Micro Finance Institutes – Are They Relevant in Poverty Alleviation? Lessons from India

Maitra Shipra
Director
Amity College of
Commerce & Finance
Amity University
Uttar Pradesh
smaitra@amity.edu

Micro finance institutes (MFIs) are providing access to credit for informal sector that cannot approach formal lending sector, i.e. the banks. It is considered to be an important instrument for poverty alleviation and improving quality of life. This paper tries to analyze how for this objective has been fulfilled in India. Over time, MFIs in India have grown from strength to strength but, unfortunately there is no clear picture related to the impact on poverty alleviation. On one hand MFIs are commercial organisations working for reduction of risk potentials while on the other hand, there is increasing doubt about their role in poverty alleviation. The Society for Elimination of Rural Poverty, set up by the AP state government, has come out with examples of coercive recovery practices followed by the MFIs and consequent suicide by the borrowers.

This paper tries to focus on this issue. The analysis is based on secondary data like reports of SIDBI, RBI, NABARD and other relevant studies. It tries to analyze how far the financing system of MFIs is responsible for creating this dilemma between enhancing social equality and focusing on cost recovery.

Keywords: credit, informal sector, poverty alleviation

INTRODUCTION

The UN Millennium Declaration, which was convened in 2002, committed the participating countries to work together to achieve the Millennium Development Goals (MDGs), the foremost being reducing absolute poverty in the world by one-half by the year 2015. Micro Finance programmes, that serve the poor, are being seen as an important vehicle for realising the MDGs and reducing poverty and vulnerability. However, empirical evidence on the impact of Micro Finance is still quite limited and suffers from several constraints. Key issues and questions, such as, who is being served by micro finance, does Micro Finance lead to a reduction in poverty, etc., still need to be answered.

In India, the history of rural finance credit, poverty alleviation and micro finance are inextricably interwoven. The forces and compulsions that shaped the initiations in these areas are best understood in context of state and banking policy over time. In the development strategy adopted in five year plans, institutional credit was perceived as a powerful instrument for enhancing production and productivity and for alleviation of poverty. It was envisaged that lending to the poor should be a part of the normal business of banks.

The subject of providing credit to support people in rural area and to the poor in particular, has been explored extensively from time to time in India. The Indian Credit System is a product of evaluation as well as intervention. The broad objectives of policy innovations have been (a) to institutionalize credit (b) to enlarge its coverage and (c) to ensure provision of timely and adequate credit to wider segment of population. The institutional innovations have been a continuous process with a multi—agency approach to provide credit to the marginalised sector.

GROWTH AND CREDIT STRATEGIES

Evolution of strategy related to credit delivery system has some parallel to the evaluation of thought on economic growth and development. At first, the major concern was to accelerate economic growth, identified with the increase in the availability of goods and services at faster pace to eradicate poverty. Second stage witnessed a greater concern with distribution of income. Development is regarded as going beyond income growth and brings out changes in the structure of the economy. In the third stage, the concept of equity was translated into provision of basic needs for the improvement in the quality of life of people.

In case of credit delivery system, similar evolution of approach has emerged. In the early stage, the emphasis was on providing more credit. In the second stage, the emphasis shifted to ensure that credit went to all segment of society. Thirdly, the priority sector lending has been specified. Despite the expansion of the organized banking system deep into the rural area, a very large number of the poor continued to remain outside the fold of the formal banking system. The formal banking system with its systems and procedures was found to be inaccessible to the poor. This led to a search for an alternative delivery mechanism which would meet the requirements of the poor and the marginalized.

To achieve the objectives of production, productivity and poverty alleviation, the strategy on rural credit has been to ensure that sufficient and timely credit reached to a large segment of rural population as reasonable rates of interest. The strategy devised for this purpose comprised of:

1. Expansion of institutional structure
2. directed lending to disadvantages borrowers and
3. Interest rates supported by subsidies.

The institutional vehicles chosen for this were cooperatives, commercial banks and Regional Rural Banks (RRB).

