MICROFINANCE : A TOOL TO SOCIO-ECONOMIC DEVELOPMENT FROM BELOW?

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Economic growth is not meaningful unless it is inclusive. For achieving inclusive growth, access to financial services is a critical precondition. This is where the growth of financial sector will help the nation greatly. Development of microfinance sector is one of the important means for facilitating financial inclusion. The Indian microfinance market is growing and evolving extremely quickly. With these changes come challenges which the microfinance sector is facing or may face if certain remedial actions are not taken timely. Based on a selective literature review, this paper appraises the role of microfinance in the empowerment of people and the realisation of financial inclusion in India. It is a common practice to look upon microfinance as a valuable tool for alleviating povert, but this paper attempts to look at the flipside of microfinance and offers a critique of some of its characteristics. Some of the practices that are followed by certain microfinance institutions (MFIs) do not seem to be appropriate. The lack of transparency, ill-designed products, inadequate communication with the clients and unfriendly methods of recovery are not consistent with the objectives of serving the poor. Microfinance is a great tool as a survival strategy, but it is not a magical solution to end poverty and promote development. Yet, in all the hype we have forgotten to question the basic premise. Is lack of credit the only problem? Or one of the many problems the poor face? If the latter is true, then the credit provision will be effective only when it is delivered after other barriers have been removed.

I- Microfinance: Meaning And Issues Of Concern

Microfinance is the method of credit delivery to the poor. According to an accepted definition, microfinance is 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.† Loosely defined, microfinance is the giving of very small amounts of credit and financial services and assistance to the poor people at low rate of interests, with no collateral, who are ignored by most institutional credit systems, to help them raise their income levels and living

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† http://www.nabard.org/pdf/publications/reports/mF_Scenario_in_the_Country.pdf (accessed 1 Aug 2009).

standards. It has emerged as one of the most effective tools to overcome chronic poverty because of its certain unique features.

II- Key Characteristics of Microfinance

It may be helpful to enumerate some of the characteristics associated with what is perceived to be 'microfinance'. The following are the features of microfinance which have contributed to its success:

1. Small loans
2. Loans for entrepreneurial activity
3. Collateral-free loans
4. Group lending
5. Target poor clients
6. Target female clients
7. Market-level interest rates
8. High repayments

Today one could say that there has been vigorous growth in the area of microfinance in India. Certainly, more clients are served today than before. But are these clients being served well? The choices made by microfinance institutions (MFIs) of widening over deepening and prioritising client numbers over adequate loans are neither in the best interests of clients nor of the institutions. The 'touch and move on' method of expansion of services could not only result in sub-optimal services to the clients but also reduce profitability of MFIs. In the following sections, the paper attempts to critically evaluate the key characteristics of microfinance which are basic pillars for ensuring its success.

III- Evaluation of Characteristics Of Microfinance

SMALL LOANS

Inadequate loan size

Certainly microfinance is not microfinance unless loans remain under a certain manageable size, but how small is best for serving the needs of both the client and the institution? The smaller size loans, generally not cater to the financial need of the poor client. A

microfinance loan is typically for Rs 3,500-5,000*. According to Srinivasan's 2008 report on Indian Microfinance, even the higher average disbursement reported during the year 2007–08 is around Rs 3,600 per Self Help Group (SHG) member. It is argued that loans of Rs 5,000 at 30% interest cannot end poverty.† One can't do much with that kind of a loan, it only eases liquidity problems. Inadequate loan size compels borrowers to find additional sources of funds, provides space for competitors to enter and encourages multiple borrowing. The small loan size is a significant reason for high operational costs and the consequent pressure on interest rates. The small loan size indicates that client acquisition is pursued more intensively than deepening the engagement with the acquired clients.

The MFIs have to develop greater sensitivity to the needs of the poor clients. The small loans should give way to livelihood support loans of a larger size. A viable loan size required to bring people above poverty line would be around Rs 50,000, if we take into account a capital to output ratio of 4:1[Srinivasan 2008 report]. Only when livelihoods and incomes are targeted, microfinance can claim that its mission is achieved.

Uniform Loan Size

Besides inadequate loan amount, under microfinance a uniform size loan irrespective of individual client's need (mechanically dividing the available funds equally to the given number of poor – no botheration of purpose and end use of the micro credit) is offered. 'One size fits for all' is quite illogical in the context of poverty reduction. It should not be forgotten that even product design is one of the means of targeting the poor. But questions are raised that do poor clients matters in microfinance sector, while designing the product?

Being poor is not just about having too little income. It is about having insecure and fluctating income. The income of the poor can vary dramatically from day to day, month to month, season to season. The fit and relevance of products with the client's requirement and the types of businesses and enterprises are not part

* Business Standard (2008): 'Microfinance is thriving, but...', November 26.

† The Times of India (2009): 'How Microfinance Institutions Beat Nationalized Banks', July 26.

of design considerations. Most MFIs offer a single-standardised product that entails the client availing a lump sum at a point of time and repaying the same in fixed repayment schedules. The client businesses very often experience cash flows, which vary in amount and time in accordance with the seasonal nature of the livelihood activity. In certain types of activities such as farming or cattle rearing, the inward cash flow of the client comes in bulk at a point of time, rather than in steady flows in regular intervals. Certain types of businesses such as petty trade and street vending require continuous infusion of cash to keep the inventory levels at a satisfactory level. But the credit products that are offered as a rule do not take into account many of these requirements of the clients. The clients in their eagerness to access credit of any sort continue to deal with the MFIs on terms that may not match their requirement.

