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State of the Sector Report 2011

N. Srinivasan

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Microfinance India

State of the Sector Report 2011

N. Srinivasan

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Los Angeles • London • New Delhi • Singapore • Washington DC

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First published in 2012 by

SAGE Publications India Pvt Ltd
B1/I-1, Mohan Cooperative Industrial Area
Mathura Road, New Delhi 110 044, India
www.sagepub.in

SAGE Publications Inc
2455 Teller Road
Thousand Oaks, California 91320, USA

SAGE Publications Ltd
1 Oliver's Yard
55 City Road
London EC1Y 1SP, United Kingdom

SAGE Publications Asia-Pacific Pte Ltd
33 Pekin Street
#02-01 Far East Square
Singapore 048763

ACCESS Development Services
28, Hauz Khas Village
New Delhi 110 016
www.accessdev.org

Published by Vivek Mehra for SAGE Publications India Pvt Ltd, Phototypeset in 10/12 pt Minion Pro by Diligent Typesetter, Delhi and printed at Artxel, New Delhi.

Library of Congress Cataloging-in-Publication Data Available

ISBN: 978-81-321-0705-7 (PB)

SAGE Production Team: Rudra Narayan, Pranab Jyoti Sarma, Vijay Sah and Umesh Kashyap
Disclaimer: The views expressed in this publication are those of the authors and do not necessarily reflect the views and policies of ACCESS Development Services.
Cover Photograph: Anna Garriott.

Contents

List of Tables, Figures, Boxes, Annexes and Abbreviations vii
Foreword by Vipin Sharma xiii
Preface xvii

1. Overview—despair to hope 1

2. Self-help group bank linkage programme—early signs of a new thrust 13

3. Microfinance institutions—slow recovery from a disaster 33

4. Andhra Pradesh—dream turns nightmare 47

5. Investment climate—fairweather partners 63

6. Social performance management—beyond responsible finance and customer protection 71

7. Policy environment and the regulation—hard times ahead 87

8. National Rural Livelihoods Mission—will it go beyond finance? 99

9. Financial inclusion—march of the banks 107

10. Global trends in microfinance 123

11. Future—beginning again? 129

Appendix 133
Bibliography 139
Index 143
About the Author 149

List of Tables, Figures, Boxes, Annexes and Abbreviations

Tables

1.1.	Client outreach—borrowers with outstanding accounts	3
1.2.	Comparison of average loan size	4
1.3.	Estimate of microfinance credit clients	4
1.4.	Concentration of financing in some states	6
2.1.	Growth trends in SBLP	13
2.2.	Regional shares in linkage	15
2.3.	Bank loans outstanding against SHGs, 2010–11	16
2.4.	Support to SHPIs and their performance	21
2.5.	Comparison of average outstanding loan per account—SHG and agriculture loans	23
3.1.	Progress of MFIs	33
3.2.	The top 10 MFIs by outreach	33
3.3.	Comparative performance of top five MFIs	34
3.4.	Growth in client outreach—a frequency distribution	35
3.5.	Classification of MFIs according to size of client base	35
3.6.	Form-wise distribution of MFIs-loan portfolio	35
3.7.	Size of institutions and yield on portfolio	37
3.8.	Comparison of costs of MFIs	37
3.9.	Comparison of market share of different regions	38
3.10.	Rang De's interest pricing	42
4.1.	Progress trends of the sector in Andhra Pradesh	48
4.2.	Loan portfolio of 10 large MFIs in Andhra Pradesh	50
4.3.	Change in expenditure patterns between 2010 and 2011	50
4.4.	Comparison of source of loans	51
4.5.	Alternatives to MFI loans	52
4.6.	Progress of SHG linkage in Andhra Pradesh	53
4.7.	Portfolio Quality of SHG loans in Andhra Pradesh	53
4.8.	Loan exposure qualifying for Corporate Debt Restructuring (CDR)	54
5.1.	Selected equity investments, 2011	64
5.2.	Loans from banks, 2010–11	65
5.3.	Loan deals	66
5.4.	MFI CDR Debt Restructuring Programme	67
5.5.	Major NCD deals	68
5.6.	Major securitization deals in 2011	68
6.1.	Scores on compliance with code of conduct	72
6.2.	Social initiatives of select MFIs	75
6.3.	Ranking of mission and performance in MFIs	76

6.4. Does a social mission lead to socially aligned performance in business 78
9.1. Commercial banks and financial inclusion 108
9.2. New micro-life insurance business contracted during 2009–10 109
9.3. Micro-insurance agents of life insurers 110
9.4. What remains to be included 110
9.5. Utilization of Financial Inclusion Funds, 2010–11 110
9.6. Ranking of select states based on MPI and MPPI 113
10.1. Caseload and salary levels 125
10.2. Top ten countries in microfinance 126

Figures

1.1. Comparison of SHG and MFI client outreach 3
1.2. Comparison of loan portfolio of SHGs and MFIs 3
2.1. Outstanding SHG loans—nominal and real terms 14
2.2. Number of SHGs holding savings accounts, 2008–11 14
2.3. Savings growth by SHGs, 2008–11 14
2.4. Market share by bank of number of SHGs with savings 14
2.5. Market share by bank of volume of savings held by SHGs 14
2.6. Market share by bank of number of SHGs with outstanding loans 16
2.7. Market share by bank of volume of SHG loans outstanding 16
3.1. Average loan size—nominal and real values 34
3.2. Client outreach by size of MFIs 35
3.3. Share of loan values, size-wise 35
3.4. Market share of different forms of institutions by loan volume 36
3.5. ROA range-wise distribution of MFIs 36
3.6. ROE range-wise distribution of MFIs 36
3.7. Regional shares in client outreach 38
3.8. Regional shares in portfolio 38
3.9. Why customers like MFIs 41
3.10. Why customers do not like MFIs 41
4.1. Growth of outreach and loan portfolio outstanding—comparison between SBLP and MFIs in Andhra Pradesh 48
4.2. Share of SBLP and MFI to per capita average loan in Andhra Pradesh 48
4.3. Reasons for not paying MFI loans 51
4.4. How did customers manage after MFIs became dormant 51
4.5. Month-wise number of groups linked post ordinance 52
4.6. Month-wise disbursement of loans to SHGs in Andhra Pradesh post ordinance 52
4.7. Household level loans—share of different sources 53
4 .8. Estimated outstanding loans at household level—by source 53
5.1. SKS equity price movement 66
6.1. Poverty tracking through PPI by Grameen Koota 75
6.2. Poverty tracking through PPI by Grameen Koota using three cycles scores 75
10.1. Number of active borrowers, 2009 123
10.2. Comparison of outstanding loan portfolio 124
10.3. Operating costs and yields, 2009 124
10.4. Size of loans as proportion of per capita national income 125
10.5. Size of loan and cost per loan 125

Boxes

2.1. Are banks listening? 17
2.2. Observations from the field 18
2.3. Promoter NGOs desert—leaders capture 20
2.4. SHG 2—ideas from an old India hand 22

2.5. Federation promotion 24
3.1. Credit reference reports—quality issues 40
3.2. Web-based microfinance 42
4.1. Findings of survey of MFIs in Andhra Pradesh 54
4.2. From tigers to cats!!! 57
5.1. Innovations in capital structuring 69
6.1. The step-by-step approach of Dia Vikas on SPM 74
9.1. MPI and MPPI 113
9.2. All-out effort in inclusion 115
11.1. Vision of microfinance and inclusion—stakeholders have a duty 131

Annexes

2.1. Interview with Dr Prakash Bakshi, Chairman, NABARD 26
2.2. Comparison of groups with outstanding loans and loan amounts—state-wise 28
2.3. Comparison of disbursements in SHG loans—state-wise 29
2.4. State-wise savings performance of SHGs 30
2.5. Credit to savings ratio across states 31
3.1. Survey of MFIs—coping with crisis and new regulations 43
3.2. Compliance with RBI caps—in APR terms 45
4.1. Suicides and microfinance 58
4.2. The Andhra Pradesh Ordinance on Microfinance—a commentary 59
6.1. Client friendly repayment practice 79
6.2. Impact Assessment Overview for the State of the Sector Report 81
6.3. List of covenants agreed upon by the Lenders' Forum 85
7.1. Key recommendations of Malegam Committee 93
7.2. Malegam Committee recommendations and RBI regulation—a comparison 94
7.3. Comparison of 2007 and 2011 versions of the microfinance bill 94
7.4. Commentary on the new microfinance bill 95
8.1. Interview with Mr Vijay Kumar, Joint Secretary, Ministry of Rural Development, Government of India 103
9.1. Interview with H.R. Khan, Deputy Governor, Reserve Bank of India 116
9.2. Microfinance Penetration Index (MPI) and Microfinance Poverty Penetration Index (MPPI) 119
9.3. State-wise index of financial inclusion 120

Abbreviations

ABCO	Average Business per Credit Officer
AML	Anti-Money Laundering
AP	Andhra Pradesh
APDPIP	Andhra Pradesh District Poverty Initiatives Project
APGB	Andhra Pragathi Grameena Bank
APMACS	Andhra Pradesh Mutually Aided Cooperative Societies
APMAS	Andhra Pradesh Mahila Abhivruddhi Society
APR	Annualized Percentage Rate
BAIF	Bhartiya Agro Industries Foundation
BC	Business Correspondent
BCNM	Business Correspondent Network Manager
BDS	Business Development Service
BF	Business Facilitator
BIRD	Bankers Institute of Rural Development
BPL	Below Poverty Line
CAB	College of Agricultural Banking
CASHE	Credit and Savings for Household Enterprise
CASHPOR	Credit and Savings for the Hardcore Poor

CBRM	Community Based Recovery Mechanism
CBS	Core Banking Solution
CDF	Cooperative Development Foundation
CDR	Corporate Debt Restructuring
CGAP	Consultative Group to Assist the Poor
CIBIL	Credit Information Bureau (India) Limited
CMF	Centre for Micro Finance
CMR	Centre for Microfinance Research
CMRC	Community Managed Resource Centres
COCA	Code of Conduct Compliance Assessment
CRAR	Capital to Risk-weighted Assets Ratio
CSC	Customer Service Centre
CSP	Customer Service Point
DCC	District Consultative Committee
DCCB	District Central Cooperative Bank
DFID	Department for International Development
DIPP	Department of Industrial Policy and Promotion
DRDA	District Rural Development Agency
DWCD	Department of Women and Child Development
EBT	Electronic Benefits Transfer
FIF	Financial Inclusion Fund
FINO	Financial Information Network & Operations Ltd
FIP	Financial Inclusion Plan
FITF	Financial Inclusion Technology Fund
FLDG	First Loss Deficiency Guarantee
FWWB	Friends of Women's World Banking
GCC	General Credit Card
GDP	Gross Domestic Product
GIZ	Deutsche Gesellschaft für Internationale Zusammenarbeit
HDFC	Housing Development Finance Corporation
HDI	Human Development Index
HiHMFPL	Hand in Hand Micro Finance Private Limited
HR	Human Resources
HUDCO	Housing Urban Development Corporation
ICT	Information Communication Technology
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation
IFMR	Institute of Financial Management and Research
IGS	Indian Grameen Services
IKP	Indira Kranti Patham
ILFS	Infrastructure Leasing and Financial Services Limited
ILO	International Labour Organization
IMEF	India Microfinance Equity Fund
IPO	Initial Public Offering
IRDA	Insurance Regulatory and Development Authority
IRDP	Integrated Rural Development Programme
JLG	Joint Liability Group
KBSLAB	Krishna Bhima Samruddhi Local Area Bank
KDFS	Kalanjiam Development and Financial Services
KfW	Kreditanstalt für Wiederaufbau
KGFS	Kshetriya Gramin Financial Services
KYC	Know Your Client
LIC	Life Insurance Corporation of India
MACS	Mutually Aided Cooperative Society

MBT	Mutual Benefit Trust
MCID	Micro Credit Innovations Department
M-CRIL	Micro-Credit Ratings International Ltd
MEDP	Micro Enterprise Development Programmes
MENA	Middle East and North Africa
MFDC	Microfinance Development Council
MFDEF	Micro Finance Development and Equity Fund
MFI	Microfinance Institution
MFIN	Microfinance Institutions Network
MFO	Microfinance Organizations
MGNREGS	The Mahatma Gandhi National Rural Employment Guarantee Scheme
MIA	Micro Insurance Academy
MIFOS	Microfinance Open Source
MIS	Management Information System
MIT	Ministry of Information Technology
MIX	Microfinance Information Exchange
MMS	Mandala Mahila Samakhya
MNO	Mobile Network Operator
MPI	Microfinance Penetration Index
MPPI	Microfinance Poverty Penetration Index
MRAP	Micro Finance Researchers' Alliance Programme
MSDF	Michael and Susan Dell Foundation
MSP	Minimum Support Price
MVDA	Maharashtra Village Development Association
NABARD	National Bank for Agriculture and Rural Development
Nabfins	NABARD Financial Services Ltd
NAFSCOB	National Federation of State Cooperative Banks
NBFC	Non-banking Financial Company
NBFC ND-SI	Non-Banking Financial Company – Non deposit taking – Systemically Important
NCAER	National Council for Applied Economic Research
NCDs	Non-convertible Debentures
NCRB	National Crime Records Bureau
NE	North-east
NFAs	No-frills accounts
NFC	Near Field Communication
NGO	Non-governmental Organization
NHB	National Housing Bank
NOF	Net Owned Fund
NPA	Non Performing Assets
NPCI	National Payments Corporation of India
NPS	New Pension Scheme
NREGA	National Rural Employment Guarantee Act
NREGS	National Rural Employment Guarantee Scheme
NRLM	National Rural Livelihoods Mission
NSSO	National Sample Survey Organisation
OER	Operating Expense Ratio
OSS	Operating Self Sufficiency
PACS	Primary Agricultural Credit Societies
PAR	Portfolio at Risk
PDA	Personal Digital Assistant
PE	Private Equity
PE Ratio	Price to Earnings Ratio
PHC	Public Health Centre
PIL	Public Interest Litigation

PLF	Panchayat Level Federation
POS	Point of Sale
POT	Point of Transaction
PPI	Progress out of Poverty Index
PPP	Purchasing Power Parity
PRADAN	Professional Assistance for Development Action
PRI	Panchayati Raj Institution
PSL	Priority Sector Lending
PSS	Payment and Settlement Systems Act
RBI	Reserve Bank of India
RFID	Radio Frequency Identification Device
RGVN	Rashtriya Grameen Vikas Nidhi
RMK	Rashtriya Mahila Kosh
ROA	Return on Assets
ROE	Return on Equity
ROGLP	Return on Gross Loan Portfolio
RPLI	Rural Postal Life Insurance
RRB	Regional Rural Bank
RSETI	Rural Self-employment Training Institute
SBLP	SHG Bank Linkage Programme
SC	Scheduled Caste
SCB	State Cooperative Bank
SCC	Swarozgar Credit Card
SEEP	Small Enterprise Education and Promotion
SERP	Society for Elimination of Rural Poverty
SEWA	Self Employed Women's Association
SGSY	Swarnajayanti Gram Swarozgar Yojna
SHG	Self Help Group
SHPA	Self-help Promotion Agency
SHPI	Self-help Promoting Institution
SIDBI	Small Industries Development Bank of India
SIFFS	South Indian Federation of Fishermen Societies
SIM	Subscriber Identity Module
SKDRDP	Sri Kshetra Dharmasthala Rural Development Project
SLBC	State Level Bankers Committee
SMGB	South Malabar Gramin Bank
SPM	Social Performance Management
SPTF	Social Performance Task Force
ST	Scheduled Tribe
UID	Unique Identity Number
UNDP	United Nations Development Program
VC	Venture Capital
VHS	Voluntary Health Services
VO	Village Organization

Foreword

When, seven years ago, we conceived the SOS (State of the Sector) Report, the idea was to effectively track the state of the microfinance sector, as it grew and evolved over the years in India. Given the standoff and the growing signs of a clash between the two channels of micro-credit delivery, the 2011 Report, regretfully, owing to the events in the last one year, will be a narrative on the 'State versus the Sector'. I recall the happy camaraderie in which the two models competed from a conversation I had with the CEO of a pioneering microfinance institution (MFI) way back in 2003, who ruefully recounted how an aggressive regional rural bank (RRB) Chairman ably wooed away all his clients in Mehboobnagar district of Andhra Pradesh and gave them self-help group (SHG) loans. There wasn't any rancour in his narration. The last few years have not only seen grim turf wars between competing MFIs, but also between MFIs and the SHG promoters. Post 2010, the battle lines seem to be drawn, and as it appears, a full war is on. The last 15 months have perhaps been the worst for the microfinance sector not only in India but also across the world. While in the neighbourhood, the Nobel Prize winning founder of Grameen Bank, Mohd Yunus was ousted from the Chair of the Bank he founded, he was labelled as someone 'who entrapped the poor towards greater indebtedness'; globally the mission and methods of the MFI model are beginning to be questioned. The discourse, whether microfinance is a good mechanism for enabling financial inclusion or it is an effective poverty reduction tool and that the methodology can deal with the poorest is yet not conclusive. What was once seen to be a magic bullet which had the ability of pulling the economically backward out of poverty is now under a shroud of deep controversy across the world.

Just a month before the 2010 SOS Report was released, the sector was confronted with its biggest crisis in the two decades since it was launched as a methodology to link poor with financial services. A series of events over the last four years, ever since the Krishna crisis, eventually culminated in the Andhra Pradesh government bringing in a tough ordinance, which effectively scuttled the ambitious aggressive plans of MFIs hitting the capital markets, post the runaway success of the SKS IPO. Operations of all MFIs in the State came to a grinding halt, recoveries dipping to an all time low of 10 per cent, in a sector which boasted of PAR > 1 per cent and soon banks refused to pump in fresh debt. The situation came to a stage where the central bank, reluctant so far, set up the Malegam Committee to look into the issues. Several rounds of discussions between the MFIs and their networks and the State, and with the Reserve Bank of India (RBI) did not see any breakthroughs. Based on the Committee recommendations, the RBI issued a set of comprehensive guidelines, which will significantly change the way MFIs have operated so far. Irrespective of these prudential guidelines, the banks have not regained their confidence in bringing in substantial new debt. Several big MFIs saw themselves going under, and a series of CDR exercises were initiated to rescue the large debt that the banks had put into the sector. Smaller MFIs were in serious danger of vanishing from the scene. Hectic efforts were mounted to expand operations in non-Andhra Pradesh states, with portfolio buyouts and other strategies. The efforts to bring in a federal MFI regulation picked up steam at the Government of India level and, meanwhile, the state of Andhra Pradesh stayed firm, and started its own plans to bolster the SHG programme. A full-fledged crisis was at hand and nothing seemed to salvage the situation. While the MFIs will have no option but to climb down from their lofty positions and start to operate under the new prudential regime, the crisis has thrown, both through design and default, a real opportunity for the SHG programme, which was seen to be losing steam for a while, for a fresh renewed momentum.

Under a regime change in the National Bank for Agriculture and Rural Development (NABARD), there are plans to tweak the two-decade-old SHG programme and give it its next burst. Several impediments that have restrained its pace are being looked into, and the design for version 2 of the SHG programme is underway. More importantly, a mammoth new poverty reduction programme of the Government of India—the National Rural Livelihoods Mission (NRLM)—is soon to be rolled out. SHGs and SHG Federations will form the building blocks of this programme. Each of the approximately 5,000 rural blocks in the country will have an SHG Federation which, besides other functions, is also expected to undertake financial intermediation. Large resources will be assigned to support and strengthen the SHGs; human resources from all possible avenues are being drawn to manage and implement this new programme. Given the reluctance of banks to go all out in financing the SHGs, new financing channels are being designed. In Andhra Pradesh, 'Stree Nidhi'—a quasi bank—is already in operation and an NBFC type mechanism to guarantee bank loans to SHGs is under design at the Government of India level. While these new efforts and investments will seemingly reinvigorate the SHG movement with large subsidies and dole outs, it is not yet clear if this is likely to disturb a fairly mature market-based arrangement that has existed so far. Also only in times to come will it become clearer in terms of how much space there will be for the MFI channel to operate. An *entente cordiale* is not in sight, yet.

The full flurry of the eventful year in the history of microfinance sector in India is captured in detail by N. Srinivasan in the SOS 2011. This year's report carries a special chapter on the Andhra imbroglio as also on the NRLM, both of which are likely to have a profound future impact on how the sector will evolve in the years to come.