Between 1950 and 1969 emphasis was on the promotion of cooperatives. Nationalisation of banks in 1969 marked the beginning of multi agency approach in provision of rural credit. After 1969, there was phenomenal expansion of bank branches in rural and semi-urban areas. Regional Rural Banks were set up in 1976 to concentrate more on availability of credit to the rural poor with a specific mandate of poverty alleviation through microfinance

During late sixties, the Central Bank intervened to address to factor which discouraged the flow of credit to the rural sector such as absence of collateral among the poor, high cost of serving geographically dispersed customers, lack of trained and motivated rural bankers etc. The policy response was multidimensional and included special credit programs for channelizing subsidised credit to the rural sector and operationalising the concept of priority sector.

Consequently, access in terms of rural branches increased from 1,833 in 1969 to around 40,000 in 2010. The proportion of rural borrowers from institutional sources increased from 7 percent in 1951 to more than 65 percent in 2010.

The significant increase in credit flow from institutional sources increased the enthusiasm of the state agencies. However, this could not be sustained as the focus was on quantitative targets, not the qualitative aspects of lending like loan defaults, erosion of repayments ethics by all categories of borrowers. The end result was disturbing growth in overdue that not only hampered the recycling of scarce resources of banks but also affected profitability and viability of financial institutions. This affected the development impact of rural finance as the desire of banks to lend to the poor declined.

This necessitated financial sector reforms to improve the efficiency and productivity of all credit institutions including rural financial institutions. The reforms sought to enhance the areas of commercial freedom, increase their outreach to the poor and stimulate additional flows to the deprived sector.

The reforms included liberalizing interest rates for cooperations and RRBs and relaxing control on borrowing purpose. Rural Financial Institutions (RFI) could lend under priority sector with prudential norms.

The financial sector reforms motivated policy planners to search for products and strategies for delivering financial services to the poor.

GROWTH OF MICROFINANCE: SHGS AND MFIS

The distinction between microfinance and micro credit has to be underlined.

Specifically, microfinance refers to loans, savings, insurance, transfer services and other financial products targeted at low-income clients whereas micro credit refers to a small loan to a client made by a bank or other institution. Micro credit can be offered, often without collateral, to an individual or through group lending.

Microfinance, in most simple terms, is described as banking for the poor and covers micro credit, micro savings, micro insurance and remittances. Asian Development Bank (ADB) defines microfinance as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and micro enterprises

(ADB, 2000). In India, the recent Task Force on Microfinance has defined microfinance as the "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards. In the Indian context terms like small and marginal farmers, rural artisans and economically weaker sections have been used to broadly define micro-finance customers (Basix,2000; Khandelwal, 2007).

Two prevalent models of micro finance in India are as follows:

1. SHG – Bank linkage Model – it involves the SHGs financed directly by the banking agencies i.e. Commercial banks RRBs and co-operative banks.
2. MFI – Bank Linkage Model – It covers financing of MFIs by banking agencies for on-lending to SHGs and other small borrowers covered under microfinance sector.

A SHG is a group of 10 to 20 persons from a homogenous background who come together for addressing the common problems. They collect voluntary savings on a regular basis and use the pooled resources to make small interest bearing loans to their members. At a later stage, these groups are able to obtain credit from outside sources to support income-generating activities very often, there is a self-help promoting institution which enables the self help group to formation effectively.

A stimulus to the rapid growth of self-help groups was provided when the SHG – Bank Linkage Programme was initiated in 1992. IT was a pilot project for promoting 500 SHGs. The idea gained acceptance from the banking system and the RBI encouraged this initiative. Banks received the instruction in 1996 to cover SHG financing as a main stream activity under the priority sector lending portfolio. SHG and bank linkage is considered as a potential innovation in the area of banking with the poor.

The evolution of SHGs can be observed at three levels –

- First Level – Households use microfinance to meet survival requirements where small savings and loans serve as a buffer in the event of emergency or servicing previous debt with more liquidity.
- Second Level – Subsistence needs are met through microfinance. A household begins to utilize microfinance to diversity its basket of income generating activities or to meet working capital requirements in traditional activities.

