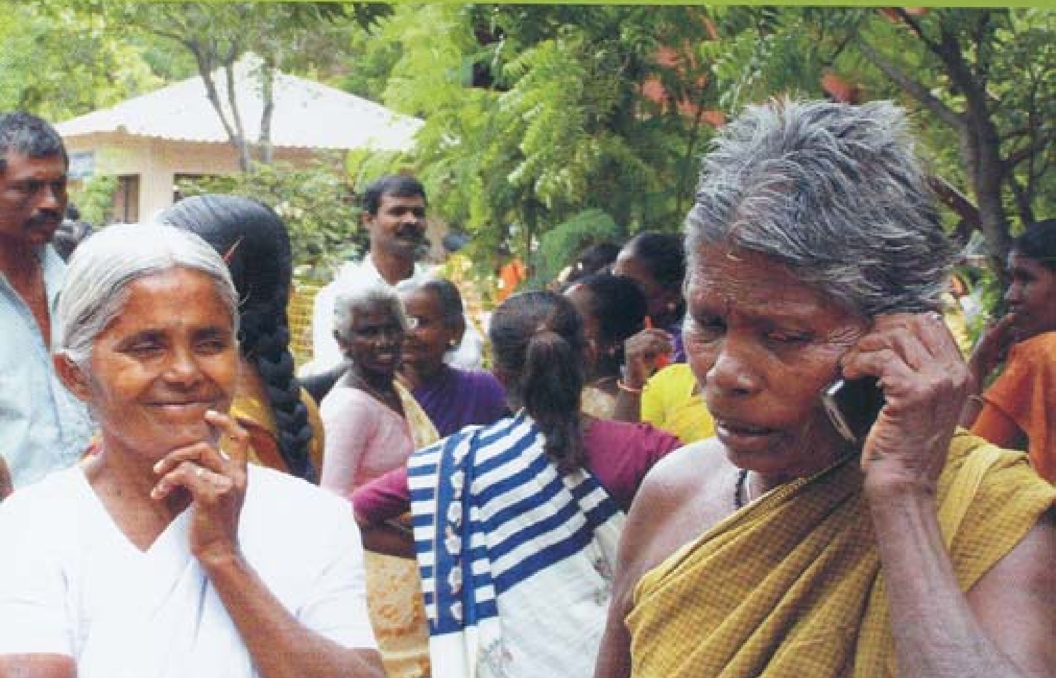
Indian Microfinance

THE CHALLENGES OF RAPID GROWTH

Prabhu Ghate



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List of Abbreviations

ABC	Activity Based Costing
ADB	Asian Development Bank
APMAS	Andhra Pradesh Mahila Abhivruddi Society
BC	Business Correspondent
BF	Banking Facilitator
BIRD	Banker's Institute of Rural Development
BPL	Below Poverty Line
CAB	College of Agricultural Banking
CAGR	Compounded Annual Growth Rate
CAP	Country Assistance Plan
CAR	Capital Adequacy Ratio
CASHE	Credit and Savings for Household Enterprises
CB	Capacity Building
CBFI	Community Based Financial Institutions
CBO	Community based Organization
CFSF	Credit and Financial Services Fund
CGAP	Consultative Group to Assist the Poor
CIDA	Canadian International Development Agency
CIF	Community Investment Fund
CM	Computer Munshi
CMF	Centre for Micro Finance
CMS	Computer Munshi System
DCCB	District Cooperative Central Bank
DFID	Department for International Development
DRDA	District Rural Development Authority
DRI	Differential Rate of Interest
EPF	Employees Provident Fund
ESIS	Employees State Insurance Scheme
FCRA	Financial Contributions Regulation Act
FLDG	First Loss Deficiency Guarantee
FWWB	Friends of Women's World Banking
GA	Group Accountant

GLP	Gross Loan Portfolio
GRT	Group Recognition Test
IASC	Indian Association of Savings and Credit
ICICI	Industrial Credit and Investment Corporation of India
IFAD	International Fund for Agricultural Development
IFMR	Institute for Financial Management and Research
IIMB	Indian Institute of Management Bangalore
IKP	Indira Kranti Patham
ILO	International Labour Organization
IRDP	Integrated Rural Development Programme
JLG	Joint Liability Group
JSBY	Jan Shree Bima Yojana
LAB	Local Area Bank
LIC	Life Insurance Corporation of India
LSS	Lights and Shades Study
MACS	Mutually Aided Cooperative Society
MCFI	Micro Credit Foundation of India
M-CRIL	Micro-Credit Ratings International Limited
MDC	Microfinance Development Council
MFDEF	Micro Finance Development and Equity Fund
MFI	Microfinance Institution
MIS	Management Information Systems
MIX	Microfinance Information eXchange
MLRC	Microfinance Learning and Resource Centre
MSDF	Michael and Susan Dell Foundation
MTO	Money Transfer Operators
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Finance Company
NGO	Non-Governmental Organization
NIBM	National Institute of Bank Management
ODA	Overseas Development Assistance
OSS	Operational Self Sufficiency
PACS	Primary Agricultural Cooperative Societies
PAR	Portfolio At Risk
PKSF	Palli Karma Sahayak Foundation
PLR	Prime Lending Rate
PS	Priority Sector
RBI	Reserve Bank of India