N. Srinivasan, fondly referred to as Srini, with this edition of SOS 2011, will complete four years of authorship of the report. It is unfortunate that this will also be his last report. Over the last four years, he has helped in bringing great prestige and position for the report with his painstaking detailing of events in the sector, insightful analysis of trends, understanding of issues, making sense out of sketchy statistics and bringing it all together in a comprehensive narrative. To bring together the report, Srini visited the hot spots and flashpoints in the sector, interviewed key stakeholders, organized small consultations, travelled extensively across the country over several months and, amazingly, still was able to deliver the manuscript to the publishers in time. Since Srini is not seen to be associated with one or the other model of delivery, the SOS Report is largely seen as honest, if not entirely neutral. With each year, his efforts have made the report much richer and more credible. In a sector so deeply divided, Srini was able to get cooperation from all. While I would like to thank Srini for this superlative effort over the last so many years, my big worry is to find a successor author who could match the knowledge and understanding of the sector that Srini has, the wit and wisdom that he possesses and the kind of credibility and stature he enjoys. I will remain quite worried till the next year author is identified; a tall task indeed. On behalf of all of us at ACCESS, we profusely thank Srini for a terrific association with the report writing; of course, he will continue to be associated with other initiatives of ACCESS, and its specialized affiliate, ACCESS-ASSIST.

The report has greatly enhanced the ACCESS position as a knowledge provider to the sector. This year, the report was extensively used by the members of the Malegam Committee to understand the issues in the sector and in making key recommendations. Release and distribution of the report at the Microfinance India Summit is much awaited by all stakeholders in the sector and they look forward to their complimentary copy.

As always, there are several challenges in bringing out the report in time for its release at the Microfinance India Summit. It is absolutely a wonderful feeling that so many across the board are willing to support Srini in the writing of the SOS. Getting the data is always the big challenge. What helped a little bit this year was the dates of the Summit moving to December from October–November, when the Summit is usually held. In bits and pieces, sometimes complete, sometimes not so, data flowed in, perhaps just in time. A few organizations like the Centre for Microfinance, Chennai, right from the beginning, have helped in making special efforts to enrich the report's content, and this year was no different. I thank Justin, and now Ajay and Santo, for continuing the support to the report over the years. MicroSave provided some important additional details which have contributed in the analysis of the Andhra Pradesh situation and the issues on financial inclusion, especially the Business Correspondent (BC) framework. Increasingly, NABARD has come on board as a key supporter of the report, providing the SHG data in time. I thank Dr Kumbhare and Dr Suran in Micro Credit Innovation Department (MCID), NABARD, as also Mohanaiah, Head of NABARD, Andhra Pradesh, for their efficient support to the report. I need to thank Mr H.R. Khan, Dy Governor, RBI, for the detailed interview with Srini. My special thanks to the new

NABARD Chairman, Dr Bakshi, for the time he spent with Srini and sharing his future perspective on the sector. As always, Small Industries Development Bank of India (SIDBI) has remained a key supporter of the report and I thank Mr Maini and his team for their continued support. I extend my sincere thanks to Liz and her team at Mix Market for key financial and SPM data on MFIs, which has helped to deepen the analysis in the MFI chapter. I also thank both Microfinance Institutions Network (MFIN) and Sa-Dhan for the much needed information on their members. My special thanks are also due to Vijay Kumar Garu for sharing his perspectives on the SHG programme as well as on the design of NRLM, which form an important part of the report. I would also like to profusely thank Navin Anand at Solutions Exchange for putting out related queries and consolidating the response, which provides an important feedback on the SOS format; and Mrs Kamla Rajan, Principal, CAB, for supporting the report, as always.

Finally, I would like to thank my own teams at ACCESS and ACCESS-ASSIST, who have admirably provided the much needed back office support to the report. Radhika, Executive Director of ACCESS-ASSIST, along with Swati provided the much needed support in organizing meetings and providing necessary information and Anna, who has joined ASSIST recently, hugely helped in cleaning up and organizing the information. Lalitha, as always, has been super efficient in providing the logistics support to Srini's travels. Importantly, I would like to profusely thank the Microfinance India Summit Advisory Group, led by Mr Y.C. Nanda and Brij Mohan who provided the much needed guidance and direction to the author and the report structure. For all of us at ACCESS, at all levels, there is a great pride to be the owners of this document, and support to its writing is available in large measure. The sponsors of the report deserve a special mention. The Ford Foundation, UNDP, NABARD, SIDBI, IFC and Plan India not only provided the resources, but offered editorial freedom which made fair chronicling of the developments of the sector possible.

At the tier three level, which consists of all its national initiatives, ACCESS is gradually working to provide knowledge products and platforms for the sector in an effort to inform and influence policy and practice. While it has started to bring out several knowledge products, hopefully of value to the sector, the 'Microfinance India State of the Sector' report remains its key knowledge product. Given its growing credibility as an important reference document, the future ambition within ACCESS is to broaden the ambit of its scope to the extent of capturing all aspects and all efforts that are being made to enable greater financial inclusion of the poor. While the detailing of the new format will be done in consultation with the new author, I hope, in the meanwhile, this sixth edition of the State of the Sector Report provides meaningful value to the sector.

Vipin Sharma
CEO, ACCESS Development Services, New Delhi

Preface

As usual there is an overwhelming sense of completion when one sits down to write the preface. The writing of the current year's report has been a very different experience compared to the previous years. The sector was reeling under problems of its own, helped along liberally by a state government. The lacklustre performance of the institutions in the second half of 2010–11 and the very low level of activity in the first quarter of 2011–12 hindered the process of the making of this report. The institutions were not very forthcoming with information and views, and understandably so, when they were fighting for survival. On my part, it was difficult to continuously persuade institutions to part with information, knowing fully well that they have several existential issues in their mind. Therefore, I consider the quality of support made available by several stakeholders, despite their problems, to be remarkably high. I have several people and institutions to thank. In terms of institutions, I have to thank MIX Market, Centre for Micro Finance (CMF), Chennai, and its Microfinance Researchers Alliance Programme (MRAP) for the extent and quality of support through different studies and surveys by the staff and interns. I express my gratitude to MicroSave for providing a wealth of information on a range of issues that filled critical gaps from the field. MIX Market, Hyderabad; College of Agricultural Banking, Pune; UNSE Micro Finance Community, New Delhi; NABARD, Mumbai; SIDBI, Lucknow; Sa-Dhan, New Delhi; MFIN, Hyderabad; and Grameen Foundation, USA, helped in my labours. H.R. Khan, Deputy Governor, Reserve Bank of India, responded to an electronic interview on payments and settlements systems and financial inclusion. Dr Prakash Bakshi, Chairman, NABARD, spent time with me discussing the sector issues. Vijay Kumar, Joint Secretary, Ministry of Rural Development, spared time over phone on a Sunday to share his insights on the design of NRLM. Mrs Kamala Rajan, Principal of College of Agricultural Banking (CAB), Pune, had been extremely supportive of the making of the report in several ways. My thanks to Amanda Hahnel, intern at CMF, for her contribution to the chapter on investment climate. Sebastian Gachot, Intern at CMF, helped Santadarshan Sahu of CMF in the survey on 'Access to Finance'. Puneet Bhasin and Kenny Kline of CMF carried out the analysis and the survey on 'Mission alignment with financial performance'. Santadarshan Sadhu, K.C. Deepti and Amulya Champatiray, along with the interns from CMF, were of great support in putting together several quick studies and surveys. Santa Sadhu also provided a note on impact assessments in microfinance specifically for the report. Liz Larsen and Rahul Shamsuka of Mix Market provided the basic data required for Chapter 3 on microfinance institutions (MFIs) in the report. Mathew Titus and Natrajan of Sa-Dhan, S.G. Anil of IFMR, Ramakrishna of Rang De, John Mayne of Anjali Micro Finance, Vasu and Venkatesh of Equitas, Graham Wright and Manoj Sharma of MicroSave, G.V.S. Reddy of Society for Elimination of Rural Poverty (SERP), Mohanaiah, Kumbhare and Suran of NABARD, Suresh Krishna of Grameen Koota, Siddarth Das of Highmark, Kalpana Sankar and Jayaseelan of Hand in Hand, Jayesh Jain of Grameen Foundation, and Ramesh Kumar and Moin Kazi of Swarnapragati Housing provided critical pieces of information for the report. Radhika, Swati and Lalita of Access supported me with information, arranging of meetings and also the logistics. Special mention should be made of Anna Garriot, an intern with Access, who took the load of data processing and ensuring data accuracy for this report and also had a quick editorial look over some chapters. Pravin Shende, as in the previous three years, did an excellent job of keying in the report from voice files despite personal misfortune. I thank Girija Srinivasan for the latent and overt contributions to the chapters on self-help groups (SHGs) and National Rural Livelihoods Mission (NRLM) and also for a

thorough review of the report from an editorial point of view. Finally, I would like to place on record my sincere thanks to the Microfinance Advisory Group at Access: Y.C. Nanda, Brijmohan, Vijaylakshmi Das, Ajay Tannirkulam, Moumita Sen Sharma and Alok Prasad for their ideas and feedback on critical issues. I am acutely conscious that I might have missed a few names. Kindly accept my sincere appreciation for your support and my apologies for not acknowledging the same.

This year, the report has 11 chapters. Apart from the usual chapters, there are two additions, one of which focuses on the developments and learning in Andhra Pradesh and the other is on the newly launched National Rural Livelihoods Mission (NRLM). Two aspects that were carried in the report in the last year, i.e., savings, investment and pension and technology in microfinance, have not been covered this year in order to make way for more topical issues. I hope that the report informs the reader objectively about what has happened in the sector during the year and enables the sector to take a view as to the best manner of going forward. While many have helped to improve the report, the errors and omissions are solely mine. The analysis and critical comments are also mine and none of the sponsoring institutions or Access Development Services is responsible for the same. I thank the sponsors—Ford Foundation, International Finance Corporation (IFC), United Nations Development Programme (UNDP), NABARD, SIDBI and Plan India—for supporting this report and giving me the freedom to express my views.

Vipin Sharma deserves special thanks from my side. Four years back he placed blind faith in me to set me off on this adventure of writing the report when I had, in fact, not written anything longer than 10 pages. But the intensity of his faith was such that I was forced to work hard and put together what I hope is a series of useful reports. The current report is the fourth in the series and will be my last. I believe that readers deserve relief from the tedium of the same style and set of ideas. I sincerely thank readers for their support over the past four years. I love feedback and please do not be sparing.

N. Srinivasan

Overview—despair to hope

1

Chapter

MACRO CONTEXT

While the Indian macro context was neutral, microfinance sector had to struggle for survival through several problems in what proved to be a difficult year. The macroeconomic environment continued to remain positive in India during 2010–11, but with inflationary pressures chasing economic activity. While recovery was taking place across the world, governments in Europe and the United States faced crisis-like situations in managing the fiscal policies, thereby putting enormous pressure on the central banks and monetary authorities in managing the monetary policies. The debt crisis faced by European countries like Greece, Ireland, Portugal, Spain, Belgium and Italy tended to drag down the European Union, resulting in painful economic conditions for the people. Some of sovereign debt papers have been downgraded by rating agencies to 'junk' category. Even the United States has recently faced a downgrade of its sovereign credit rating resulting in significant impact on several countries. The protracted negotiations between lawmakers and the president of the United States on the borrowing limits for the federal government gave sleepless nights to financial markets and governments across the world. The failure of public funding and the quantitative easing policies pursued by monetary authorities to achieve projected outcomes in many countries was a telling comment on the textbook economic policies pursued across the world. The rising commodity prices and steady high price for fossil fuels kept inflationary conditions on the boil. The low growth and high unemployment pressures in most developed countries do not augur well for countries that are still developing.

The Indian economy

The Indian economic environment had turned positive with the Reserve Bank of India (RBI) commenting, in its annual report, that 'the economy had returned to high growth during the year 2010–11'. The gross domestic product (GDP) growth is assessed to be at 8.5 per cent compared to the previous year's growth of 7.4 per cent. The index of industrial production increased by 8.2 per cent during the year compared to 5.3 per cent in the previous year. The vigorous GDP growth (which is lower than the desired growth rate of 9 per cent) was rendered possible by the continuing good performance of the services sector. Agriculture performed reasonably well during the year on the back of a good monsoon. RBI has been cautious about the inflationary pressures and the inflation potential that is inherent in the economy. The monetary policy continued to adopt a restrictive stance throughout the last year. The inflation during the year was at 9.6 per cent (year on year). RBI had raised its operational policy rates by 4.25 per cent during the 17 month period beginning from March 2010. Of this, in 2010–11 alone the increase was of the order of 3.25 per cent. Despite these measures, inflationary conditions continued to persist in 2011–12.

The latter half of 2010–11 saw a decline in capital investments.[1] The economic growth was more driven by a vigorous increase in consumption demand. Tight liquidity conditions prevailed in the market (caused primarily by the cash balances that the Government of India had with RBI for a major part of the year on account of its successful auction of the 3G spectrum). Banks in India continued to do well. The capital adequacy ratio of the banking system was satisfactorily above the regulatory

benchmarks at 13.86 per cent of risk adjusted assets. The Non Performing Assets (NPA) had seen a marginal increase from 2.35 per cent in 2009–10 to 2.52 per cent during the year. In RBI's view, the prospects for the year 2011–12 seem to be positive. The monsoon has been near normal and, in fact, by the end of August rains had turned excessive. Both the *Kharif* and the *Rabi* crops for the current year are likely to be above normal barring any aberrations of nature. The risk of a downside movement in the case of industrial performance is a concern. Factors such as commodity inflation, falling business confidence, tight money conditions and weak supply response are the major reasons for the weak performance of the industrial sector cited by RBI. The projected GDP growth during 2011 is of the order of 8 per cent again, aided by a strong services sector performance. The Indian economy will have to face the challenges of a continuing high global oil price; the increases will have to be passed on to consumers, both industrial and domestic. This will not only increase the fuel prices for the transport sector but will also increase the cost of fertilizer and electricity. The high fiscal deficit is likely to fuel the inflationary conditions. Exports, which put in a robust performance in the early part of 2011–12, do face downside risks for the remainder of the year.

The food inflation that affects the poorer sections of the population more than others has not shown much abatement. This is likely to impact the vulnerable people who are the majority customers of microfinance in the country. Credit flow to the economy as a whole grew by 20.8 per cent during the year, which was higher than the last year's credit growth of around 17 per cent. Agriculture saw an increase in credit flow only to the extent of 10.6 per cent and the priority sector registered an increase of 15.2 per cent in credit flow. This points to the fact that the priority sector and agriculture did not seem to be the preferred sectors of credit deployment for banks during the year. RBI introduced the base rate concept for the commercial banks starting in July 2010. From June 2010 to August 2011, RBI raised the repo rates by 275 basis points. During the same period, banks increased the rates of interest offered on deposits in a range between 25 and 550 basis points. In the case of credit, the range of increase during the period was between 75 and 375 basis points. The transmission of policy rates to actual financial sector transaction rates became effective after the introduction of the base rate. The microfinance sector has faced the increased finance costs arising from the tight monetary policy stance and the reduced resources being allocated to the priority sector by the banking system.

The making of the XII Five Year Plan is in full swing. The approach paper targets 9 per cent growth with significant contributions from agriculture and services. The key requirements for achieving this high level of growth are a strong political will, a dynamic private sector, management and labour skills and a strong aspiration for change among the public. The paper points out that against a target of reduction in poverty levels by about 2 per cent per annum, the decline is at a rate exceeding 1 per cent from 2004–05 till 2009–10. The contribution of India to the World GDP is about 2.8 per cent in 2011 and is expected to rise to 5.2 per cent in 2020 and further to 7.1 per cent in 2025. The high growth in the XII Plan period is achievable if household-level private capital formation reaches a level of 12 per cent of GDP, savings rate of households rises to 24 per cent (from the present 23.2 per cent) and subsidies as a proportion of GDP declines from 1.6 per cent currently to 1.24 per cent. The role of financial institutions, including banks, in funding private sector in capital formation has been underlined. The paper recognizes that the financial inclusion plan based on brick and mortar bank branches is high cost and that more recourse to business correspondents and technology options should enable cost-effective expansion of financial services. The paper does not recognize the existence of the microfinance sector, perhaps on account of its negligible financial footprint. With inclusive growth as the driving principle of planning, the omission of a highly inclusive and participative sector from the paper is striking.

MICROFINANCE

The microfinance sector surprisingly recorded a positive growth during the year despite the massive problems of a catastrophic nature in the state of Andhra Pradesh. The number of self-help groups (SHGs) savings linked increased to about 7.5 million with a member base[2] of 98.1 million. The SHG bank linkage programme (SBLP) and the microfinance institutions (MFIs) put together achieved a growth in their customer base by about 10.8 per cent. The combined borrowing customer base increased to 93.9 million from 86.3 million in the previous year. The SBLP[3] recorded a growth of 4.9 per cent in the number of members of SHGs that had active borrowings from banks. There was an increase of about 4.7 million customers of MFIs. The growth rate of MFIs in terms of customer outreach was of the order of 17.6 per cent,[4] which is surprising considering the

conditions that prevailed across the country in the latter half of the year. This might possibly be on account of vigorous growth posted in the first half of the year and also the fact that a number of defaulting customers in Andhra Pradesh (who should have paid off the loans and ceased to be active borrowers) are continuing in the books of MFIs.

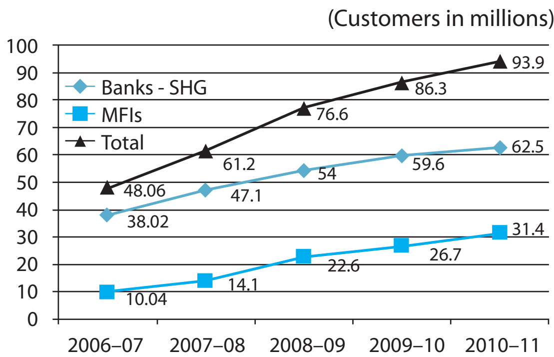

Figure 1.1 Comparison of SHG and MFI client outreach

The overlap of customers between SHGs and among MFIs continued. The MFIs are now more open about their failings and have adopted some norms on how many loans should a single borrower have. While adjusting the overlap,[5] a 10 per cent reduction has been made in respect of number of members of SHGs and a 35 per cent reduction in respect of customers of MFIs. After adjustment of overlap, the number of customers of microfinance[6] is estimated to have increased by 8 per cent, which is much higher than the growth rate of last year.

Outstanding SHG loans from banks showed an increase of about 12.3 per cent and the MFIs showed an increase of 13.1 per cent in their loans. Overall the loans outstanding in the microfinance sector increased by about 12.7 per cent.[7] In terms of absolute amounts, the increase was of the order of ₹57 billion. However, a realistic assessment of the portfolio can be made only when the loans that have turned delinquent are taken into account. The possibility is that between ₹60 to 70 billion worth of MFI loans pertaining to about 5 million customers in Andhra Pradesh have turned delinquent. If this is excluded from the overall numbers, the active portfolio of microfinance loans is likely to be more moderate at around ₹450 billion. The gap of ₹89 billion in outstanding loans between SHG and MFIs last year had increased to ₹99 billion during the current year. While SBLP added ₹33.6 billion[8] more loans to outstanding portfolio, the MFIs had added ₹24 billion[9] more to the loans outstanding against their customers. The outstanding loans of MFIs and loans by banks to SHG put together formed 1.47 per cent of bank credit at the end of March 2011.[11] The outstanding microfinance loans of MFIs and SHGs formed 4.34 per cent of priority sector loans outstanding.

Table 1.1 Client outreach—borrowers with outstanding accounts[10]

(millions)

Segment	2006–07	2007–08	2008–09	2009–10	2010–11	Growth percentage 2010–11
Banks – SHG	38.0	47.1	54.0	59.6	62.5	4.9%
MFIs	10.0	14.1	22.6	26.7	31.4	17.6%
Total	48.0	61.2	76.6	86.3	93.9	8.8%
Adjusted for Overlap	44.9	56.0	70.0	71.0	76.7	8.0%

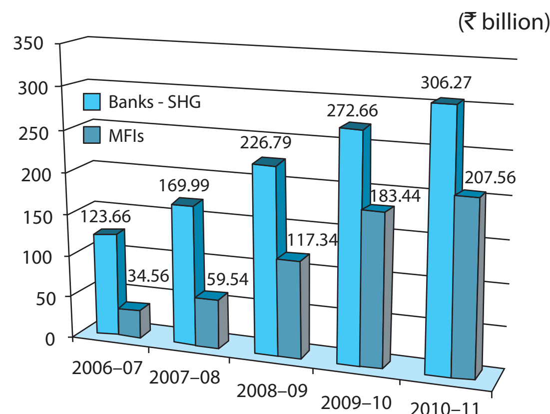

Figure 1.2 Comparison of loan portfolio of SHGs and MFIs

Whether the Andhra Pradesh events would lead to a drop if not a break from the continuing growth of MFIs has to be watched during the current year. The full impact of the Andhra Pradesh events is likely to be felt in 2011–12 as the sector had been starved of funds and many institutions had spoken of scaling down operations. The first quarter of 2011–12 witnessed contraction in loan portfolios both on account of liquidity constraints and the compliance issues arising from regulatory guidelines of RBI on NBFC–MFIs.

The average loan size of members of SHGs increased to ₹4,900 representing an increase of around ₹330 from last year. In the case of MFIs the average loans per customer increased to ₹6,600[12] that's by less than 10 per cent over the last year's average loan

of ₹6,060. This increase in average loan size is likely to prove to be beneficial to MFIs in the current context of margin and interest caps that are placed. During the current year, the average loan size would continue to increase in an effort to reduce operating costs and manage the margin.

