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Vision of Microfinance in India

Sakshi Varshney
Department of Humanities and Social Science
Jaypee Institute of Information Technology, Noida (INDIA)

Abstract

Microfinance sector is expanding rapidly and growing its business in recent years. Microfinance has occupied centre stage as a promising conduit for extending financial services to unbanked sections of the population. India owns the highest concentration of the number of borrowers with 188 million accounts of clients representing 18% of the total population in the developing world. The overview articulated in this discourse highlights the Origin and concept of Microfinance, its channels & the funding sources. The paper briefs about the main costing elements of microfinance and its impact on India.

1. Introduction

Over the last few decades, Indian economy has been at the forefront of world trade and industry [1]-[2]. The opening up of the economy to encourage foreign investors, financial services providers and global corporations has transformed modern day India into a bustling world power and brought in state of the art technology and wealth across different sectors.

This has however not able to transfer a sizeable section of the population, which continues to remain excluded from the most basic opportunities and services provided by the traditional financial system. Microfinance emerged as a powerful tool which brought a sea of change in the lives of many poor and the citizens overpopulated country, India. Microfinance plays a vital role in reducing poverty since it paves the way for employment and empowerment, which leads to economic development. By reaching the un-reached rural poor in the rural areas, microfinance innovations are yielding results and giving hope to the millions of poor through providing credit.

Microfinance basically means providing financial services to poor persons especially women whose scale of operations are very small and hence are excluded from the purview of the existing service providers. Since the clients of microfinance institutions (MFIs) have lower incomes and often have limited access to other financial services, microfinance products tend to be for smaller monetary amounts than traditional financial services .It refers to economic services which serve as an important tool of development paradigms for poverty alleviation through social and economical empowerment of poor. It includes various finance related services like providing small loans, providing insurance, mobilizing small savings, money transfer services, pension services, housing and other private loans to the poor. Microloans are given for a variety of purposes, frequently for microenterprise development. The diversity of products and services offered reflects the fact that the financial needs of individuals, households, and enterprises can change significantly over time, especially for those who live in poverty. Because of these varied needs, and because of the industry's focus on the poor, microfinance institutions often use non-traditional methodologies, such as group lending or other forms of collateral not employed by the formal financial sector.

MIX recognizes many general definitions of microfinance, but for analysis purposes, employs a functional definition:

Microfinance services – as opposed to financial services in general – are retail financial services that are relatively small in relation to the income of a typical individual. Specifically, the average outstanding balance of microfinance products is no greater than 250% of the average income per person (GNI per capita).

2. The History

The history of micro financing can be traced back as long to the middle of the 1800s when the theorist Lysander Spooner was writing over the benefits from small credits to entrepreneurs and farmers as a way getting the people out of poverty. Independently to Spooner, Friedrich Wilhelm Raiffeisen founded the first cooperative lending banks to support farmers in rural Germany. However, the pioneering of modern microfinance is often credited to Dr. Mohammad Yunus, a Professor of Economics in Bangladesh. Prof. Yunus was hurt when he saw the poor condition of people at the time country faced a feminine. He felt guilty of teaching theories of economics in the comfort of classroom. He left the campus and went to Jobra, a village in Chittagong of Bangladesh, to learn a new method of banking for the poor. There he developed the idea of tiny loans for self employed of the poor. Hence the idea of microcredit was born. It is from here that it took the shape of Gramin Bank, Bangladesh. NABARD with the Self Help Group model has created opportunities for commercial banks to lend to the poor. It has been encouraging voluntary agencies, bankers, and socially spirited individuals, other formal and informal entities and also government functionaries to promote and nurture SHGs & Microfinance Institutions (MFIs) (http://wekepedia.org).

3. Channels of Microfinance

In India microfinance operates through two channels:

3.1. SHG-Bank Linkage Programme (SBLP):

This is the bank–led microfinance channel which was initiated by NABARD in 1992. SHGs formed by Non-Government Organisations as well as Government agencies are considered to be very important bodies in rural development. A SHG is an association of generally 20 members usually a woman who contributes their savings in the group periodically and provide small loans to other members. As more SHGs are formed they have started federating themselves into clusters and clusters in turn as SHG Federations. The Federations are able to channelize funds to the SHGs and also help in improving the managing and financial skills of SHGs.