RGVN	Rashtriya Gramin Vikas Nidhi
RMK	Rashtriya Mahila Kosh
RMTS	Regular Monthly Transactions Statement
RoA	Return on Assets
RRB	Regional Rural Bank
SBLP	SHG Bank Linkage Programme
SBS	Side-by-Side Study
SDC	Swiss Agency for Development Cooperation
SEWA	Self Employed Women's Association
SFMC	SIDBI Foundation for Microcredit
SGSY	Swarnajayanti Gram Swarozgar Yojana
SHG	Self Help Group
SHPA	Self Help Promotion Agency
SHPI	Self Help Promoting Institution
SIDBI	Small Industries Development Bank of India
SKS	Swayam Krishi Sangam
STEP	Strategies and Tools against Social Exclusion and Poverty
TA	Technical Assistance
TCB	Training and Capacity Building
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VCF	Venture Capital Fund
VO	Village Organization
VWS	Village Welfare Society

Notes: 1 crore = 10 million; 1 lakh = 100,000; US$1 = Rs 45.5 approximately

Foreword

This book is the published version of the report 'Microfinance in India: A State of the Sector Report, 2006' presented at the conference organized by Microfinance India on 30–31 October 2006. The report is intended to be the first in a series of annual reports reviewing the progress of the sector in its entirety. Since demand for the report far exceeded the limited number of copies distributed to participants at the conference, it has been decided to publish it as a book. The contents of the report have been left unchanged.

The book is an attempt to put together a one-stop document that will help a variety of readers catch up on the latest developments, issues and achievements of the microfinance sector in India. The sector is growing rapidly, both in the scale and in the diversity of actors, and is sitting on the cusp of regulation. It is, therefore, in the midst of rapid flux. The book is in a sense a snapshot of the sector, taken when it was written. While parts of it will be overtaken by events, most of the issues and analysis will remain relevant for some time to come. We, therefore, expect it to retain permanent value as a reference document.

Not only has the rate of growth of the microfinance sector in India accelerated in the last few years, making it the largest in the world, so have changes in its institutional diversity. For some time now, there has been a growing demand by practitioners, financial institutions, policy makers, regulators, the research community, the media and the development community generally for a periodic, comprehensive and up-to-date account of the sector. Players in various parts of the sector want to know much more about the parts of the sector they would like to engage with more.

To take just a few examples, bankers and social venture capitalists are vitally dependent on the success of the efforts of the training and capacity-building service providers in easing the human resource constraints facing the sector, and would like to know more about their activities. The insurance companies are interested in opportunities offered by the Self Help Group (SHG) Bank Linkage Programme, just as bankers are curious about any opportunities that might lie in money transfers. Additionally, not enough is known about the unfolding priorities of the donors. Everyone is affected by what the regulators are doing (or should be doing), and the regulators in turn need to know more about the sector they are charged with regulating. This book furthers the goal of Microfinance India to bring the sector together to look at critical issues, propose solutions and vision the harmonious growth of the sector as a whole.

A number of extremely useful annual reports are already being prepared, such as those on various parts of the sector by the National Bank for Agriculture and Rural Development (NABARD), Sa-Dhan and Micro-Credit Ratings International Limited (M-CRIL), to name just a few. Some of the best information on microinsurance in India is being gathered and disseminated by the Strategies and Tools against Social Exclusion and Poverty (STEP) programme of the International Labour Organization (ILO). An increasing number of useful documents are emanating from abroad such as the recent Microfinance Information eXchange (MIX) survey of microfinance in South Asia, with a special emphasis on transparency, and several recent case studies by the Consultative Group to Assist the Poor (CGAP) on microinsurance in India. One of the aims of the State of the Sector Report and this book is to synthesize as many findings of these reports and studies as possible, highlighting issues on which continued progress depends, identifying knowledge gaps, calling for further research and greater statistical effort, and so on. Most important of all, this book aims to exercise strong advocacy for much needed policy and regulatory changes.