Table 1.2 Comparison of average loan size

Type	Average loan/ customer 2008–09	Average loan/ customer 2009–10	Average loan/ customer 2010–11	Extent of increase in 2010–11
SHG Member (₹)	4,120	4,570	4,900	330
MFI customer (₹)	5,190	6,060	6,610	550

The total number of clients of the broad microfinance sector stood at 161.5 million as at the end of March 2010. Of this 45.2 million were customers of commercial banks. This number had increased significantly from the previous year's level of 39.2 million. Commercial banks had disbursed ₹435 billion to the small borrowers. The SHGs and MFIs put together had disbursed ₹456.1 billion in respect of their borrowers. Thus, for the first time, the microfinance sector has exceeded the performance of the commercial banking sector in providing direct small loans to vulnerable people. The average loan given by commercial banks to small borrowers declined from ₹10,950 in the last year to ₹9,640 in 2009–10. The reasons for this decline are difficult to fathom especially in the context of the high inflation rates reducing the real value of loans. In the case of microfinance sector there is a continuing increase in the average loan size. The overall increase in credit customers for small loans has registered an increase of 17.6 million, which is a welcome development from a financial inclusion point of view.

The Andhra Pradesh government brought in an ordinance to regulate the microfinance institutions

Table 1.3 Estimate of microfinance credit clients (millions)

Agency	March 2008	March 2009	March 2010
Commercial banks (including RRBs) small loan accounts[13]	41.00	39.2	45.2
PACS borrowers[14] (small, vulnerable)	28.5	28.7	30.0
SHGs – members	47.1	54.0	59.6
MFIs – clients	14.1	22.6	26.7
Total	130.7	143.9	161.5

and prevent their lending money to members of SHGs and their households to curb build up of excessive debt and secure them from exploitative practices. The ordinance, which was a temporary legislation, was passed in to law subsequently. This law led to a total stoppage of MFIs' business in the state and reduced repayments to a trickle. A detailed analysis of the development and the implications are carried in chapter 4.

The growth recorded by both SBLP and MFI segments seem to indicate that the apparent impact of AP events on the sector has not been seriously adverse. Nothing could be farther from the truth. MFIs have tried to continue with business in other states after 15 October 2010 with whatever liquidity they had and to the extent banks allowed them to draw from the already sanctioned limits. The first-half disbursements by MFIs last year had been vigorous and that explains how the growth had resulted even with a lacklustre second half. But the MFIs have since seriously scaled down their operations and reduced both customers and loan outstanding in a bid to contain risks and maintain repayments to banks. Banks on their part restricted lending to MFIs and even stopped disbursements against sanctioned limits. Some banks recalled loans not due a year before due date in a panic reaction. Rating agencies scaled down their ratings across the sector without undertaking institution-specific analysis, on the flawed premise that the Andhra Pradesh law would somehow impair the every MFIs' ability to service their obligations. Small Industries Development Bank of India (SIDBI) turned extremely cautious and managed to disburse only a third of the previous year's disbursements. The impact of rerating of risk and denial of credit to MFIs has been felt in the first quarter of 2011–12. Banks and financial institutions have proved to be fairweather friends. At the first hint of trouble they tried to distance themselves though they had lent ₹140 billion to MFIs till the beginning of the year 2011–12. The price of banks' inability to come together and have a dialogue with the government of Andhra Pradesh is about ₹70 million in loans to MFIs which had been restructured with very slim hopes of recovery.[15] Several small and medium MFIs have reportedly closed down, without making headline news. Andhra Pradesh based small MFIs might remain on paper till banks loans are outstanding, but in a business sense they do not exist anymore. A measure of the problems is reflected in the number of MFIs reporting data to Sa-Dhan that came down to about 170 from 264 last year.

The pre-budget economic survey and the Union budget brought the first wave of support to SHGs and the battered microfinance institutions. The finance minister in his budget speech iterated the importance of MFIs to poor households as follows:

> The Micro Finance Institutions (MFIs) have emerged as an important means of financial inclusion. Creation of a dedicated fund for providing equity to smaller MFIs would help them maintain growth and achieve scale and efficiency in operations. I propose to create in the course of the year, 'India Microfinance Equity Fund' of 100 crore with SIDBI. To empower women and promote their Self Help Groups (SHGs), I propose to create a 'Women's SHG's Development Fund' with a corpus of 500 crore. The Committee set up by RBI to look into issues relating to microfinance sector in India has submitted its report. The Government is considering putting in place appropriate framework to protect the interests of small borrowers.

This statement cleared the air for banks and the rest of the financial sector. Earlier the *Economic Survey*,[16] commenting on the situation arising from the Andhra Pradesh crisis, said:

> In regulating MFIs it has to be recalled that they have played a major role in drawing poor people into India's mainstream finance and enabling farmers to make useful investments and marginal workers to start up small self-employed enterprises.

The positive view of MFIs provided a dose of confidence to the sector in which encouraging news was scarce. The forthright stance of the Central government perhaps warded off other states from taking precipitate action.

The default rates tended to increase. The SHG programme has reported higher levels of default especially in the case of Andhra Pradesh. In the case of MFIs, Andhra Pradesh has had a debilitating impact on portfolio at risk. The reported overdues of 10 large MFIs in the state amounted to ₹31.74 billion by the end of March 2011. The impact of the Andhra Pradesh law on the recovery practices of MFIs in the state not only resulted in virtual stoppage of repayments by customers but also contaminated the SHG portfolio where banks were facing large delinquencies. At the end of June 2011, about 228,000 SHGs had defaulted on repayments (17 per cent of linked groups) with loan balances in these accounts amounting to ₹22.9 billion. This constitutes a portfolio at risk ratio of 16.7 per cent. The customers and target households being the same, it is very difficult to engineer, through regulation, differing responses to different sets of institutions when it comes to repayment of loans. The state induced moral hazard in people is likely to cost dearly in the long run.

There are indications that at the customer level the financial flows have declined causing stress on their consumption and investments. While the debt levels have declined, the resource availability for pursuing livelihood activities has become restricted. A study carried out by the Centre for Micro Finance (CMF), Chennai,[17] found that the proportion of households reporting reduced expenditure was 85 per cent in relation to consumption, 81 per cent in relation to business, 74 per cent in relation to education, 83 per cent in relation to home improvement and 76 per cent in relation to health. The proportion of households reporting large fall in spending was 33 per cent in consumption, 35 per cent in business and 34 per cent in health. Recourse to moneylender as a source of loans had increased in the sample surveyed in Cuddapah district, Andhra Pradesh, from 16.5 per cent families in 2009 to 22.5 per cent in 2011. Households reporting multiple loans from moneylenders in Cuddapah increased from 9.4 per cent to 11 per cent while in case of MFIs it declined from 3.7 per cent to 3.1 per cent. The effect of regulation in Cuddapah had been to drive people to moneylenders as had been pointed out the *Economic survey 2011*.

Geographic skew

The events in Andhra Pradesh had a positive effect on the geographic distribution of MFI portfolios. MFIs had virtually stopped expansion and, in fact, had closed down few branches and withdrawn operations from a number of locations in the state. There was an active search for increasing the portfolio in other states and other locations. The lessons learnt included avoidance of concentration of portfolio and diversification of the risk by distributing business growth across varied states. In the case of SHGs, most mainstream states suffered a decline. Karnataka, Tamil Nadu, Uttar Pradesh, Orissa, West Bengal and Andhra Pradesh could provide disbursements to a lesser number of groups compared to last year. Ten states reported a decline in both number of groups and disbursements. While Andhra Pradesh had the largest number of groups there seems to be a conscious reduction in lending, especially in terms of number of groups in the state. The southern region increased its share from 52.8 per cent of groups linked with loans to 55.3 per cent. The eastern region increased its share in the number of groups from 21.5 per cent to 24.4 per cent. But on account of the

reduction in number of groups availing fresh loans during the year, the share of southern region is likely to decline in 2011–12. In case of MFIs, 16 states had a positive growth rate and 11 states had a negative growth rate in client outreach. Loan portfolio declined in 10 states while in 17 states the portfolio recorded a positive growth. Client outreach recorded the highest growth in Uttar Pradesh, Gujarat and Manipur. The steepest declines in outreach were in Orissa, Andhra Pradesh and Tamil Nadu. Gujarat had the highest growth in portfolio followed by Uttar Pradesh and Manipur. The decline in portfolio was pronounced in Orissa followed by Tamil Nadu and Delhi. Business diversification is taking place in states with lesser concentration of financing which is good for the excluded geographies and mitigation of concentration risk.

Over the last two years the report has been making a specific reference concentration risk in lending in some states, but with little impact on the sector. States like Andhra Pradesh, Tamil Nadu and West Bengal continued to report growth of portfolio and thereby are likely to face increased stress in the microfinance portfolios in the times to come. A surprising addition to the list is the north-eastern state of Manipur where significant disbursements by MFIs have reportedly taken place. The state has the highest level of per poor household loan outstanding as also the highest number of loans per poor household. Andhra Pradesh, despite the slowdown in disbursements to SHGs and decline in MFI portfolio, has high outstanding debt at household level. One hopes that banks and MFIs will have a closer look at concentrated lending under SHG and MFI streams and do the needful to diversify the risks.

The investment climate had worsened with fewer equity deals and much smaller investment flows. Equity inflows fell from ₹9.4 billion in 2009–10 to 3.86 billion in 2010–11. National Bank for Agriculture and Rural Development (NABARD) refinance to banks covering their SHG lending had declined from ₹31.73 billion in 2009–10 to ₹25.45 billion in 2010–11. As a proportion of NABARD's refinance SHG share fell from 26.4 per cent to 18.9 per cent.[19] SIDBI had reduced its loan disbursements to MFIs from ₹26.65 billion in 2009–10 to ₹8.40 billion in 2010–11.[20] This drastic reduction exacerbated the liquidity constraint among MFIs. Even in the current year, SIDBI plans to disburse not more than ₹10 billion. Total loans from financial institutions to MFIs during the year were ₹73.28 billion, about 68 per cent of the disbursements made in the last year. The outstanding bank loans to MFIs reached a level of ₹126.18 billion which is about ₹13.3 billion less than the previous year's level. How the MFIs managed to post a portfolio growth during the year when the bank support declined is an aspect for study. The continuing hardening of interest rates is exerting pressure on the thin margins available to MFIs and might render the margin cap redundant.

RBI had appointed the Malegam Committee to study the issues relating to microfinance institutions and their regulation. The report of the committee had been examined with the benefit of public consultation and the RBI had issued[21] guidelines to the banks on their lending to microfinance institutions[22]; the banks are to ensure that the MFIs conform to norms if the bulk loans given by banks to MFIs are to count towards priority sector lending. The RBI's policy measure on MFIs required them to be more selective in client acquisition in order to take in only low-income clients; lend within reasonable limits of customer's ability to service loans; set up prudent practices in relation to recoveries and introduce grievance redressal mechanisms. Quantitative ceilings on interest rates to be charged and

Table 1.4 Concentration of financing in some states[18]

Aspects	Karnataka	Andhra Pradesh	Tamil Nadu	West Bengal	Manipur
Number of households 2011 (million)	12.22	16.92	14.42	18.26	0.54
Number of poor households (million)	2.77	2.52	2.91	4.16	0.08
Number of credit SHG members (million)	3.27	21.89	6.96	7.46	0.06
Number of MFI clients (million)	3.68	5.75	4.25	3.39	0.83
Total microfinance clients (million)	6.96	27.64	11.21	10.85	0.89
Microfinance clients as proportion of poor households (multiples)	2.51	10.96	3.85	2.60	11.12
Microfinance clients as proportion of total households (multiples)	0.56	1.63	0.77	0.59	1.64
SHG loans (₹ billion)	22.74	128.69	43.17	16.25	0.20
MFI loans (₹ billion)	24.45	52.05	21.17	22.71	6.32
Total mf loans (₹ billion)	47.19	180.74	64.34	38.96	6.52
Loans outstanding per poor household (₹ billion)	17,036	71,722	22,109	9,365	81,500
Microfinance Penetration Index (MPI)	1.46	4.20	2.0	1.53	4.23

margin caps to be observed had also been placed. Absolute limits on loan sizes and portfolio restrictions on consumption lending had been introduced. Verification of compliance in respect of a few aspects of the guidelines through certification by chartered accountants has been stipulated. While not entirely being happy with RBI's guidelines, especially those relating to interest rate cap, the sector has chosen to welcome the same in order to escape the kind of attention that they received from the state government in Andhra Pradesh.

RBI had issued fresh guidelines relating to Electronic Benefits Transfer that now allows more banks in each district to handle government payments (especially wage payments under The Mahatma Gandhi National Rural Employment Guarantee Scheme [MGNREGS]). RBI also relaxed mobile banking guidelines, raising the ceiling on transactions to ₹50,000 and providing for payments of up to ₹5,000 to non-account holders on instructions from account holding customers through mobile banking. A further boost to mobile banking is the creation of settlement platform for mobile transactions by National Payments Corporation of India (NPCI). The much-hyped agreements between SBI and Airtel[23] and ICICI Bank and Vodafone did not lead to any action on the ground so far. Regulatory issues have yet to be satisfactorily sorted out in both these cases.

The Government of India, on its part, set up a drafting committee to come up with a microfinance institutions bill which has since been placed for public discussions. This comprehensive bill is a better attempt at regulating the entire MFIs sector regardless of the form of institutions.[24] This bill seeks to register every institution engaged in the business of microfinance and empower RBI to put in a regulatory framework that ranges from prudential requirements to operational safeguards. By and large the steps taken by RBI in the case of NBFC and MFIs would also be applicable to all the institutions under this bill. But the bill bestows a great measure of flexibility on RBI for calibrating its regulatory guidance in accordance with the needs of the market and specific locations, as also specific institutions. There have been certain apprehensions about the bill that it might entail a large regulatory effort and impose costs on MFIs through its control of business processes. The bill in its present form offers the best opportunity for the sector to grow along orderly lines. However, one of the issues with financial sector legislations is that in the past such bills have not been prioritized by the Parliament. The banking regulation amendment bill has been with the Parliament for a long period of time. The previous version of the microfinance regulatory bill had also been with the government and the Parliament for more than three years. The sector is waiting with fingers crossed for this bill to be passed in to law at an early date so that the risk of different states bringing MFIs under money lending regulation is negated.

RBI had set up two committees[25] that had bearing on the microfinance industry. The first is the one dealing with holding companies in financial sector chaired by former deputy governor Mrs Shyamala Gopinath and the other is the one on supervision of NBFCs headed by former deputy governor Usha Thorat. The committee on holding companies in the financial sector opined that in future the holding company route for handling different companies active in verticals relating to finance should be preferred rather than the complex arrangements that exist today. The committee has proposed a framework for effectively regulating such financial conglomerates and the holding companies. The committee on NBFC supervision called for enhanced supervision of NBFCs keeping in view the rapid changes and very fast asset build-up among such companies. It has suggested a rigorous supervision and monitoring of NBFCs with asset size of ₹10 billion and more. But the committee did not make any specific recommendations relating to NBFC–MFIs.

NABARD has taken up a programmatic review of the SHG bank linkage programme. Very soon it intends to launch version II of the SBLP (called SHG II)[26] comprising new features such as voluntary savings, mechanisms for graduating customers to higher individual or small group loans and a more sustainable mechanism for handholding of SHGs in their initial stage. The SHG II is expected to improve the present lot of SHGs, some of which are not in the best of health. Further an ambitious target of linking 5 million groups over the next 5 years (to be achieved at the rate of a million new groups per annum) across the country has been fixed.[27] In the initial one or two years groups that have been formed but have not been linked under several government programmes in different states may be targeted. It will be a tough task in the remaining years to form and link such a large number of groups. Human resources and supporting institution network for such a large order mobilization have to be developed in the first stage. It would be in the fitness of things to ensure that all the existing SHGs aligned to the banking system are first improved even while attempting to form more groups under the new framework of SHG II.

SIDBI has been very active in bringing some order to a depressed and chaotic market. It has launched several responsible financing initiatives during the year and intensified some others that were already in place. The lenders forum led by SIDBI seeks to work towards voluntary adoption of measures on governance, transparency, competitive practices and condition support to MFIs on their adherence and adoption of these industry standards by building them into loan covenants. SIDBI has also been working with the sector on reduction of interest rates, compliance with the code of conduct, transparency, customer protection related issues and improving the competence levels of personnel in the sector through capacity building programmes.

Other developments

Highmark[28] had commenced its credit information services during the year and a large number of MFIs both in for profit and not for profit forms have signed up. Highmark reports that it has 55 million loan records in its database pertaining to 30 million borrowers. So far 1.2 million references for credit reports have been made in the five months of its operation. While profitability and viability of the entity is probably some distance away, there is a considerable level of comfort among MFIs. They make effective use of the bureau for seeking credit reports regarding customers who have applied for loans. Credit Information Bureau (India) Limited (CIBIL) and Equifax Credit Information Services Private Limited, India, have also been active in this sphere and during the current year we expect a more competitive situation to develop in credit information services.

Microfinance Transparency launched its operations in India last year and published data of participating MFIs (about 80) in February 2011.[29] The industry and the lending banks welcomed the publication of transparent prices of MFIs in the public domain. India had been the most active country in terms of MFIs reporting changes in interest rates to Microfinance Transparency and currently the Microfinance Transparency offers information that would enable even the regulator to verify whether the MFIs are compliant with interest rate caps that are in place. The new microfinance bill also emphasized the importance of having an 'all inclusive' price as a disclosure parameter.

The Ministry of Rural Development, Government of India, launched the National Rural Livelihoods Mission (NRLM), which will be the flagship poverty eradication programme during the XII Five Year Plan period. NRLM has significant investments planned in intermediate-level institutions of the poor based on SHGs that would be active in financial services. A dedicated bulk financing entity is also on the drawing boards to supplement resource requirements of SHGs and their federations.

The financial inclusion plan for opening points of presence by banks in large villages is progressing steadily. Reports indicate that 76,800 villages are being covered through 58,300 business correspondents (BCs) and customer service points (CSPs). More than 74 million no-frills accounts have been opened with ₹65 billion in savings balances. A total of 19.8 million lives were covered in new policies written during 2009–10 by life insurance companies with LIC taking a major share.[30] The Post Office has issued more than 4 million Rural Postal Life Insurance (RPLI) policies during 2009–10, taking the total of active RPLI policies to 9.9 million.[31] However the non-life micro-insurance has yet to be mainstreamed. Several interesting pilots had remained small islands and not been scaled up. A network of BCs has come in to existence with facilitation from MicroSave.

Sa-Dhan and MFIN collaborated closely to dialogue with government and RBI on the issues affecting the sector. Under the leadership of International Finance Corporation (IFC) and Michael and Susan Dell Foundation (MSDF), a convergence on an industry code of conduct is being attempted. Both the industry associations have come together in this initiative too. Compliance with the code of conduct is being monitored. While Sa-Dhan has developed its process for monitoring, SIDBI had commissioned eight studies on Code of Conduct Compliance Assessment (COCA)[32] based on a tool developed by M2I. SIDBI and other lending banks have formed a Lenders Forum which is now actively collaborating on exchange of information, unifying lending disciplines, joint commissioning of portfolio audits and coordinated action towards the issues facing the sector.

The Andhra Pradesh government had set up an Apex Cooperative Society to cater to the financial needs of the federations of SHGs. A proposal at an advanced stage for setting up a finance corporation for financing SHGs for livelihoods under NRLM is also doing rounds. At the same time, Rashtriya Mahila Kosh (RMK)[33] has been going in to a steep decline with its business in 2010–11 being less than that achieved in 1997–98. While setting up niche financial institutions might be easy for the government, finding lendable resources for the same and

ensuring that they have a sound business model are difficult. The experience with government-promoted financial institutions such as RMK, Minorities Finance Corporation, SC/ST Finance Corporation and several state finance corporations does not provide confidence in the current effort.

Insurance Regulatory and Development Authority (IRDA) had issued guidelines to streamline the insurance agent system, payments to agents and the charges that could be levied on the customer. Some regulatory action against some MFIs and the insurers was also taken for breach of IRDA guidelines that led to loss of customer protection. The distribution of insurance products through MFIs is set to become more orderly and adopt a service approach instead of a sales approach in evidence in the past.

An important development is the heightened interest evinced by both the print and television media in the microfinance sector. Beginning from the run up to the Initial Public Offer (IPO) of SKS Microfinance, Hyderabad, media has been providing extensive coverage of developments in the sector. Part of the coverage was not based on facts and analysis, but on hearsay, anecdotal evidence passed off as representative of the total sector; some of the coverage was aimed creating a sensation and succeeded in doing so. Stories of demonic lenders driving poor customers to suicide were filed without pausing to examine evidence that over the last several years farmers in Andhra Pradesh have been committing suicides in good numbers and at a level well above the national average. Hopefully the microfinance sector learnt lessons on the need to keep the media engaged with information at all times and not just during crises when truth is likely to be rejected with skepticism.