The design of these products is not only uncomfortable for the clients but also imposes additional costs on the clients who very often resort to borrowing from other informal sources to keep up the regularity of payment [Sinha and Matin, 1998].* Clients with rigid contracts may take actions which reduce the return on their investments. Dairy farmers may under-feed their animals during difficult times. Asset owners may sell off (productive) assets to repay debts. Thus, the mismatch between debt payments and income can create serious distortions.

There is a need to follow a flexible recovery method and schedule which would ease the pressure on the members. It is also suggested to develop a more sophisticated segmentation of MFIs offerings according to the needs of different types of clients such as poor, very poor and according to their earning capacity. Otherwise, the basic question remains: Where is the 'need based' financial intermediation? Are poor clients last in the long list of MFIs objectives?

IV- Loans For Entrepreneurial Activity

It is believed that microfinance greatly reduces poverty. But according to different researches, it is a gross exaggeration. Studies

* Sinha, Saurabh and Imran Matin (1998): 'Informal Credit Transactions of Microcredit Borrowers in Bangaldesh', *IDS Bulletin*, Vol. 29 (4).

(like a recent one of Hyderabad's slums by Bannerjee, Duflo, Glennerster and Kinnan) show no short-term link between micro-credit and poverty or consumption. The research showed that only one in five loans in Hyderabad created new businesses*. Only a minority of loans are taken for businesses, since all people are not entrepreneurial and entrepreneurship requires skills and attitudes that are not universal. Besides this, not enough market opportunities are there to create a viable enterprise. Yunus† himself agrees that micro-credit is not enough to solve the multidimensional problem of poverty.‡ So, MFIs are just focusing to increase number of borrowers, not entrepreneurs. They are providing (bad) consumer loans instead of (good) entrepreneurial credit. Microfinance has become a consumption-smoothing tool only and not a poverty alleviating tool.

Thus, the solution lies in providing the borrowers business training. Give a person a fish and they will eat for a day, teach a person to fish and they will eat for a lifetime. This proverb highlights the process of teaching which makes the difference here. MFIs can give consultancy to their clients in selecting the micro-enterprise. The clients should be encouraged to invest in profitable enterprises for higher profits. The other alternative lies in linking poor people to markets, financial institutions and even multinationals. Yunus, himself, has put forward the concept of micro-franchising§. He has set up Grameen telephones in collaboration with a Scandinavian company that leases mobile phones to poor women, who then act as public call offices. This is profitable and sustainable. Such franchising could be extended to several fields, linking poor entrepreneurs to local firms and multinationals. But the government must finance infrastructure and skills, apart from basic education and health, to create the conditions in which higher-income livelihoods become possible. Unless enterprise and livelihood activities are supported, the microfinance access to SHGs would merely have a liquidity-smoothing effect and it will not be able to meet the objectives of poverty eradication. Besides this, checks on how loans

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* The Times of India (2009): 'How Microfinance Institutions Beat Nationalized Banks', July 26.

† The Nobel Prize committee awarded the 2006 Nobel Peace Prize to Muhammad Yunus and the micro-credit organizations Grameen Bank for their efforts to uplift the poor.

‡ The Times of India (2006): 'End of Poverty', December 16.

§ Ibid.

are being spent a week after disbursing the money should be kept. In addition to this, random house visits can be made to ensure that the loans are not being used for consumption purposes.

V- Collateral-Free Loans

Another reason for the success of microfinance lies in its ability to deploy collateral substitutes. They are used in place of traditional physical collateral such as land and jewellery, employed in conventional lending. In practice, this is achieved in two main ways. Firstly, the MFI can exploit the social sanction opportunities that exist between potential borrowers. Secondly, the MFI can threaten a defaulting borrower with the denial of future credit. Thus, in microfinance, punishment mechanisms are serving the role of collateral substitutes as a way to deter defaults. Questions are raised: Do collateral substitutes raise repayment rates? or discourage the poor from participating in MFIs? Questions are also being put up on the effectiveness of collateral substitutes in comparison to traditional collaterals.

Social Sanction

Social sanctions refer to a variety of non-pecuniary punishments such as shame or ostracism. In practice, such sanctions can only be imposed by insiders (including other villagers, local traders and possibly local loan officers) but not by outside lenders (such as commercial banks or the MFI headquarters). When MFIs make use of social sanctions, they are forced to rely on a third-party (e.g. a friend, neighbor, village member etc.) to actually impose these social sanctions. Doing so exposes them to the possibility of collusion between this third-party and borrower, which may undercut the borrower's incentives to repay. This leads to a delegation problem in which the MFI must concern itself with whether or not the third-party charged with imposing social sanctions will actually carry out this task. Further, it is argued that microfinance is exploiting social relationships to obtain higher repayment rates and to reduce their administrative costs. A study shows that social relationships indeed deteriorate in case of default: trusting friends and neighbours can suddenly turn into suspecting ones.* This means that microfinance

* Karlan, D. (2005): 'Social Connections and Group Banking', Center Discussion Paper, No. 913, Yale University

transactions can actually reduce social capital. The question then becomes: Whether financial capital is generated at the expense of social capital?

This calls for educating the borrowers about the importance of financial discipline and making timely repayments.