- Third Level – Households reach a stage where they can assume a higher degree of risk micro finance would be used to invest in setting up on enterprise or facilitate entry into employment in order to make the household sustainable.

The idea of financial inclusion was in-built into group-lending system much before the term became popular. Ela Bhatt established the Self-Employed Women's Association (SEWA) in 1972. It was to bring poor women together and give them ways to fight for their rights and earn better livings. Its membership grew to 7000 members in 1975 and to over 700,000 now. The SEWA Cooperative Bank has $1.5 million in working capital and more than 30,000 depositors with a loan return rate of 94 per cent. SEWA's efforts to increase the bargaining power, economic opportunities, health security, legal representation, and organisational abilities of Indian women have brought dramatic improvements to hundreds of thousands of lives and influenced similar initiatives around the globe (Ramakrishnan, 2007). The rapid growth and finer success of SHGs has given a fillip to all-round development of its members.

Another approach to providing microfinance has been through the Micro Finance Institutions (MFI). Even before the SHG method was improvised, many NGOs were using a variety of delivery mechanisms to provide credit to the poor with financial support from external donors and by apex institutions like Rashtriya Mahila Kosh set up by the Government, the Small Industries Development Bank of India (SIDBI) Foundation for Micro Credit and National Bank of Agriculture and Rural Development (NABARD). Since 2000, commercial banks including RRBs are providing funds to MFIs for on-lending the poor clients. There are around 800 private MFIs operating in the country in various legal forms:

1. NGO MFIs – Registered under Societies Registration Act 1860 and / or Indian Trust Act 1880
2. Co-operative MFIs – Registered under State Co-operative Societies Act or Mutually Aided Co-operative Societies Act (MACS) or Multi-State Co-op. Societies Act, 2002
3. NBFC MFIs—incorporated under Section 25 of Companies Act, 1956 (Not for profit)

Following the RBI guidelines in 2000 to all scheduled commercial banks including RRBs, MFIs are availing bulk loans from banks for on-lending to groups and other small borrowers.

NABARD has tried to collect detailed data since 2006--07 on progress in microfinance sector in the basis of returns furnished by commercial banks, RRBs and Co-operative Banks operative in the country. NABARD has been instrumental in facilitating various activities in micro-finance sector, involving all possible partners in the area. NABARD has been encouraging voluntary agencies, bankers, socially spirited individuals, other formal and informal entities and also government functionaries to promote and nurture SHGs. The focus is on training and capacity building of partners promotional grant assistance to SHGs revolving find assistance to MFIs, equity/capital support to MFIs to supplement their financial resources and provision of refinance against bank loans provided by various banks for microfinance activities including SHGs.

Table 1 Overall Progress under Micro-finance: 2006-07 --2007-08

(Rs. Crore)

Item	**2006-07**	**2007-08**	**% growth**
Savings A/C of SHGs with Banks	3,512.71	3,785.39	7.8
Bank Loans disbursed to SHGs	6,570.39	8,849.26	34.7
Bank Loans Outstanding with SHGs	12,366.49	16,999.91	37.5
Bank Loans disbursed to MFIs	1,151.56	1,970.15	71.1
Bank Loan outstanding with MFIs	1,584.48	2,748.84	73.5

Source: Status of Micro Finance in India, NABARD, 2007-08

The loan disbursed to SHGs by the banks is more than double the deposits. The rate of growth of loan disbursed is also highly impressive. Loans disbursed to MFIs are much less in amounts but it is growing at much faster rate. However, outstanding loans with MFIs are growing at much faster rate than that with SHGs (Table 1).