The dark clouds show signs of clearing. With some regulations in place and more comprehensive regulation on the anvil, the MFIs will get an identity and be able to operate under a set of known norms with certainty. The credit reference bureau becoming functional will deal with some issues in customer selection and examination of multiple lending. The MFIs need to get to their drawing boards to look at their products and processes to find ways of complying with the regulatory guidelines. Building confidence in the minds of banks and funders does seem to be a harder task; the MFIs could do with some support from RBI and the Central government in this. There are some signs of easing of equity and loan fund flows in the second quarter of 2011–12. While the immediate future holds out promise that MFIs can recover, the long-term future is not too rosy. Stiff competition from banks through their BCs, a restructured SHG programme, NRLM that would use institutions of the poor to deliver financial services and the impending roll-out of mobile-based financial services is likely. Even as they emerge from the current struggle for survival, the MFIs should rethink their long-term business objectives and competition strategies. The SHG II will hopefully clear the cobwebs and infuse fresh energy into members, groups, banks and supporting institutions. Achieving convergence of SBLP with NRLM, MGNREGS and financial inclusion plan is one of the tasks before NABARD. Keeping the SHGs and their higher tier institutions clear of political influence as also the threat of elite capture is another priority, in the light of increased funds flow that is anticipated. There is hard work ahead in SBLP in adapting to voluntary savings with saver protection and shift to livelihood finance. The wild elements in the MFI sector had been tamed. Even the SBLP, which grew stridently in the southern states, has shown initial signs of moderation there and is now increasing its presence in other regions. The focus of both legs of microfinance will hopefully shift to strategic expansion taking cognizance of changes that have taken place in the customers and the market. The customers deserve better in terms of appropriate products, services and more responsive delivery institutions. It is time to make a fresh start with the customer in focus.

NOTES AND REFERENCES

1. The assessments are excerpted from RBI annual report 2010–11.
2. The number of members of SHGs is not based on a count of actual members. As in the case of last three years, based on a number of field studies, average number of members of SHGs had been taken at 13. With increased number of government programmes and the associated time-bound targets, the actual group size might tend to be smaller.
3. The data on SBLP is provisional and is likely to undergo changes at the time of finalization. This data was made available to SOS for the purpose of analyzing trends and comparisons with the past and is incomplete at this point of time. The final data for the year will be published by NABARD by October 2011—as is the normal practice—in its annual publication '*Status of Microfinance in India 2010–2011*'.
4. Data source: Sa-Dhan—provisional information collected for Quick Review.
5. The overlap adjustment ratios follow the last year's logic and convention. The Access to Finance study carried out by CMF in Andhra Pradesh revealed

that the overlap between SHG members and MFI customers was around 13 per cent. This had been moderated to 10 per cent across India considering that Andhra Pradesh has a concentrated portfolio of both SHGs and MFIs. The study of multiple lending carried out in Karnataka by Krishnaswamy and Alejandro last year brought out that for every 100 loan accounts of MFIs, there were 65 unique customers. Therefore, inter-MFI overlap has been taken 35 per cent of total number of borrowers reported by MFIs.

6. The numbers assume that every member of a borrowing self-group has taken loans from the SHG. In Andhra Pradesh, most SHGs equally divide the bank's loan among all the members; in many other states, equal division of bank loans among the members has become the norm. Apart from bank loan, members also avail of loans from SHGs corpus. But a small proportion of members of SHGs do not have a loan from their group. For want of reliable information, this has been ignored in estimating numbers of customers.
7. There is some variation in data submitted by MFIs to MIX Market and Sa-Dhan. Sa-Dhan, based on information submitted by 170 MFIs, reports that the loan portfolio reached ₹207 billion. MIX Market collated data submitted by 83 MFIs and found the loan portfolio amounted to ₹231 billion' which includes managed portfolios. The report takes Sa-Dhan data (which excludes managed portfolios) for analysis in this section for consistency and comparability with previous years.
8. The final data put out by NABARD last year showed that the outstanding SHG loans with banks was ₹280.38 billion, a marginal revision from the ₹272.66 taken as provisional data. Comparisons have been made on the basis of provisional data of last year as, in the current year too, the data is likely to undergo revision at the time of finalization.
9. The data for the last year as reported by 93 MFIs to MIX Market indicates that the portfolio outstanding reached was about ₹199 billion including managed portfolios. Compared to this the current year's portfolio outstanding reported by 83 MFIs is ₹231 billion. The calculations of the growth rates have been made at the levels already reported last year. In the current year too, revision and addition to the data reported will take place when more MFIs complete their data submission to MIX.
10. The number of customers in case of SHGs is worked out as 13 members per SHG. NABARD suggests that this is higher at 14 members per group, but two national level studies a couple of years back found the average membership at around 13.
11. Data on bank credit from RBI's *Handbook of Statistics of Indian Economy 2010–11*. The bank credit taken in the denominator is non-food credit, which is the base for calculation of net-bank credit.
12. This is computed from the data provided by Sa-Dhan. However the average loan computed from MIX Market's data that includes managed portfolio is about ₹7400, more than 20 per cent increase over the previous year.
13. Loans up to ₹25,000 (US$550) are classified as small loans by RBI. Data sourced from *Basic Statistical Returns of Banks 2010*, Reserve Bank of India.
14. Data sourced and computed from *Primary Agricultural Credit Societies 2009–10* by National Federation of State Cooperative Banks website (www.nafscob.org). The number comprises small farmers, rural artisans and scheduled caste and tribes members that borrowed from Primary Agricultural Credit Societies (PACS) during the year.
15. While the restructuring scheme has been concluded, the formal signing is yet to take place.
16. Cited from Chapter 2 of the *Economic Survey*, Ministry of Finance, February 2011.
17. Centre for Microfinance, Chennai (IFMR affiliate), carried out a survey on Access to Finance in Cuddapah and Visakhapatnam districts; the survey was carried out on the same sample that was covered in the earlier survey in 2009 so as to get comparable data. The study was led by Shantadarshan Sadhu.
18. Population data from the *Census of India 2011*, Poverty data from Planning Commission database, SHG data from NABARD, MFI data from Sa-Dhan and calculations by author.
19. *Annual Report 2010–11* of NABARD.
20. *Annual Report 2010–11* of SIDBI.
21. RBI/2010-2011/505 RPCD.CO.Plan BC. 66 /04.09.01/2010-11 dated May 2011.
22. A detailed analysis of the Malegam Committee recommendations and the RBI regulations that followed is carried in a latter chapter on regulation and policy environment.
23. Major telecom service provider in India with business interests in African continent.
24. A critical appraisal of the new microfinance bill is carried in a latter chapter on regulation and policy environment.
25. More information on the recommendations of the two committees is given in a latter chapter on regulation and policy environment.
26. Dr Prakash Bakshi was interviewed on SHG and financial inclusion related issues. Please see the annex 2.1 for details.
27. The finance minister is credited with this ambitious target.
28. Highmark Credit Information Services Limited is a credit information bureau that focuses on MFIs.
29. See www.mftransparency.org for more details. In a later chapter on social performance (chapter 6), some more discussion on MF transparency's work in India is carried.
30. Data from Insurance Regulation and Development Authority (IRDA) *Annual Report 2009–10*.

31. Data from *India Post Annual Report 2010–11*.
32. Code of Conduct Compliance Assessment (COCA) is carried out by M2I consultants, who had developed the tool. Reportedly, World Bank is keen on all lending banks commissioning such compliance assessments. So far eight institutions had been covered. The essence of the findings is covered in a later chapter on social performance and responsible finance.
33. A financial institution set up by the Central government (Department of Women and Child Development) to cater to financial needs of SHGs, their federations and other forms of organizations that provide loans to SHGs.

Self-help group bank linkage programme—early signs of a new thrust

2

Chapter

Last year the report had commented that the SBLP had hit a plateau and is in search of both leadership and direction. The provisional data available from NABARD for the year 2010–11 shows that the growth rate of the SBLP continued to be moderate. The number of groups that had outstanding loans at the end of March 2011 had increased by about 4.9 per cent. The outstanding loans against these groups had increased by about 12.3 per cent. A severely affected MFI segment posted growth rates of 24 per cent in customer outreach and 26.4 per cent in loan outstanding. The number of clients added by the SBLP was about 2.9 million. The MFIs in comparison added 6.4 million clients during the year. In terms of incremental loans outstanding the SBLP added ₹33.6 billion. Savings by SHG members continued to increase; 7.54 million groups had saved ₹69.25 billion in banks which is about 10 per cent more than the previous year's level.

Banks disbursed loans amounting to ₹14.7 billion to 1.2 million groups during the year. The average loan disbursed per group amounted to ₹122,700 which is higher than the comparable levels of last year. Compared to last year's growth rate, the SBLP had underperformed during the year. One of the significant reasons could be that fatigue has set in among bankers in states outside of Andhra Pradesh. Andhra Pradesh reported the maximum number of groups as in the previous years. While the state had a share of 35 per cent of all groups with loans and 42 per cent of the outstanding loan amounts, there were signs of deceleration in terms of number of groups linked and disbursements. The growth is more on account of the large base and the long-term nature of loans.

Though the outstanding loans have been increasing at a healthy rate year after year in nominal terms, the growth rate had been more sedate in real terms. There was almost no growth in loans in real terms (2004–05 prices) between 2010 and 2011. The average disbursed loan per SHG had declined in real terms from ₹84,500 in 2010 to ₹81,000 in 2011. The decline in value of loans in real terms implies that customers would find it difficult to finance

Table 2.1 Growth trends in SBLP

	2005	2006	2007	2008	2009	2010	2011
No. of SHGs provided with bank loans	1,618,456	2,238,565	2,924,973	3,625,941	4,224,338	4,587,178	4,813,684
Of which in southern region	938,941	1,214,431	1,522,144	1,861,373	2,283,992	2,421,440	2,663,569
Share of southern region (percentage)	58	54	52	51	55	53	55
Average disbursed loan per group (₹)	32,019	37,574	44,343	46,800	74,000	115,820	122,744
Outstanding loans (₹ billion)			123.66	169.99	226.76	272.66	306.27
Incremental groups (million)			0.69	0.70	0.60	0.36	0.27
Incremental loans O/S (₹ billion)				46.33	56.80	45.87	33.61

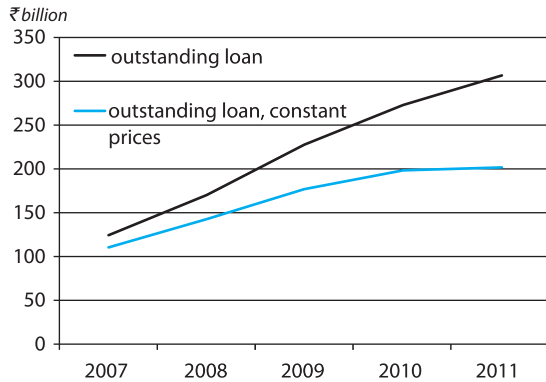

Figure 2.1 Outstanding SHG loans—nominal and real terms[1]

livelihood activities and may have to borrow from other sources.

SAVINGS PERFORMANCE OF SHGS

At the end of March 2011, 7.54 million groups had been saving linked with the banking system, which is 10.7 per cent higher than the position obtaining at the end of March 2010. An increase of ₹5.76 billion was reported in amounts saved with the total saving by SHGs held with the banks rising to ₹69.25 billion. At this level it formed 22.5 per cent of outstanding loans. This means that SHGs had funded more than one-fifth of the loans extended by the banking system to the groups. The amount of savings quantified here does not include amounts that have been lent to members. These savings represent money placed with the banks. Neither data is available on the extent of savings utilized in intra-group lending, nor do reliable estimates thereof exist.

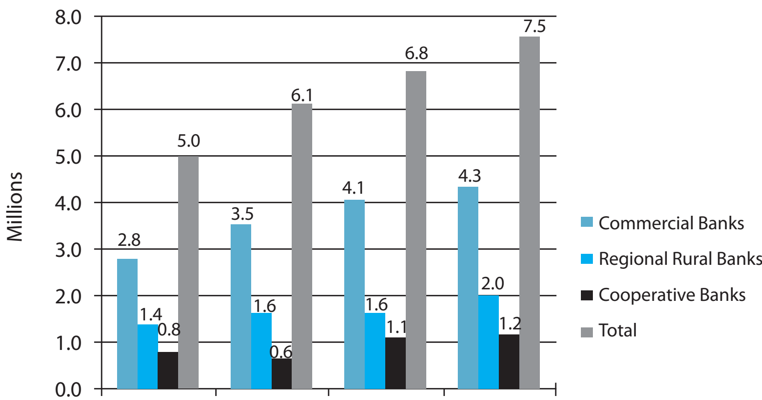

Figure 2.2 Number of SHGs holding savings accounts, 2008–11

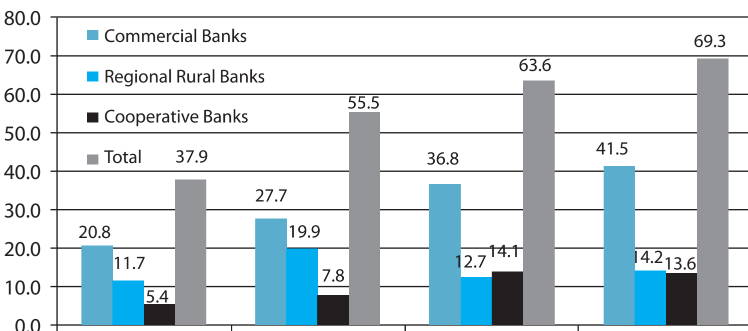

Figure 2.3 Savings growth by SHGs, 2008–11 (₹ billion)

Commercial banks had 57 per cent of all groups that are savings linked followed by regional rural banks with a share of 27 per cent. While share of cooperative banks remained at the same level as that of last year, commercial banks share declined 3 per cent from last year. The regional rural banks (RRBs) gained 3 per cent in their share.

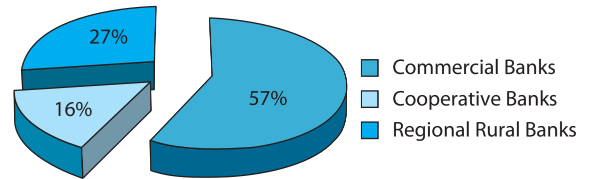

Figure 2.4 Market share by bank of number of SHGs with savings

Commercial banks had a share of 60 per cent of the amount saved by SHGs with the remainder being almost equally shared by cooperative banks and regional rural banks at about 20 per cent each. The share of cooperative in outstanding savings declined by 2 per cent compared to last year. Commercial banks increased their share of savings by 2 per cent, despite their loss of share in the number of groups.

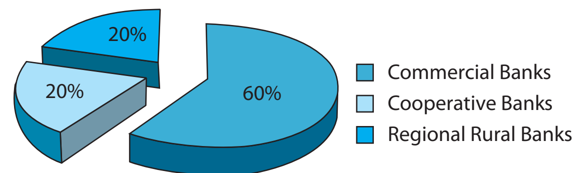

Figure 2.5 Market share by bank of volume of savings held by SHGs

The savings with the cooperative banks had seen a decline from the levels attained last year, whereas commercial banks and RRBs had recorded net increases. Average savings per group was the highest in the cooperative bank at ₹11,400 followed by commercial banks at ₹9,600. The state-wise

distribution of savings performance of SHGs is given in Annex 2.4 at the end of this chapter.

Though savings performance seems impressive, the rigidity associated with withdrawing savings, excessive build-up of corpus in older groups and the erosion of mutual trust with increased volumes hinder the savings effort. More and more groups divide the savings and corpus funds at the end of the year rather than accumulate the same into equity over a longer time. The lack of access to saved funds for emergent purposes and the loss of trust in the group when the loans become large are two major causes for this. The difficulty of managing large corpus funds leading to drawing down the corpus through distribution to members has been reported in several states. Banks, as collateral for loans, insist on SHGs retaining their savings in bank accounts rather than use the same for intra-group lending. While some banks are willing to take fixed deposits from SHGs at higher rates of interest, there are banks that retain the money in savings accounts of SHGs at low rates of interest, thereby indirectly increasing the cost of borrowing for groups. The strength of SHGs used to be their focus on savings; but in recent times, the groups are focused on bank loans and do the necessary minimum savings to qualify for the loan. In the case of government programmes, the focus is on subsidies and revolving funds and the group effort is directed at fulfilling the requirements. If this mammoth movement covering 100 million people is to deliver sustained benefits to members, it has to be reoriented towards savings. New ideas and products are needed that would make savings dynamic, flexible and purpose-oriented. Subsidy-led distortions have to be minimized and such support should be directed at building systems, infrastructure and skill sets.

REGIONAL SPREAD OF THE LENDING PROGRAMME

During the current year ending March 2011, southern region increased its share from 52.8 per cent of groups linked with loans to 55.3 per cent. The eastern region increased its share in the number of groups from 21.5 to 24.4 per cent. The north-eastern region also increased its share to 3.1 per cent from 1.9 per cent. The northern region, central region and the western region registered a decline in their share. The steepest fall was in the case of central region which saw its share shrink by 3.3 per cent compared to 2010.

Andhra Pradesh topped the list of states with the maximum number of groups with a share of 35 per cent; West Bengal with 11.9 per cent had the second place with Tamil Nadu slipping to the third place with 11.1 per cent share. Orissa with a share of 7 per cent and Karnataka with a share of 5.2 per cent of the number of groups made up the fourth and fifth places. In loans outstanding, Andhra Pradesh had a 42 per cent share with Tamil Nadu following as a distant second with a 14.1 per cent share. Karnataka with 7.4 per cent share was in the third place and Uttar Pradesh was a surprising inclusion in the top five list with a 5.6 per cent share in the fourth place. West Bengal had a share of 5.3 per cent. While four out of five states in the top five increased their share of loans, Tamil Nadu showed a marginal decline of 0.2 per cent compared to the previous year.

Compared to the last year, some states have put in a weak performance in SBLP. Fourteen states had a lower number of groups with outstanding loans by end of March 2011 compared to the previous year-end. Loan outstanding at the end of March 2011 was lower in eleven states. Large states like Maharashtra,

Table 2.2 Regional shares in linkage

	SHGs with o/s loan 2008		SHGs with o/s loan 2009		SHGs with o/s loan 2010		SHGs with o/s loan 2011	
	Groups	Percentage share	Groups	Percentage share	Groups	Percentage share	Groups	Percentage share
Northern Region	134,783	3.8	166,511	3.9	158,829	3.9	151,260	3.1
Northeastern Region	103,424	2.9	117,812	2.8	85,276	2.8	151,280	3.1
Eastern Region	753,048	20.8	933,489	22.1	985,094	22.1	1,171,840	24.3
Central Region	326,763	9	332,116	7.9	497,340	7.9	361,822	7.5
Western Region	446,550	12.3	393,499	9.3	439,199	9.3	313,913	6.5
Southern Region	1,861,373	51.3	2,280,911	54	2,421,440	54	2,663,569	55.3
All Regions	3,625,941	100	4,224,338	100	2,165,738	100	4,813,684	100

Tamil Nadu, Orissa, Rajasthan and Madhya Pradesh recorded a decline both in terms of number of groups and loans outstanding. A comparative table is provided in Annex 2.2. The states that were termed 'priority' such as Madhya Pradesh, Rajasthan, Uttar Pradesh and Orissa showed a decline in number of linked groups. Loan disbursements in 2010–11 were marginally higher than the previous year by about ₹3.2 billion. The number of groups that availed loans during the year declined drastically by 383,000; the extent of shrinkage was almost 25 per cent compared to 2009–10. A state-wise comparison of loan disbursements and number of SHGs availing loans for the last two years is provided in Annex 2.3. Andhra Pradesh saw the steepest decline in number of groups availing loans by 187,000 groups and a reduced disbursement flow of ₹3.5 billion.[2] The reduced loan flows and reduction in coverage of groups in a year when the state also experienced disruption of services to 6 million customers of MFIs should have compounded the problems of the vulnerable households. Most mainstream states suffered a decline. Banks in Karnataka, Tamil Nadu, Uttar Pradesh, Orissa, West Bengal and Andhra Pradesh provided disbursements to a lesser number of groups compared to last year. Ten states reported a decline in both number of groups and disbursements. The reasons for this decline in performance in such a large number of states are not clear. Are the banks withdrawing from SBLP is the first question that comes to mind. NABARD would no doubt study these developments even as it prepares for launch of SHG II during the year.

PERFORMANCE OF BANKS IN LENDING

The commercial banks had a share of 64 per cent of all groups with outstanding loans followed by RRBs with a 26 per cent share. The cooperative banks' share of number of groups had fallen from 11 per cent to 10 per cent compared to the previous year.

Commercial banks had 71 per cent of all loans outstanding with SHGs followed by RRBs with a 23 per cent share. The share of cooperative banks in

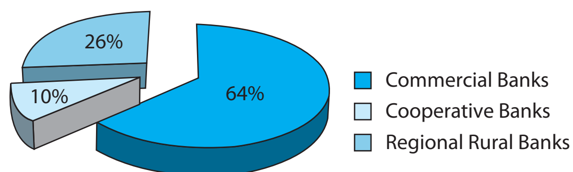

Figure 2.6 Market share by bank of number of SHGs with outstanding loans

loans at 6 per cent was considerably less than the 11 per cent share they had last year. The average loan disbursed per groups was the highest in case of commercial banks at ₹145,000. Cooperative banks disbursed less than half the average of commercial banks at ₹72,300 per group. RRBs had an average disbursement per group of ₹110,000.

