment. While her neighbors vouch for her honesty, the MFI field officer is unable to relax the condition regarding regular attendance at group meetings. Field officers only accept members who reside in the street where the meeting is held, or in the next street. Hence she cannot even consider joining groups in other locations. This requirement of MFIs follows from experience that attendance in group meetings tend to falter when the member lives further away.

Regular attendance in group meetings is an important pre-condition for MFI membership. This ensures payment discipline and also reduces instances of frauds by members. However, it also means that women like “U” remain financially excluded.

When the researcher suggested that field meetings could perhaps be held in the evening for such members, it was pointed out that this may be risky considering field officers carried a substantial amount of cash and that thefts were more likely during the late hours of the day.
Box 5.2: Reasons for dropping out of MFI Groups

“T” had dropped out of her microfinance group and did not want to rejoin. Her reason for dropping out was that she did not need any more loans. She had taken loans earlier to meet her daughter’s wedding expenses. Now she lived all alone and preferred to live within her means and not incur any liability. This case brings out the fact that borrowing is a condition for membership in MFIs. As a result, the financial inclusion provided by MFIs is necessarily temporary in nature, unless the member continuously keeps borrowing.

Another drop-out, “S” had to discontinue her three-year MFI membership a year ago, when her husband and she moved in temporarily with relatives in another town. The reason was that S was expecting her first child after 12 years of marriage and wanted to be cautious and so did not want to be alone when her husband was at work. After the child was born, they both moved back to their house and she was very keen to join the MFI group once more. As the MFI field officer had changed in the mean time, she found rejoining difficult. Members do not have documentary proof of their credit history created during the period of membership and so she had to make out a case for herself with the help of her neighbors. “S” came on a weekly basis to the centre meeting to plead with the field officer to rejoin the group. The researcher observed her and her neighbors arguing her case. This again points to the temporary nature of the financial inclusion provided by MFIs as the membership is very location specific.
Box 5.3: Continuous MFI membership, continuous borrowing

“V” now 50 years old was still a member and had taken seven loans till date. Her early loans were used for buying livestock, thereafter she borrowed for her elder son to set up a barber shop. Her current loan is for her younger son to set up his own barber shop. When asked if her sons sent her the installment on a weekly basis, she replied that whenever they can they do, else she pays it herself by working as a day laborer. When asked if she found being an MFI member a burden in some ways, V mentioned that as a senior member she is invited to functions and asked to give speeches; hence she enjoys the membership. While “V” continues to be a member and hence remains “financially included”, this continuous borrowing may not be desirable as it appears to prevent her from saving for her old age.
Box 5.4: The Extraordinarily high and low contributors at household level.

There were two cases in which the member’s share in household income was in excess of 50 percent. The first was member “M” whose husband was disabled, making her the sole earner. The second was member “L” who contributed 59% to her household income. While L actually earned around Rs. 1,500 per month by selling incense and saris at home and conducting adult literacy classes, she received investment income as she has invested some of her microfinance loans in the computer centre run by her sister. Her sister gives her Rs.10,000 per month as a return on that investment.

There were 2 members who were presently not contributing to their household income. The first was member “G” who had discontinued her activity of selling vegetables as her family’s financial position had improved after her son and daughter started earning. Her husband was an auto driver and had his own auto. She had used her recent microfinance loans for expenses relating to her husband’s auto. The other was member “A” whose business of making flower decorations for functions had dwindled considerably with availability of cheaper plastic decorations. Her recent microfinance loans were used to finance her daughter’s beauty parlor.
**Box 5.5: Using loans as a means to save**

When asked what she planned to do with their next loan, “H” mentioned that she plans to buy jewelry to provide security in times of need while “N” wanted to use her next loan to deposit a sum in the bank in her daughter’s name. When the researcher explained to both of them that instead of taking a loan, they can save by means of a bank or post office account and avoid paying the high rates of interest on the loan, they said that they had never thought of it that way. Incidentally, “N” who is educated till the 12th grade was one of the most highly educated interviewees. “Q” also wants to use her next loan to buy jewelry for her daughter. In the case of “Z”, the MFI loan each time is entirely deposited as savings for her family, as her husband has a tendency to spend all his spare cash on alcohol, she uses the MFI loan installment as a means to extract cash from him. She finds that this works better than asking him for cash for household expenses. These examples illustrate that loans are often used as indirect means to save, or as second best instruments to manage household finances.
**Box 5.6: Consistent Saver in SBLP**

BB is a member of the SBLP mainly so that she has an avenue to save. She runs an embroidery shop in the nearby city and earns Rs. 8,000 per month. Her husband works in a soap company in another city and earns Rs. 12,000 per month. BB and her husband do not have any children yet. As a result BB is able to save a large part of her income though she does incur expenses on the medical treatment she is undergoing due to a gynecological problem. BB is often a net lender in the internal lending operations of her SHG. It so happens that her husband’s aunt in whose house she lives is a well known money lender in the area, though she denies having anything to do with her business. It is however possible that with moneylenders’ businesses being adversely affected by the mushrooming of MFPs, there is a possibility of some excess moneylender funds being routed into the SHG.
Box 5.7: Cost of mismatches between MFI loans and MFI member needs

“I”s husband is in the business of processing coconut fibre for which he co-invests in a coconut plantation with a contract to obtain the coconut fibre from the produce. This year, at the time when the loan from the MFI was available to her, her husband had not yet negotiated a contract. So she took the loan and invested in jewellery so that the cash is not frittered away. She plans to later sell these and invest in the plantation. She does not seem to have considered the possibility of losses on account of changes in gold prices or jewelry making charges foregone in making this decision. She also did not seem to have considered the possibility of depositing the money in a bank account instead. In this case, there was a timing mismatch between the MFI loan and the need of the member, with the former having preceded the latter. The main cash flows of “I”s household during 2009 are at Appendix 5.2.

Another case where there was a mismatch in both timing and amount of MFI loan was that of “C” whose husband was an auto driver. C had used most of her loans so far for buying and repairing the auto that he drove. Some time ago, her husband came across the opportunity to buy another auto for a good price and thought he could purchase it and rent it out to supplement his income. As “C” was due to obtain a loan from the MFI soon, they took a loan from a money lender at a high interest rate (around 36% p.a.) with a view to repaying it within a short period. However, at that time due to the global financial crisis, banks in India reduced their lending, which impacted the funds flow of the MFI. This resulted in a 10 month delay in obtaining the loan. To make matters worse, while she was expecting a loan of Rs. 40,000; the amount actually approved was Rs. 30,000. “C” was greatly disappointed about the episode as it meant longer dependence on the high cost moneylender funds. (contd.)
When the researcher later discussed with the branch manager about her case, he mentioned that had “C”’s husband spent a small sum in getting the auto transferred to his own name, he could have obtained the loan amount sought in full. “C” and her husband however did not seem to know about this and could not fathom why they had not got the entire amount requested. Timing mismatch and inability to fully understand and address the financier’s requirements seem to have affected “C”’s household adversely.

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**Box 5.8: Feeling the Need for Individual loans**

Two members from the MFI model and two members from the SBLP expressed a desire for loans on an individual basis. All of them wanted larger loan amounts and hence wanted individual loans.

Among the MFI members, member “G” wanted a larger loan so that her husband could buy space for his auto repair unit and thereby save on rent. As Rs. 50,000 is the limit for group loans, she wanted an individual loan.

Member “L” too wanted a loan in excess of Rs. 50,000. She had invested in her sister’s computer business for which she received investment income. She would like to invest more so that her income increases further.

Among SBLP members, Member “EE” was running two chit funds in addition to her vegetable business. With a larger loan, she felt she can buy her own house and save on rent.

Member “AA” wanted a larger loan but was not able to convince her SHG members who objected on the grounds that she lived in rented and not owned accommodation. She wanted an individual loan so that she could achieve her business goal of setting up her own beauty parlor. She felt that the earnings from the business this would enable her to buy her own house. She felt it was unfair for her group to insist on house ownership as a precondition for availing a larger loan.
Appendix 5.1: Demographic Profile of Interviewees

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Member</th>
<th>Area</th>
<th>Age (in Years)</th>
<th>Education</th>
<th>Profession</th>
<th>Monthly Household Income (in Rs.)²³²</th>
<th>Household Details²³³</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A</td>
<td>Urban</td>
<td>43</td>
<td>10ᵗʰ grade</td>
<td>Flower Decorator for functions</td>
<td>10,000</td>
<td>Husband: Laborer in Saudi Arabia</td>
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<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Daughter: Runs Beauty</td>
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<td></td>
<td></td>
<td>parlor (22 years, unmarried)</td>
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<td></td>
<td></td>
<td>Son: Apprentice in Railways</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>(20 years, unmarried)</td>
</tr>
<tr>
<td>2</td>
<td>B</td>
<td>Urban</td>
<td>31</td>
<td>6ᵗʰ grade</td>
<td>Cooks, packs pickles for a Company</td>
<td>8,500</td>
<td>Husband: Professional photo and</td>
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<td></td>
<td>videographer</td>
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<td></td>
<td></td>
<td>Son – student (13 years)</td>
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</tbody>
</table>

²³¹ Participants A to Z were interviewed at GVMFL while AA to HH were interviewed at HIH.

²³² Average income was taken where there was variation within a range. Income from business is given net of expenses as that is how respondents found it easy to report.

²³³ Professions of married children not contributing to household income is not mentioned.
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<tr>
<th>S.No</th>
<th>Member</th>
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<th>Monthly Household Income (in Rs.)</th>
<th>Household Details</th>
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<tbody>
<tr>
<td>3</td>
<td>C</td>
<td>Urban</td>
<td>35</td>
<td>6th grade</td>
<td>Makes and sells Idli(^{234}) Batter</td>
<td>18,800</td>
<td>Husband: Drives an auto(^{235}) and rents out another Sons – students (15 years and 12 years) Daughter – student (9 years)</td>
</tr>
<tr>
<td>4</td>
<td>D</td>
<td>Urban</td>
<td>28</td>
<td>10th grade</td>
<td>Buys and Sells Saris</td>
<td>8,000</td>
<td>Husband: Has a repair unit for autos (tinkering and welding unit) Daughter – student (7 years)</td>
</tr>
<tr>
<td>5</td>
<td>E</td>
<td>Urban</td>
<td>31</td>
<td>10th grade</td>
<td>Tailor though unable to stitch much now due to</td>
<td>7,500</td>
<td>Husband: Has a spray painting unit</td>
</tr>
</tbody>
</table>

\(^{234}\) Idlis are a popular snack in South India made from rice and lentils. Sale of readymade batter for preparation of Idlis is a source of livelihood for low income women.