Table 2 Savings of SHGs with Banks 2007-08

(Rs. Crore)

Agency	No. of SHG	% Share	Amount	% Share	Per SHG Savings (Rupees)
Commercial Banks	28,10,750	56.1	2,077.73	54.9	7,392
Regional Bank	13,86,838	27.7	1,666.49	30.8	8,411
Cooperative Banks	8,12,206	16.2	541.17	14.3	6,663
Total	**50,09,794**	**100.0**	**3,785.39**	**100.00**	**7,556**

Source: Status of Micro Finance in India, NABARD, 2007-08

SHGs have kept maximum deposits with commercial banks. These deposits have increased over time. Maximum growth rate in deposits also have been observed in commercial banks over time, while the RRBs and cooperative banks accounted for moderate growth rates. However, per-capita deposits have shown a negative growth rate. The increase in numbers of SHGs was much faster than increase in number of deposits. RRBs created specifically for disbursing loans to the marginalized sector, have not been able to penetrate significantly. The strong, stable and widespread infrastructure of commercial banks creates more confidence in the system(Table 2).

Table 3 Bank Loans Disbursed and Outstanding against SHGs – 2007-08

Agency	Loans Disbursed (Rs. Crore)	Loans Outstanding (Rs. Crore)	Per SHG Disbursement (Rs.)	Per SHG Outstanding (Rs.)
Commercial Banks	5,403.90 (61.0%)	11475.47 (67.5%)	73,511	48,240
RRBs	2,651.84 (30%)	4,421.04 (26%)	80,935	50.485
Cooperative Banks	793.52 (9.07%)	1,103.39 (6.5%)	48,092	29,711
Total	**8,849.26 (100%)**	**16,999.90 (100%)**	**72,076**	**46,884**

Source: Status of Micro Finance in India, NABARD, 2007-08

Outstanding loans are serious cause of concern for the commercial banks. RRBs and cooperative banks are relatively smaller players but the former is comparatively more active in loan disbursement. Cooperative banks have a fair share of SHG deposits but very low share of loan disbursement (Table 3). They cannot take large risks and operate within moderate secure investment and small loan disbursement.

Outstanding loans are not immediately transformed into Non-Performing assets (NPA). In the long run, commercial banks have been able to show very low proportion of NPA. The record of private sector commercial banks is even a little better in this context (Table 4). However, RRBs and cooperative banks have higher proportion of NPAs even with comparatively low loan disbursement. This is more elaborated in the recovery performance of these agencies (Table 5). About half of commercial banks reporting recovery data, show more than 95 per cent recovery rate that did not fall below 50 per cent. For the cooperative banks, though half of them showed more than 95 per cent loan recovery, a significant number also reported less than 50 per cent recovery. For the RRBs, only

22 of 70 banks show more than 95 per cent recovery. RRBs and cooperative banks are yet to make substantial contribution in spreading financial infrastructure to the marginalised.

MFIs grew almost double in number during the two years under consideration. Majority of them relied on the commercial banks for getting loan. RRBs and cooperative banks contributed marginally in loan disbursement to MFIs—only 7 out of 334 MFIs received loan from RRBs during 2006—07. This number rose to 8 during 2007—08 while the number of MFIs increased from 334 to 518. No MFI sought loan from the cooperative banks during 2006—07. However, in the next financial year, 13 MFIs received loan from this source. MFIs also have better record of loan repayment as compared to the SHGs (Table 6).

Table 4 Non-Performing Assets (NPA) of Bank Loans to SHGs – 2007-08

(Rs. Crore)

Agency	Total No. of Banks reported NPA Data	Outstanding loans to SHGs	NPAs	% of NPAs to outstanding loans
Commercial Banks (Public Sector)	24	9,647.53	206.99	2.1
Commercial Banks (Private Sector)	9	544.61	6.72	1.2
Regional Rural Banks (RRB)	57	3,870.48	173.27	4.5
Co-operative Banks	181	746.86	35.95	4.8
Total	**271**	**14809.48**	**422.93**	**2.9**

Source: Status of Micro Finance in India, NABARD, 2007-08

Table 5 Recovery Performance of Loans to SHGs

Agency	Total No. of Banks reported recovery data	Percentage Distribution of Recovery			
		95% and above	80-94%	50-79%	<50 %
Commercial Banks (Public Sector)	25	11	6	8	0
Commercial Sector (Private Sector)	8	7	0	1	0
RRBs	70	22	25	17	6
Co-operative Banks	226	113	39	51	23
Total	**329**	**153**	**70**	**77**	**29**
Percentage of Banks	100.0	46.5	21.3	23.4	8.6