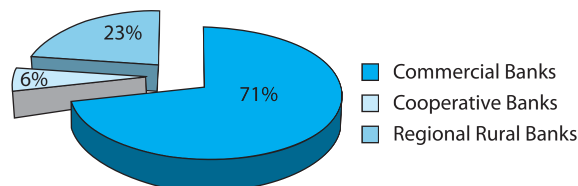

Figure 2.7 Market share by bank of volume of SHG loans outstanding

The average outstanding loan per group in case of commercial banks was ₹71,500. In case of cooperative banks it was about 50 per cent of that of commercial banks at ₹36,000.

The cooperative banks, while participating in the SBLP, did not do justice either to their community-based character or to their large network in the rural heartland. The declining performance of cooperatives in the SBLP is a matter of concern. Dr Prakash Bakshi, Chairman, NABARD, had expressed a view that the cooperatives have the basic requirements for good performance under SBLP. The legal impediments have been sorted out with cooperative law in most states allowing for admission of informal groups as members of Primary Agricultural Credit Societies (PACS) and customers of cooperative banks. He felt that improved human resources and capacity for handling savings of their members will go a long way in ensuring that the primary credit societies are able to link SHGs in the villages and provide necessary services. NABARD is likely to bestow greater attention on this aspect as part of the cooperative banking reform[3] that it is implementing on behalf of Government of India.

Table 2.3 **Bank loans outstanding against SHGs, 2010–11**

Agency	No. of SHGs	o/s loans (₹ million)
Commercial Banks	3,057,175	218,798
Regional Rural Banks	1,272,845	70,098
Cooperative Banks	483,664	17,376
Total	**4,813,684**	**306,272**

Box 2.1 Are banks listening?[4]

Hand in Hand Micro Finance Private Limited (HiHMFPL), the consultancy associate of Hand in Hand India, has been working with AIDS Prevention And Control Project of Voluntary Health Services (VHS), Chennai, to improve the quality of life of some of the most disadvantaged women in community, namely, female sex workers. The key components of the programme are imparting functional literacy and vocational skills to these women. The project conceived by the AIDS Prevention and Control Project (APAC)–VHS and designed and executed by HiHMFPL has an overall objective to build the capacity of the female sex workers in Viluppuram district to read, write and acquire skills that could lead to alternative livelihood options and gradually give them better choices.

Out of 258 women who were initially screened for the project, 90 women attended a six-month literacy course followed by 76 women who attended entrepreneurship development programme. Of these, 47 women have undergone various vocational/skill programmes like animal husbandry, tailoring, managing small retail shops and food outlets, coir rope making, cashew nut processing, etc. While they have formed SHGs and now have acquired these skills and are raring to start their own enterprises, the big question is who will fund their ventures? They do not need grants or aid; they want enterprise loans. With mobilization into traditional structures like SHGs and JLGs posing substantial social and institutional challenges, are banks and other relevant institutions geared up to address the livelihood transformation of these women through a niche form of microfinance?

The Swarnajayanti Gram Swarojgar Yojana (SGSY) continued to run parallel to the SHG movement in the country. The SGSY had been underperforming its potential, and though the average loan size in the SGSY was higher than in the case of normal SHGs which are not supported by the government, the repayment rates had suffered. The Planning Commission had, in its midterm appraisal[5] of SGSY, been critical of its performance. The low subsidy to credit ratio and the small number of livelihoods that had been supported as compared to the number of SHGs and their members who had been linked to the banking system came under critical scrutiny. The incremental income generated at ₹40 per day for those SHG members that had been linked with livelihood options was also felt to be inadequate.[6] During 2010–11, SGSY had formed 311,314 SHGs. Credit disbursed to SGSY groups amounted to ₹45.85 billion, which was 88 per cent of the target for the programme. The average investment per person was estimated ₹31,378. There were variations across the states with Himachal Pradesh reporting the highest per capita investment of ₹54,425. Andhra Pradesh and Tamil Nadu had a lower per capita investment of ₹27,851 and ₹32,374, respectively. The credit to subsidy ratio had increased to 2.53 during the year reflecting the increased support from banking system. However in states like Gujarat, Jharkhand and Bihar, bank loans were low and the credit to subsidy ratio was less than 2. Himachal Pradesh had the highest ratio of 5.75. The reported performance improvement in SGSY should be welcome in the light of the proposed conversion and transformation of the programme in to NRLM. The fact that more than 310,000 SHGs have been assisted to take up economic activities compared to the low level of achievements in the past should be a morale booster to NRLM. Loan repayment rates have to be improved to induce banks to lend more to groups under government programmes.

Quality of implementation of SBLP

The formation and support processes continued to have the same type of problems described in previous years reports. The problems of groups that did not have a promoting agency to support were severe. They did not have the disciplines of regular meeting, regular savings and record keeping. In some states the groups did not have a long-term view and tended to act more like chit fund groups[7] that distributed the savings and corpus among members every year. SHGs that were regarded to be active and dynamic were also not keen on leadership rotation. While initial hesitation among members could be a reason, in mature groups with more than five years of life, non-rotation of leaders could indicate a deeper problem of elite capture. Groups continued to have different norms on repayment of internal loans and servicing of bank loans. Bank loans were repaid more diligently than the intra-group loans. Bank loans were divided equally among members in most groups. The assumption that the group will carry out appraisal of each member's needs and then take credit decisions has turned out to be fallacious. The lower cost at which bank loans are available in most states is a major factor. SHG members see the low cost loans as a benefit and want an equal distribution of benefits.

Self-help Promoting Institutions (SHPIs) have reservations about the group promotion processes that financial institutions have designed. The costs, period of handholding to facilitate the group's development and the exit strategy are all issues over which most SHPIs have a difference of opinion. The unwillingness of banks to link groups and provide second and subsequent cycle loans in different parts of the country has been criticized. The number of credit-linked groups in the country formed 63 per cent of the groups linked to the banking system. The average loan disbursed per group was low in Gujarat, West Bengal, Rajasthan and some north-eastern states. The per member loan size in Gujarat, for example, was around ₹2,700 and in West Bengal it was ₹3,450. At such low levels, the loans at best could be used for consumption and not for any income-generating purpose. The all-India averages are distorted by the Andhra Pradesh data. If the Andhra Pradesh data is removed, the average loan disbursed across the country declines to ₹101,800 from ₹122,700. The average per member loan (excluding Andhra Pradesh) is about ₹7,830, which is inadequate for most livelihood and income-generating activities. The relative rigidity of SHG savings had been a deterrent for many groups in some states to raise their thrift levels. The influence of government schemes on purely NGO- or bank-promoted SHGs has not been received well by the promoters in some locations and the groups themselves.

Bankers have valid concerns on functioning of the groups. Lack of capacity in SHPIs, attrition of staff, lack of commitment to community-based groups, use of SHGs for other purposes/programmes of the SHPI and unwillingness to help the bank in case of defaults are some common complaints heard from bankers. The increasing numbers of groups in each rural branch increased workload in thinly manned branches that had been already burdened with opening of no-frills accounts and MGNREGS wage payments. Some banks considered SHGs as a business proposition and strategized linkage of groups. Some RRBs were very active in this sphere. In case of cooperative banks very few had such considerations. But in case of cooperative banks, the change in boards after each election led to policy discontinuity and SHG programmes that began with fanfare in some banks had lost their way with passage of time.

SHPIs and NGOs were critical of the low costs that were paid for formation and nurturing of groups. Inadequate period of handholding led to poor quality and the SHPIs had to take the blame, whereas the flaw was in design and funding. The frequent rotation of branch managers, delays in linkage, corrupt demands for documents and collateral and the launch of government programmes that split existing good quality groups were some of the hazards faced by SHPIs.

Box 2.2 Observations from the field[8]

The existing savings facilities are felt to be inadequate. SHG women want more avenues to save with specific goals for larger lifecycle expenditures such as education, festival, marriage, etc. But they want to be assured that such large savings will be safe. In many areas, groups want to distribute savings and common funds after five years and restart their group/savings. This satisfies a need of members to have lump sum cashback after long years of saving. This also provides an excellent opportunity for institutional change; change of leadership facilitated, uninterested members exit, rules regarding savings and group process reset. Promoters are not in favour of such disbanding and reforming of groups out of fear that the groups may not resume function or will not be able to avail bank loans.

In many mature SHGs there is a strong demand for income earning or enterprise opportunities. Government agencies, promoting NGOS and banks, do not have many ideas on income-generating activities. As a result their functions stop with savings, credit and subsidy. Many women, especially in semi-urban areas where farmland is getting converted to other uses, find it difficult to pursue their original income-generating activities/enterprise. The gradual loss of farm-based income activities has not been fully recognized and no alternative skills are developed in women.

The original intent of the SHG bank linkage programme was to establish credit history of members so that they can have individual access to banks. Despite passage of many years, how this graduation will happen has not been thought out. Individuals with larger loan demand borrow in the name of other members of the group leading to problems in groups. Banks are also comfortable in lending through the groups and reduce their risks. Risk of members increases without commensurate benefits which might lead to group splitting or becoming defunct.

Attendance of group meetings has been falling steadily with the age of the groups. It is not uncommon to send savings and loan repayment through family members or friends and attend

the meeting only when a loan is required. Without attending the meetings, the members lose control over the decision-making process and provide space for capture of the group by a few members.

SHGs face difficulties in opening bank accounts even after 20 years of linkage programme. The equal distribution of bank loan is commonplace in SHGs especially where subsidies are involved. When the members do not have ideas on how to utilize the loan, they engage in moneylending.

Many banks have centralized sanction process; the branches do paper work, visit the field where necessary and forward applications to the controlling office. This process delays loan sanction. It is not unusual for the groups to have to wait for 3 to 9 months in between two loans. Several groups have to rotate the revolving fund assistance for three to four years before they are considered for either direct loan or SGSY loan.

Banks demand a recommendation from a promoter such as NGO, federation or government department. If other groups earlier recommended by the agency have defaulted, the newly recommended group is refused a loan even if it has an excellent track record. Some NGOs charge a service fee of 1 to 3 per cent for such recommendation and group maintenance. Groups are torn between NGO and government-promoted federation many times; they strongly feel that they should not desert the NGO that has promoted them.

A few studies had been carried out by different agencies on the SBLP and its impact. The Maharashtra Village Development Association (MVDA)[9] had carried out a survey of 2,490 SHGs in 424 villages in the Vidarbha region of Maharashtra. The survey found that more than 2,000 SHGs were saving regularly. About 10 per cent of the groups had intra-group repayment problems and 56 per cent of the groups were irregular in repaying their loans to the bank. Eight hundred and thirty-six groups were found to have no records. Seventy per cent of groups had been graded as either average or poor. Only 30 per cent groups had been graded as excellent or good groups. Out of the 2,400 groups, only 189 had been linked with income-generation activities comprising 2,200 members. Meetings were irregular in 36 per cent of the groups and 144 groups comprising 6 per cent of the sample had become defunct. The quality of book keeping was found to be poor in 42 per cent of the groups. These groups did not have much by way of handholding support and they had not been supported for accounts maintenance. Monitoring by the banks of these groups was reported to be weak. It was not a surprise to learn that only about 1,000 groups had been provided second and subsequent bank loans out of a total of 2,400 groups. The study brings out some of the critical failures in guiding the groups to become qualitative financial intermediaries that work in the interest of their members.

Dr Samathi Guha[10] had carried out an impact evaluation study of SHGs covering covered four states comprising a sample of 632 members of SHGs. The study found that 75 per cent of the groups conducted regular group meetings with enforcement of attendance through a system of penalties. Fifty-four per cent groups reported more than 90 per cent attendance. Across all the four states, i.e., Andhra Pradesh, Gujarat, Jammu and Kashmir and Himachal Pradesh, the SHGs were not found to have changed their leaders from time to time. The leaders maintained records of the SHG in 70 per cent of groups. The SHPI and NGOs helped only in 20 per cent of the SHGs to maintain records. While savings had been regular, it varied from ₹10 to ₹150 per month. Typically the savings amounts were ₹50 per month. Bank loans comprised 59 per cent of the financial support in SHGs reflecting the strong influence of their own corpus to the extent of 40 per cent. Forty-six per cent of SHGs reported that they could get linked to the bank within six to eight months of formation. The delay in case of more than 50 per cent groups is a matter of concern. In a significant finding, 70 per cent households stated that the value of assets owned by them increased after they joined the SHG. Gujarat had the maximum accretion to assets of the movable kind. In Andhra Pradesh, the preference was more for immovable assets. The average savings per member increased by about ₹2,000 in the post-SHG stage. Forty-one per cent members in Andhra Pradesh and 88 per cent members in Gujarat started borrowing after joining SHGs. SHG members utilized loans for new economic activity or diversification of existing activities in varying proportions. In Andhra Pradesh, 66 per cent members took up one income generation activity over a three year period and 25.8 per cent members took up to three activities. In Gujarat, 46 per cent members took up one activity over a three year period. Of the sample of 632 members 149 had set up 30 different types of micro-enterprises and 158 more members had taken up 31 different types of income generating activities. Twenty-five per cent of the total sample reported increase in income

in the post SHG stage. This was much higher in Gujarat (38 per cent) and in Jammu and Kashmir (81 per cent). In case of members who had been with their SHGs for more than six years, the increase in income was 162 per cent in Andhra Pradesh, 129 per cent in Gujarat and 117 per cent in Jammu and Kashmir. The study had the following suggestions to strengthen the SHG linkage programmes with livelihood enterprises and income:

> Training and capacity building had been stated as a priority. Linking of SHGs to different technical institutes for building their capacities for taking up new and innovative income generation activities and enterprises. Leadership training was felt as a necessity for all the members of SHGs so that rotational leadership in groups is facilitated. A network that engages micro entrepreneurs NGOs and fair trade organizations had been suggested as a means of providing market access to the groups.[11]

In a study carried out by a team of researchers on behalf of CMF–IFMR the theme of economic returns to social interactions was probed. A sample of 1,000 SHG members was studied over 100 weeks to see whether the frequency of their meeting leads to any economic fallouts. The study found that meeting frequency leads to long-run increases in social interaction and eventually results in much lower defaults. The economic return on social interaction has been assessed to be lower default risks.[12] Suran and Narayana, in a study[13] to understand financial needs of poor households, found that the existing array of services including the SHGs have failed to penetrate into rural hinterland. A few customers that had joined the SHGs and availed its loan facilities continue to depend on moneylenders for their real needs. The design of the SHG product had fundamental weaknesses such as its inability to provide a second or a third loan even when it is within the repaying capacity of the borrowing member. The study had called for a redesign of the SHG lending product which should be more like a cash credit account from which the borrower could draw multiple times as and when needed as long as within the overall limits subject to repayment capacity.

In a detailed study of defaults of SHGs in Rajasthan,[14] the Centre for Microfinance, Jaipur, found that improper process of group formation was the foremost reason of default. Appropriate norms such as area selection, proper selection of members and concept seeding had not been followed in any of the defaulting groups. The groups with 100 per cent repayment were found to have gone through some localized formation process. The study found that the prime objective of 66 per cent of members was to get bank credit and 13 percent members focused on subsidy. Only 16 percent leaders and 13 percent members have undergone any training on group concept.

Group records had not been updated for years together. During the study, it was found that even though 74 per cent groups maintained attendance books, only 28 per cent updated it regularly. Thirty per cent and 62 per cent groups possessed cashbook and general ledger respectively; these books were written up only in 34 per cent groups. Transparency in groups (which is maintained through proper record-keeping) was not in evidence and hence members stopped repayments. Interestingly the crucial activity, i.e., intra-group loaning with groups corpus was found only in 46.5 per cent of the SHGs surveyed. The proportion of members who have availed intra-group loans was low, i.e., 34.9 per cent of all the members, about whom information was collected through the survey. The group's fund was used only to the extent of 18 per cent by members. The study found that all the stakeholders, i.e., SHG, SHPI and banks, had a role in improper implementation of concerned loan schemes that eventually resulted in groups turning defaulters.

Box 2.3 Promoter NGOs desert—leaders capture[15]

It was seen that small NGOs that work on a project mode find it difficult to carry on with group strengthening work as they are not financially supported beyond the initial phase. A large majority of SHGs promoted by one NGO in the northern district of Rajasthan (Churu) became defaulters after the organization withdrew from the villages at the end of one year 'project' of SHG promotion. The NGO said that it was forced to get out of the villages due to paucity of funds and personnel. At the same time, large NGOs with integrated activities were found to be doing well in terms of SHG activity as they use the groups to channelize multiple activities. Many groups suffered because of their dependence on what can be called 'a single individual support system'. The relocation and transfer of the key individual resulted in degeneration of many such groups. In the case of SGSY loans, it was found that the amount of loan is generally decided after the SHG promoter or the bank manager informs that a specific loan can be applied for rather than how much credit is actually required. In many SHGs,

there is manipulative intermediation by the president or secretary to corner a lion's share of the loan and distributing the rest among the members. This is further aggravated by multiple group membership of leaders. Permanent leaders, often the ones with power and resources, form convenient groups and use it to source bank loans for themselves. Lack of knowledge on the part of the members about the rules and structure of leadership further deteriorates the situation. The leadership in many cases stayed with the same women since the formation of groups.

Another study[16] on SHGs in the north-west part of India covering four states found that

> SHG movement financing has reduced dependency on moneylenders, enhanced financial inclusion. Many households have been able to buy durable assets in the past three to four year in terms of TV, washing machine, cows, buffaloes, farm equipment and so on. This means that poverty reduction took place. The survey also shows that if little better off individuals are provided low interest finance then, greater chances are there for them to come out of poverty situation. However, these households also show that existing asset base is important as most households had land and other assets to rely up on. Repayment is a problem in a sense that money for repayment is taken from other sources and also new loans used to repay the existing loans.

The different studies provide a mixed picture of the programme. While benefits accrue in terms of income, assets and increased savings problems of default and member indiscipline also exist. Group formation and handholding processes play a key role. Accounts and record keeping do not get enough attention from the stakeholders including the group members until it is too late.

NABARD's role and performance[17]

NABARD continued its refinancing and promotional role to support stakeholders including banks. During the year refinance of ₹25.45 billion was provided to banks covering their lending to SHGs. This was a decline from ₹31.73 billion disbursed in 2009–10. As a proportion of NABARD's total refinance disbursements, SHG share fell from 26.4 per cent in 2009–10 to 18.9 per cent in 2010–11. Under the Microfinance Development and Equity Fund, ₹473.8 million was released during 2010–11, of which 299.5 million was grant support for promotional activities and 174.3 million for capital support/revolving fund assistance to MFIs, as against 204.9 million and 604.2 million, respectively, in the previous year. The decline in revolving fund/capital support to MFIs is steep. It seems to have been caused by an informal policy decision taken during the year that SIDBI should fund the MFI sector and the Micro Finance Development and Equity Fund (MFDEF) with NABARD should not be used for the same.

Table 2.4 Support to SHPIs and their performance

Agency	Sanctions during the year 2010–11: No	Amount	No of Groups	Total groups formed so far
DCCB	6	11.29	7,850	47,203
RRB	3	1.60	1,350	55,548
NGO	223	360.10	69,165	268,791
FC	47	1.26	1,085	17,321
IRV	3	4.39	2,440	12,208
Total	282	378.6	81,890	401,071

During the year, grant assistance of ₹378.6 million was sanctioned to various agencies for promoting and credit linking 81,890 groups. Grant assistance of ₹510 million was released during the year. Nearly 0.26 million SHGs were credit linked. So far 0.40 million groups have been formed and bank linked since the inception of the scheme with NABARD grant support. But this constitutes a small proportion of less than 9 per cent of total groups credit linked and 5.3 per cent of groups savings linked. Given the ambitious target for linking 1 million groups each for the next five years, the nature and extent of this assistance should undergo a radical change. The effective costs of SHPIs for promoting and nurturing groups to a reasonable quality has been estimated to be between ₹7,000 and 10,000 in different studies. The average cost[18] granted so far under the MFDEF to SHPIs is around ₹2,520. Unless reasonable costs are allowed, it might be difficult to attract competent institutions to act as SHPIs.

NABARD continued with its initiative of promoting Joint Liability Groups (JLGs) with a view to promote access to credit for small and marginal farmers and tenant cultivators. A grant of ₹247 million was sanctioned for promoting 125,000 JLGs across the country till March 2011. The JLGs fill a critical gap in the rural areas where marginal farmers and tenant farmers find it difficult to access bank loans. The JLGs are typically of such farmers and facilitate their availing loans for farming. Reportedly, banks

are keener on JLGs on account of larger loan size and lower monitoring/handholding requirements. During the year, 1,606 Micro Enterprise Development Programmes (MEDP) were conducted for 37,138 members on various location-specific farm, non-farm and service sector activities. So far 109,000 participants had been covered under the enterprise development programme. The reported numbers are small in comparison with the requirements. Scaling up the MEDP so as to serve at least 15 per cent of all mature groups (of 4 years vintage or more) might make a discernible impact.