I am grateful to our sponsors, to the author who faced the daunting task of bringing out the report in time for the conference and the Microfinance India Advisory Group for overseeing its preparation.

Vipin Sharma
CEO, ACCESS Development Services

Preface

Information on Indian microfinance is scattered over a wide variety of sources, as one would expect in a highly decentralized development and financial movement, which has evolved as a result of the combined actions of a large number of creative, dynamic and idealistic individuals in civil society—supported initially by donors and then, increasingly, by the National Bank for Agriculture and Rural Development (NABARD) and the Small Industries Development Bank of India (SIDBI)—the banks and the government. Fortunately, Indian microfinance is not as under-researched as it used to be, although we are still touching the tip of the iceberg in terms of what needs to be known. One of the aims of the book is to publicize and synthesize the findings of important recent studies.

Due to constraints of time, several important topics could not be covered, including 'empowerment'; Self Help Group (SHG) federations; the cooperative Microfinance Institution (MFI) movement; the role of many of the public sector banks including some prominent Regional Rural Banks (RRBs) and District Cooperative Central Banks (DCCBs) in supporting the SHG movement; and community-based microfinance generally, which after all constitutes the bulk of the sector. Hopefully, these omissions will be rectified in the forthcoming issues of the annual 'State of the Sector Report'. Other topics that could not be covered here are urban microfinance and impact assessment, or the prospects of new technology applications. Of MFI financial services, only two of the 'younger' ones, microinsurance and money transfers, could be covered briefly, and not innovations in credit or savings.

While I have attempted to consult as many sector participants as possible, I am conscious that a number of significant approaches, programmes, initiatives, institutions, studies and documents have escaped mention because of the constraints of time and space and my own lack of familiarity with them. In particular, it has not been possible to do justice to the individual building blocks of the MFI model, the MFIs themselves or to the NGOs promoting the SHG movement, many of whom are setting new standards in good governance, transparency, product development, and successful identification and targeting of the poor. A report like this cannot expect to match their insights or have as nuanced an understanding as they do. I hope the individuals and organizations concerned will understand.

I am grateful to Vipin Sharma of CARE India for having had the vision to launch this effort and for the energy to see it through. Malcolm Harper was an endless source of good advice and useful comments. The other person, who went way beyond the call of duty and ploughed through many of the chapters out of sheer interest, although with considerable scepticism and disagreement on many points, was Ajay Tankha.

Rewa Misra prepared Section B of Chapter 8 on donor participation, Annie Duflo and her colleagues at the Centre for Micro Finance (CMF) contributed Chapter 9 on ongoing research, and Sakshi Varma assisted with Chapters 2 and 4, and Sheela Bajaj with the editing. Many thanks to all of them. Anjum Khalidi was a great source of support, as were Prabhat Labh and Rekam Jayasurya at CARE India. Others who spared time to comment on draft chapters and share valuable material were Krishan Jindal, Ajit Kanitkar, Vishal Mehta, Rajkamal Mukherjee, D. Narendranath, Jayendra Nayak, Sitaram Rao, Santosh Sharma, Sanjay Sinha, Frances Sinha, Mark Socquet, M.S. Sriram and Blaine Stephens,

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I am extremely grateful also to Viji Das and her team at Friends of Women's World Banking (FWWB); Annie Duflo, Rati Tripathi and other friends at CMF; Punit Gupta, Berenice Rose and Rupalee Ruchismita of the Social Initiatives Group at Industrial Credit and Investment Corporation of India Bank (ICICI Bank); Sneh Lata Kumar and her colleagues at Rashtriya Mahila Kosh (RMK); Vijay Kumar, Navin Mittal and other officials of the Andhra Pradesh government in Hyderabad and Krishna district; Jayant Madhab, Amiya Sharma and their colleagues at Rashtriya Gramin Vikas Nidhi (RGVN); Mathew Titus and his colleagues at Sa-Dhan; J.S. Tomar and his team at Cashpor; Graham Wright and Ranjani at MicroSave. Stuart Rutherford, Shashi Rajagopalan and many others were kind enough to give me guidance and share material through e-mail. My apologies to the many others whom I may have left out. Thank you again, all of you. It goes without saying that the usual disclaimers apply.