Credit Denial

The second main form of punishment used in microfinance is the denial of future credit. That is, if a borrower defaults on a loan he is punished by being excluding from future credit. Credit denial is a threat that can be unilaterally invoked by an MFI, thus avoiding the delegation problem inherent in the use of social sanctions as a collateral substitute. Nonetheless, it is prone to problems of its own. Firstly, the lender does not actually know how much the borrower values future access to credit. Secondly, the bankrupt lender is forced to impose credit denial even on borrowers who repay. This weakens the repayment incentive. Further, in the case of group lending, in the event of non-repayment by one of the members, credit denial is the punishment directly inflicted on the group. The defaulter, rather than the entire group, should be penalized.

Clearly credit denial can function as an effective threat only when access to future credit is actually valued by the borrower. Of course, a similar statement obviously applies to physical collateral. But a lender making a loan based on physical collateral is in a much better situation for a simple reason that physical collateral is tradable and so it possesses a market price.

VI- Group Lending

The reasons for success of MFIs, where so many others have failed, lie in their unique group lending or the joint liability contracts, which ensure repayment without requiring collateral from the poor. But, there are certain issues related with the group lending scheme which require attention.

No longer Viable

The success stories of microfinance in developing countries (rural areas) cannot be easily replicated in the developed world (urban areas). The foremost reason is the inability of potential borrowers to

form a group, which resulted in failure of the group lending contract. This challenge especially exists in developed areas where poverty rates, population density and close network of social ties among the poor do not exist in same proportion as in case of developing areas.

Several critics also argue that group loans lead to high transaction costs. The main advantage of group loans according to the advocates of microfinance is that group loans drastically reduce monitoring costs, since group members live in the same village and know each other well. This, however, ignores the fact that group members sometimes live far away from each other and need to spend time and energy to assess each other's projects [Marr, 2004].* Moreover, most microfinance schemes have regular group meetings. During these meetings, information about the projects is exchanged and repayment problems are discussed. These group meetings often imply high transaction costs [Armendáriz De Aghion and Morduch, 2000†; Murray and Lynch, 2003‡]. Obviously, then, these costs may reduce the positive income generating effects from access to credit.

Poor Group Quality

A strong focus on the quality of SHGs by their non-governmental organization (NGO) promoters was a key factor in the success of this model in its pilot phase. But in recent years, growing concerns have emerged about group quality. A variety of means are adopted for SHG promotion that involve, apart from NGOs, the staff of banks, government departments, part-time, casual staff of governments, a variety of individuals under individual rural volunteer (IRV) scheme and others. The staff from organisations other than NGOs does not normally have the development outlook. The groups that have been promoted either lack the required skills and local knowledge or ones that are driven by short term monetary incentives. Many groups have come together on an ad hoc basis, only because they want a loan. Very often, different concepts and cost structures are used for

* Marr, A (2004): 'A Challenge to the Orthodoxy Concerning Microfinance and Poverty Reduction', *Journal of Microfinance*, Vol. 5 (2).

† Armendáriz De Aghion, B and J Morduch (2000): 'Microfinance Beyond Group Lending', *Economics of Transition*, Vol 8(2).

‡ Murray, I and E Lynch (2003): 'What Do Microfinance Customers Value?', Women's World Banking: What Works, http://www. womensworldbankin g.org/English/PDF/ Focus%20Note%201%20What%20Customers%20Value_April04.pdf.(accessed 4 Aug2009).

formation of groups by the different parties; but the result of all these efforts is the lack of a coherent mission and problems of field-level coordination. Indeed, evidence suggests that the quality of groups is already beginning to suffer. A survey by Andhra Pradesh Mahila Abhivruddhi Society (APMAS) in 2002 indicated that only 17% of all groups were of adequate quality for bank linkage and this was in a state which is considered the leader in the movement. Further, the group mortality rates would be much higher in case of groups that have not been linked to banks for a long time. According to the Srinivasan's 2008 report, the states of Madhya Pradesh, Maharashtra and Rajasthan are estimated to have between 0.1 and 0.2 million SHGs that are not linked to the banking system. Banks have been wary of linking these groups as the government support may not materialise for such large numbers. The quality of the groups is perceived by the banks to be suspect. But the economic cost of such unlinked groups is enormous as the government machinery has spent time and money on formation of such groups. The National Bank for Agriculture and Rural Development (NABARD) annual report 2007–08 states that, there has been a decline of more than 0.13 million in the number of new groups linked to banks.

Inadequate attention to group quality could threaten the longer term credibility and viability of the entire program. Therefore, greater focus on the unlinked groups should be given and the means of linking these to the banking system quickly should be explored. Means of upgrading the capacities of these groups and increasing the comfort level of banks in financing them should be explored, so that the sunk costs in these groups are recovered.

High Cost of Formation and Nurturing SHGs

A much deeper structural change that is set to sweep the microfinance landscape is the transformation of NGOs into lending institutions. A survey of more than 50 NGOs indicates that 80% of NGOs that have formed and linked groups want to become MFIs, preferably non-banking financial companies (NBFCs) [Srinivasan's 2008 report]. The reason behind this mass movement is that they feel that they are not adequately compensated for formation and nurturance stage of SHGs. In the year 2007, a major impact study on the SHGs linkage project was carried out by National Council for Applied Economic Research (NCAER) commissioned by Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) and NABARD.