3.2. Microfinance Institutions:

A range of institutions in public sector as well as private sector offers the microfinance services in India. They can be broadly categorized into two categories namely, formal institutions and informal institutions. The former category comprises of Apex Development Financial Institutions, Commercial Banks, Regional Rural Banks, and Cooperative Banks that provide microfinance services in addition to their general banking activities and are referred to as microfinance service providers. On the other hand, the informal institutions that undertake micro finance services as their main activity are generally referred to as Micro Finance Institutions (MFIs). While both private and public ownership are found in the case of formal financial institutions offering microfinance services, the MFIs are mainly in the private sector.

3.3. Microfinance Service Providers:

The microfinance service providers include apex institutions like National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), and, Rashtriya Mahila Kosh (RMK). At the retail level, Commercial Banks, Regional Rural Banks, and, Cooperative banks provide microfinance services. Today, there are about 1,61,480 retail credit outlets of the formal banking sector in the rural areas comprising 13,000 branches of District level cooperative banks, over 15,480 branches of the Regional Rural Banks (RRBs) and over 38,400 rural and semi-urban branches of commercial banks besides almost 94,600 cooperatives credit societies at the village level. On an average, there is at least one retail credit outlet for about 4600 rural people. This physical reaching out to the far-flung areas of the country to provide savings, credit and other banking services to the rural society is an unparalleled achievement of the Indian banking system. An attempt is made here to deal with various aspects relating to emergence of private microfinance industry in the context of prevailing legal and regulatory environment for private sector rural and microfinance operators.

4. MFIs and Legal Forms

Firm data regarding number of MFIs operating in the country is not available. An attempt to create an information base on micro finance institutions operating in 13 microfinance intense States was made in 2008 under “NABARD GIZ Rural Financial Institutions Programme” (RFIP).

5. MFIs of India

Forbes magazine named seven microfinance institutes in India in the list of the world's top 50 microfinance institutions.

Bandhan, as well as two other Indian MFIs- Microcredit Foundation of India (ranked 13th) and Saadhana Microfin Society (15th) – have been placed above Bangladesh-based Grameen Bank (which along with its founder Mohammed Yunus, was awarded the Nobel Prize). Besides Bandhan, the Microcredit Foundation of India and Saadhana Microfin Society, other Indian entries include Grameen Koota (19th), Sharada's Women's Association for Weaker Section (23rd), SKS Microfinance Private Ltd (44th) and Asmitha Microfin Ltd (29th).

Table 1. Legal Forms of MFIS in INDIA

Types of MFIs	Estimated Number*	Legal Acts under which Registered
1. Not for Profit MFIs a.) NGO - MFIs	400 to 500	Societies Registration Act, 1860 or similar Provincial Acts Indian Trust Act,

		1882
b.) Non-profit Companies	10	Section 25 of the Companies Act, 1956.
2. Mutual Benefit MFIs Mutually Aided Cooperative Societies (MACS) and similarly set up institutions	200 to 250	Mutually Aided Cooperative Societies Act enacted by the State Governments
3. For Profit MFIs Non-Banking Financial Companies (NBFCs)	6	Indian Companies Act, 1956 Reserve Bank of India Act, 1934
Total	700 - 800	

*The estimated number includes only those MFIs, which are actually undertaking tending activity (Source-NABARD)

6. Funding Sources for Microfinance Institutions

Capital availability for meeting the funds requirements of MFIs are ample and diverse [3]. Broadly there are two sources for meeting the funding requirements.

6.1. External Sources:

Saving deposits: Micro saving products also known as retail deposits, offered by MFIs serve as a low cost source of funding.