\(^{235}\) Auto is the commonly used term for “auto rickshaw” in Tamil Nadu.
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<tr>
<th>S.No</th>
<th>Member</th>
<th>Area</th>
<th>Age (in Years)</th>
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<th>Monthly Household Income (in Rs.)</th>
<th>Household Details</th>
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<tr>
<td>6</td>
<td>F</td>
<td>Urban</td>
<td>45</td>
<td>8th grade</td>
<td>Cleaner in hospital</td>
<td>13,500</td>
<td>Son: student (11 years) Daughte: student (7 years)</td>
</tr>
<tr>
<td>7</td>
<td>G</td>
<td>Urban</td>
<td>44</td>
<td>8th grade</td>
<td>Housewife (earlier sold vegetables door to door but now can afford to be housewife)</td>
<td>8,000</td>
<td>Husband: Drives and auto Daughter: Assistant in office after completing computer course (22 years) Son: Driver (20 years)</td>
</tr>
<tr>
<td>8</td>
<td>H</td>
<td>Urban</td>
<td>50</td>
<td>10th grade</td>
<td>Makes and sells Idli batter Retails Nightwear at home</td>
<td>11,750</td>
<td>Husband: Retired police constable (receives pension),</td>
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<td>S.No</td>
<td>Member</td>
<td>Area</td>
<td>Age (in Years)</td>
<td>Education</td>
<td>Profession</td>
<td>Monthly Household Income (in Rs.)</td>
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<tr>
<td>9</td>
<td>I</td>
<td>Semi-Urban</td>
<td>45</td>
<td>10th grade</td>
<td>Engages in agriculture, Has Livestock</td>
<td>18,800</td>
<td>Husband: Coconut Fiber Business Daughter in law: Housewife Son: Supervisor in Company</td>
</tr>
<tr>
<td>10</td>
<td>J</td>
<td>Semi-Urban</td>
<td>44</td>
<td>8th grade</td>
<td>Agriculture and Milk Business</td>
<td>15,350</td>
<td>Husband: Has photo studio Daughter Studying MPhil (23 years) Son: Engineering Student (21 years)</td>
</tr>
<tr>
<td>11</td>
<td>K</td>
<td>Semi-Urban</td>
<td>45</td>
<td>12th grade, Diploma in Computer Studies</td>
<td>Runs Photocopying and Computer Center with Husband</td>
<td>9,000</td>
<td>Husband: Photocopying and Computer Center Daughter-</td>
</tr>
<tr>
<td>S.No</td>
<td>Member</td>
<td>Area</td>
<td>Age (in Years)</td>
<td>Education</td>
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<td>Monthly Household Income (in Rs.)</td>
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<td>12</td>
<td>L</td>
<td>Semi-Urban</td>
<td>33</td>
<td>B.A.</td>
<td>Conducts adult literacy classes, sells saris and incense, has invested in sister’s computer center</td>
<td>19,500</td>
<td>Husband: Insurance Agent Son: Student (10 years) Daughter: Student (8 years)</td>
</tr>
<tr>
<td>13</td>
<td>M</td>
<td>Semi-Urban</td>
<td>59</td>
<td>7th grade</td>
<td>Catering food</td>
<td>4,000</td>
<td>Husband: Disabled due to age Sons - married</td>
</tr>
<tr>
<td>14</td>
<td>N</td>
<td>Semi-Urban</td>
<td>34</td>
<td>12th grade</td>
<td>Salesperson in Music Shop</td>
<td>5,000</td>
<td>Husband: Tailor Daughter: Student (11 years)</td>
</tr>
<tr>
<td>15</td>
<td>O</td>
<td>Semi-Urban</td>
<td>27</td>
<td>10th grade</td>
<td>Runs a fancy store and sells Idli batter</td>
<td>13,250</td>
<td>Husband: insurance Agent Daughter: Student (12 years) Son: Student (9 years) Mother –in-law:</td>
</tr>
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<td>S.No</td>
<td>Member</td>
<td>Area</td>
<td>Age (in Years)</td>
<td>Education</td>
<td>Profession</td>
<td>Monthly Household Income (in Rs.)</td>
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<tr>
<td>16</td>
<td>P</td>
<td>Semi-Urban</td>
<td>45</td>
<td>10&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Agriculture (has one acre farm); also works as laborer in other farms</td>
<td>8,200</td>
<td>Receives pension as her husband was a Government Employee</td>
</tr>
<tr>
<td>17</td>
<td>Q</td>
<td>Semi-Urban</td>
<td>28</td>
<td>8&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Sells vegetables at home</td>
<td>8,000</td>
<td>Husband: Has a vegetable shop in market</td>
</tr>
<tr>
<td>18</td>
<td>R</td>
<td>Semi-Urban</td>
<td>40</td>
<td>12&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Tailor, Sells dress materials</td>
<td>17,000</td>
<td>Husband: Head Constable in Airport in a neighboring state (Karnataka)</td>
</tr>
<tr>
<td>19</td>
<td>S</td>
<td>Semi-Urban</td>
<td>32</td>
<td>10&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Agriculture (one acre farm)</td>
<td>6,500</td>
<td>Husband: Agriculture Daughter (6 months)</td>
</tr>
<tr>
<td>20</td>
<td>T</td>
<td>Semi-Urban</td>
<td>48</td>
<td>5&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Agricultural laborer</td>
<td>2,400</td>
<td>Daughter: Married</td>
</tr>
<tr>
<td>21</td>
<td>U</td>
<td>Semi-Urban</td>
<td>48</td>
<td>10&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Flower picker, agricultural laborer</td>
<td>2,500</td>
<td>Daughter (20 years unemployed</td>
</tr>
<tr>
<td>S.No</td>
<td>Member</td>
<td>Area</td>
<td>Age (in Years)</td>
<td>Education</td>
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<td>Monthly Household Income (in Rs.)</td>
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<tr>
<td>22</td>
<td>V</td>
<td>Rural</td>
<td>50</td>
<td>2&lt;sup&gt;nd&lt;/sup&gt; grade</td>
<td>Agricultural laborer, Tends livestock for sale</td>
<td>15,800</td>
<td>Husband: Barber Two sons each runs a barber shop in nearby cities (one married) Daughter (married)</td>
</tr>
<tr>
<td>23</td>
<td>W</td>
<td>Rural</td>
<td>34</td>
<td>5&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Sells food items at home</td>
<td>4,500</td>
<td>Husband: Agriculture (2 acres of land) Son: Student (16 years)</td>
</tr>
<tr>
<td>24</td>
<td>X</td>
<td>Rural</td>
<td>32</td>
<td>8&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Agricultural laborer; livestock</td>
<td>3,650</td>
<td>Husband: Has flower stall Daughter: Student (12 years) Son: Student (13 years)</td>
</tr>
<tr>
<td>25</td>
<td>Y</td>
<td>Rural</td>
<td>27</td>
<td>12&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Runs tea shop with husband</td>
<td>6,000</td>
<td>Husband: Runs tea Shop Daughters: Students (11 years, 2 years) Sons: Students (8</td>
</tr>
<tr>
<td>S.No</td>
<td>Member</td>
<td>Area</td>
<td>Age (in Years)</td>
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</tr>
<tr>
<td>26</td>
<td>Z</td>
<td>Rural</td>
<td>30</td>
<td>8th grade</td>
<td>Has a shop for sale of cashew nuts</td>
<td>8,000</td>
<td>Husband: Agricultural Laborer Son: Student (17 years) Daughter: Student (16 years)</td>
</tr>
<tr>
<td>27</td>
<td>AA</td>
<td>Semi-Urban</td>
<td>37</td>
<td>9th grade</td>
<td>Tailor</td>
<td>10,500</td>
<td>Husband: Works In a Studio in nearby city Son: Married Daughter: Married</td>
</tr>
<tr>
<td>28</td>
<td>BB</td>
<td>Semi-Urban</td>
<td>32</td>
<td>10th grade</td>
<td>Has an embroidery shop in nearby city</td>
<td>20,000</td>
<td>Husband: Works in a soap company in nearby city Husband’s Aunt: Moneylender (lives with her)</td>
</tr>
<tr>
<td>29</td>
<td>CC</td>
<td>Semi-Urban</td>
<td>32</td>
<td>8th grade</td>
<td>Sari Business, Part of an SHG that has</td>
<td>6,500</td>
<td>Husband: Driver Son: Student (10 years, 5 years)</td>
</tr>
<tr>
<td>S.No</td>
<td>Member</td>
<td>Area</td>
<td>Age (in Years)</td>
<td>Education</td>
<td>Profession</td>
<td>Monthly Household Income (in Rs.)</td>
<td>Household Details</td>
</tr>
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<td>231</td>
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<td></td>
</tr>
<tr>
<td>30</td>
<td>DD</td>
<td>Semi-Urban</td>
<td>40</td>
<td>7&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Has a tiffin shop</td>
<td>5,900</td>
<td>Husband: Watchman</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Daughter: Student (8 years)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Mother: Sells firewood, stitches disposable plates out of leaves</td>
</tr>
<tr>
<td>31</td>
<td>EE</td>
<td>Semi-Urban</td>
<td>28</td>
<td>10&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Has a vegetable shop</td>
<td>8,500</td>
<td>Husband: Sales representative of a company</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Son: Student (8 years)</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Daughter: 2 years</td>
</tr>
<tr>
<td>32</td>
<td>FF</td>
<td>Semi-Urban</td>
<td>47</td>
<td>7&lt;sup&gt;th&lt;/sup&gt; grade</td>
<td>Runs small restaurant with husband</td>
<td>5,000</td>
<td>Husband: Runs small restaurant</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Daughter: Student (23 years)</td>
</tr>
</tbody>
</table>

A “pandal” is a temporary structure put up by the side of the road to conduct small functions or events.
<table>
<thead>
<tr>
<th>S.No</th>
<th>Member</th>
<th>Area</th>
<th>Age (in Years)</th>
<th>Education</th>
<th>Profession</th>
<th>Monthly Household Income (in Rs.)</th>
<th>Household Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>33</td>
<td>GG</td>
<td>Semi-Urban</td>
<td>47</td>
<td>10th grade</td>
<td>Sells Idli batter</td>
<td>11,000</td>
<td>Son: Student (21 years)</td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>Husband: Trades in rice, earns pension as retired from Government service</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Son: Student (20 years)</td>
</tr>
<tr>
<td>34</td>
<td>HH</td>
<td>Semi-Urban</td>
<td>40</td>
<td>3rd grade</td>
<td>Tailor</td>
<td>7,900</td>
<td>Husband: not alive Daughter (married)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Son: Working in nearby city (25 years)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Son: Student (20 years)</td>
</tr>
</tbody>
</table>
Appendix 5.2: Samples of Cash flows of MFI Member households.\(^{237}\)

**Household Profile A**

“Y”, 27 years old, runs a tea shop along with her husband in Sembattur, a village in Pudukkottai district, Tamil Nadu with a population of around 2500. She lives with her husband and four children aged 11, 8, 5 and 2 years in a rented house near the shop. As her shop is on the main road and is one out of just three similar ones in the village, there is a stream of regular customers who patronize it. Another set of customers comprise drivers of vehicles passing through the village. Last year the earnings from the tea shop fell substantially for a couple of months as due to repair on the road adjoining it, which reduced street and pedestrian traffic considerably. To supplement income, at times Pandiselvi and her husband lease out land for some agriculture activity, which, at the moment, is a break-even proposition. "Y" has been a member of GVMFL since 3 years. She used her first loan of Rs. 5,000 to buy an electric grinder for the tea shop and her second loan of Rs. 7,000 to buy utensils and other things for the shop. This year she has got a loan of Rs. 8,000. She is also simultaneously, a member of a self help group (SHG) for the last two years and this year she got a loan of Rs. 1,500 from there as well. The SHG also obtained a Government subsidy to the extent of Rs. 500 per member towards repayment of the loan.