It revealed that on an average, NGOs incurred an expense of Rs 8,700 per group; banks incurred Rs 3,575 per group for promotion. The maintenance expenses were around Rs 1,100 per annum for NGO and Rs 960 per annum for the banks. NABARD's present level of support at Rs 3,000 per group for not only promotion but also for handholding, for a three-year period was in no way adequate even for the low-cost models of banks, not to mention the intensive service models of NGOs. The costs of taking the SHG Bank Linkage Programme (SBLP) to states with low growth would be higher. Further, the SHGs are facing problems in dealing with banks. The denial of loans, delay in dealing with their proposals, low initial loan volumes, repeated visits, documentation requirements, lack of time on the part of branch staff to visit the groups in their villages and the lack of continuity of branch staff add to the woes of the groups.

Conversion of these SHGs into captive clients of a for-profit private company is tantamount to misapplication of public funds for private use. Therefore, policies for remunerating NGOs for formation and nurturance of SHGs should be developed.

Unlinked Groups

The reduced number of new groups linked to banking system indicates a loss of appetite for SHG clients. According to the NABARD's annual report 2007–08, the number of new groups credit linked with banks declined to 0.552 million during the year 2008 compared to 0.68 million, groups in the previous year. The fall in the number of new groups linked by about 0.13 million is attributed to the slowing down of SHG linkage in the southern states and the failure to gather momentum in other states. Saturation in four southern states is a major reason for the declining numbers in the south. In AP, more than 85% of poor families are already covered; similar is the situation in Tamil Nadu (TN), Kerala and Karnataka. There is not much headroom for growth from SBLP in the south. The southern region accounts for 65% of the SHGs linked and over 75% of the amount disbursed. In contrast, the north-eastern region accounts for 0.6% of the SHGs and 0.3% of the amount. Even the densely populated and highly poor eastern region accounts for 12.6% of the SHGs linked and 5.9 % of the amount.* The Srinivasan's 2008

* Basu, Priya and Pradeep Srivastava (2005): 'Scaling-up Microfinance for India's Rural Poor', Policy Research Working Paper, World Bank.

report points out that the southern states of Andhra Pradesh (AP), Karnataka and TN together account for almost 52% of clients and 59% of the portfolio outstanding. There are six major states and all the north-eastern states in which MFIs have very few clients, constituting less than 1% of total clients. The north, central, eastern and north-eastern still have considerable scope for growth. The underlying causes for slow growth of microfinance in these areas is very little demand for credit from the poor and the absence of good quality NGOs, that are willing to initiate microfinance programs in these states (there are a large number of small NGOs but all of them with limited experience and outreach) [Mahajan and Ramola, 2003].* Expansion into remote areas is fraught with risks and additional costs and long breakeven periods; hence the lack of focus on such areas.

Expanding the MFIs network in central, eastern and north eastern India is not a challenge that can be met overnight. To begin with, overall economic growth has to pick up in these states. This requires long term, lumpy public investments. However, once made, they unlock the potential for enhancing the livelihoods of millions of poor people, moving them up from subsistence production to surplus production and thereby increasing the demand for credit.

SHGs Dropout Syndrome

The phenomenon of member's dropout from SHGs has been a subject of several discussions. In the case of the 'borrowers in trouble', they may initially cause loan default but in many cases, they are dropped out or pushed out (thanks to peer pressure, drastic measures and collection incentives by MFI) and likely are substituted with the kind of borrower capable of making good repayment (trouble free) over a period of time for keeping the norm for running the group. A study by Baland † and others in 2007 found in a sample of 1,102 Professional Assistance for Development Action (PRADAN)-promoted groups, that 10% of groups formed between 1998 and 2006 were no longer active in three tribal districts of Orissa and Chhattisgarh. In the NCAER study, the incidence of members' dropout was reported by 43% of the SHGs. The dropout rate was

* Mahajan, Vijay and Ramola Gupta, Bharti (2003): 'Microfinance in India: Banyan Tree and Bonsai', Background paper prepared for the World Bank. World Bank.

† Baland, Jean-Marie, Rohini Somanathan and Lore Vandewalle (2007): *Micro-finance Life spans: A Study of Attrition and Exclusion in Self-Help Groups in India*, New Delhi: Sage Publications India Pvt. Ltd

8.2% of members. The Lights and Shades Study conducted by EDA Rural Systems and APMAS in 2005 also reported a member dropout rate of 9.8%. The Srinivasan's 2008 report points out that about 43% of SHGs witnessed dropouts and the dropout rate was 8.2, group mortality with 10% and defunct and broken group at 7%.

The reasons that were offered for the dropout were migration, dissatisfaction with the SHGs, member becoming defaulter, unethical financial dealings, illness etc. According to the Srinivasan's 2008 report, the most significant of the reasons was the dissatisfaction of the members of SHGs with 43.5% members reporting the same. Migration was the next most important reason adduced by about 29% members. Lack of financial capacity was cited as the reason by 15% who had turned as defaulters. The Lights and Shades Study 2005 had found that migration was cited as the major reason for dropout (40%) followed by financial weakness (27%) and conflict with the group (20%).