NABARD Financial Services Ltd (NABFINS) set up last year disbursed an amount of ₹500 million to 2,019 groups through 31 BCs during 2010–11. In addition, disbursements to the extent of 15 million were made to MFIs and Federations. This being the first year of operation, the company will probably add to its suite of products and innovate on processes and product design. NABFINS by itself cannot hope to have a large footprint over the country to create a significant impact. The *raison d' etre* of an institution like NABFINS is to provide ideas to the sector on scalable models in financial inclusion.

NABARD is now in the process of preparing a strategy for invigorating the SHG movement. Recognising that fatigue has set in, NABARD is on the drawing boards to tweak and reengineer the SHGs with additional features and greater support both in terms of choice of institutions and also type of support services. Malcolm Harper had suggested to NABARD that version II of SHGs should be launched to provide a fillip to the movement. He had underlined the need for restoring saving as the prime objective of SHGs and prioritising access to banking services for individual members of the group. Addition of remittance, payments, insurance and pension products through the SHGs would being in greater customer loyalty to the groups and deepen financial inclusion.

Box 2.4 SHG 2—ideas from an old India hand[19]

Changes needed

Bankers and existing and potential SHG members should regard SHG membership as a route to *financial inclusion* through individual banking services. Banks should be encouraged, or if possible mandated, to open individual no frills savings bank (SB) accounts for all SHG members. The present emphasis on credit (that is, indebtedness) should be corrected. SHGs should be seen as a way of *saving*, in a group and individually, as a way of accessing pensions and other transfers, and also to get a loan when it is required. SHG 2 should not be seen as a 'scheme', with subsidized loans and other incentives. There may be a need for some such expedients to 'kickstart' the revival process, but the overall message must be that membership of an SHG is worthwhile in its own right, as the preferred source of financial services for the poor, and that business with SHGs is good business for banks, without subsidies. SHGs cannot be promoted to the stage of taking, or even repaying, a first loan, and then abandoned. Most SHGs need indefinite support, which they may be able to pay for themselves or which may have to be subsidized. The concept of 'SHG Linkage' should be revised so that it means an SHG which is making regular use of its SB account, with or without credit, not merely an SHG which has borrowed once, and can then be counted and forgotten.

Guiding principles for SHG 2

The focus should be on developing new strong groups and improving existing ones, rather than on ever more 'sidelines' such as enterprise training, or federations or other institutional structures. The members of a strong group can themselves decide whether and how to work with others, and to use their money, and will do it effectively.

Avoid training for its own sake; the existing training modules should as a matter of urgency be redesigned in the context of 2011, including the new aspects of SHG 2, and should also cover recently emerging problems and opportunities such as multiple borrowing and over-indebtedness, the dangers inherent in MFI lending practices, and newly emerging business opportunities and mobile telephone applications.

SHGs need to keep simple records, and many excellent systems have been designed which can be used even by illiterate people. There is no need to 'reinvent' the wheel; the best existing systems should be selected and 'rolled out'.

There may be no effective NGO SHPIs or other existing agencies in a given area. Funds are available to make it possible to create appropriate agencies, in the same way as commercial businesses create distribution channels for their products if none are available.

The future of SHGs will critically depend not only on the additional features that would be bundled, but also on the higher tier institutions that exist and are likely to emerge. The banking system that was struggling to deal with individual customers with small transactions was willing to acquire SHGs as customers on account of the aggregated volumes. But, per group volumes did not increase in a manner envisaged and did not keep pace with the rest of the economy. While initial thinking was that each group would comprise 20 members or very close to that, the average membership has fallen to 13 and many of the new groups being formed under government programmes over the last few years have ten or less members. The low membership per group brings down the transaction value and increases costs for bankers. A significant fact is that the average outstanding loan per SHG account is smaller than the outstanding average per agriculture loan account. As long as the size of transaction continues to be small, the indifference of the banker will continue.

Table 2.5 Comparison of average outstanding loan per account—SHG and agriculture loans[20] (Amount in ₹)

Year	Outstanding per SHG a/c	Outstanding per agri loan a/c
2008	46,881	56,654
2009	53,679	60,800
2010	57,763	72,402

In planning for the future the means of increasing the ticket size of transactions should be explored. With all-round increase in costs and prices, many groups save insignificant amounts. Banks also keep their loans low in an effort to minimize risks. A combination of these two produce business volumes that are not significant. Even in case of SHGs, a focus on income-generating activities and livelihood financing should be introduced. The stated ideological approach of making SHGs autonomous to take their own decisions does not seem to work well enough. Extra efforts are needed in building capacities of SHGs. They should be in a position to appraise the needs of entrepreneurial members and allocate sufficient resources instead of the equal division of resources. Dr Prakash Bakshi, in his exclusive interview (see Annex 2.1) mentioned the introduction of voluntary withdrawable savings, use of BCs of banks as SHPIs, focusing cooperatives on SHGs, greater use and integration of technology especially for accounting and record-keeping as some of the ideas under consideration. Voluntary savings enablement in SHGs is a good idea; it requires careful preparation of the SHGs, the accounting, MIS and control systems as also customized design of products. The present difficulty in members availing a second loan from the group even for emergent purposes should be dealt with; the proposal is for a cash credit type of loan from which members can draw to the extent of availability of the limit any number of times during the currency of the limit. SHG movement is in for exciting times. With new ideas and new strategies a resurgent SHG movement could catalyse the rural households. If NRLM and MGNREGS achieve convergence with SHG 2, the synergies of these three programmes will offer a complete suite of superior institutional and service choices.

One of the facts that go unnoticed in discussions on SHGs is that a number of MFIs finance SHGs. Not all MFIs have JLGs and Grameen groups as sole type of customers. Some of these MFIs have a good track record and image among their customers. Sangamitra, Sarvodaya Nanofinance, Sri Kshetra Dharmasthala Rural Development Project (SKDRDP), Hand in Hand, South Indian Federation of Fishermen Societies (SIFFS), Kalanjiam, NABFINS and BWDA Finance Limited are some examples of such MFIs working through SHGs. Linkage of SHGs is not only possible with MFIs, but could be a superior option in locations where bank branches are scarce. From the government side, a level playing field between banks and MFIs should be created for linking SHGs. A question about how savings will be handled is often raised in case of MFI linkage with SHGs. MFIs referred to above have found solutions for the same which could be used by others.

HIGHER TIER INSTITUTIONS

One of the ways of bulking business volumes is the use of higher tier institutions instead of dealing with individual SHGS. SHG federations[21] operate in several states with varying degrees of success. In Andhra Pradesh, and to a lesser extent in states of Bihar and Orissa, federations are acting as financial intermediaries. There are also stand-alone federations operating in other states but not as part of an organized effort. Under NRLM many states are on the job of setting up such higher tier institutions of SHGs. The advantages of higher institutions are obvious. They can perform the handholding role and ensure adequacy of accounting and audit in SHGs. With a viable membership of SHGs, federations

can hire professional staff to serve as a common resource for the network. The federations can also act as trainer, aggregator and problem solver for the members. Whether federations should take up a financial intermediation role is a critical question. Federations could merely act as balancing centre for their member SHGs by taking surplus savings from one providing loans to the other. Federations can also borrow from banks on own account and on-lend to SHGs. Many in the sector are not comfortable with financial intermediation role.

Box 2.5 Federation promotion[22]

CARE INDIA'S WORK WITH HIGHER TIER INSTITUTIONS

Savings-led community finance offers an effective way to address basic financial needs of the poor and existing services have been shown to have a measurable impact on reducing poverty and improving the general well-being of clients. Microfinance can enable clients, the majority of whom are women, to buy basic necessities, access health and education services, cope with emergencies and invest in income-generating activities. The programme focuses on building and sustaining SHGs and their federations to intermediate financial, livelihood and development services to their constituent members.

Programme objective:

- Improve **outreach** by providing access to savings-led community finance
- Improve **impact** by introducing innovations in community finance methodology
- Increase **financial inclusion** through piloting further services, products and channels

Outreach

The programme is focused on the widespread presence of SHGs in the state of Tamil Nadu to reduce the vulnerability of poor households. Four community-based federations (two federations are in pipeline) were formed and groups are enrolled into the federation. The groups that are enrolled into the federation will be graduated to avail Bank Linkage Program. Also services like micro-insurance and micro-pension are provided with the support of formal service providers. So far it has reached 21,047 members (against a target of 32,500) with average savings of ₹17,000 per member and a total loan outstanding of ₹24 million. The federations are given following support.

1. Technical Support
   a. Institutional Building
      i. System building
      ii. Developing operational manual
      iii. Guiding to identify appropriate legal structure
      iv. Grading and rating of each group
      v. Graduating the groups to access loan from banks
      vi. Improving capacities to become BCs

   b. Capacity Building
      i. Identifying the training needs of the federation
      ii. Designing the Training module based on the need
      iii. Trainings on Accounts and Book Keeping, SHG & Federation Formation, Governance and Financial Literacy

   c. MIS
      i. MIS by Care India to track progress

The programme envisions achieving impact at three levels:

1. At client level, reduced vulnerability and increased income levels
2. At SHG level, improved access to financial services
3. At SHG Federation and Promoting Institution level, efficiency and sustainability

NABARD has for long been emphasizing the non-financial role of federations and advising them to be selective in taking up financial services in view of the risks involved. One view is that with the large network of bank branches and promised BCs in rural areas federations may not be required to play a financial role. A contrary view is that bank branches have not delivered in linking SHGs even in southern states and, hence, institutions that take the risk of financing the initial stages of the groups are necessary.

A study of federations,[23] carried out by Girija Srinivasan and Ajay Thanka in 2010, found that the space available for federations to form and function has been much smaller than assumed. As the federations head into the future they need to be conscious of the changing environment and be prepared to change their form. They should be

prepared to change into a company, cooperative society or other form that ensures continued support from external stakeholders. While financial intermediation is seen as a panacea for sustainability related issues, federations would do well to embed financial intermediation in livelihood development programmes over time. Federations cannot rely on financial intermediation to generate resources for their non-financial interventions. Appropriate sources of long-term funds must be accessed. The federations need much stronger policy support. They find themselves discriminated against in terms of bank loans, for involvement as service organizations to government programmes and even in institutional ratings. NABARD and the government should come out with clear criteria on how federations would be supported and the benchmarks they must achieve to qualify for support. The captive federation format adopted in some states has converted the structure to a dedicated distribution channel of governments' social and welfare programmes. As a result federations have become contract service organizations without a mission of their own. The future approach to government's partnership with federations should ensure that they are equal partners and not pushed into accepting all or any of the governments' interventions.

The study concludes:

> Federations as a concept have a lot to offer. Banks should be able to find comfort in well run federations functioning as financial intermediaries as they can lower costs of providing numerous loans by channelling it through a federation. The government could also rely on federations to reach a large number of grass root customers at low effective costs. The members of the federations benefit from having an institution of their own that has the size and competence to negotiate on their behalf and function in their interest. But all these are possible only when federations find their space through appropriate policies, bank support and member loyalty.

The continued promotion and establishment of federations of SHGs is seen as inevitable in the light of the design features of NRLM. In forming such federations observance of some ground rules would avoid the problems of captive federations explained earlier. Some of the principles in promoting federations should be:

- There should be no compulsion on SHGs to join any federation.
- Federations should not be supply driven institutions.
- Autonomy of federations should be ensured.
- The SHG constituents should determine the services to be offered by the federation.
- While initial support might be provided to such institutions they should be self-supporting and be able to borrow on normal commercial terms from banks in case they take up financial intermediation.
- These federations should also be brought under microfinance regulation to ensure that customer protection and savings protection are available to members.
- The tendency to control the federations through government staff and promoter organizations should be curbed through appropriate by-law provisions.

The beginning of a shift in emphasis towards SHGs as more suitable vehicles of microfinance is discernible in the light of tacit acceptance of the loss of mission focus and customer centricity by the MFIs. The SHG movement having run long had been pausing over the last couple of years. Now with the second wind and new ideas, it is building momentum to reach more people with hopefully improved quality of services. The insistence of RBI and the government that financial inclusion is possible only through banks, launch of SHG-centric NRLM and the employment of BCs in rural areas seem to make the job of SHGs easier. How will the movement respond? Will it let the government departments determine priorities as well as strategies or will it develop an agenda unique to its members and offer them greater choices that ensure sustainability and growth. NABARD having piloted the SHGs in the first 15 years has a pivotal role; that of guiding resurgent SHGs towards what is best for the members. If higher tier institutions are felt necessary to handhold the SHGs as they mature, NABARD should not hesitate to revisit its policy and provide an enabling environment; similar to what it offered SHGs 15 years ago. A fresh beginning from an old starting point!

ANNEX 2.1
Interview with Dr Prakash Bakshi, Chairman, NABARD[24]

Dr Prakash Bakshi agreed to discuss a few issues relating to microfinance and financial inclusion. Most of the discussions expectedly centered on the SBLP.

Question: How do you view the performance of SHG bank linkage programme so far?

Answer: The SBLP was the outcome of a pilot started in 1983 for improving access of rural poor to financial services. It was about making formal financial institutions accessible to rural poor. The SHGs were not thought of as a parallel system but trained to use existing financial institutions. For the banks, it was a way of reducing their transaction cost by dealing with groups and reducing their risk cost by making people save and through peer pressure. Financial literacy and counseling to enable them to do so happens in the regular SHG meetings. But today we have other means of reducing transaction costs with the help of technology. The introduction of business correspondent also has a huge potential. The self-help promoting institutions that were originally working on grants for promotion of groups would today be considered as business facilitators (BFs).

In the process of expanding the coverage of the programme in the last 20 years, we missed out on leveraging some other developments. For example, we should have brought in more technology in dealing with the groups and also accounted for the changing environment due to large government programmes like MGNREGS which bring in substantial cash resources to the poor. NABARD now intends to introduce a reworked version of the SHG model. The new elements of the reworked model which we will call SHG 2 are: (*a*) voluntary savings apart from compulsory savings, (*b*) widening the livelihood opportunities including those in services sector, and (*c*) graduating select members of the groups that have entrepreneurship potential into a joint liability groups for borrowing larger amounts. With these additions and more intensive capacity building the groups would start performing even better. The idea is to link a million groups each year—SHGs and JLGs—in the next 5 years apart from improving the quality and efficiency of existing SHGs.

Question: What do you propose to do with those states where the SBLP lags behind others?

Answer: In these states formation of new SHGs will be prioritized. It is possible that joint liability groups might be formed first and then this would become the nucleus which would turn into an SHG later. At the same time we would also continue the traditional methods of formation of SHGs. Using a combination of these two and also using new partners such as government functionaries, anganwadi workers and agricultural extensions officials, we would try and accelerate the process of promotion of groups in these states. Further, banks are likely to have business correspondent serving 73,000 large villages. We would use the business correspondents as self-help promoting individuals and transaction points for the SHGs. The challenge in using the BCs as SHPIs lies in providing quality training on the related aspects. We will create master trainers of SHG mobilizers using the existing NGOs. We would also use experienced SHG members to promote other SHGs and link the groups through the BCs with bank branches. We have to design new ways of compensating the mobilizers and the BCs to ensure that everyone has an incentive to perform well.

Question: How do you view the National Rural Livelihoods Mission?

Answer: NRLM should converge with SHGs eventually. NRLM should have a combination of SHGs and JLGs to deliver its services. The proposal under NRLM that at every level (village, block and district) there would be a federation of SHGs is not a bad idea. But we should carefully think through the idea of delivering financial services through these federations because of the large number of such institutions that will require quality staff and supervision. As I said earlier, if SHGs are linked to bank branches through the BCs, we may not need federations at all. The 73,000 BCs will make the SHG linkage of all the groups that are set up possible. NRLM should focus on capacity building for livelihood activities and related services through their federations rather than making all the federations undertake financial intermediation. Velugu and Indira Kranti Patham (IKP) were successful programmes that included all stake holders. But these were high-cost models but with a large multiplier effect. The strengths in these programmes should be used in NRLM.

Question: What's your view on the Andhra Pradesh Legislation regulating the microfinance sector?

Answer: We should remember that there is a history to the Ordinance. The state goverment had built up IKP over a period of time. Though there are some negatives even in IKP, the positives outweigh them. IKP

brought convergence of all government initiatives and benefitted the rural poor. Given that subsidy of government was limited, quality assessment of SHGs automatically came in and banks were persuaded to lend only to quality SHGs. In the case of MFIs, unhealthy practices including multiple lending and coercive recovery practices were possibly a trigger for the Ordinance. Over indebtedness caused problems all around including for recovery of bank's dues as members thought it prudent to first repay MFI loans which bore high rates of interest. Possibly the Andhra Pradesh legislation could be construed as a mechanism of protecting the government's own programme, but it was more addressed at eradicating the unethical practices of microfinance institutions.

Question: Government of India has brought in a new bill to regulate microfinance. Whether this bill would answer all the problems of the sector?

Answer: The new bill is a flexible one and does not bind the institutions and the sector with specific limitations. It focuses on protecting the borrower while the earlier avatar of the bill focused only on protecting the tiny thrift and savings of the poor. It has the best chance of being successful especially for the microfinance institutions sector.

Question: What is your opinion on the relatively low performance of the cooperative banks when it comes to SBLP?

Answer: For a long time cooperative law in many states did not permit SHGs to be members PACS. With the amendment of the law, PACS should be able to link the SHGs. A key challenge is the development of confidence and capacity in PACS to handle savings of members before they start taking SHG savings. An institutional protection and deposit safety scheme has been formulated by NABARD and it is under consideration of the Government of India. The human resources and technology enablement of PACS should happen before they become fully functional. At least 35,000 primary societies out of the 53,000 covered by the reform package are to be computerized. Once they are computerized, deposit taking can take place far more easily. We do have to establish higher standards of governance in primaries and the depositors should be elected to the Boards of these institutions. PACS should learn to prioritize savings and not just act as pass through agencies for refinance loans. Sustained work over a next three or four years will ensure that cooperatives participation in SBLP improves.

Question: What are NABARD's priorities in financial inclusion?

Answer: Today 12 crore farmer households carry out farming but only 5.4 crore farmers access bank credit. The remaining 6.6 crore farmers are outside institutional credit support. NABARD would like to double the number of farmers availing credit from the present 5.4 crore by removing the impediments faced by them. NABARD would also like to form and link a million SHGs and JLGs every year for the next five years. This includes formation of at least 2 lakh joint liability groups every year for the next five years. NABARD will strengthen the development initiatives that it is already undertaking on the field, namely, Farmers Club, Watershed Development, Tribal Development through Wadis to focus on formation of new groups and move excluded households into customers of the banking system. NABARD will also closely monitor the performance of MFIs. Eventually NABARD believes that institutions really do not matter—markets will encourage or drive out institutions based on their efficiency and ability to deliver. Technology is a key enabler. NABARD is supporting pilots and mainstreaming of technology adoption. NABARD is partnering a project with UID for issuance of a KCC smart card. This is aimed at examining the extent to which rural economy can be made cashless. There is another pilot in Tamil Nadu in collaboration with 'Paymate' to reduce cost of services to farmers in cash-handling. There are a few other continuing projects that focus on integrating technology with financial services at group and bank levels.