As shown in the chart, loans are fitted into the budget according to current household needs, depending on the value of...

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\(^{237}\) The presentation of these cash flows are drawn from Lejano and Shankar (Forthcoming).
the loan and the time of disbursement. This year, the MFI loan was of the right amount to purchase a gift for a relative on a special occasion. The SBLP loan was used for agriculture, as it happened that it was disbursed at the time when inputs for farming were to be purchased. Asked if she prefers the MFI or the SBLP, “Y” smiles and say “they are both good, both of them help us”.

**Household Profile B**

“II”, 45 years old, lives in Samayapuram, a town of 746,000, 20 km north of Trichirapalli in Tamil Nadu. Years ago, her family was allotted 1.5 acres of agricultural land belonging to a religious organization in the area, for which a rental of Rs.1500 per year is paid. In that land, her husband and she grow bananas and rice alternately during the year which yields them around Rs.70,000 per annum.

“II” has a son and a daughter. Her daughter married last year, but as she married into another caste against both families’ wishes, there was no expenditure on the marriage.

Seven years ago, “II” had joined GVMFL. As she took the initiative to form the five member group, she was appointed the group leader. She initially used the loans obtained to purchase livestock, at first a goat and later a cow. Two years later, her husband and she decided to commence the business of processing coconut fiber, for which she used the MFI loan.

“II” was approved a GVMFL loan of Rs. 50,000 this year, the maximum MFI loan amount. However this year they were not able to enter into any deals for coconut fiber. While still on the lookout for deals, they invested the MFI loan amount in jewelry, reasoning that, this way,
the money does not get frittered away on unnecessary expenditures. They plan to convert the jewelry into cash once the deal is finalized. “I” and her husband have not considered the eventuality of an adverse movement in gold prices or loss on account of jewelry making charges.
6. A Suggested Framework for Microfinance Regulation

The results of the empirical study at the sector, provider, and member levels, presented in Chapters 4 and 5 highlighted the need for expansion in scope of microfinance activities, particularly saving products, as these are not offered by the MFI Model, the faster growing model in the country. The largest MFIs in the country, which cumulatively account for 70 percent of the sector in terms of portfolio outstanding, are non-banking finance companies (NBFCs), who are unable to accept savings deposits. In order to do so, NBFCs need to obtain investment grade rating from a credit rating institution, which is difficult for MFIs due to their collateral free loan portfolios. As a result, most of the growth in microfinance in India has been concentrated on provision of loans or “microcredit”. Other studies (such as Rutherford, 2001) too have stressed the importance of savings for the poor. This is because, as observed in Chapter 5, many MFI members simultaneously both borrow and save. The lack of saving services results in their saving in less convenient, riskier and often lower yielding ways such as through purchase of ornaments. For MFIs, this lack of access to deposits implies that they tend to be highly leveraged. The introduction of savings services by MFIs, however must be preceded by putting in place a framework for their prudential regulation.

A second insight from the empirical study also suggests the need for regulation. This is the lack of financial literacy observed even among mature microfinance members. While providing financial literacy to address this issue is crucial, non-prudential
regulation providing for transparency in interest rates and consumer protection is also equally important.

There are other reasons why regulation is already on the policy agenda of the Indian government. First, microfinance sector institutions are no longer solely socially motivated. Due to the growing perception, that it is possible to earn high returns through microfinance lending, commercially driven entities are also being attracted to the sector. This further underlines the need for supervision and consumer protection. Second, some MFIs have started offering products such as insurance, remittances and pensions by tying up with mainstream providers. While this helps in broadening the scope of microfinance services, it also calls for coordinated regulation of the sector particularly in view of the limited financial literacy of its participants. Such increasing overlap between various financial institutions is expected to continue.

Third, while the diversity of legal forms in the sector has arisen due to its unplanned, entrepreneurial growth, a uniform regulatory framework for all categories of MFIs would enable a level playing field and prevent regulatory arbitrage.

Fourth, the recent global financial crisis has drawn attention more generally to the importance of appropriate financial regulation and supervision\textsuperscript{238} for the financial sector as a whole.

\textsuperscript{238} Singala and Asher (2010) have suggested that in the aftermath of the 2008 global financial and economic crisis, rethinking the purpose, scope and methods of financial sector regulation is necessary while Adams (2010) has argued for establishment of high level systemic risk councils in each country for overseeing systemic risks on a regular basis and coordinating activities of key Government ministries, agencies and the Central bank. Singala and Rao (2009) have stressed that the capacity, culture and commitment of national level agencies would determine how effective an internationally coordinated framework for monitoring financial stability would be.
While regulation is essential, avoiding over regulation that hampers innovation and unduly increases transaction costs is also equally important.

The rest of the chapter is structured as follows. As any regulatory structure must be consistent with current and emerging characteristics of the sector, in Section 6.1, the implications of the empirical study on the regulations relating to the microfinance sector in India are briefly discussed. The regulation of the microfinance sector presents unique challenges which need to be recognized and addressed. Section 6.2 analyses these challenges. This is followed by an overview of the current regulatory arrangements for the microfinance sector in India in Section 6.3. Section 6.4 provides an outline of the suggested framework for regulating microfinance sector in India, while Section 6.5 draws conclusions.

6.1 Present Arrangements for Microfinance Regulation in India

Definition of microfinance

The term microfinance is defined in the Indian context as “the provision of thrift, credit, and other financial services and products of small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards”\textsuperscript{239}. In 2000, it was indicated that loans up to Rs.50,000 (Rs.125,000 in

\textsuperscript{239} Defined by the Task Force on Supportive Policy and Regulatory Framework for Microfinance set up by NABARD in 1998.
the case of housing finance) were considered as microfinance\textsuperscript{240}. The draft microfinance Bill (2007) reiterated the same definition. While the upper limit of microfinance loans has been specified as Rs.50,000, the lowest-end loans of most commercial banks, namely personal loans, start at Rs. 100,000\textsuperscript{241}. This implies that there is a “missing middle” in the continuum of financial services in the country. Though the average loan per customer in the Indian microfinance sector is only around Rs.6,519 in the MFI Model and Rs.3,789 in the SBLP (Sa-dhan, 2010), some microfinance members interviewed as part of the empirical study were already touching the Rs. 50,000 mark and had plans requiring larger loans in the future. As explained in Chapter 2, graduation of microfinance members to larger individual loans is desirable for MFIs as well as the members. Hence increasing the upper limit of microfinance loans to Rs. 100,000 may be beneficial.

Moreover, the definitions needs to be broadened beyond the microcredit and micro-housing aspects to cover microinsurance, micro-pensions and remittances as these services are also being offered.

\textit{Eligibility for Priority Sector Lending for Banks}

The Reserve Bank of India (RBI) encouraged banks to participate in microfinance by reckoning lending to the sector as part of their priority sector lending, which needs to

\textsuperscript{240} This was indicated while granting exemption for microfinance companies registered under Section 25 of the Companies Act from the core regulatory provisions governing NBFCs in January, 2000.

\textsuperscript{241} Small ticket personal loans with average ticket size between Rs. 25,000 to Rs.32,000 were being offered extensively during 2005-07, but were discontinued by most banks in 2008, due to increasing defaults on such loans.
account for 40 percent and 32 percent of net bank credit in the case of domestic and foreign banks respectively. However, as seen in Chapter 4, the sector level enquiry suggests that in view of the large inter-state disparities in microfinance penetration, it may be advisable to target the eligibility to states that show levels of microfinance penetration.

*Initiatives for Development of the sector*

In 1993, the Ministry of Human Resource Development, Government of India set up the Rashtriya Mahila Kosh (RMK) with initial funding of Rs.310 million to act as a provider of wholesale funds for the sector and to develop the sector through capacity building and advocacy. In 1999, the SIDBI Foundation for microcredit was launched to provide both financial and non financial support to MFIs.

In 2001, the microfinance development fund of Rs. 1 billion was set up under NABARD to fund various development activities relating to microfinance. It was later in 2005-06, re-designated as the Microfinance Development and Equity Fund with an increased corpus of Rs.2 billion. In 2005, NBFCs engaged in microfinance were permitted to obtain foreign equity investment subject to the permission of the Foreign Investment Promotion Board. The minimum amounts were $0.5 million when investment was less than 51 percent of the total equity, $5 million when it was less between 51 percent and 75 percent of total equity and $7.5 million when investment was greater than 75 percent of total equity.
As seen from the member level enquiry conducted, there is a need for similar initiatives aimed at improving financial literacy of microfinance members to help the sector as a whole. While members benefit by being able to make more informed decisions, MFIs too stand to gain if their borrowers understand financial products and manage their finances better.

**Business Facilitator/ Business Correspondent Model**

In 2006, RBI permitted banks to appoint business facilitators and business correspondents (BC)\(^{242}\). While the former can merely promote the business of the bank; the latter can take on a larger scope of activities, such as disbursal of small value credits, collection of small value deposits, sale of microinsurance, pension and other third party products as well as receipt and delivery of small value remittances and other payment instruments.

There are reports that some BCs\(^ {243}\) have made innovative use of technology in order to ensure secure financial transactions in the absence of branches. One example is the provision of biometric based smart cards to customers who use these cards to carry out financial transactions in remote areas through BC representatives who use hand held devices similar to credit card swipe machines. The disadvantage however is that the transactions are not updated on a real time basis but only when the representative

\(^{242}\) RBI circular dated January 25, 2006

\(^{243}\) Examples are Seed Financial Services (BC for 15 banks) and Eko Financial Services (BC for two large banks)
connects the device to the internet. Another example is the use of cell phone technology, though its use is restricted to areas with mobile connectivity and to customers having mobile phones.

Provision of BC services by MFIs would enable microfinance members to avail a wider range of financial services. The BC model has however not been widely used by MFIs for a number of reasons.

First, the eligibility criteria excluded a number of large MFIs in the country. While most other kinds of MFIs are eligible to function as BCs, NBFCs not registered as not-for-profit companies were excluded through subsequent notification\textsuperscript{244}. The reasons for this exclusion are reported to be the possible use of the model to bypass time consuming requirements to obtain branch licenses and possible exploitation of customers due to excessive commercialization (Tankha, 2006). Some MFIs who have group entities registered as trusts and societies, have made use of these structures to become BCs. It is also possible that the potential costs of record keeping and coordination with the concerned bank are likely to far outweigh the advantages of offering the additional services to customers\textsuperscript{245}.

Second, BCs are not permitted to charge fees from the clients as banks are expected to remunerate them. In the case of loans, this results in effective capping of the overall interest rate that the borrowers could be charged as banks are not permitted to

\textsuperscript{244} RBI circular dated March 22, 2006

\textsuperscript{245} Based on discussions with MFI CEOs in July 2009.
charge interest rates above their benchmark prime lending rate for loans which are lower in amount than Rs. 200,000\textsuperscript{246}. This caps the interest rate of all microfinance loans as these loans by definition are lower than Rs.50,000.