The situation relating to members dropout if left unchecked, will paralyze the entire microfinance system. The inability of the group to satisfy the members fully with its services being a major cause provides a line of thinking for the practitioners on the nature of improvements needed for retaining the members. Migration as an issue also brings to fore the precarious livelihood scenario of the people in areas where income opportunities are scarce. In such areas, formation of SHGs needs to be done with greater care. Means of retaining members in the local area have to be first examined and brought in as an entry norm before the groups are formed. Even though the level of incidence of dropouts seems to be within manageable limits, the NGOs and self-help promoting institutions (SHPIs) should be in a position to address the same otherwise, it would pave the way for exclusion of (already included) weak poor/poorest and inclusion of able (non poor) ones.

VII- Target Poor Clients

Microfinance continues to grow fast and furiously. The sector saw impressive growth in terms of client coverage. During the year 2008, clientele expanded by 9.9 million— after eliminating the overlap between the clientele covered by SBLP and MFIs—taking the number of total clients to 54 million [Srinivasan's 2008 report].

But the microfinance is growing somewhat purposelessly. There are apprehensions on the role of MFIs to provide services and products to the poorest of the poor category [Hulme and Mosley, 1996]*. Setting up institutions to function as non-profit entities does not translate into social performance. 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 earn higher profits per loan since transaction costs per rupee tend to fall with loan size. There are evidences of inclusion of non poor much against their mission statement for patronizing the poor/poorest and many poorest still remain excluded. Many critics show that microfinance does not reach the poorest of the poor [Scully, 2004]† or that the poorest are deliberately excluded from microfinance programmes [Simanowitz, 2002]‡.

In case of SHG linkage, except the government-sponsored programmes that are mandated to focus on poor, the other efforts do not prioritise the poorest. The Lights and Shades Study 2005 had found that only 51% of its sample SHG members were poor. The impact study on the SHGs linkage project carried out by NCAER has found that in Uttar Pradesh (UP), AP and Maharashtra, SHGs with majority non-poor members were as high as 63%, 43% and 34%, respectively. Poverty audits commissioned by Small Industries Development Bank of India (SIDBI) revealed that in 5 MFIs out of 8, the proportion of non-poor clients was more than the poor, with coverage of non-poor ranging from 42% to 88% of the clientele. Only in three MFIs the poor clients were more than non-poor [Srinivasan's 2008 report].

Exclusion of poor is not unique to MFIs; it is evidenced in SBLP where the self-selection processes that are practiced for choosing members of SHGs end up in the not-so-poor-becoming members of SHGs. The core poor are often not accepted in group lending

* Hulme, D. and Mosley, P. (1996): *Finance against Poverty*, London: Routledge.

† Scully, N (2004): 'Microcredit No Panacea for Poor Women', Global Development Research Centre, Washington DC, http://www.gdrc.org/ icm/wind/micro.html (accessed 1 Aug 2009).

‡ Simanowitz, S (2002): 'Microfinance for the Poorest: A Review of Issues and Ideas for Contribution of Imp-Act', ImpAct-Improving the Impact of Microfinance on Poverty: An Action Research Programme, http:// www.microfinancegateway.org/content/ article/detail/3395 (accessed 1 Aug 2009).

programmes by other group members because they are seen as a bad credit risk [Hulme and Mosley, 1996]*. Comparatively wealthier villagers are selected into programs. These groups also set high benchmarks for other groups to be formed in the same locality that makes it difficult for the very poor to become members. The higher requirements of periodic savings, small loans, too much of financial discipline/stringency, that is, strict repayment requirements and penalties for delays, the need for frequent meetings and the socio-cultural differences between the local populations tend to keep the neediest among the rural poor away from the SHGs [Kirkpatrick and Maimbo, 2002†; Mosley, 2001‡]. Besides this, the field workers get incentives to lend to less-poor, more educated clients. Staff members of microfinance institutions may prefer to exclude the core poor since lending to them is seen as extremely risky [Hulme and Mosley, 1996]§. The problem is undoubtedly a reflection of the fact that development intervention is often driven by performance indicators, a direct result of NGO desires to offer positive reports back to their donors [Ahmad, 69]**. Other reasons resulting in the exclusion of the core poor are lack of awareness among poor, uniform microfinance products (without taking into account the comfort of the clients), social exclusion of the poor and collusion of officials of micro-credit institutions with non-poor households.

Questions are raised as to whether microfinance is for financial inclusion or financial exclusion? Keeping focused on its target population is critical for the success of microfinance. The client selection and acquisition processes, product designing are some of the key areas in SBLP and MFIs that require a review.

The financial inclusion initiatives should focus on coverage of remote areas and the excluded people. But microfinance is focusing on financial exclusion. In terms of geographical coverage, well-endowed and high-growth areas have been prioritised. The expansion

* Hulme, D. and Mosley, P. (1996): *Finance against Poverty*, London: Routledge.

† Kirkpatrick, C and M Maimbo (2002): 'The Implications of the Evolving Microfinance Agenda for Regulatory and Supervisory Policy', Development Policy Review, Vol 20(3).

‡ Mosley, P (2001): 'Microfinance and Poverty in Bolivia', *Journal of Development Studies*, Vol 37(4).

§ Hulme, D. and Mosley, P. (1996): *Finance against Poverty*, London: Routledge.

** Ahmad, Mokbul M. (2003): 'Distant Voices: The Views of the Field Workers of NGOs in Bangladesh on Microcredit', *Geographical Journal*, Vol. 169 (1).

within such areas has also not consciously targeted the poor. The most vulnerable are not clients of choice, for most organisations engaged in SHG promotion or MFI lending. Hardcore poor remain excluded; so are remote areas [Srinivasan's 2008 report] (Fig 1.1).