Source: Status of Micro Finance in India, NABARD, 2007-08

Table 6 Bank Loan provided to MFIs – 2006-07 and 2007-08

Agency	Years	Loan Disbursed		Loan Outstanding		Percentage Recovery of Loans
		No. of MFIs	Amount (Rs. Crore)	No. of MFIs	Amount (Rs. Crore)	
Commercial Banks (Public and Private)	2006-07	327	1,151,34	541	1,584.27	92-100
	2007-08	497	1,968.60	1,072	2,745.24	82-100
	% growth	52.0	71.0	98.2	73.3	
Regional Rural Banks (RRBs)	2006-07	7	0.22	8	0.20	90
	2007-08	8	1.51	24	3.58	95.5-100
	% growth	14.3	586.4	200.0	1,690	
Co-op. Banks	2006-07	0	0	1	0.01	100
	2007-08	13	0.04	13	0.02	NA
	% growth			1200	100	
Total	**2006-07**	**334**	**1,151.56**	**550**	**1,584.48**	
	2007-08	**518**	**1,970.15**	**1,109**	**2,748.84**	
	% growth	**55.1**	**71.1**	**101.6**	**73.5**	

Source: Status of Micro Finance in India, NABARD, 2007-08

OPERATIONAL FEATURES OF MFI MODELS

Many of the MFIs started as development support institution, with the vision of improving the quality of life of the poor and underprivileged, through interventions in various social activities. They adopted micro finance activities subsequently. Their experience in working with the poor helped them in offering micro finance services to their clients. All of them were accepting savings from their clients earlier, but of late, many of them have stopped the practice, as they had no legal status to accept deposits. Apart from providing credit, some of them offered other services, like training facilities and marketing arrangement to their clients.

Table 7 Operational Features of Micro Finance Models in India

Operational Features	SHG	Grameen	Individual Banking & Sector Specific Model
Area of operation	Mainly Rural	Rural & Urban	Rural & Urban

Main Clients	Poor, borderline Poor, Women	Poor & Poorest, Women	General, Non-Poor Men & Women
Service focus	Savings & Credit	Cyclical credit	Need based credit (higher amount)
Transactions	Monthly / Weekly meetings	Weekly meetings	Individual
Savings	Rs. 20 – Rs. 200	Rs. 5 – Rs. 30	Flexible, minimum 10 – 15 % of the loan
Interest on savings	3% - 4%, Bank rate	Nil – 4%	4.5% - 9.5%
Loan size	Rs. 2500 – Rs. 50000	Rs. 1000 – Rs. 30000	Rs. 5000 – Rs. 200000
Effective interest rate	12% - 24%	21% - 26%	12% - 24%
No. of loan installments (monthly)	12 – 24 months	12 – 18 months	12 – 36 months
Insurance	Mostly voluntary	Compulsory & Voluntary	Compulsory
Developmental services	Training & linkage with enterprise development programmes	Group training & occasional market support	None, occasional enterprise support

Source: SIDBI Study on Assessing Development Impact of Micro Finance Programmes-- 2008

The table shows that the SHG model is the most poor—friendly model in terms of low interest rate, longer repayment period and larger amount. The dual pursuit of social ends and financial profits is an ongoing tension for all in microfinance. Mission drift is a common fear as pressures mount to serve richer clients with larger loans and thereby to earn higher profits per loan since transactions costs per rupee tend to fall with loan size. Keeping focused on their respective target populations has thus been central to the missions of the successful institutions.

There are several advantages of the group lending system.