Third, in a later notification\textsuperscript{247}, RBI stipulated that every BC should be attached to a particular bank branch (called the base branch) and the distance between the place of business of a BC and that of the branch should not exceed 15 km in rural, semi-urban and urban areas and 5 km in metropolitan areas. This restriction also reduced the attractiveness of the scheme in general and particularly for MFIs operating in remote areas.

As seen from the member level enquiry, the need for savings avenues among microfinance members is high. Some members tend to use “microcredit loans” as a proxy for saving by availing a loan and saving up, to repay installments. It is apparent that this results in them paying unnecessarily high interest rates. Others save in the form of jewelry which engenders risks of various kinds including theft.

\textbf{Capital Adequacy Requirements of NBFC MFIs}

In 2008, RBI increased the capital adequacy ratio of MFIs registered as NBFCs and having an asset size of Rs. 1 billion\textsuperscript{248}. As against 10 percent, their minimum capital

\textsuperscript{246} Reiterated in RBI master circular on interest rates on advances dated July 1, 2008.

\textsuperscript{247} RBI circular dated April 24, 2008.

\textsuperscript{248} These are referred to as “systematically important” NBFCs.
to risk assets ratio was required to be 12 percent by March 31, 2009 and 15 percent by March 31, 2010. While this in itself is a positive development from the financial regulation viewpoint, it has lead a number of MFIs to consider equity infusion from various sources including commercial ones, leading to concerns of “mission drift” discussed in Chapter 2.

**Mobile Banking Guidelines**

With growth in number of mobile phone subscribers in the country\(^{249}\), some banks have started offering mobile based services to customers including mobile payments, which implies debit or credit of funds in a customer’s account based on instructions received over mobile phones. Taking note of this, RBI has issued guidelines for mobile payments in July 2008. Only banks which are licensed and supervised in India, and have a physical presence in the country, are permitted to offer mobile payment services to residents. In August 2009, RBI has permitted entities other than banks to issue mobile phone based payment instruments of maximum value Rs. 5,000 subject to RBI approval. The facility is to be used only for purchase of goods and not for person to person transfer.

While these measures are appropriate in encouraging use of mobile banking in a conservative manner, as found in the member level enquiry, not many microfinance members utilize their bank accounts. As only banks can offer mobile based

\(^{249}\) Around 529 million active subscribers as of December 2010 ([www.trai.com](http://www.trai.com)) [accessed on February 10, 2011]
financial services, the widespread use of this facility by microfinance members is not likely. Spread of use of mobile banking is desirable as it offers scope for reduction in transaction costs. For example, in Philippines, a typical transaction through a bank branch which cost US$2.50 is estimated to cost only $0.50 when automated using a mobile phone (Asian Banker, 2007).

**Committee on Financial inclusion**

The Rangarajan Committee on Financial Inclusion (2008) provided a systematic overview of the issues and suggested that RBI may consider bringing all regulatory aspects of microfinance under a single mechanism. The committee has also recommended the setting up of a Financial Inclusion Technology Fund to support the costs of technology adoption for financial inclusion purposes. It also suggested that NBFCs focused on microfinance (MF NBFCs) could be permitted to offer thrift, credit, microinsurance and remittance products up to specified amounts.

However, implementation of financial inclusion by way of targets at various levels as suggested by the Committee has not worked with respect to opening of bank accounts as was seen in Chapter 1, where accounts were opened though their utilization was very low.

### 6.2 Unique challenges of microfinance regulation

As explained in Chapter 2, regulation of the microfinance sector poses unique challenges.
In 2010, the Basle Committee\textsuperscript{250} on Banking Supervision has developed a guidance report for the application of the core principles for effective supervision of depository microfinance institutions (BIS, 2010). The report recognizes four key issues in microfinance regulation which include efficient allocation of supervisory capacity (particularly when dealing with a large number of small institutions), developing specialized knowledge on microfinance models, recognizing how control and managerial practices differ from conventional retail banking and clarity in specifying which activities are permitted for which microfinance institutional types (while retaining some degree of flexibility).

The CGAP (Consultative Group to Assist the Poor), an international consortium of public and private development agencies, evolved a set of “Microfinance regulation consensus guidelines” in 2002 which have been adopted by its donor agencies (CGAP, 2002). These guidelines are general in nature and each country is expected to evolve its own regulatory framework based on considerations of likely effectiveness and cost of supervision.

As in the case of regulation of any financial institution, two basic issues arise in regulating MFIs, prudential and non-prudential. The first relates to issues regarding solvency of the institution, which is important to maintain confidence in the financial system and protect depositors. The second, non-prudential regulation includes all other

\textsuperscript{250} A Committee of bank supervisory authorities.
matters such as guidelines on interest rates, truth-in-lending laws and anti money laundering rules.

The CGAP guidelines favor a clear distinction between the supervision of depository (deposit accepting) and non depository MFIs, as the former require closer monitoring. Housing the supervision of non depository MFIs separately would help to avoid confusion and more importantly so as to prevent the public from being misled into believing that the authority is vouching for the financial health of these MFIs when it is not (and should not be) closely monitoring their financial health. The guidelines provide that for deposit taking MFIs, the supervisory body most appropriate would be the authority which supervises commercial banks. This leverages existing supervisory skills and reduces incentive for regulatory arbitrage. The supervisory staff needs however to be trained in the particular portfolio characteristics of MFIs. Another alternative suggested for supervision of MFIs is “delegated supervision” which refers to an arrangement where the Government delegates direct supervision to an outside body while monitoring and controlling the body’s work.

**Prudential Issues**

Some of the main issues include minimum capital limits, capital adequacy requirements and loan loss provisions. A minimum capital limit is usually set which is often used as a rationing device in order to keep the number of MFIs to be supervised within manageable limits (Rosenberg, 2008). Capital adequacy requirements are based on
the premise that capital acts as a cushion against possible losses for depositors and creditors. Similarly loan loss provisions are required so as to build reserves to provide for future losses. The peculiarities of MFI portfolios discussed earlier need to be taken into account while setting these requirements.

Non-Prudential Issues

Transaction costs in microfinance typically include cost of group formation, group training and cost of weekly collections at the customer’s doorstep. As the value of the loans are typically small, these transaction costs are high on a percentage basis and contribute to higher interest rates as interest rates are a function of risk, cost of funds, and transaction costs.

Should there be interest caps?

High nominal interest rates charged on microfinance loans sometimes lead to demands being made for interest rate caps. Such caps can lead to the exclusion of customers whose profiles call for interest rates in excess of the cap. In the context of microfinance, a uniform interest rate would create incentives for MFIs to move away from difficult and new geographies where transaction costs are higher. With financial products being inherently complex, it is not easy for the Government to determine appropriate caps and more so to enforce them. There is a possibility that as a result of the interest rate cap, MFIs may be encouraged to repackage loan contracts by varying repayment schedules, fees, and other aspects such that effective interest rates remain the
same. Interest rate caps could also be detrimental in attracting capital to the sector, which is critical in order to build scale and thereby reduce lending costs.

Availability of low interest microfinance loans, financed through state budgets may result in efficiency and equity losses. This is because budget subsidy has opportunity costs and could be better utilized for expenditures with greater social utility both by the State, while artificially low interest may distort decisions by the borrowers. The low interest rates necessitate regulating access, which may then not be based on need or other objective criteria. Such benefit cheating could result in inequities.

With growth of the microfinance sector and increasing competition among MFIs, it is expected that interest rates may exhibit tendency to fall. In a study of three mature microfinance markets, Bangladesh, Indonesia and Bolivia, Porteous (2006) found that competition appears to be putting a downward pressure on interest rates only in the latter two countries. While the poverty focus and wide outreach of Bangladeshi MFIs and their lower interest rates from the beginning may be important explanatory factors, the lack of financial literacy of the MFI customers compounded with the lack of uniformity among MFIs in the manner of quoting interest rates were found to be other important limiting factors.

In many countries including India, interest rates charged by MFIs are often not quoted in transparent annualized terms. Moreover, often loans involve upfront fees and service charges making calculation of effective interest rates complex. Sometimes interest rates are calculated on a flat basis and not on a diminishing balance basis. **Appendix 6.1** provides examples of how different means of quoting interest rates impact
the customer’s payout. Even though there have been recent initiatives by various microfinance apex bodies (Sa-dhan, APMAS and MFIN) to develop voluntary codes of conduct for the sector, it is unlikely that such codes even if adopted will be closely monitored for compliance by all sector participants.

Regulation encouraging transparent disclosure of interest rates, offering appropriate financial products, fair selling practices and methods for collecting loans are important elements of non-prudential regulation of MFIs.

6.3 Current Regulatory Structure in India

Of the two main models of microfinance in the country, the SHG Model is implemented through banks which are regulated by the RBI. In the MFI model, while NBFCs are regulated by RBI; societies, trusts, not-for-profit companies and cooperatives are not. Appendix 6.2 briefly summarizes the regulators for different legal forms of MFIs and the advantages and disadvantages that each form entails. An example of the effect of differential regulation is the usurious interest prevention acts of state governments (such as Tamil Nadu Money Lenders Act, 1957 and Kerala Money Lenders Act, 1958) which are not applicable to banks as they fall under the purview of the RBI Act, but are applicable to MFIs which are registered as societies and trusts.

In March 2007, the draft Microfinancial Sector (Regulation and Development) Bill, 2007 was introduced in the Indian Parliament to promote and regulate microfinance organizations (MFOs). The definition of MFOs specifically included societies, trusts and
cooperatives. The Bill designates NABARD as the regulator for the sector. The features of the Bill are discussed below. The draft Bill lapsed and a revised document (not referred to as a Bill) with no substantive difference from the original document was placed on the NABARD web site in February 2010 for comments of sector stakeholders. The draft was discussed on various platforms including on the Solution Exchange (www.solutionsexchange-un.net.in), an internet based discussion group of stakeholders in microfinance moderated by the UNDP. A brief discussion of the features of the draft document follows.

**Features of the Draft Document**

The draft has at least three positive features.

First, the Draft permits MFOs to register with NABARD and accept savings from members subject to their meeting the following conditions: it should have been in existence for at least three years, it should have net funds owned of at least Rs.0.5 million, and it should have satisfactory management.

Second, the Draft provides for mandatory registration and periodic report submission (including annual audited reports) by all MFOs, seeking to accept deposits. This has the potential to build a robust database of the sector over time; and help institute greater professionalism in the functioning of the MFOs.

Third, it provides for inspection of MFOs by the regulatory authorities in case of complaints, and a dispute resolution mechanism. These steps could serve as important consumer protection steps in the microfinance sector.
There are several provisions in the Draft which, however, merit reconsideration.

First, the Draft designates NABARD as the regulator. As mentioned earlier, NABARD is an active participant in the SHG Model. It has also in 2007, announced plans to promote an MFI jointly with commercial banks. The regulatory role will strengthen its role relative to other participants in the sector. This situation may not be beneficial for the promotion of contestability in the sector and also for the customers who stand to gain if there is healthy competition in the sector.