- *Commercial Debt capital*: Short term loans and long term debt can be acquired from commercial banks. Additionally, international investment funds also known as microfinance investment vehicles (MIVs) act as intermediaries between investors and MFIs by selling securitized debt. Even though loans from commercial source are generally priced at the market rate, which new and small MFIs may find expensive, debt capital is a popular source of funds for microfinance providers.
- *Soft Loans and Grants*: Concessionary/Soft loans (low cost debt) or grants may be sourced by microfinance providers from socially responsible investors, which include national and regional development banks, aid agencies, international NGOs, non –profit corporations, charitable trusts, or funds held by donor and development agencies.
- *Equity Capital* : Equity capital, which is acquired through the sale of ownership shares, via capital markets is the most expensive source of capital for MFIs but most attractive for investors because of high returns prevalent in the microfinance sector.

6.2. Internal Sources:

Income from operations and income from investments are some sources which generate funds on a self sustainable basis.

7. Main Cost Drivers

An MFI's main objective is to provide poor and low income households with an affordable source of financial services. Interest charged on loans is the main source of income for these institutions and, because they incur huge costs, the rates are correspondingly high. Four key factors determine these rates: the cost of funds, the MFI's operating expenses, loan losses, and profits needed to expand their capital base and fund expected future.

The administrative costs are inevitably higher for tiny micro lending than for normal bank lending. Lending out a million dollars in 100,000 loans of $100 each will obviously require a lot more in staff salaries than making a single loan for the total amount. As a result, interest rates in microfinance institutions (MFIs) are substantially higher than the rates charged on normal bank loans.

Further, the MFI has to cover the cost of the money that it lends and the cost of loan defaults. For example, if the cost paid by the MFI for the money it lends is 15 percent, and it experiences defaults of 2 percent of the amount lent, then these two costs will total $17 for a loan of $100. An interest rate of 11percent of the loan amount thus covers both these costs for either loan. In addition to this, there is another major cost, transaction costs. The transaction cost of the $500 loan is not much different from the transaction cost of the $100 loan. Both loans require roughly the same amount of staff time for meeting and to train, recruit, the borrower, appraise the loan, processing the loan disbursement and repayments, and follow-up monitoring. MFIs incur costs not only in sourcing funs and disbursements of these funds to microcredit clients but also in promotion and monitoring of microfinance client groups and development of process for improving efficiencies of service delivery and distribution of costs for major group of activities as presented below:

Table 2. Composition of MFIs Costs

	Percentage of total costs
Promotion & Monitoring of group process	4.40
Taking financial services to the client	11.05
Service sustaining and managing activities	27.69
Establishment expenses	6.69
Process, improvement and	6.45

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institutional development	
Operating costs	57.01
Financial costs	42.99

Suppose that the transaction cost is $50 per loan and that the loans are for one year. To break even on the $1000 loan, the MFI would need to collect interest of $150 + $20 + $50 = $220, which represents an annual interest rate of 22 percent. (http://cgap.org)

This does not mean that all high interest charges by MFIs are justifiable. Sometimes MFIs are not aggressive enough in containing transaction costs. The result is that they pass on unnecessarily high transaction costs to their borrowers. Sustainability should be pursued by cutting costs as much as possible, not just by raising interest rates to whatever the market will bear. Muhammad Yunus says 'interest rates should be as much that the MFIs should be able to recover their cost of servicing the loans. Anything above 20 per cent rate should be profit making MFI'. He further adds that Micro finance should be a social business. If companies are focusing on generating profits out of MFI business, they should start calling themselves commercial micro credit firms.

8. Challenges before Microfinance in India

In view of high economic growth and vast development, microcredit through MFIs has got good future [4]. Micro lending to poor helps to cover vast majority of financial needs of low income groups in India. But the high interest rate charged by the MFIs curb the borrowings of poor people. Public sector banks have raised the effective interest rate at which they lend money to microfinance institutions (MFIs) between 15% to 18%, citing higher risks in the sector. High operating costs brings down the graph of social benefit of microcredit. Encouraging MFIs for opening new branches in untouched areas of microfinance in the state will encourage rural penetration in the state.

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