The SHG movement can, at minimum, serve as a quick way to deliver microfinance in an "interim" period, before other institutions can be developed or adapted. The idea is to graduate SHG members to these other institutions where they can access standard individual loans, possibly on a fully commercial basis. The borrowers show their increased reliance on micro finance as also on formal sector and reduced dependence on informal sector (both costly sources of finance and other private informal sources). Access to microfinance leads to a fall in the proportion of borrowing at very high rates of interest and with outstanding debts. The increasing access to formal loans by the SHG sector

indicates towards achieving that goal. There are already around 100,000 SHGs in India under various stages of operation.

The membership entitlement has a value-addition effect as it creates opportunity for them to get access to other credit facilities from the friends/relatives/neighbours as the membership itself proves to be a guarantee for repayment of the loan. The members can get easy loans from them in case of emergency, as they are sure to get the money back through the MFI assistance of the client. The poor people value convenient, reliable, continuous, and flexible financial services, but that is not all that they value. Access to other kinds of interventions and opportunities may be even more critical to help people effectively invest for the future, cope with periodic difficulties, and maximize the use of resources.

Few issues in microfinance have been as contentious as those surrounding interest rates. Microlenders have also worked hard to maintain quality standards, with the aim to charge a fair rate for a good product. By stressing convenience, reliability, continuity, and flexibility, programs have delivered products that are both much cheaper than those available from the informal sector and higher quality as well. The SHGs, through deposit—based lending system, have been able to keep the low level of interests compared to the loan-based MFIs. If interest rates were simply costs imposed on borrowers, it would strengthen the brief for minimizing interest rates in the cause of social progress. But interest rates play other important roles; most importantly they function as rationing and incentive mechanisms, and they provide organizations with resources to reward savers.

The SHG movement can, at minimum, serve as a quick way to deliver microfinance in an "interim" period, before other institutions can be developed or adapted. The idea is to then graduate SHG members to these other institutions where they can access standard "individual" loans, possibly on a fully commercial basis.

In India, both the SHG and the MFI (popularly known as Grameen model) models show maximum concentration in the Southern states of Tamil Nadu, A.P, and Kerala where around 90 per cent of the poor have mobilized into groups to take benefits of microfinance. This percentage varies from 5 to 30 in eight states, Bihar, Jharkhand, UP and MP having the lowest share. Size of microfinance industry in India is approximately Rs. 30, 000 crore of which AP accounts for rs. 10,000 crore. The SHG linkage programme is spread over all the states, the MFI model has expanded in only a few states.

The financial and organizational differences of these two models are as follows:

Table 8: Financial and Functional Difference—Grameen vs. SHG

Grameen Model	Self-Help Groups
Evolved in Bangladesh; widespread across the world and also in India	Popular in India. Also practiced in Indonesia, parts of South-East Asia and Africa
Centrally managed by Micro Finance Institution	Government/NGOs/Banks promote them and empower them to manage their own affairs. Banks provide loans to groups
Joint liability Groups of five	Informal affinity Groups of 10 to 20
5 to 8 groups – one center – only purpose facilitating weekly meetings with MFI	Federation of SHGs are separate entities - provide several financial and non-financial services to member SHGs.
Weekly meeting routine -supervised by MFI staff. Savings and repayments - collected and handed over to MFI.	SHG does similar functions, but they do this on their own behalf, since it is effectively a micro-bank.
Lending driven Insistence on loans utilisation for 'productive' purposes Compulsory savings as a condition of accessing such loans	Savings driven Loans from banks for need based lending to members – purpose determined by individual members Savings – used for internal lending – builds group corpus and helps members in emergencies
Loan process quick – less than a month	Bank linkage process slow - from a few months to 2 years (6 months in AP)
The members have their accounts with the MFI directly	Members have their accounts with the SHG, not with the bank
Group is not autonomous; formed for a specific purpose of delivering financial services	SHG is an autonomous financial and social organisation
Interest rates high - cost to borrowers vary from 24% to 48%	Banks lending - 9% to 12% to S.H.Gs. Cost to the member + 3%
Members have to compulsorily borrow from their MFI	Members can borrow from S.H.G's own funds and from Bank loan to S.H.G
More appropriate for countries with poor banking infrastructure	SHG system reflects the scale, and the organizational diversity, of the Indian financial system
MFI staff visit every group, every week.	Group manages its own affairs after the initial intensive nurturing phase
Members - limited stakes in the MFI; profits do not benefit them	Group owned by members - Interest margins retained at SHG level for the benefit of members.