Further, NABARD is already a regulator for Regional Rural banks (RRBs) and cooperatives and hence there are concerns that NABARD’s regulatory capacity may be over stretched. Limited success of the RRBs and of the imperatives also raises concerns about NABARD’s effectiveness. There are also concerns that NABARD lacks expertise to regulate and develop MFOs in the urban sector as its role has been confined to rural areas and to agriculture. Urban microfinance is potentially a high growth segment which needs appropriate development.

Second, the Draft does not include in its scope NBFCs and not-for-profit companies. In terms of client outreach, 10 percent of the total number of MFIs, accounted for 76 percent of all customers (Srinivasan, 2009). Many of these large MFIs are NBFCs and so are not covered by the Draft. As a basic general principle, regulation should be uniform across all institutional forms so as to discourage regulatory arbitrage. This involves structuring operations in such a manner that the organization comes under the jurisdiction of a weaker regulator.
Third, the prudential norms prescribed for the deposits collected by MFOs are inadequate. The Draft introduces a single safeguard for savings which is the requirement that MFOs offering thrift need to create a reserve fund into which they should deposit 15 percent of their net profit before dividend every year. The use of reserve fund as the single prudential norm has severe limitations. An MFO not making profit, need not form the reserve fund leaving no safety net for the depositors, even though the need is greater. Further the reserve mechanism covers only savings collected through the group mechanism. Dynamically one may expect MFOs to start offering individual loans and collect individual savings. The requirements of protection of these savings also need to be addressed.

The fourth serious concern is that the Draft does not specify a prudential limit on the volume of deposits that an MFO can accept. The volume of deposits accepted by the MFO should be linked with its reserve fund or its capital. This anomaly may encourage misuse of NABARD registration, to mislead customers into believing that the Government was guaranteeing these savings.

A fifth area is that promotion of financial education, which is essential for development of this sector has not been specifically addressed by the Draft. Though MFIs provide some basic training to members, financial education by independent outside agencies would help MFI customers make more informed choices with regard to financial products.

The contents of the Draft contrast with what the CGAP consensus guidelines suggest. For instance the Draft designates NABARD as the single regulator for both
depository and non-depository MFOs, while the consensus guidelines suggest separate regulators for each. Further while the guidelines suggest that the RBI should regulate depository MFIs, NABARD has been appointed regulator.

6.3.1 Recent Developments in the state of Andhra Pradesh

In October 2010, there were reports of suicides in the state of Andhra Pradesh, the state which has the highest level of microfinance penetration in the country (as mentioned in Chapter 4) on account of collection practices of MFIs. Reports indicated that some borrowers had over extended themselves and were unable to repay their loans. The MFIs used coercive collection practices which resulted in some female borrowers committing suicide. In response, the Andhra Pradesh Government enacted the Andhra Pradesh Microfinance Institutions (Regulation of Money lending) Act, 2010. The Act made it mandatory for MFIs to register with the concerned District Registering Authority in each district that they were operating in within a period of 30 days, specifying their rate of interest and method of operation and recovery. MFIs are required to suspend operations until they get registered, leading to non repayment of loan installments by members. Moreover some state politicians issued statements discouraging repayment of loans by borrowers. The Act requires MFIs to collect repayment of its loans only in the offices of the local Government. Further, MFIs need to seek prior permission from the registering authority before extending new loans to members. The Act imposes several other tedious administrative requirements on MFIs, along with penalties for non compliance.
While a combination of factors may have contributed to the situation in Andhra Pradesh, multiple lending and coercive collection practices are frequently being cited by analysts as the causes of the crisis. These may be the proximate causes, but there are other underlying reasons. These include the lack of financial education of microfinance customers (as indicated by the results of the empirical study in Chapter 5) and the nature of incentives offered to field staff by microfinance institutions (MFIs) and the lack of a uniform code of conduct for the sector.

First, lack of financial education is an important factor why some MFI borrowers find themselves in difficult debt repayment situations. While microfinance providers claim that they train borrowers, what they impart is usually product knowledge, aimed at ensuring compliance by the borrowers with terms of lending.

Imparting financial education empowering the borrower to make financial decisions such as ascertaining the effective cost of loans, and the extent of debt they can handle, rightfully needs to precede provision of financial services. Currently, such education is not being routinely made available to all microfinance borrowers by any stakeholder, government or non-government.

With increasing pressure on MFIs to reduce interest rates, it is unrealistic to expect them to incur additional transaction costs on financial education and so this will necessarily need to be addressed by socially-oriented donor or state funded bodies. It is also desirable that financial education be imparted by an independent entity.

Second, the incentives of the field staff are typically directly linked to the number of new loans and the volume of “on-time” loan collections. Considering that often field
staff comes from relatively low income segments, these have the potential to lead to unethical actions.

Third, while there are shortcomings in the operating models of MFIs, the State has also contributed to the current crisis due to the long delay in introducing microfinance regulation, which have ongoing discussions since 2007. A uniform nation-wide code of conduct for all MFIs needs to be established urgently.

The widespread politicization of microfinance in Andhra Pradesh is an additional contributing factor. It is believed in some quarters that the success of MFIs may have adversely impacted state-supported subsidized microfinance programs whose objectives included developing political constituency for certain parties, and this may caused the Government to introduce the Act.

In response to concerns regarding the microfinance sector and the likely impact of the Andhra Pradesh Act on it, the RBI appointed a committee under the chairmanship of one of its Directors, Mr. Y. Malegam to study the underlying issues. Its report (Malegam Report) released on January 19, 2011 suggested that MFIs be exempt from state government money-lending acts such as the Andhra Pradesh Act. However, the Malegam Report has raised other issues which are highlighted briefly in Box 6.1. RBI has invited comments on the Report, and a regulatory framework for microfinance is expected to be evolved subsequently.
6.4 Proposed Model for regulation of Microfinance in India

It is only recently that most countries have started seriously addressing microfinance regulation. Hence the possibility of learning from the experience of other countries is limited. A few examples from countries where the sector has a reasonable history are however taken into account in the suggested framework for India. An early model of regulation developed in Indonesia involved the central bank as the regulator, with delegation of supervision to a Government owned bank, Bank Rakyat Indonesia (BRI) and some provincial banks (Maegher, 2002). In the Philippines, performance standards have been developed in a collaborative manner by stakeholders in the sector, including representatives from Government, private sector, as well as wholesale and retail MFIs. These standards are meant for use as industry benchmarks for all types of MFIs (Almorio et. al., 2006). Though Bangladesh has one of the oldest histories of microfinance practice, it enacted regulation for the sector only in 2006 when a central authority to regulate microcredit was set up.

The policy with regard to microfinance in India has been largely positive and developmental, and at the same time marked by caution and prudence. While the policy has brought the sector to its current state of development, in order to enable the sector to grow further in an orderly manner, certain major policy initiatives need to be taken.

The most important missing link in the country’s financial inclusion efforts is that of adequate saving channels for the poor. While commercial banks, regional rural banks, 

\[251\] This section draws from Shankar and Asher (2010).
and post offices, have good geographical networks, they are often unable to provide the
doorstep collection of small deposits on a regular, frequent basis as required by the low
income groups. These groups are usually unable to visit formal financial institutions
during specified working hours without incurring considerable transaction costs in terms
of time and money. MFI operations on the other hand are tailored to more effectively
meet their requirements, and hence they should be permitted to provide savings services.
While the BC model attempts to increases savings avenues for the poor, large MFIs
which have the scale required to provide these services in an economic manner, have not
been incentivized to participate in it.

The other important missing link in the country is the inability of low income
people to access affordable remittance and payments services. Mobile banking provides
the greatest scope for this to take place.

It is proposed that to address these two missing links, some of the large MFIs
should be selectively permitted to be converted to a special category of MFI banks with
lower initial capital requirements\textsuperscript{252}. These MFI banks should be permitted to offer
savings as well as mobile payment services. Given the large geographic area of the
country, licenses to collect deposits need to be provided selectively to entities, so as to
enable effective regulation. Regulators should assess an MFI thoroughly based on
financial, management and operational criteria. These entities should also have the

\textsuperscript{252} RBI has in August 2010 issued a discussion paper on “Entry of new banks in the private sector” and
invited comments on various aspects such as minimum capital requirements and whether industrial houses
or non bank finance companies should be permitted to promote banks. This could indicate that RBI may be
open to MFI NBFCs promoting banks.
capability to increase outreach substantially and reap economies of scale and scope so that lending costs in microfinance reduce considerably. Large MFIs who have a satisfactory track record are possible candidates. After a license is provided, continued supervision and monitoring of these entities is called for.

It may be desirable to extend deposit insurance, which is presently available to depositors in commercial and cooperative banks, (up to an amount of Rs. 0.1 million) to MFI Bank depositors, it may also create moral hazard issues. In any case, the contingent liability of the savings collected is likely to be on the State given India’s political economy characteristics. This therefore calls for strict and close supervision and regulation.

The MFI banks should also be permitted to offer mobile payment services. In Kenya, the success of M-PESA, the mobile money scheme launched by Safaricom, its largest mobile operator has nearly seven million users out of a total population of 38 million (Economist, 2009). The benefits for customers include quicker and cheaper transfer of money and a means to save small amounts of money for emergencies. The huge customer base and powerful brand of the mobile company enabled outreach to unbanked segments of the population. As regulators in many countries do not permit non bank entities to offer banking services, other models have developed. For example, in Uganda, a leading mobile company has partnered with a bank to offer a similar service (Economist, 2009).

In India, permitting MFI banks to partner with mobile companies to offer mobile banking services has the potential to enable access to remittance services to a large
number of unbanked customers. While the banks have a relationship with these customers and are best placed to serve them, the mobile companies have the technology and expertise required. Such collaborations can bring down transaction costs considerably.

The creation of MFI banks amounts to allowing entry of private well governed deposit taking small finance banks as recommended by the Raghuram Rajan Committee on Financial Sector Reforms (2008). As suggested by the committee, these banks will be in closer touch with customers and will provide tailor made products and services to them.

As small banks are likely to be geographically focused, the Rajan Committee calls for offsetting their higher risk by imposing more stringent regulations. The measures suggested are higher capital adequacy norms, stricter prohibition on related party transactions, and lower allowable single party transactions. While the last of the three may not be applicable in the case of MFIs, which usually have large number of small borrowers, the first two suggestions should be considered in developing regulatory norms for MFI banks. As recommended by the committee, the supervisory capacity should be developed to deliver greater monitoring these newer banks will require.

RBI would be an appropriate choice for prudential regulation of MFI banks, as it is the regulator for banks in India. This may stretch the regulatory capacity of RBI but would nevertheless be a worthwhile investment for the country as in the long run it could result in large scale financial inclusion and financial deepening. Training a team of
officials at RBI on various microfinance models and the peculiarities of microfinance regulation as well as the intricacies of prudential regulation will be required.