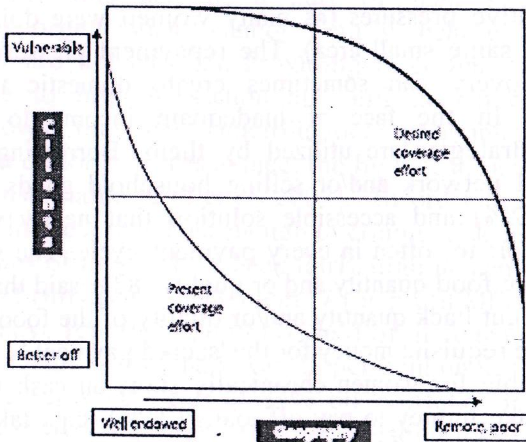

Figure 1.1 Microfinance coverage

The inference is that the microfinance market, by and large, is expanding horizontally covering the easier areas and the better-off clients.

VIII- Women Empowerment

One of the aspects of social performance is that of integrating gender concerns into the microfinance operations. On account of the overwhelming number of female clients in the microfinance sector, there is an assumption that 'gender' is not an issue. But there is a different view that gender concerns have not really been brought into play in the microfinance operations, despite a large part of the clients in the sector being women.

While many microfinance programs lend solely to women, studies of women borrowers have found evidence in varying degrees that control of the loan often gets transferred to their husbands or other male relatives, depending on the program, region, or measurement. Women have been seen redirecting loans to men right in front of their bank officers. The problem is difficult to measure or enforce,

but it is one that the development community needs to be wary of [Goetz and Gupta, 49]*. The particular concern, of course, is that these women nonetheless bear the liability for repayment of these loans. It is far easier for the women to borrow than to repay. The microfinance programs boast remarkable repayment rates, but the women nonetheless bear the burden of rigid repayment schedules and great competitive pressures (as many women were doing the same thing in the same small area). The repayment pressures that help in loan recovery can sometimes create domestic tension between spouses. In the face of inadequate income to make payments, three strategies are utilized by them. Borrowing from within their social network and/or selling household goods is the most common (92%) and accessible solution that nearly all the women had to resort to, often in every payment cycle. The second strategy is to reduce food quantity and/or quality. 83% said that they had at some point cut back quantity and/or quality of the food given in order to save the requisite money for the 'sacred payment.'. . . The final option available for women chronically short on cash was to obtain work to make money to pay off loans (21%) (e.g., taking in laundry, housekeeping, working on a road crew) [Brett, 15]†. In short, the women who enthusiastically availed the seed money found themselves saddled with debt.

Uma Ramaswamy and Anuradha Prasad‡ observe '. . . what stands out poignantly is that the persistent drive for savings and credit . . . has diverted attention away from the more pressing issues of women's lives. The increasing emphasis on microfinance by policies, financial institutions and funding agencies has visibly shrunk the spaces of NGOs—to work deeply on issues relating to women's empowerment.' They add further 'In the name of providing services, MFIs have squarely transferred all transactions costs to the poor women.

* Goetz, Anne M. and Rina S. Gupta. (1996): 'Who Takes the Credit? Gender, Power, and Control over Loan Use in Rural Credit Programs in Bangladesh', Gender and Development: Theoretical, Empirical and Practical Approaches, vol 2.

† Brett, John A (2006): "We Sacrifice and Eat Less': The Structural Complexities of Microfinance Participation', Human Organization, Vol. 65 (1).

‡ Ramaswami, Uma and Anuradha Prasad (2007): 'Integrating social justice dimensions of women's empowerment in microfinance'.

In such cases the questions which are bound to come up are: Are women really empowered? Can we say that microfinance is a magical solution for women empowerment?

IX- Market-Level Interest Rates

Microfinance programs are seen as effective mechanisms to alleviate poverty. While this may be a part of their stated mission, microfinance organizations cannot simply behave as charities, because they are not charities. Providing microfinance is a costly business due to high transaction and information costs. Recent research shows that most microfinance programmes are still depending on donor subsidies to meet the high costs, i.e. they are not financially sustainable [Cull et al, 2007].* In order to survive, they are charging interest rates high enough to counter risk and cover their costs. The rates of interest have been fairly high in many institutions. According to Srinivasan's 2008 report, 7 for-profit MFIs and 11 non-profit MFIs have reported a portfolio yield of more than 30% during 2007–08 (Sa-Dhan's benchmark was 25 per cent on this ratio). Some of these have reported yields of 37% on portfolio. 36 MFIs have yielded rates between 25% and 30%. A question for examination is whether institutional sustainability is prioritized over borrower sustainability.