Source: Society of Elimination of Rural Poverty (SERP), Annual Report 2009--10

It is clear from the table that the Grameen model or the MFI model is comparatively rigid in delivering financial services. The mushrooming growth of the MFIs can largely be attributed to priority sector lending clause issued by the RBI in 2000. Under this clause, banks would have to lend 40 per cent of their total loan portfolio to the priority sector, MFI lending being included. If the banks failed to meet the target, they will have to buy NABARD bonds which yielded very low returns (3--4 per cent). The MFIs were paying 12—13 per cent interest. Hence, the banks merrily increased lending to the MFIs without monitoring the status of borrowers of the MFIs.

The MFIs, specially the large ones, have a difficult and to some extent conflicting mandate to satisfy both shareholders and borrowers. Many of them has tried to consolidate their position in the form of for-profit Non—Banking Finance Companies (NBFC) rather than non—profit NGOs that most NGOs started out as. As a result, more than 80 per cent of MFI lending is now concentrated with such NBFCs.

Despite the banking industry's ambitions on financial inclusion, MFIs cater to only around 20 per cent of the unbanked households. MFIs reach out to a segment where the transaction sizes are too small for the traditional loan products to be affordable. These transaction costs are therefore piled up on loans in form of higher interest rates. Banks cannot add these charges on to interest rates as these are capped for small loans.

As a result, yields on advances are almost double of that for a successful MFI. For instance, weighted average yields for advances on commercial banks is 10.8 per cent against 20—24 per cent for MFIs. From borrower's perspective, this rate is much cheaper compared to what he will pay the money lender. The MFIs have achieved expertise in almost 100 per cent achievement in loan recovery. The expansion of money and emphasis on total recovery has contributed significantly to the crisis that AP experienced recently and put a serious question mark on poverty alleviation impact of the MFI model. The thrust on repayment is forcing MFIs to focus on increasing size and attracting private equity capital. At present,private equity investments are estimated to be around $200 million in IndiaMFIs are now offering concurrent loans to existing customers.

Availability of easy loan is creating another dangerous possibility. While repayment rates continue to be almost perfect in MFI model, multiple borrowings are rising alarmingly. This triggers a concern that borrowers may be heading for a debt trap as they borrow from one MFI to repay another. NABARD argues that rural women are borrowing more as more credits are available. Over last ten years, AP has seen an explosion in rural credit. Earlier, there was three sources of rural credits—banks, family and moneylenders. Now the banks give loans to SHGs at 3 per cent and directly at 8—9 per cent. But as they are reluctant lenders, the borrowers turn to MFIs for rest of the loans. The SHGs can monitor the loan activities of group members but it is not possible for MFIs to keep track of loans.

The MFI's insistence on weekly repayment also accounts for multiple borrowing. The rural poor have always borrowed to meet expenditure requirement as money enters the village economy only

after the harvest. It is not easy to sustain weekly repayment as money supply is tied up with agricultural cycle.

The multiple avenues of credit that have opened up in AP and Karnataka also mirror the change in the nature of funding for Indian MFIs over the years. Ten years ago, the microfinance industry comprised of philanthropy—based models built around long—term soft loans. Around 2001, they began to get loans from Development Finance Institutions like SIDBI and IFC. Then the private equity capitals were introduced and the stage is gradually being set for IPOs. The larger MCIs are growing at such larger pace that private equity will not be able to provide enough capital to fulfill capital adequacy ratio norms of the RBI.

The MFIs are now offering concurrent loans to existing customers. The explosion of credit supply is attracting more MFIs in the same areas where other MFIs are already there. This is because the borrowers do not need fresh training regarding MFI activities. This means a large number of loans are disbursed to micro enterprises and subsistence farmers that are very unlikely to be able to survive beyond a few months or, at most, years. Poor people may lose their assets when their micro enterprise fail, as well as fall further into debt. Moreover, the poor finds it difficult to repay micro credit when interest rates are very high, which only adds to the problems of running such a tiny business, and so contributes further to the high failure rate of microfinance clients in general. This largely explains the AP debt crisis.