The non-prudential regulation of MFIs may be carried out by an independent regulator in the nature of an oversight board reporting to the RBI, so as to not to overstretch the regulatory capacity of RBI. The board should be broad based in nature consisting of representatives from Government, banks, MFIs, SHG federations, Sa-dhan, NGOs and consumer forums.

MFIs of all legal forms should be required to register themselves with this regulator and adhere to the uniform code of conduct prescribed. The code should cover truth in lending, transparency with regard to charges, financial education, selling appropriate financial products, practices for monitoring and collection as well as norms for provisioning of loans. Channels for customer complaints and dispute resolution should also be provided. The regulator should use creative means for communicating with SHG and MFI members so that they are made aware of them. The regulator should coordinate with other financial sector regulators, namely IRDA and Pension Fund Regulatory and Development Authority (PFRDA), with regard to insurance and pension services.

6.5 Concluding Remarks

This Chapter suggested a regulatory framework that addresses some of the issues that emerged in the course of the empirical study. These include the need for savings
services, which calls for prudential regulation of MFIs and the lack of financial literacy of MFI members which suggests a need for non-prudential regulation.

The regulatory structure in which an MFI operates has a strong bearing on its governance practices as these are often geared to meet the expectations of its external stakeholders. Hence a structure that encourages transparency and fair practices can result in higher levels of internal governance of MFIs. Moreover, regulation is imperative to enable the microfinance sector to contribute more effectively to the goal of financial inclusion, and to provide an environment in which all stakeholders can participate with confidence.

The recent developments in the state of Andhra Pradesh show the importance of regulation so that in times of crisis, hurried steps, without adequate deliberation such as those taken in Andhra Pradesh, can be avoided. The recommendations of the Malegam Committee which considered issues relating to NBFC-MFIs have not been well considered and some of them have potential to threaten the financial viability of these institutions. As a result the Committee Report has drawn criticism from various stakeholders in the sector. RBI has invited comments on the Report, and a regulatory framework for microfinance is expected to be evolved subsequently.

The thesis suggests a framework of regulation which effectively amounts to having two regulators. For prudential supervision of MFI banks, regulation by RBI is proposed. For non-prudential supervision for the sector as a whole, an independent oversight board (OB) reporting to the RBI is suggested. The members of the OB should have the requisite expertise as a group, and access to public and private sector experts.
This can be accomplished through appropriate advisory committees. The creation of regulatory capacity for prudential and non-prudential regulation of the Indian microfinance sector will be a major challenge, but is likely to be a worthwhile investment for the country as in the long run it could result in large scale financial inclusion and financial deepening.
Box 6.1 Malegam Committee Report on Microfinance Sector
The report’s recommendations relate to MFIs that are NBFCs. According to the committee itself, in 2010, NBFC-MFIs account for only 34 percent (Rs 183 billion) of the microfinance loans outstanding in India. The Self help group- bank linkage model, and other institutional structures such as societies, trusts and cooperatives account for 58 percentage, and 8 percentage of loans in India, respectively. The Report should have considered the entire MFI sector, so as to promote uniform regulation for the sector as a whole.

The Report makes a case for creating a separate category of NBFC-MFIs so as to enable the specialized treatment that MFIs require as compared to other NBFCs, due to the population sub-group they serve. Second, the Report specifically states that NBFC-MFIs should be exempt from the provisions of Money-Lending Acts. Such an exemption will prevent the misuse of such Acts by State Governments to pursue short term partisan objectives at the expense of public interest. Third, the Report points out the drawbacks in the draft Microfinance Bill and the Andhra Pradesh MFIs Act. It recognizes the conflict in interest inherent in case NABARD, a sector participant, also becomes a regulator. Finally, the Report suggests standardization in quoting interest rates; mandatory participation of MFIs in credit bureaus; and introduction of corporate governance norms for MFIs. These are urgently needed if the Indian microfinance sector is to reach its potential.

However, a number of the Report’s suggestions also have severely negative implications both for MFIs and their members. First, the Report suggests that MFIs should restrict their lending to households with annual incomes up to Rs. 50,000. On the one hand, assessing the precise value of a household’s income is difficult. On the other hand, a number of households with incomes well above this threshold remain unbanked and restricting possibly their only means to access financial services does not serve national objective of financial inclusion. (..contd.)
Second, the Report suggests that MFIs restrict loan size to Rs. 25,000. At present definition loans up to Rs. 50,000 are considered microfinance loans (other than in the case of housing loans where the limit is Rs. 150,000). It would be expected that over a period of time this cap would need upward revision as borrower needs and capabilities increase along with such macroeconomic factors such as inflation and increase in per capita income.

A downward revision of the nature prescribed by the Report is detrimental both to MFIs and borrowers. As larger loans reduce transaction costs, and often are more profitable, it could help MFIs in cross subsidizing their smaller loans. The MFI borrowers too should be encouraged to increase the scale of their microenterprise with time and a cap on borrowing will only serve to put a cap on aspirations in this regard, clearly not a desirable phenomenon.

Third, a cap of 24 percentage p.a. on lending rates of MFIs is proposed. Various other restrictive measures have also been suggested. For instance, 75 percentage of MFI loans are to be directed towards income generation activities. Further a cap on margins of MFIs has been proposed with the cap being 12 percentage for smaller MFIs (having loans outstanding less than Rs. 1 billion) and 10 percentage for larger MFIs. The Report also suggests that the minimum tenure of loans up to Rs. 15,000 should be at least one year while for larger it should be at least two years.

The restrictions are expressed using nominal monetary values which are likely to decline in real value over time. More importantly, such detailed restrictions imply a controlling mindset on the part of policymakers and will serve to considerably dampen the entrepreneurship that the sector is well known for. Preliminary projections have revealed that the suggested cap on interest rates combined with the additional administrative costs imposed for compliance with the proposed restrictions of the Malegam Committee is likely to render all MFI operations unprofitable irrespective of the size of the MFI (Krishnamurthy, 2011).
Appendix 6.1 Interest Rates in Microfinance

A number of reasons have promoted lack of interest rate transparency in the microfinance sector. First, as explained in Chapter 2, due to high costs of operation, interest rates that cover costs of microfinance providers tend to be high. To avoid political measures that may seek to constrain their interest rates and to avoid putting off potential donors, MFIs have adopted ingenious ways to obfuscate the real interest rate on microfinance loans. Second, the lack of regulation of MFIs on these matters makes such measures easy to adopt. Third, the lack of financial literacy of microfinance customers as well as their eagerness to avail finance ensures that customers also do not insist that interest rates are quoted transparently.

Given overleaf are cash flows associated with three microfinance loans. All of them are for value Rs. 9,000 with an upfront fee of Rs. 180 (2 percent), and insurance fee\(^{253}\) of Rs. 90 (1 percent). All of them claim to charge 12 percent p.a. The first MFI (MFI 1) charges interest on a flat basis and front-ends the interest payments, and markets it loans claiming that the customer benefits because her cash outflow keeps reducing over time. The second MFI (MFI 2) charges interest on a flat basis. The third MFI (MFI 3) charges interest on a declining basis. Using a spreadsheet and the Microsoft Excel function, the effective rate of return (ERR) (at times referred to as internal rate of return [IRR]) for the MFI in each case was calculated as shown overleaf. Moreover the sheet

\(^{253}\) This is typically for credit life insurance which implies that the loan is written off on death of the borrower.
also shows that when upfront fees are deducted by the lender, the effective principal loan amount is lower than the nominal principal loan amount. This too increases the effective annual interest rates as interest charges are calculated on the nominal principal amount.

In the absence of such a detailed calculation (made easier by use of spreadsheet tools), it is hard for even educated individuals to realize the huge difference that methods in which interest rates are quoted can make. It is therefore obvious how difficult it is for an average microfinance member to decide which MFI is offering a better deal.

There is increasing recognition of the issue of transparency in interest rates within the microfinance community. “MF Transparency” (www.mftransparency.org), a global initiative for promotion of this objective engages with stakeholders in different countries and also conducts workshops to increase awareness among MFI officials besides collecting data on microfinance products. A workshop was conducted in India in April 2010, and drew participation from 85 large MFIs in the country.
Calculation of Interest Rate Using Three Different Methods

Loan Amount:  Rs. 9000

Upfront Fee:    Rs. 180 (2 percent of loan amount)

Insurance Fee: Rs. 90 (1 percent of loan amount)

Membership Fee: Rs. 30 (Flat fee)

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<td>180</td>
<td>202</td>
<td>182</td>
</tr>
<tr>
<td>47</td>
<td>12-Nov-10</td>
<td>180</td>
<td>202</td>
<td>182</td>
</tr>
<tr>
<td>48</td>
<td>19-Nov-10</td>
<td>180</td>
<td>202</td>
<td>181</td>
</tr>
<tr>
<td>49</td>
<td>26-Nov-10</td>
<td>180</td>
<td>202</td>
<td>181</td>
</tr>
<tr>
<td>50</td>
<td>3-Dec-10</td>
<td>180</td>
<td>202</td>
<td>180</td>
</tr>
</tbody>
</table>

**ERR (or IRR)**

| Total Repayment (Principal plus interest) | Rs.10,080 | Rs.10,080 | Rs.9,540 |
| Interest Charges | Rs.1,380 | Rs.1,380 | Rs.840 |
| Annual Interest Rate as percent of Rs.8,700<sup>254</sup> | 16 percent | 16 percent | 10 percent |
| Annual Interest Rate as percent of Rs.9,000<sup>255</sup> | 12 percent | 12 percent | 6 percent |

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<sup>254</sup> Effective Principal (Nominal Principal of loan less fees deducted upfront)

<sup>255</sup> Nominal Principal of loan
Appendix 6.2 Features of Different Legal forms adopted by MFIs\(^{256}\)

The following table briefly summarizes the regulators for different legal forms of MFIs; and the advantages and disadvantages that each form entails.