ANNEX 2.2

Comparison of groups with outstanding loans and loan amounts—state-wise[25]

State/UT	No of SHGs	Loan portfolio Mar 10 (₹ million)	No of SHGs	Loan portfolio Mar 11 (₹ million)	Growth SHGs	Growth loans (₹ million)
Andhra Pradesh	1,471,284	117,395	1,683,993	128,694	212,709	11,299
Arunachal Pradesh	3,203	107	3,910	83	707	–23
Assam	100,422	4,912	111,589	5,146	11,167	234
Bihar	82,215	5,578	190,341	7,784	108,126	2,206
Chhattisgarh	52,588	1,995	62,740	1,930	10,152	–64
Goa	3,425	246	9,446	360	6,021	114
Gujarat	69,286	1,416	73,695	1,554	4,409	138
Haryana	15,802	1,551	18,704	1,909	2,902	358
Himachal Pradesh	27,209	1,060	25,116	1,599	–2,093	540
Jammu & Kashmir	1,665	103	2,163	116	498	13
Jharkhand	63,741	2,908	72,422	3,220	8,681	312
Karnataka	300,738	20,553	252,129	22,748	–48,609	2,195
Kerala	257,760	10,153	182,114	15,904	–75,646	5,751
Madhya Pradesh	76,928	4,451	64,350	3,924	–12,578	–527
Maharashtra	384,765	12,033	230,772	9,659	–153,993	–2,375
Manipur	4,452	188	4,561	201	109	14
Meghalaya	3,191	134	3,412	148	221	14
Mizoram	2,097	233	311	62	–1,786	–171
Nagaland	4,236	145	3,930	163	–306	18
New Delhi	1,564	134	657	62	–907	–72
Orissa	372,646	15,161	335,041	15,779	–37,605	618
Pondicherry	13,463	1,533	7,393	943	–6,070	–590
Punjab	10,044	671	11,343	960	1,299	289
Rajasthan	96,206	4,633	93,068	4,491	–3,138	–142
Sikkim	1,604	47	5,466	70	3,862	23
Tamil Nadu	538,867	40,594	535,384	43,173	–3,483	2,578
Tripura	14,580	969	18,101	785	3,521	–184
Uttar Pradesh	338,357	16,359	216,879	16,999	–121,478	640
Uttarakhand	30,049	1,823	17,853	1,469	–12,196	–354
West Bengal	507,782	13,269	574,036	16,255	66,254	2,986
Total	**4,850,169**	**280,383**	**4,813,684**	**306,273**	**–36,485**	**25,890**

ANNEX 2.3
Comparison of disbursements in SHG loans—state-wise[26]

State	No of SHGs 2010–11	Disbursement 2010–11 (₹ million)	No of SHGs 2009–10	Disbursement 2009–10 (₹ million)	Growth in no of groups	Growth in disbursement (₹ million)
Andhra Pradesh	376,667	63,542	564,089	67,066	–187,422	–3,525
Arunachal Pradesh	956	45	919	32	37	13
Assam	29,094	2,272	39,058	1,957	–9,964	314
Bihar	31,495	3,160	24,309	2,258	7,186	903
Chhattisgarh	8,979	596	13,609	677	–4,630	–80
Goa	3,058	236	1,784	254	1,274	–18
Gujarat	25,767	901	37,059	1,087	–11,292	–186
Haryana	4,628	607	4,023	467	605	140
Himachal Pradesh	5,293	733	3,797	382	1,496	351
Jammu & Kashmir	622	68	675	58	–53	10
Jharkhand	11,286	1,433	12,065	1,122	–779	311
Karnataka	89,259	13,668	104,151	11,304	–14,892	2,363
Kerala	73,275	7,836	62,058	5,075	11,217	2,762
Madhya Pradesh	9,408	2,215	16,042	935	–6,634	1,280
Maharashtra	63,420	4,607	110,287	5,128	–46,867	–522
Manipur	721	35	538	30	183	5
Meghalaya	1,113	76	1,895	88	–782	–13
Mizoram	420	29	417	47	3	–18
Nagaland	321	27	603	64	–282	–37
New Delhi	344	38	416	45	–72	–6
Orissa	71,343	5,750	117,226	6,667	–45,883	–917
Pondicherry	4,016	788	6,259	1,347	–2,243	–559
Punjab	2,686	328	1,790	194	896	133
Rajasthan	40,766	2,762	26,674	1,917	14,092	845
Sikkim	331	17		0	331	17
Tamil Nadu	190,942	25,486	259,161	25,613	–68,219	–127
Tripura	4,391	489	5,424	627	–1,033	–138
Uttar Pradesh	30,328	4,178	42,636	4,242	–12,308	–64
Uttarakhand	4,159	481	5,559	468	–1,400	13
West Bengal	117,824	5,284	123,520	5,342	–5,696	–58
Total	**1,203,559**	**147,730**	**1,586,822**	**144,533**	**–383,263**	**3,197**

ANNEX 2.4
State-wise savings performance of SHGs[27]

State/UT	Savings No of SHGs	Savings amount (₹ million)
A & N Islands (UT)	4,750	11.6
Andhra Pradesh	1,351,330	10,891.6
Arunachal Pradesh	7,079	18.6
Assam	245,120	813.8
Bihar	243,407	1,061.8
Chandigarh	557	5.8
Chhattisgarh	119,684	852.6
Goa	7,926	81.9
Gujarat	192,421	1,716.1
Haryana	34,227	983.0
Himachal Pradesh	53,021	369.7
Jammu & Kashmir	5,569	38.7
Jharkhand	87,189	1,419.6
Karnataka	671,032	11,351.2
Kerala	500,599	4,219.8
Lakshadweep	164	1.0
Madhya Pradesh	166,447	1,445.8
Maharashtra	826,934	6,481.4
Manipur	10,306	24.0
Meghalaya	10,653	37.6
Mizoram	4,592	17.8
Nagaland	9,866	36.3
New Delhi	3,042	31.8
Orissa	520,388	3,535.5
Pondicherry	20,335	241.8
Punjab	39,717	431.6
Rajasthan	302,743	1,710.4
Sikkim	2,811	16.9
Tamil Nadu	938,390	9,814.1
Tripura	34,312	339.5
Uttar Pradesh	457,475	3,501.4
Uttarakhand	44,870	418.4
West Bengal	630,313	7,329.7
Total	**7,547,269**	**69,250.9**

ANNEX 2.5
Credit to savings ratio across states[28]

State	Average loan outstanding/SHG	Average savings/SHG	Loans to savings ratio (Multiples)
A & N Islands (UT)	22,886	2,435	9
Andhra Pradesh	76,422	8,060	9
Arunachal Pradesh	21,352	2,632	8
Assam	46,116	3,320	14
Bihar	40,896	4,362	9
Chandigarh	113,665	10,408	11
Chhattisgarh	30,764	7,124	4
Goa	38,081	10,330	4
Gujarat	21,092	8,918	2
Haryana	102,053	28,721	4
Himachal Pradesh	63,683	6,972	9
Jammu & Kashmir	53,596	6,952	8
Jharkhand	44,458	16,281	3
Karnataka	90,225	16,916	5
Kerala	87,328	8,430	10
Lakshadweep	39,500	6,317	6
Madhya Pradesh	60,984	8,686	7
Maharashtra	41,853	7,838	5
Manipur	44,152	2,331	19
Meghalaya	43,509	3,531	12
Mizoram	199,514	3,879	51
Nagaland	41,597	3,679	11
New Delhi	94,152	10,451	9
Orissa	47,095	6,794	7
Pondicherry	127,557	11,892	11
Punjab	84,604	10,867	8
Rajasthan	48,251	5,650	9
Sikkim	12,814	6,010	2
Tamil Nadu	80,639	10,458	8
Tripura	43,378	9,895	4
Uttar Pradesh	78,378	7,654	10
Uttarakhand	82,273	9,324	9
West Bengal	28,317	11,629	2
Total	**62,157**	**8,447**	**7**

NOTES AND REFERENCES

1. GDP deflator has been used for calculation of real values.
2. According to the progress report of Ministry of Rural Development, Andhra Pradesh, the number of groups that were disbursed loans during 2010–11 was 38,944 and the amount of loan disbursed was ₹70.9 billion. NABARD's provisional data puts the number lower by 12,700 groups and ₹7.4 billion in disbursements.
3. The rural cooperative banking reforms are underway over the last five years at a cost of ₹150 billion. Twenty-five state governments have signed up for the programme; the reform envisages conversion of primary credit societies, district cooperative banks and state cooperative banks in to professional, member-driven organization that could compete with the financial sector institutions. World Bank, Asian Development Bank and kfw Bankengruppe (Frankfurt) are providing loan funds to the Government of India for implementation of the reforms package.
4. Contributed by Ashwin Kumar and Hemantha Pamarthy of HiHMFPL, Chennai—in response to the query on United Nations Solutions Exchange—Microfinance community.
5. Mid-term appraisal of the XI Five Year Plan 2010—Planning commission. (www.planningcommission.nic.in)
6. Cited from the mid-term appraisal of planning commission which in turn quotes from the assessment report of the committee headed by Professor Radhakrishna.
7. Chit Fund groups are like Rotating Savings and Credit Associations—the savings of each interval (weekly, fortnightly or monthly) is given to specified number of members. The selection of members is mostly based on an auction; in some groups by draw of lots.
8. Contributed by Girija Srinivasan, consultant in development finance.
9. MVDA is an NGO based in Vidharba region of Maharashtra. The study was commissioned by NABARD. The information used is based on a presentation made by MVDA in CAB, RBI, Pune.
10. Sampati Guha, 'Microfinance for Microenterprises: An Impact Evaluation of Self Help Groups', occasional paper number 55 (Department of Economic Analysis and Research, NABARD, 2010).
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13. B. S. Suran and D. Narayana, 'The Deluge of Debt: Understanding the Financial Needs of Poor Households', Working Paper Series 412 (Kerala: Centre for Development Studies, 2009).
14. 'Study of Defaults in SHGs', Centre for Microfinance, Jaipur, 2010; supported by Centre for Microfinance Research, BIRD, Lucknow.
15. Excerpted from Study of Defaults in SHGs, Centre for Microfinance, Jaipur, 2010; supported by Centre for Microfinance Research, BIRD, Lucknow.
16. Gagan Bihari Sahu, 'SHG Bank Linkages in North West India—2010'; supported by Center for Microfinance Research, BIRD, Lucknow.
17. Data cited in this section relating to NABARD is sourced from *Annual Report of NABARD 2010–11*.
18. This average comprises both historical and current costs as it is the worked out cumulative number of groups.
19. Suggestions made by Malcolm Harper, Professor Emeritus, Cransfield Business School to NABARD.
20. SHG data from NABARD; Agricultural lending data calculated from basic data maintained by RBI. The averages contain the higher averages of Andhra Pradesh. If Andhra Pradesh averages are removed the comparison will show SHG loans in even poorer light.
21. Andhra Pradesh Mahila Abhivruddhi Society (APMAS) maintains a comprehensive database on SHG federations. The report had carried some of the basic data in the past years.
22. Excerpted from contribution made by Sashi Kumar, CARE India in response to the Query in the United Nations Solutions Exchange—Microfinance Community.
23. Girija Srinivasan and Ajay Thanka, *SHG Federations—Development Costs and Sustainability* (commissioned by Rabobank Foundation, Utrecht, the Netherlands, and Access Development Services, New Delhi, India, 2010).
24. The author is grateful to Dr Prakash Bakshi, Chairman, NABARD, for the interview and making information available for the report.
25. Calculated from data provided by NABARD.
26. Calculated from data provided by NABARD.
27. Data source: NABARD.
28. Calculated from data provided by NABARD.

Microfinance institutions—slow recovery from a disaster

3

Chapter

The year 2010–11 undoubtedly was the most problematic year for the MFIs so far. The vigorous growth recorded by MFIs in the first half of the year was negated by the developments in the early part of the second half. These adverse developments arising from the Andhra Pradesh event and the escalating consequences over the entire sector across the country pulled down the growth rate and, in fact, reduced several MFIs to a negative growth rate. As per provisional data made available by Sa-Dhan, MFIs achieved a client outreach of 31.4 million with a gross loan portfolio level of ₹207 billion. During 2009–10 MFIs had recorded 18 per cent growth rate in case of client outreach and 56 per cent in loan portfolio. In 2010–11 client outreach had grown at about the same rate of 17.6 per cent.[1] However, the growth rate in terms of loan outstanding had been modest at 13.1 per cent. As against 264 MFIs that reported information to Sa-Dhan last year, only 170 MFIs found the motivation to do so this year.

This reversal of the growth rates between clients and portfolio reflects the impact of the developments in the sector which squeezed out the liquidity on account of the higher risk perceptions of banks regarding MFIs.

Perhaps in keeping with the troubled times, MIX Market has not published its list of top 100 MFIs across the world for the year 2010 so far. Among the MFIs operating in India, the list of top 10 MFIs according to client outreach is provided in Table 3.2. While the list contains more or less the same entities that were there in the last year's list, there have been some changes inter se among them.

Bandhan which occupied the fourth place last year has moved up to the third place. Share dropped down by one place, whereas Asmita dropped down two places. Basix has entered the top five by becoming the fifth placed MFI in terms of customer outreach. The top 10 MFIs have a significant influence over the entire sector. The top 10 MFIs accounted

Table 3.1 Progress of MFIs[2]

	2009	2010	Growth rate (percentage)	2011	Growth rate (percentage)
No. of MFIs reporting	233	264	–	170	–
Customer outreach (million)	22.6	26.7	18.1	31.4	17.6
Outstanding loans (₹ billion)	117.34	183.44	56.7	207.56	13.1

Table 3.2 The top 10 MFIs by outreach[3] (₹ billion)

Name of MFI	Outreach (million)	Loan o/s	Own funds	Borrowings
SKS	6.24	41.11	17.81	22.36
Spandana	4.18	34.58	NA	11.95
Bandhan	3.25	25.07	3.77	18.48
Share	2.84	20.65	3.01	20.98
Basix	1.53	12.49	2.10	12.31
SKDRDP	1.38	9.58	0.25	8.71
Asmita	1.34	13.25	2.15	11.94
Equitas	1.30	7.94	3.04	5.92
Grama Vidial	0.93	5.20	0.90	3.47
Ujjivan	0.84	6.25	1.16	4.72
Total	**23.85**	**176.11**	**34.19**	**108.89**

for nearly 76 per cent of the outstanding loan portfolio and 76 per cent of the client outreach.[4] The overall borrowing levels of nine out of the top ten MFIs for which data was available, showed a decline by 5.5 per cent in 2011 compared to the previous year. Six out of the ten MFIs had increased borrowing during the year. SKS, Asmita and Grama Vidial had scaled down borrowings.

The top five MFIs as per the client outreach numbers are SKS, Spandana, Bandhan, Share and Basix.

Table 3.3 Comparative performance of top five MFIs

Name	Clients (million)		Growth (percentage)	Loans (₹ billion)		Growth (percentage)
	2010	2011		2010	2011	
SKS	5.80	6.24	8	29.7	41.1	38
Spandana	3.66	4.19	14	21.6	34.6	60
Bandhan	2.30	3.25	42	12.1	25.1	107
SHARE	2.36	2.84	20	17.2	20.6	20
BASIX	1.11	1.53	37	7.9	12.5	58

Bulk of the growth both in clients and in loan outstanding came from Bandhan which increased the clients by 42 per cent over the last year and the outstanding loans by 107 per cent over the last year. It is remarkable that Bandhan could grow at such a good pace in the midst of struggle for funds and survival by the rest of the sector. Bandhan was able to grow aggressively as it has been operating outside of Andhra Pradesh. The other four MFIs in the top five had significant exposure to Andhra Pradesh and suffered as a result. Basix also increased the client base by 37 per cent and the loan outstanding by 58 per cent. It seems that Basix posted good growth in the first half of the year. In the second half of the year, Basix, on account of its heavy concentration in Andhra Pradesh, struggled for funds and in fact indicated as late as in July 2011 that if fresh equity and loan funds do not flow in then they might become technically insolvent.[5]

The listing of top MFIs does not take in to account the ground reality that some of these MFIs with a portfolio concentration in Andhra Pradesh have accounts that are no more active. SKS, Spandana, Share and Basix have significant proportion of their portfolio outstanding in Andhra Pradesh which has become non-performing. MFIs have weathered the storm for the time being by treating loan instalments as overdue on the due dates if they are not repaid and also making incremental provisions based on the small percentage of loans that are falling in to NPA category. However, more than ₹7,000 crore worth of microfinance loans in Andhra Pradesh are effectively in default. The recoveries affected out of these loans are very low—around 10 per cent—which barely covers the operating cost and does not service even the interest on bank funds. Under such circumstances, calculation of number of active borrowers should be made net of clients who are in default (and who do not seem to be inclined to pay back their loans to MFIs). If the defaulting clients and the loan outstanding relating to such clients are removed from the overall arithmetic, the sector would show that there is a decline in business. It has not been possible to precisely quantify the numbers that are involved both in terms of client outreach as also loans outstanding in Andhra Pradesh.[6]

The average per capita outstanding loan size[7] declined marginally compared to last year from ₹6,870 to ₹6,610. The loan size is still small compared to the demand and a borrower might have to borrow from other sources to fully fund the purpose of loan, especially if it is for livelihood enterprises. With the stipulation that 75 per cent of loans should be given for livelihood activities, the average loan size has to be stepped up. While the nominal value of the loan is increasing, in real terms, after factoring the effect of inflation, the growth in size is modest. Between 2007 and 2011 the real increase in loan size was 41 per cent compared to the 91 per cent growth shown in nominal terms. MFIs have to take in to account the effect of inflation and ensure that loan sizes relate to real terms growth, as otherwise the borrowers will not be able to fund their investments in income generating assets.

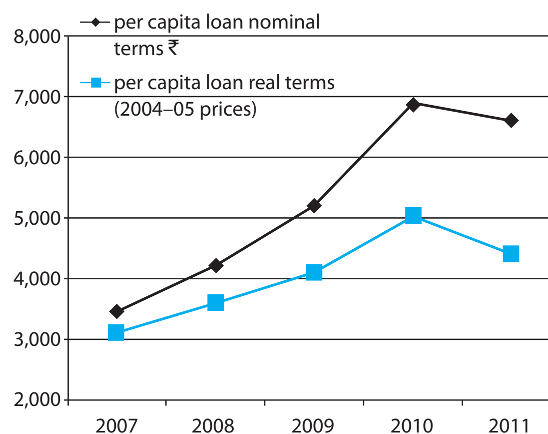

Figure 3.1 Average loan size—nominal and real values

An analysis of the growth rates in client outreach was made to understand whether the reported increase in the number of clients has taken place across all the MFIs. The data shows that out of 75 MFIs for which full information is available, 56 recorded an increase in the number of clients while 19 recorded a reduction in the same. Ten MFIs doubled or more than doubled their client base while 25 others increased the client base by more than 25 per cent. Three MFIs saw the client base eroding by 25 to 50 per cent. The market has not had the same destabilising impact on all MFIs; some managed to find ways and means of growth.

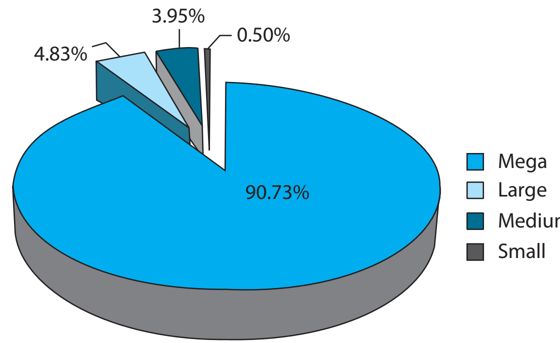

Figure 3.2 Client outreach by size of MFIs

Table 3.4 Growth in client outreach—a frequency distribution[8]

Growth range (percentage)	No. of MFIs
Increase	56
0–25	21
25–50	14
50–100	11
More than 100	10
Decrease	19
More than 50	0
25–50	3
1–25	16

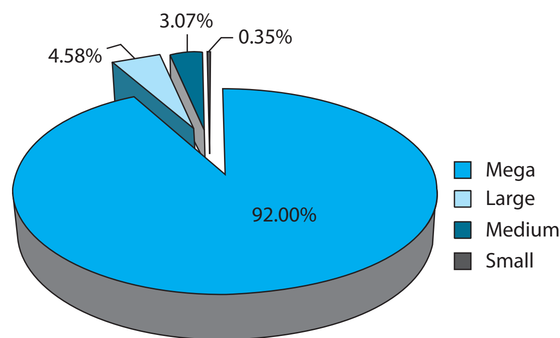

Figure 3.3 Share of loan values, size-wise

For the purpose of disaggregated analysis of comparative performance of MFIs, they have been divided into four classes on the basis of the size of loan portfolio. Based on this classification, the performance of MFIs have been analysed to understand whether MFIs in any specific size category did better than the others.

Out of 82 MFIs, 27 belong in the 'Mega' category, 15 in the 'Large' category, 26 in the 'Medium' category and 14 in the 'Small' category. The client outreach by the mega MFIs was highest at 91 per cent of all clients. The large MFIs accounted for 5 per cent of the clients and the medium ones accounted for the 4 per cent of the clients. The small MFIs had a negligible share of less than 1 per cent. In terms of loan volumes, the mega MFIs had a share of 92 per cent and the large MFIs had a share of 4.5 per cent.

MFIs were in different forms such as for profit companies, non-profit companies,[10] societies, cooperatives and trusts. The chart in Table 3.6 provides the segment-wise details of loan portfolio according to the form of organization. There were very few cooperatives in Mix Market database and one Local Area Bank.

Table 3.5 Classification of MFIs according to size of client base[9]

Size of portfolio	Class
More than ₹1,000 million	Mega
₹500 to 1,000 million	Large
₹100 to 500 million	Medium
Less than ₹100 million	Small

Table 3.6 Form-wise distribution of MFIs-loan portfolio

Form	No of MFIs	GLP (₹ billion)
NBFC	46	206.75
Society	19	7.94
Section 25	6	4.21
Trust	6	10.41
Cooperatives	4	1.75
Local Area Bank	1	0.88

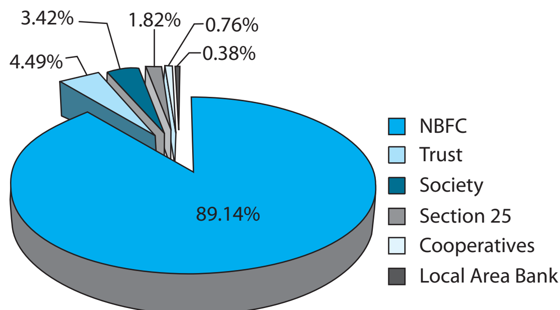

Figure 3.4 Market share of different forms of institutions by loan volume

It is seen that the for profit company form MFIs have been able to generate the largest share of clients as well as loan portfolios. The other forms of institutions had not been able to generate resources necessary for large-scale expansion. Managerial capacities, technology investments and low equity base that restrict leverage of loan funds are the typical problems faced by the other forms of institutions.