Overview and Summary of Main Recommendations

1

THE GOOD NEWS (WHICH FAR OUTWEIGHS THE BAD)

Indian microfinance has continued growing rapidly towards the main objective of financial inclusion,[1] extending outreach to a growing share of poor households and to the approximately 80 per cent of the population, which has yet to be reached directly by the banks.[2] The larger of the two main models, the Self Help Group (SHG) Bank Linkage Programme (SBLP) covered about 14 million poor households[3] in March 2006 and provided indirect access to the banking system to another 14 million, including the 'borderline poor'. Although firm estimates are lacking, the other, the Microfinance Institution (MFI) model, served 7.3 million households, of which 3.2 million were poor. Even allowing for a degree of overlap of borrowers from both models, the total number of poor households being reached was roughly a fifth of all poor households,[4] as well as a smaller share of the larger number of non-poor households who have yet to be reached by the formal financial sector.[5] Apart from providing financial services to both these segments of the population, there is widespread evidence that the much stronger competition provided to the informal sector has significantly improved the terms of credit provided to both segments by this sector, which is losing its share to both the formal and the (semi-formal) MFI sector.

Now that the sector[6] can be reasonably confident that it will continue growing rapidly enough to be able to make a major dent in financial inclusion within the next 10 years or earlier (subject to success in tackling the main uncertainty facing the MFI model, the difficulties stemming from the lack of public and regulatory awareness of the need to charge cost-recovering interest rates), it can perhaps afford to sit back a bit and look more closely at issues of quality such as improving book-keeping in the SHG model, consumer protection issues in the MFI model, and extending the depth of outreach and evolving products that are more responsive to consumer needs and preferences in both models. Solving quality issues will, in any case, contribute to higher growth in the long term. These issues have become increasingly salient, both because recent studies have given us a better understanding of their nature and extent (in the case of the SHG model), and because the sector is now a big enough player for its mistakes to be noticed and publicized.

This has been an unexpected price of success, but the sector has perhaps always underestimated the age-old image problem that confronts the business of money lending (no matter how exalted its purpose). It remained shell-shocked for a while by the harshness with which some of its practices were brought to public notice during the Andhra Pradesh (AP) crisis which came to a head in March 2006, but better to be woken up this way than not at all. The consensus is that the sector will emerge stronger if it reads the lessons the right way, and conjures up the collective will to implement them. The experience has left many observers less sanguine about the sufficiency of self-regulation left to itself, unaided by external regulation, and has highlighted the need for a combination of both. Ironically, it is the sector that wants outside regulation more strongly than the National Bank for Agriculture and Rural Development (NABARD), the agency likely to be entrusted with the task under the proposed microfinance bill.

Growth under the MFI model has been greatly facilitated by the sharp increase in bank credit to MFIs. A wide range of banks are now financing the sector, the private sector banks lending mostly to MFIs, and the pubic sector banks through their wide network of rural bank branches, mostly to the SHGs. The private sector banks are financing MFIs both because they regard it as good business and due to priority sector obligations. More and more public sector banks are also viewing SHG financing as profitable and are undertaking it less and less because of moral suasion from the government and NABARD.

Thus, one of the main constraints on expansion under both models, the availability of on-lending funds, has been greatly relaxed in the last couple of years. More recently, a number of new venture capital funds are making a similar contribution with respect to equity capital, which is required to: (i) meet capital adequacy concerns; (ii) entry capital requirements to the more formalized parts of the sector, mainly the Non-Banking Finance Companies (NBFCs); and (iii) provide longer term capital for financing MFI infrastructure, and working capital during the long expansion phase, between 5 to 10 years, when a start-up MFI is running deficits.

Aided by increases in the sources of equity capital, the sector is heading in the direction of greater formalization, with several former NGO-MFIs and Section 25 companies seeking to transform themselves into Non-Banking Finance Companies (NBFCs). Some of them are buying out existing NBFCs—registered before 1999 when entry capital requirements were much lower—which have ceased operating and are available for sale. Moreover, an increasing number of start-ups are seeking to enter the sector as NBFCs from the outset. The latter trend has been assisted by the growing number of experienced professionals who are being attracted to the sector; many of them are retired bankers or former MFI professionals, who find it easier to provide the necessary comfort to equity investors and lenders.

One of the most exciting new trends in the sector is the imminent expansion of urban microfinance in India. At least four new and one existing urban MFI (one of the very few in the country), two in Bangalore, and one each in Ahmedabad, Kolkata and Mumbai, are negotiating with equity investors and lenders so as to enable them to expand rapidly as NBFCs. Another new trend is downscaling, with an existing NBFC—an urban finance company—planning to expand lending to micro borrowers in Delhi. Downscaling has for long been an emphasis of donors and technical assistance providers in Latin America, and is an approach that applies to lending by the banks too.

Further, financial sources for technical assistance for much-needed capacity building are becoming more diverse; these include the new equity investors who provide it through grants to accompany their capital assistance; some of the larger lenders, such as ICICI, tying up with the capacity-building providers to provide