<table>
<thead>
<tr>
<th>Legal Form of MFI</th>
<th>Regulator</th>
<th>Advantages for MFIs</th>
<th>Disadvantages for MFIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Society under Societies Registration Act, 1860</td>
<td>Registrar of Societies in each state</td>
<td>1) Simple requirements</td>
<td>1) No system for equity investment or ownership so unattractive for commercial investors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2) Low possibility of interference by regulator</td>
<td>2) Not permitted to accept deposits from</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3) Tax exemption for charitable activities</td>
<td>3) Vulnerable to the use of ‘usurious interest prevention acts’ of various state governments</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4) Have been permitted to act as agents for microinsurance by IRDA</td>
<td></td>
</tr>
<tr>
<td>Trusts under Indian Trusts Act, 1882</td>
<td>No specific regulator</td>
<td>1) Simple requirements And low possibility of interference</td>
<td>1) No system for equity investment or ownership so unattractive for commercial</td>
</tr>
</tbody>
</table>

\(^{256}\) The Appendix draws on MCRIL.(2005).
<table>
<thead>
<tr>
<th>Legal Form of MFI</th>
<th>Advantages for MFIs</th>
<th>Disadvantages for MFIs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not for profit Companies under Section 25 of the Companies Act, 1956</td>
<td>1) Simple procedures and low regulator interference&lt;br&gt;2) Has several exemptions from requirements of Companies Act&lt;br&gt;3) Can take up the activity of microfinance lending without the permission of RBI&lt;br&gt;4) Can obtain</td>
<td>1) Not permitted to accept deposits from customers&lt;br&gt;2) Not attractive to commercial investors as not permitted to distribute dividend</td>
</tr>
<tr>
<td>Company Law Board</td>
<td>Tax exemption for charitable activities</td>
<td>2) Not permitted to accept deposits from customers&lt;br&gt;3) Vulnerable to the use of ‘usurious interest prevention acts’ of various state governments</td>
</tr>
<tr>
<td></td>
<td>by regulator</td>
<td>investors</td>
</tr>
<tr>
<td>Legal Form of MFI</td>
<td>Regulator</td>
<td>Advantages for MFIs</td>
</tr>
<tr>
<td>------------------</td>
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<td>----------------------</td>
</tr>
<tr>
<td><strong>Non banking Finance Companies (NBFCs)</strong></td>
<td>Reserve Bank of India (RBI)</td>
<td>1) As they are regulated by RBI, investor confidence tends to be high 2) Attractive for investors as exit options are possible</td>
</tr>
<tr>
<td><strong>Urban Cooperative Banks</strong></td>
<td>Registrar of Cooperative Societies and RBI</td>
<td>1) Can be formed with 3000 members and capital of Rs. 100,000 2) Can accept member</td>
</tr>
<tr>
<td>Legal Form of MFI</td>
<td>Regulator</td>
<td>Advantages for MFIs</td>
</tr>
<tr>
<td>-------------------</td>
<td>-----------</td>
<td>---------------------</td>
</tr>
<tr>
<td>Cooperatives under various state acts on mutually aided cooperative societies</td>
<td>No regulation</td>
<td>1) Simple procedures  2) Can accept deposits  3) Can raise equity from members</td>
</tr>
</tbody>
</table>

- **Advantages for MFIs**:
  - 1) Simple procedures
  - 2) Can accept deposits
  - 3) Can raise equity from members

- **Disadvantages for MFIs**:
  - 1) Lack of regulation makes it difficult to attract funds
  - 2) No tax exemption
7. Summary, Policy Implications, and Directions for Future Research

This chapter provides a summary of the thesis and policy implications arising from the research undertaken. It also suggests areas for future research that merit consideration.

The microfinance sector in India has seen rapid growth. Two predominant models, namely the SBLP and the MFI models have emerged, both having their own strengths and weaknesses.

The strengths of the SBLP include its broader social objectives that go beyond mere provision of credit, focus on training of group leaders and members, and emphasis on savings. Moreover, the model offers greater flexibility in terms of procedures, as SHG meetings can be held according to the convenience of members, with presence of NGO staff necessary only in the initial stages. Its primary weakness is the quality heterogeneity in groups that invariably results as groups manage themselves after a point. Another serious threat to the SBLP with increase in membership of SHGs is that of politicization. With SHGs being used to channel benefits to low income segments, the motivation to provide benefits to these segments with political agenda can be expected to be high, particularly during election times. If over a period of time SHGs become political vehicles, availability of funds from commercial banks may reduce.

The MFI model has strengths in the greater uniformity of services, provided across groups, and standardized record keeping by MFI employees. The model potentially offers larger loans, which could be advantageous for members who are able to
service them. However, the sole emphasis on microcredit and the lack of savings services due to regulatory constraints are significant weaknesses. Moreover, with rapid growth of the sector, MFIs need to strengthen their institutional and governance capabilities.

While the share of the SHG model in total microfinance outreach is high at 70.5 percent; the outreach of the MFI model is growing faster. Analysis however suggests that both models need to be strengthened.

The thesis has analyzed the role of microfinance program in promoting financial inclusion in India through enquiry at three levels, the sector level; the provider level; and the member level. The sector level enquiry analyzed- if microfinance penetration in India addressed gaps in the geographic spread of banking services, thereby reducing geographic barriers to financial inclusion. It also examined availability of outcomes of financial inclusion such as access to a range of financial services and credit histories. It finally addressed graduation of group microfinance members to individual financial services

The analysis of the geographic spread of microfinance revealed, that microfinance penetration in the country was non-uniform, with state specific contextual factors playing a major role in driving microfinance growth. A comparison of the spread of microfinance services with that of banking services, found four distinct regional categories. While the Southern and Western regions were characterized by widespread availability of both kinds of services, the Central region had low availability of both kinds of services. The Eastern and North Eastern regions showed high availability of microfinance but not
banking services, while the Northern region showed high availability of banking but not microfinance services.

The above findings suggest the need to assign priority to the Central region, as it does not seem to be adequately served by microfinance or banking services. Development of microfinance services in other under-served states, which show widespread prevalence of banking services, will enable availability of a continuum of financial services for different income groups in those regions.

The study also found that within regions, there were States which showed a substantially higher or lower level of microfinance penetration than that of the region as a whole. These differences are likely to be explained by state-specific factors relating to public safety, security, nature of state politics, infrastructure, and cultural factors including attitudes towards business, finance and group membership.

The sector level enquiry also considered if the outcomes of financial inclusion, by way of a range of financial services and build-up of credit histories, was available to Indian microfinance members. Developments with regard to microinsurance, micro savings, remittances, micro-pensions and micro-housing were reviewed; and it was found that these services were developing with substantial scope for quantitative and qualitative development. The thesis highlighted that for future growth, product and process innovations and reduction of transaction costs by adaptation of technology and resources sharing will be required. The outcomes relating to development of credit histories are partially available to members, as these credit histories are developed only at the MFI level, and cannot be easily leveraged to access financial services from other providers.
The setting up of the credit bureau by MFIs, incorporated as NBFCs, is a useful first step though a credit bureau with wider sector participation will be more beneficial to members as well as providers. The project for providing unique identification numbers for residents of the country (UIDAI) holds considerable promise for financial inclusion, as well as building uniquely identifiable credit histories for individuals who lack documents, such as migrant workers.

Individual lending is at present a small segment within the Indian MFI sector. While the SBLP is completely group based and does not provide for graduation, even in MFIs; graduation to individual financial services of group microfinance customers does not appear to be systematized. As individual loans necessarily involve greater customization and closer monitoring, MFIs need to develop these capabilities.

The provider and member level enquiries examined - if in areas where microfinance is provided, barriers to financial inclusion are adequately addressed and whether expected outcomes of financial inclusion, such as access to required financial products and development of financial literacy, are observed among members.

The provider and member level research in the thesis suggested that there are individuals who may want to access microfinance, but are not able to do so due to various reasons. These include requirements such as attendance at weekly group meetings, documentation such as address proof, and a lack of a market-oriented economic activity. The findings also indicate that microfinance does not imply ongoing access to financial services, as it is found in a number of cases that access is temporary as members drop-out. There is a need for greater portability of microfinance accounts, in order to address
drop-outs due to migration and marriage. Such portability could also reduce overall resource costs of providing microfinance services.

At the provider and member level, the need for a wider range of financial services, particularly savings services, was observed. Availability of savings services could enable microfinance members who drop-out because they do not require loans, or those who are unable to service loans, to continue using financial services and prepare for contingencies. This is particularly important as they no longer have access to loans.

The research findings indicate that awareness regarding financial concepts and financial management needs to be nurtured, specifically in microfinance members. SBLP members displayed higher degree of awareness regarding interest rates, perhaps as book keeping is done by group members. Inability of the member to assess their repayment competence (taking into account all their liabilities) could be a serious risk factor when loan sizes and access to loans increase over time, for both members and institutions.

The research also suggests that graduation to individual loans is not usually actively sought by group members of both models. The research revealed that those capable of graduating need to be informed and trained on individual financial services, so that they have the confidence to use such services if offered to them. Graduation ultimately depends on repayment ability of the member, which typically is low when members join microfinance groups, but needs to increase over time by appropriate utilization of the loan.

It is understandable that the cash flow management constraints facing members will result in some microfinance loans (or some parts of them) being used for non-business
purposes. However, on a long term basis, members need to build up their economic activities over time, and ultimately their repayment capacity. This requires envisioning growth of their business enterprise, which was observed in only half of the members interviewed. Careful nurturing is required for members to more consciously pursue moving beyond their current capacities.

The study identifies two distinct categories of MFI members, “effective utilizers” and “ineffective utilizers”. The former build up individual repayment capability during group membership, which later enables them to graduate to individual loans. The ineffective utilizers consistently use their loans to meet consumption related expenses, hence do not build up repayment capacity. “Effective utilizers” were observed among both model groups. In addition, two other kinds of SBLP members were also observed, “cash flow smoothers” and “consistent savers”. While the first do not receive adequate finance from the group to invest substantially in their enterprise, the last category uses the SBLP mainly to save.

The three levels of enquiry enabled development of an explanatory framework for financial inclusion through microfinance. The framework points to the various factors that can contribute to financial inclusion through microfinance, and to the factors that could enable graduation of group microfinance members. The study additionally highlights drawbacks that arise due to inflexibilities and limitations of the financial products accessed by microfinance members of both models, and the need for more comprehensive financial training for microfinance members.
Policy Implications

National Level

There are three broad implications of the analysis at the national level.

First, all three levels of enquiry pointed to the need for savings services, which necessitate a regulatory framework for microfinance services at the national level. The development of a uniform framework at the national level, rather than regulation at the State level, is important to prevent distortions in the spread of microfinance based on variations in the nature of regulation in different states. Moreover, a uniform regulatory framework could provide greater administrative ease and flexibility for MFIs to expand operations, which could result in increase in scale and reduction in transaction costs.

The lack of financial literacy observed, even among mature microfinance members, also underlines the need for non-prudential regulation providing for transparency in interest rates and consumer protection in the sector. A framework involving two regulators, RBI for prudential supervision of MFI banks and an independent Oversight Board (OB)\(^{257}\) reporting to the RBI for non-prudential supervision for the sector as a whole, is suggested. The members of the OB should have the requisite expertise, and be able to access public and private sector experts.

Second, the sectoral enquiry suggests, the need to develop the microfinance sector in inadequately served regions. Targeted incentive packages at the national level to encourage the spread of microfinance to these areas could be useful. Thus, the RBI could

\(^{257}\) Elaborated in Section 6.4, Chapter 6
consider providing higher weightage on meeting priority sector lending requirements of microfinance loans channeled to these regions. NABARD could also consider restricting the availability of funds under the Financial Inclusion Fund, for promotion of financial inclusion in these areas.

A third implication which does not follow directly from the study results but is nevertheless relevant to promote creation of credit histories is the unique identity number and credit bureau initiatives. These are also promising for graduation of group microfinance members towards individual loans. The former needs policy encouragement by universalizing its use. The latter needs to cover all microfinance sector participants, for which active encouragement by policymakers may be required.

**State Level**

The study was conducted in Tamil Nadu, a state in which both models of microfinance are at a mature stage. Hence the results of the study may be more relevant to states in which the microfinance sector shows similar characteristics. However, three broad implications of the study may be indicated.