Not only that MFIs charge absolutely high interest rate (upwards of 20%), but their practices like forced savings, applying a flat rate method and adding service and other charges, over and above the annual interest rate, further exacerbate the cost. This leads to an overall high cost of borrowing for the poor, making MFI's rates look almost usurious. Further, MFIs lack transparency with regard to their interest rate practices, which is helping them to transfer various costs on to the gullible borrowers. The borrower is unable to make a comparison and take an informed judgement on the affordability of the loan because of complicated and opaque loan terms. Clients have no alternative, but to pay the rate of interest as fixed by the MFIs for want of alternative sources of finance. At times it becomes difficult to estimate the effective rate of interest charged by the MFIs. Not many MFIs make it clear to their borrowers what the effective rate

* Cull, R, A Demirgüç-Kunt and J Morduch (2007): 'Financial Performance and Outreach: A Global Analysis of Leading Microbanks', Economic Journal, Vol 117(1).

would be. No doubt MFIs have dramatically improved access to credit for the poor, but they have not been able to provide the services at costs which are on par with the formal banking system. The interest rates prevailing in the microfinance sector are certainly much higher than the rates of formal agencies With regard to MFIs, though the rates are much lower than the informal sector, they have ended up creating an interest rate structure which is only second best for the poor. More importantly, the poorest are being charged the highest rate of interest more in fact than any other class of borrowers. But it should not be so high that they make supernormal profits as they are working with a very poor clientele. Concerns are raised that as to what extent do high interest rates drive out the poor?

It is proposed that interest rate ceilings be imposed on MFIs, but this might lead them to avoid lending to poorer people. Otherwise, a rate ceiling might discourage potential investors or put a MFI out of business.

MFIs are often seen as focusing on being self-sufficient at the expense of battling poverty [Hughes and Awimbo, 75]*. From a development perspective, financial sustainability is not an end in itself. Rather, it is a tool for reaching the poor clients.

The need for transparency in communication regarding loan terms and interest-pricing are matters that require a lot more attention. This will enable borrower to make informed choices. The basis for interest pricing such as a flat rate or a declining balance rate has to be made clear. The implications of these different bases in terms of the annualized interest rates should be made known to the borrower. Practices such as collecting interest at weekly or monthly intervals, taking advance repayment of the first installment while disbursing the loan, collection of security deposits, charging of processing and monitoring fees, are aspects of interest pricing that need to be brought into a single calculation. The borrower should be made aware of the effective rate of interest. The client's education on an on-going basis through financial literacy programmes and setting up of credit counseling centres is a must for this to succeed in developing countries like India.

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* Hughes, Denise and Anna Awimbo(2000): 'Microcredit: Moving Women Forward', United Nations Chronicle, Vol. 37 (2).

Donors and funders can play a major role in ensuring that the ground-level rates are not too high. NABARD deals with only those MFIs, for the purpose of support, that charged interest of not more than 25% per annum on a declining balance. But many others including SIDBI do not impose conditions relating to either a margin or a ceiling on interest rates as they feel that this is a business decision best left to the MFIs. The thinking is that MFIs have to compete in a market where others also offer similar products and the competition would discipline the interest rates.

X- High Repayments

The MFIs lend to small groups of 5 to 10 people. These borrowers mutually guarantee each other's loan. If one member of a joint lending group defaults, the others cannot get credit, so they put social pressure on the defaulter to pay up. But it is questioned whether the community pressure behind repayment is sometimes too severe? We cannot assume that simply because people are repaying those small loans that they actually benefited or that they are indeed the ones most in need of that credit. Repayment rates and other commonly reported measures tell us nothing about the impact of microfinance program on poverty. One cannot assume that simply because people are repaying those small loans that they actually benefited. For many MFIs, only repayment is enough and they think that is development. But repayment is not development. They are actually looting the poor in the name of development.

A review of the available data provided by banks in the NABARD's statistics and also the evidence gathered by the different studies at the micro-level by NCAER and EDA—APMAS indicates that the unique selling proposition (USP) of high repayment rates is waning. The recovery data reported by banks to NABARD for the period 2007-08, reveals that several banks have a recovery of less than 90%. 6 commercial banks, 15 regional rural banks and 36 district cooperative banks had recoveries of less than 75%. The analysis of information in the impact evaluation study of NCAER reveals that only 69.2%of the SHGs had an excellent record of recovery. Another 7.6% of the groups posted recovery rates in excess of 90% and 22.6% groups had recoveries of less than 75% of demand. Arrears were reported by 7.6% groups which were outstanding for more than

twelve months that amounted to 0.86%, of outstanding loans. AP- and Orissa-based SHGs had reported much lower repayment rate when compared to the rest of the country. In Orissa, 27% of SHGs had reported arrears reflecting the fragile nature of the local economic activity and the vulnerability of the group members in that region. Nationwide, average Indian household debt from microfinance lenders almost quintupled between 2004 and 2009, to about $135 from $27 or so, according to a survey by Sa-Dhan. Sa-Dhan 2007-08 report states that the average loan outstanding per client increased from Rs 3,442 to Rs 4,222, by 22% across all clients. According to SIDBI, its outstanding loans to MFIs reached a level of Rs 9.58 billion in 2007–08 from Rs 5.48 billion by the end of March 2007. The Bharat Microfinance Quick Report on MFIs 2008 points out a growth in the outstanding portfolio of loans is almost by Rs 2,500 crore.