It is perceived that lending to everyone in the local economy would help them all to benefit and escape poverty. This suggests the need for microfinance institutions to be scaled up in order that everybody could access a micro loan.

However in areas which are saturated with microfinance institutions, it is often found that there was a fall in price in the products sold, leading to falling profits for local micro enterprises. This came as a result of a large number of micro enterprises being able to supply the same products, in turn leading to lower prices for these products and less margins for profit for these micro enterprise owners.

The small family farms that could most productively use small farm credit lose out due to their size and relative complexity, but the smallest and least productive ‘postage stamp’ farms get access to as

much micro credit as they want. This adverse selection problem also means that agricultural cooperatives, which are hugely important in helping to generate what are called 'collective economies of scale', also losing out on sources of finance.

MFIs charge high interest rates in order to become financially self-sufficient. They can indeed survive with high interest rates, but the micro enterprise structures that then begin to emerge around them are weak and unsustainable. Microfinance institutions can therefore survive by charging high interest rates, but the local economic structure they end up producing is weak and unsustainable. The microfinance institutions end up as 'cathedrals in the desert'. Another important point are the high costs of these microfinance institutions resulting from the high salaries and bonuses paid to their managers and executives; this helps to keep interest rates much higher that they would otherwise be if the institution was genuinely dedicated to resolving poverty. These high interest rates are also often justified because they allow microfinance institutions to expand their operations to include other poor people. However this means poor people are effectively being asked to pay these high interest rates so that other poor people can have access to microfinance, which is a very shaky moral justification for expansion. The very poor are helping out other equally poor escape poverty, because most micro enterprises cannot operate upon such a high cost

When we have people with limited productive capabilities and limited access to resources, once they are given money to invest, they generally all end up producing the same thing. In order to make microfinance credit work, a range of collective institutions, such as cooperatives for agriculture, local business associations etc. are required. Otherwise individual based entrepreneurship will not take the people that are receiving microfinance credit very far. It would be impossible to expect people who have to repay 40% or more interest to be able to develop a serious business that would possibly involve technology, innovation, training or any meaningful complexity (Bansal, Hema (2005)).

There is no clear evidence that self—sufficient MFIs, whether large or small, have been able to push local economy, though there are a few isolated best practices. International evidence also shows cooperatives have been able to provide better economic results in terms of creating stable social capital. SHG model seem to be better equipped to achieve the goal of poverty alleviation than the MFIs, which depend more on market—driven interest rates.

REFERENCES

ADB (2000). *Finance for the Poor: Microfinance Development Strategy*, Manila: Asian Development Bank.

Basix (2000). 'Equity for Equity'. Available at *www.basixindia.com/micro_finance_in_inda.asp*

Bansal, Hema (2005), SHG – Bank Linkage Programme in India, *Journal of Micro Finance*, Vol 5, No. 1

Khandelwala, Anil K. (2007). "Microfinance Development Strategy for India", *Economic and Political Weekly*, Vol. XLII, No.13, March 31-April 6, pp. 1127-35.

NABARD (2008) – *Status of Micro Finance in India,* Mumbai

Ramakrishnan, R. (2007). 'Micro Finance – Emerging Trends in Financial Management, April 17. Available at *http://www.indianmba.com/Faculty_Column/FC557/fc557.html*

Reserve Bank of India Annual Reports, 2009-10 & 2010-11

SIDBI (2008) – Assessing Development Impact of Micro Finance Programmes – Report submitted to *Agricultural Finance Commission*, New Delhi.

Society for Elimination of Rural Poverty (2009), Annual Report, Hyderabad Sriram, M.S. (2007) – The Transformation of the Micro Finance Sector in India, *Journal of Micro Finance*, Vol 6, No. 2