First, the study has emphasized that special efforts need to be made to improve financial literacy of microfinance members. As these involve substantial cost, they are unlikely to be carried through by commercial entities and require involvement of others, particularly state bodies. Moreover, financial training by third parties may be desirable. State Governments are well placed to coordinate the development and delivery of financial literacy programs, in culturally appropriate ways.
Two other implications follow from the observations about the Indian microfinance sector and recent developments, though not from the study in particular. First, some States have used microfinance loans as a means to channel subsidies. In such cases there is a political risk of these loans becoming instruments of partisan electoral politics to the detriment of public interest. Such schemes could adversely impact fiscal consolidation (i.e. keeping budget deficits sustainable); and on fiscal flexibility (i.e. reallocating budgets towards growth and equity enhancing avenues). Moreover, the member level enquiries suggest the presence of consistent savers in SHGs who are from higher income groups, implying that providing such subsidies through SHGs may result in them not reaching the intended recipients. More generally, it is important to recognize the need to insulate the microfinance sector from populist policies. Politicizing microfinance could result in creating significant moral hazards among stakeholders, as it may encourage undesirable behavior by members such as willful default on loans, which could eventually contribute to reduction in funds flow to the sector.

Second, States must take into account transaction costs and other implications of the rules and regulations they impose on operations of microfinance providers. The rules should be consistent with the implementation capacity of the State and should aim to facilitate, improve and not unduly restrict microfinance operations or micromanage them. In fact, it is preferable that once microfinance regulation is introduced at the central level, state specific regulation should be avoided as it could be dysfunctional creating an uneven
playing field within the country. As many large MFIs have a presence in more than one state, wide differences in regulation between states could create operational problems.

**Microfinance Provider Level**

There are five major implications at the provider level.

First, the provider and member level enquiries suggest the need to encourage development of a range of microfinance models, in addition to the SBLP and MFI models. This is to accommodate the requirements of heterogeneous groups observed among the low income households in the country.

Second, for group microfinance members to graduate to individual loans, more active encouragement in effective loan utilization is required. Even though microfinance members are encouraged to use the loans for income generating activities, it is often found that this is not adhered to nor insisted by the providers. While a certain degree of flexibility in use is desirable, special skill training may be needed to help individuals develop to engage in a productive enterprise that would enable income increase.

Third, microfinance providers should seek to provide portability of accounts between their branches so that members are not forced to drop out on account of relocating. This could provide great benefits to members and could also help providers retain customers.

Fourth, providers need to offer a wider range of financial services so as to cater to different financial needs of their diverse customers. The need for education loans, housing loans, and savings was articulated by those interviewed.
Fifth, recent events in Andhra Pradesh suggest that microfinance providers need to find ways to work together to not just evolve but also implement voluntary codes of practice on important operational aspects, such as standard and transparent ways of quoting interest rates. Such voluntary adherence to high ethical standards could allay concerns regarding the sector and reduce the demand for State directives regarding its operations.

**Member Level**

Microfinance members should show greater responsibility in their dealings with providers, if they want to reap the true benefits of microfinance. They need to take a longer term view of their financial goals and aim to build up strong credit histories and repayment capacities, to be able to graduate to individual financial services. This implies that they should take loans according to their repayment capacity and utilize loans in a manner that would boost this capacity over time. Members should avoid actions such as on-lending loans to other individuals at higher interest rates; as such actions may expose them to high levels of risk and may endanger their ongoing access to loans.

**Funding Agency Level**

The findings of the study have important implications for funding agencies, such as donors and social investors who fund microfinance with the objective of having a favorable social impact.

First, the study strongly suggests a need for funding programs to improve financial literacy and financial capability of microfinance members so that they are able to make more informed choices regarding financial products offered. These could enable them to
choose between similar competing products (such as between two providers of microfinance loans), choose the appropriate financial product to use at a particular time (such as whether to save or avail a loan) and finally to make use of a wider range of financial products (such as insurance, and pensions). While funding for microfinance operations is available from a variety of sources, funding for financial literacy and capability development may need to come primarily from non-commercial sources. Hence it may be desirable for funders to target funding to such areas, rather than merely contributing to the pool of resources of microfinance providers.

Second, socially oriented funding agencies could consider targeting funding in the area of livelihood and skill development. Its importance arises from research finding, that members who did not have market oriented economic activity for loan investment, were unable to build repayment capacity over time. Moreover, training and consultancy sessions for members targeted at encouraging better utilization of loans could be beneficial.

Third, it was found that in a majority of the cases, microfinance loans were not used by the members themselves but by their household members. However, this was not found to work negatively as often such loans were effectively utilized, and contributed to household income. Though the enterprises were run entirely by a household member, members viewed the enterprises as their own, in keeping with Indian ethos and culture. Moreover, allocation of responsibilities among household members with regard to running the microenterprise and attending weekly microfinance group meetings is based on practical considerations (e.g. men often cannot attend these meetings as they leave for
work early; while women cannot engage themselves in the enterprise due to other household responsibilities). Hence it appears that in the Indian scenario, effective utilization of the loan, rather than by which member of the household seems to be a more important factor. This could provide some insights to funding agencies on which features of microfinance programs to focus, on when deciding fund allocation.

**Directions for future Research**

The study points to several areas for further research.

First, as financial inclusion is not an end in itself but a means to promote more inclusive growth, research on how financial inclusion can effectively promote more inclusive growth is necessary. The potential role of technological improvements leading to transaction cost reduction; and improving the processes involved in accessing financial products, would be of particular interest.

Second, research on political economy factors that promote or hinder microfinance development could be useful to indicate, under what circumstances microfinance can flourish in a region. The findings could be useful for microfinance practitioners as well as policy makers. The uneven spread of microfinance in India, among states, provides a good opportunity for such research. In particular, research on how the state’s role with regard to microfinance can be consistent with its political and economic objectives would be important.
Third, experimentation and research on designing group microfinance programs that encourage better utilization of loans and specifically target graduation to individual financial services needs to be undertaken.

Fourth, while business training is at times offered by MFIs, analysis regarding whether incorporating business training combined with graduation to individual financial services, increases the profit the MFI makes from the customer over the total time period of MFI membership, could be useful.

Fifth, the study identifies the importance of financial literacy and training for microfinance members, which may not be undertaken by commercially oriented MFIs. As this may require involvement of Government or not-for-profit agencies, research on public-private partnership microfinance models or hybrid profit- not-for-profit microfinance models could be useful.

Sixth, more insights may be obtained by conducting bivariate or multivariate analysis on the contribution of microfinance to financial inclusion relative to other factors, and determinants of effective utilization.

**Concluding Remarks**

The thesis represents an attempt to enhance the quality of public debate on microfinance and financial inclusion. Drawing on primary research, academic literature and analysis, the thesis provides support for a nuanced approach to microfinance, void of over generalizations regarding its benefits or limitations. There is considerable scope for
further policy oriented research on microfinance in an empirically rigorous, yet locally contextual manner.


ADB website [www.adb.org](http://www.adb.org) [November 1, 2008]


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Annexure 1: Sample Questions for Discussion with MFP Senior Personnel

Name of Respondent:
Name of Organization:

Q1. How extensively do MFPs cover financially excluded population by microfinance providers in their areas of operation? Do you have data, aggregate or branch wise?

Q2. Are there any financially excluded segments of the population that you do not cover? If so, what are the reasons?

Q3. What mechanisms are required to provide access to these segments?

Q4. Are there any financial services that you feel you should offer but are not doing so right now? If so, what are the constraints preventing the launch of these products?

Q5. What do you envision as the future of group microfinance members? Do you think they should be graduated out of groups? What are the reasons?

Q6. Is the financial training they receive at the time of joining sufficient to enable them handle individual loans in future?

Q7. If a member wants to stop borrowing but would like to avail other financial services such as insurance for example, is it possible? If no, why not? If yes, how many such members do you have so far?
Q8. Do members build up individual credit histories when they avail of loans from your organization? How is it recorded? Can they take advantage of it to avail financial services from elsewhere in future?
Annexure 2: Sample Questionnaire for MFP Field Personnel

Name of Respondent:  
Name of Organization:  
Name of Branch:  
Number of borrowers handled:  

Tick Appropriate Answer

Nature of Branch: Urban Semi-Urban Rural

Q1. Have you come across a situation where a financially excluded member could not access group microcredit?  
Yes No

Q2. If yes, approximately how frequently do you come across such cases?  
Everyday Once a week Once a month Once a year

Q3. What are the main reasons? Please rank

Inability to form a group  
No address proof/documents  
Cannot attend meetings/Does not want to  
Does not have any economic activity  
Is not able to pass test after receiving training

Q4. Are there any financial products which are currently not being offered but which members ask that you should offer?
Q5. In your experience, have group micro credit members expressed a desire to move out of groups into individual financial services?

Yes [ ] No [ ]

How many of your borrowers have asked you about this aspect:
- Fewer than 10 [ ]
- 10-50 [ ]
- More than 50 [ ]
- More than 100 [ ]

Q6. In your opinion do you think, group micro finance members can handle individual financial services?

Yes [ ] No [ ]

Why?

Q7. What are the main reasons why members drop out of groups?
Annexure 3: Sample Questions for Discussion with MFP Member (In-depth interview)

Name of Respondent:
Name of Organization:
Name of Branch:

Tick Appropriate

Answer

Nature of Branch: Urban Semi-Urban Rural

Demographic Information:
Age:
Education:
Number of members in family:
Occupation:

Q1. What are the sources of your family income and how much does each source contribute? Are there any fluctuations in the income during the year?

What were the sources when you joined the MFP 3 years ago? What were the fluctuations then?

Q2. Financial decisions

a. Savings
Where are you saving your money and why?
Jewelry/ safe/ bank / others
Reason for saving

b. Loans
Trace out the history of the different loans availed in the last three years and the utilization by your family. What is the interest rate on the different loans?

How many times have you had to borrow from the money lender in the last 3 years, when and why? What is the interest rate you paid?

If another MFP were to offer you a loan, how would you decide if you should take the loan from them or from your existing MFP?

Are you able to repay installments of the loans comfortably? If no, why? If yes, how do you manage?

c. Other financial services
What other financial services have you availed and why? (ask about specific financial services not used at present)

Q3. At any stage did you think you needed any financial products which you could not access? If so, details?

Q4. Do you know which other MFPs operate in this area? Do you know what terms they offer? How many MFPs have you dealt with? Are you happy with the services you got?

Q5. Financial Planning
What are
a. Your costs to produce/ work per week?

b. The expenses of your family per month

c. The incomes of your family per month

d. Your capacity to save money?

e. Are there any major expenses for your family in the next few years? How do you plan to meet them?

f. How do you plan your day to day finances? Has there been any difference in the way you plan them after becoming an MFI member?

Q6. What do you envision for your self going forward?

Q7. Have you planned what to do with your next loan? How long do you plan to keep borrowing?

Q8. Do you want to avail individual financial services in future? What are the reasons?

General Question:

Q9. Have you come across a situation where a financially excluded individual could not access group microcredit? If yes, what are the reasons?

Q10. What are your suggestions for the MFP?