The reasons for lower repayment rates and arrears are many. Firstly, the principal incentive to repay is the customer's desire to keep access to a highly valued service. In the case of loan size having reached its limit, there is little scope to aspire for a higher loan. This incentive weakens further when borrowers see widespread default and start to worry that the MFI may not be able to make future loans. Secondly, irrational rigid repayment schedule having no link with the repaying capacity or the potential for income generation of the purpose or scheme for which micro loan issued, influences the level of persistent repayment and good collection trend. Ignorance of factors which reduces cash flows of clients at the time of product designing such as illnesses, natural calamities, payment blockage by buyers etc further aggravates the problem. Thirdly, the loan waiver declaration by the government has impacted the microfinance operations. A significant number of the waiver client families are likely to be common clients of the microfinance sector as well. The clarification issued by the government that SHGs and members who had borrowed for farming purposes would also be eligible for the waiver who has opened the sector to newer risks. Lastly, borrowers are simply "walking away" from their debts due to the lack of credit information sharing amongst MFIs, coupled with increasing competition, underfinancing and a migration away from group lending to direct lending is resulting in multiple loans being granted to the same individuals – who themselves lack the knowledge to manage their financial affairs responsibly. As per Srinivasan's 2008

report, the estimates made to study this phenomenon put the present stage of multiple borrowers in given localities as anything from 10% to 20%. The report also showed that repeat loans, which constituted only 17% of the loans in 2002, had risen to 40% by 2007. This may lead to higher levels of indebtedness of the clients [Ciravegna, 2005]* and lower repayment rates [Vogelgesang, 2003]† endangering the long-term sustainability of the programme. These unbridled unethical practices which causes 'debt fatigue', are observed both in demand and supply side. From the demand side, there is shift in utilization of microcredit from ethical end use (income generation or genuine need based) to unethical end use (ostentatious consumption). From supply side, there is a shift from social engineering to financial business engineering practiced with unethical practices in both delivery and recovery process in the poverty sector. There is also shift in product design from demand based to supply oriented. Eventually, repayment ethics has become the first causality with the enhanced level of debt.

For many MFIs, the problem is very small and nothing like subprime crisis. But how long did it take for the subprime crisis to erupt after showing its first signs? Not long. May be this would not reach the size of housing bubble but if it happens, it would hurt the most vulnerable segment of society. Thus, attention must be paid to the developing world to prevent a potential parallel crisis in the microfinance sector. Probably its time to have a level of self regulation and code of conduct mutually agreed upon by the MFIs to prevent such a thing from happening.

XI- Unrealisable Expectations

Poverty alleviation requires an understanding of the interplay between economic, social, cultural extracts of the developmental process. Understanding the problems and the cause-effect relationships, is critical for a holistic view of development. There will always be problems behind the problems. Problems behind

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* Ciravegna, D (2005): 'The Role of Microcredit in Modern Economy: The Case of Italy', www.flacso.or.cr/fileadmin/documentos/ FLACSO/auCiravegna2.DOC (accessed 30 july 2009)..

† Vogelgesang, U (2003): 'Microfinance in Times of Crisis: The Effects of Competition, Rising Indebtedness and Economic Crisis on Repayment Behaviour', *World Development*, Vol. 31(12).

problems, therefore, require 'solutions behind solutions' that target the root cause of problems.

Holistic Approach on the Part of the Lenders

It is becoming increasingly apparent that addressing financial exclusion will require a holistic approach on the part of the banks as well in creating awareness about financial products, education and advice on money management, debt counselling, savings and affordable credit. The banks would have to evolve specific strategies to expand the outreach of their services in order to promote and achieve financial inclusion. One of the ways in which this can be achieved in a cost-effective manner is through forging linkages with microfinance institutions and local communities, technology usage etc.

Holistic Approach on the Part of MFIs

MFIs on their own have to take certain measures which would help them to overcome their problems and shake off the charge of being unethical and charging usurious interest rates. The voluntary code of conduct adopted by the AP MFIs is a welcome step and could be adopted by other MFIs in the country. The code needs to be followed in true letter and spirit and should not only remain on papers. Further, focus should be given at conceptual level, i.e. there is a gap between the concept and practice. That is to highlight the wrong notion, practiced widely but wrongly, of treating microcredit on par with microfinance. Microcredit is one among the various components of microfinance such as microsavings, microinsurance and other financial services intended for the poor community. Mere provision of microcredit without other components, only increase the level of debt of the poor. This irresponsible microfinancing need to be checked and corrected for reduction of poverty and vulnerabilities of the poor. Thus what is required is to gradually replace ‘credit alone’ approach with ‘credit also’ approach (integrated) in development context in the poverty sector.

XII- Concluding Remarks

It is felt that in the microfinance sector too much hype is created about its magical effects to reduce poverty. Question is raised: Is microfinance crowding out other good development? It is pointed out that valuable aid money from donor agencies has been diverted to untested and non-viable microfinance programmes - away from vital

programmes on health, education etc. that are in dire need of such money. Microfinance is indeed an essential ingredient in the development process - but not the only ingredient. MFIs on their own cannot solve the problem of poverty because poverty is a whole set of problems. Microcredit can only constitute one small input towards women's empowerment and poverty alleviation. The government remains accountable to ensure basic entitlements such as those related to health, education and employment to all citizens. It would be easy for donors and governments to create and fund credit programs and ignore other, potentially more serious problems faced by the rural poor. The 1998 UN report 'The Role of Microcredit in the Eradication of Poverty' recommends microfinancing as one part of a larger effort for promoting small business enterprise. The other components include improving access to land, appropriate technology and markets, as well as promoting SHGs and counseling to help poor people successfully manage small businesses. To conclude, one can say that microfinance can prove to be powerful tool in eliminating poverty, but it is clearly no panacea for all problems the poor face.

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