PROFITABILITY

Out of the 54 MFIs for which profitability data was available, 9 had a negative return on assets. While only 2 MFIs managed to post Return on Assets (ROA) in excess of 6 per cent, a large number (29 MFIs) generated ROA of between 0 and 2 per cent. In terms of return on equity, 12 MFIs had a negative return, while 2 MFIs posted Return on Equity (ROE) in excess of 50 per cent. Twenty-three MFIs had less than 10 per cent as ROE. Compared to last year, the ROA had declined across the sectors. Institutions have had to make provisions towards non-performing assets in their books in the latter half of the year. MFIs with significant exposure in Andhra Pradesh will have to make much higher provisions in 2011–12, which will dent their bottom line further.

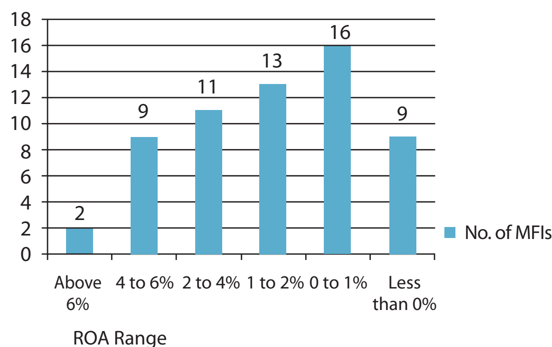

Figure 3.5 ROA range-wise distribution of MFIs

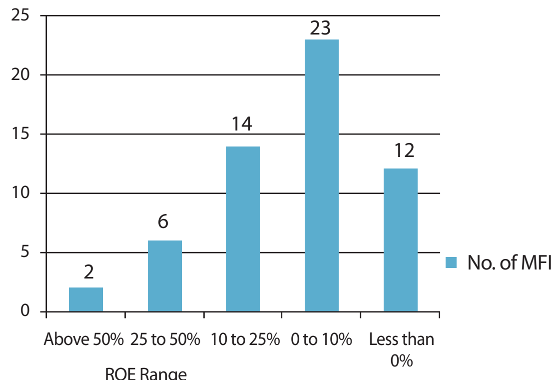

Figure 3.6 ROE range-wise distribution of MFIs

One of the recent stipulations issued by the RBI to NBFCs is that their rate of interest should not exceed 26 per cent on a declining balance and the interest margin should not exceed 12 per cent. The MFIs have been permitted to charge a service charge not exceeding 1 per cent and no other charges have been permitted. The RBI has also advised that security deposits and compulsory savings of any kind should not be collected by the MFIs. These measures have been introduced to ensure customer protection from exploitative high price loans. These measures would impact the profitability of MFIs, especially those which work in remote areas with high cost of operations and also with very small borrowers having small average loan requirements. The MFIs that serve remote locations and very small borrowers would find the going tough on account of interest rate caps. These caps would tend to make the larger MFIs scale down their operations in sparsely populated areas so as to protect their profitability. An analysis of the rates of interest (in the form of yield on loan portfolio) was carried out. (*The yield data pertained to 2010–11 when the RBI stipulation had not been issued. The analysis does not measure compliance, but the extent of adjustments required by MFIs to comply*). It showed that 38 MFIs had yield of 28 per cent or less indicating that these are in a position to readily comply with RBI regulations.[11] The remaining 32 MFIs in the database had yields ranging from 28 to 50 per cent, indicating that they were going to find it difficult to comply with the RBI norms.

It is seen that MFIs that are more than 10 years of age are able to operate even with lower yields of less than 25 per cent, but a majority of MFIs of age between 5 to 10 years and almost all the MFIs in the age range of less than 5 years had yields above 25 per cent, reflecting that in the earlier stages of their growth they need higher yields and interest margin.

Table 3.7 Size of institutions and yield on portfolio

Size of MFI	No. of MFIs with 25 per cent or more yield	No. of MFIs with 10–25 per cent yield	No. of MFIs with 10 per cent or less yield
Mega	16	5	1
Large	7	6	0
Medium	8	10	0
Small	5	1	1
Total	36	22	2

Malegam Committee worked out cost norms based on certain assumptions and came out with an operating cost of 9 per cent and on that premise argued that an interest rate of 22 per cent is a viable one for MFIs. This was based on the assumption of 12 per cent as cost of borrowings. The Committee suggested an interest rate cap of 24 per cent and margin caps of 10 per cent and 12 per cent for large and small MFIs, respectively. Operating costs do not apply across all institutions evenly. The cost differs according to the model of microfinance, size of groups, products offered, repayment intervals, technology adopted and most importantly the average size of loans. The cost of borrowing has already touched 15 per cent on recent loans to MFIs, far removed from the assumed 12 per cent. While a floating margin cap might be useful in short run, absolute interest rate caps are counterproductive. In a low interest rate regime the caps are irrelevant and, in a tight money situation like the one that exists in recent months, the cap will lead to unviability of institutions and contraction of business. Even the higher interest rate cap of 26 per cent imposed by RBI along with the margin cap of 12 per cent has become unsustainable. With borrowing costs climbing to 15 per cent with a margin of 12 per cent, the MFIs should be able to charge 27 per cent but are limited by the 26 per cent cap which will erode profitability. While the objectives of customer protection is achieved, banks that lend to MFIs run the risk of their customer MFIs becoming weak.

SIDBI has commissioned a study of costs and returns in 30 MFIs recently. The study revealed that the large MFIs (Tier I) had a lower operating cost and funding cost profile which is not surprising. The medium MFIs (Tier II) had the highest operating costs which is surprising. The small players (Tier III) had a lower cost of operation than the medium MFIs on account of grants and donations.

Table 3.8 Comparison of costs of MFIs[12]

Particulars	Tier I	Tier II	Tier III
Operating costs	10.00%	15.00%	14.00%
Financial expenses	9.00%	11.00%	8.00%
Provisioning costs	2.00%	2.00%	2.00%

TRANSPARENT APR

Microfinance Transparency, an international nonprofit organization, had collected and collated information on prices paid by customers on loans of MFIs. The sector collaborated voluntarily in this effort. While the initial data submission has been diligent and prompt, there seems to be a failure in MFIs keeping the data current. Information available on the website of Microfinance Transparency shows that only 22 MFIs are likely to be compliant with the RBI stipulation of 26 per cent interest and 1 per cent service charge[13] (the list is in Annex 3.2) on their most significant loan product. Microfinance Institutions Network (MFIN) avers that all its 42 members are compliant with the regulatory prescription on interest rates. Eventually when the interest rate cap is expressed in Annualized Percentage Rate (APR) terms as proposed in the microfinance bill, MFIs may have to carry out one more round of adjustments. Only 83 MFIs are members to this platform out of a possible 300. Microfinance Transparency should undertake another round of awareness building, marketing and ensure that MFIs are current in terms of periodic submission of data.

REGIONAL DISTRIBUTION

While overall growth has been recorded, interstate variations exist, with some states recording a negative growth. During 2010–11, 16 states had a positive growth rate and 11 states had a negative growth rate in client outreach. Loan portfolio declined in 10 states, while in 17 states the protfolios recorded a positive growth. Client outreach recorded the highest growth in Uttar Pradesh (1.6 million), Gujarat (1.53 million) and Manipur (0.8 million). The steepest declines in outreach were seen in Orissa

(0.65 million), Andhra Pradesh (0.5 million) and Tamil Nadu (0.31 million). Gujarat had the highest growth in protfolio at ₹10.8 billion followed by Uttar Pradesh at ₹6.3 billion and Manipur at ₹6.24 billion. The decline in portfolio was pronounced in Orissa at ₹4.25 billion, followed by Tamil Nadu at ₹2.7 billion and Delhi at 2.19 billion. The surprise is the performance of Manipur in posting high growth in terms of customer acquisition and loan portfolio. The fall in client numbers in Andhra Pradesh will intensify next year, as the current year's client number contains the defaulted accounts as well. The growth of business in the north-east and central regions is a good sign of widening of the sector. The next year is likely to witness more of such expansion to uncovered areas.

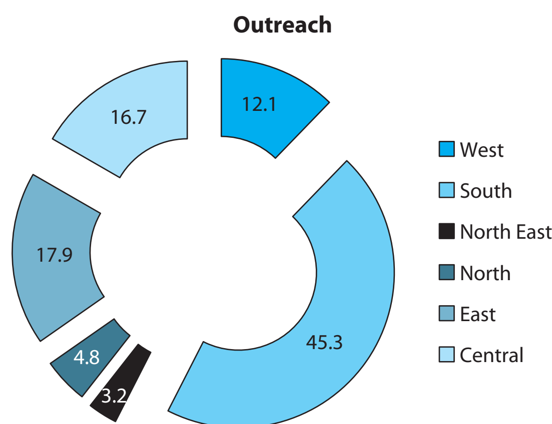

Figure 3.7 Regional shares in client outreach

The regional shares in client outreach reveal that south is the unsurprising leader. With higher average loans per capita, the southern region had a more-than-proportionate share of loan portfolio when compared with the client shares. The north-eastern region also had a significantly higher proportion of loans compared to their share of clients.

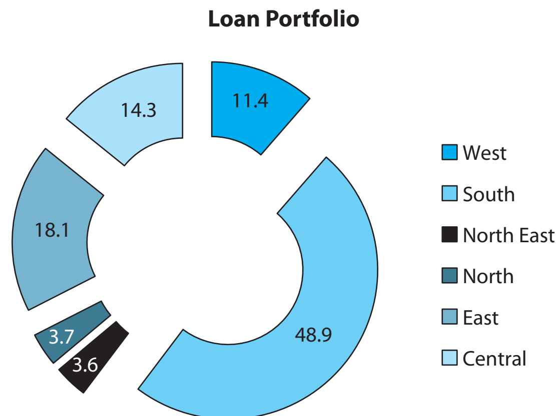

Figure 3.8 Regional shares in portfolio

The southern region has lost considerable share in the market compared to last year. The eastern region has also lost share on account of the declining business level in Orissa. The north-eastern region doubled its share of loans. The central region has impressively increased its share of clients and loans. The geographic distribution thus tended to shift the balance away from the south. The heavy concentration in the southern region, and especially in Andhra Pradesh, was the cause of the problems faced by the sector during the year. The intensity of operations of MFIs in the state and the impact of multiple lending to customers in the state are clearly evident from the table. The concentration has turned somewhat moderate on account of incremental business being negligible in the latter half of the year.

CMF, Chennai,[14] carried out a follow up survey on Access to Finance in two districts covering 420 families in Cuddapah and Visakhapatnam in Andhra Pradesh. The study reveals that the percentage of rural Andhra Pradesh households indebted to MFIs declined from 9 per cent in 2009 to 5 per cent in 2011. The percentage of households indebted to

Table 3.9 **Comparison of market share of different regions**

Region	Share of clients 2009–10 (percentage)	Share of clients 2010–11 (percentage)	Share of loans 2009–10 (percentage)	Share of loans 2010–11 (percentage)
North	2.1	4.8	4.3	3.7
North East	1.9	3.2	1.8	3.6
East	21.3	17.9	22.5	18.1
Central	9.5	16.7	9.9	14.3
West	14.2	12.1	6.8	11.4
South	51.1	45.3	54.8	48.9

SHGs increased from 65 to 67 per cent. The biggest change was in the reduction of the proportion of households indebted to informal lenders; it declined from 83 to 67 per cent. In terms of amount of loan outstanding, MFIs had a share of 1 per cent in 2011 which was the same as that prevailing in 2009. The significant changes in the profile of loan amounts outstanding were in the reduction of debt from informal sources from 76 to 49 per cent and an increase in loans from banks from 15 to 40 per cent during the same period. However, the significant increase in bank loans is on account of the data from Cuddapah district where the Andhra Pragathi Grameena Bank (APGB) had taken significant steps to increase its portfolio. The average loan outstanding per household declined from ₹68,000 in 2009 to ₹54,800 in 2011. This decrease which is about 20 per cent is a direct fallout of the curtailment of MFIs' operations in the state. On the one hand, one could legitimately claim that excessive debt, especially from informal sources, has declined significantly which should improve the welfare of the borrowers. However, the problem to be examined is whether the decline in availability of loans from different sources is hampering the livelihoods and livelihood activities of people who had possibly based their plans on continued availability of these loan sources. Whether the stoppage of resources from a significant set of players is causing distress among the rural households is a question to be analysed. There is some evidence from a survey carried out by CMF that rural households are finding it difficult to raise money to meet different expenditures for consumption, enterprises, health, income generating activities and education.

Microfinance institutions no longer enjoy the preferred customer status among the banking system nor do most of them exhibit any symptoms of being able to attract significant equity funding. The liquidity constraints have forced many MFIs to (*a*) scale back their expansion plans, (*b*) close down some of the unviable branches (especially in the state of Andhra Pradesh) and (c) have a reappraisal of their overall strategic plan for the near future. There are other issues that continue to have an impact on the business of the MFIs. The interest rate cap and the cap on margins announced by the RBI in May 2011 will exert pressure on the MFIs and make it difficult for them to expand to remote and sparsely populated areas. In fact, in such areas even the existing operations may be scaled down. Similarly, small loans that carry very high operating cost would not be in favour with MFIs on account of the margin cap of 12 per cent that has been imposed. While in 2010–11, the stringent regulation imposed by Andhra Pradesh had an impact across the country on the growth rates of MFIs in 2011–12, the need to comply with regulation and retooling that is required in order to reframe the business model and operational processes is likely to moderate the growth rates.

To understand the impact of the Andhra Pradesh events and also the subsequent introduction of regulations on NBFC MFIs by RBI, a survey was carried out by the Micro Finance Researchers' Alliance Programme (MRAP) facilitated by CMF–IFMR.[15] A table summarising the survey results is provided as Annex 3.1. The survey covered 7 states and 32 MFIs comprising a wide variety of form and size. The survey results indicate that significant impact has been caused among the MFIs post the Andhra Pradesh events. In case of the 15 NBFCs that were surveyed, 8 reduced their interest rates in order to be complying with the new rates announced by RBI. Three retained their earlier interest rates while three others actually increased the rates of interest. Twelve MFIs felt that the regulations and the Malegam Committee report were positive while two of them felt it to be negative. Nine MFIs reported that the 26 per cent interest rate cap will adversely affect their profitability. Twelve MFIs felt that the margin cap of 12 per cent will be unsustainable. Despite all the problems of the year, 8 out of 15 NBFCs reported that they could access fresh funding after October 2010. In terms of impact on business, 6 NBFCs reported closing down branches and 5 of them had laid off staff. Seven NBFCs reported that they had scaled down their operations and had withdrawn from certain locations where they were operating prior to October 2010. As for strategies, the MFIs said that they had to rethink how they will do future business. They indicated that moving out of Andhra Pradesh, foray into individual loans, increasing focus on the client, introduction of bi-weekly and monthly instalments in the place of weekly instalments for loans, targeting fee-based income and improving the client acquisition processes as some of the strategies that they are adopting in order to cope with the changes in the regulatory and operating environments. Out of the 15 NBFCs, 8 did not offer any flexibility to the customer in repayment of loans. Seven of them felt that if the customers are given choice of how they would like to fix their repayment instalments, it will affect their business models. Ten MFIs planned to inform clients about the choices as indicated in RBI regulations while three did not have any such plans.

Seventeen NGO MFIs were also surveyed as part of the study. Ten of these had retained their original interest rates and 4 actually raised the rates as the interest rate cap provided adequate headroom. Only two reported reducing interest rates in order to comply with the RBIs requirements. All the 17 MFIs had said that the 26 per cent interest rate cap will not affect their business but 11 of them felt that the 12 per cent margin cap will adversely affect them. Only four of the NGO MFIs felt that the margin cap could pose a problem for their sustainability. Ten out of 17 NGOs had reported that they were able to find fresh funding after October 2010 though most of these were not from mainstream banks. Five reported having withdrawn from some locations and scaling down their operations. Seven had to change their business strategies.

The survey brings out that across the country the Andhra Pradesh events as also the RBI regulation have had an impact. While in general the attitude of the MFIs whether for profit or not for profit has been positive towards RBI regulation, they have continuing problems of managing profitability and sustainability with the given margin cap of 12 per cent. The cap also had the unintended effect of some MFIs hiking their interest rates. The fact that the Andhra Pradesh events had forced some of these MFIs to either scale down their business operations or withdraw from existing locations where they were carrying on business is a reflection on how regulation could adversely impact services to customers. The problems were not confined only to the for-profit NBFCs but also to the NGO forms. What is clear is that the business strategies have to be reengineered in order to ensure that MFIs are able to cope with the changed regulatory environment.

The regulatory norms of RBI announced in May has necessitated changes in customer acquisition processes, product design, recovery methods and pricing of loans. In customer acquisition, MFIs have to ensure that only low-income households are served and also that they do not have more than two loans from any MFIs at the time of giving a loan. The debt burden of the borrower has also to be within the repaying capacity. The ongoing work on setting up a credit bureau came in handy for the MFIs. Highmark, CIBIL and Equifax are some who offer credit reference services to MFIs. Highmark, the first mover in the MFI market, reports that it has 45 MFI subscribers. It has captured 55 million loan records from 30 million customers. It has completed 12 million inquiries in the last five months. The prevalence of multiple borrowing is about 25 per cent, but Highmark estimates that it is likely to be around 45 to 50 per cent once the data, presently not on the database, is extrapolated. The bureau is set to serve the MFIs not only in identifying multiple lending, but in overall risk mitigation as well.

Box 3.1 Credit reference reports—quality issues

PROBLEMS IN CREDIT REFERENCE—RESPONSE FROM HIGHMARK[16]

How good is the data quality and how do you ensure the accuracy of the report?

Data quality is acceptable but insufficient in information to uniquely identify borrowers—for instance, only about 40 per cent of all records have a spouse name. Data quality can be significantly improved through a simple one-time effort, leveraging MFIs' close and frequent contact with their customer to enhance data with spouse name, father's name, etc.

How will you deal with the fact that SHG loans are not part of your database?

Information from SHG lending and lending from informal sectors is missing from our database. Information regarding MFI borrowings is accurate and that should be of considerable value to both regulators and MFIs. It is also possible to apply an allowance for likely SHG borrowing and still the bureau can predict of overall indebtedness. Such extrapolation will imply that those who's SHG borrowings are below average or non-existent would get needlessly penalized—so such means of extrapolation, if at all used at a policy level, must be used with caution.

Do you face difficulties in getting information from member MFIs?

NBFC MFIs appear to be quite advanced in electronic information collection and recording. In our experience the majority of MFIs have had little trouble sharing data with us. There remain a few MFIs in the for-profit segment that are not well equipped with IT to share and use bureau data, but these too are in a process of transformation. A more serious problem is rural internet connectivity, which poses latency issues with regard to both data submission and usage. The most significant impact is felt at the branch level in their inability to directly connect to a bureau.

QUALITY OF GROWTH

Growth had been muted and cautious in MFIs. After a hectic first half, MFIs turned attention inwards on their processes and improving governance, compliance with code of conduct and fair practices. Several MFIs announced reduction in interest rates, some before the RBI regulations came in and many after the RBI regulations stipulated interest and margin caps. The products have now to comply with stipulations relating to size, repayment period and interest rates. With customer having the choice of repayment installments, MFIs have to make their systems and MIS flexible. Compliance with RBI guidance has to be certified in certain aspects by chartered accountants for which MFIs will have to introduce verification systems. Verification of borrower income levels and number of loans taken by the borrower is a tough requirement that MFIs have to fulfil. Use of tools such as Progress out of Poverty Index (PPI) can help MFIs identify the poverty status of the borrowers and also track their progress over the different loan cycles.

In the field, problems relating to multiple lending and customer resistance were noticed in certain locations. Influenced by the Andhra Pradesh events, customer pressure groups tried to escape their repayment obligations in a variety of ways, including filing Public Interest Litigations (PILs). With closer scrutiny, MFIs became more conscious of multiple borrowing and ghost loans, especially in urban and semi-urban locations. The backlash from the centre leader arrangements was visible during the year. The Centre leaders (commonly known as ring leaders in the sector on account of the unsavoury role played by some of them) were behind most of the organized resistance and recourse to political pressure. The pressure from bulk lenders and regulators led to MFIs introducing complaint handling systems, loan reschedulement arrangements and guidelines to staff on acceptable behaviour in the field. The quality and extent of information provided to customers has increased. Most MFIs provide contact telephone numbers in the passbooks issued to the customers. Some have introduced toll-free calling facility to reduce customer costs.

MicroSave's survey in Andhra Pradesh analyzed the reasons customers liked or disliked borrowing from MFIs. The top three reasons for liking MFIs were timeliness of loans, convenient instalments and low interest rates. The three strong reasons for disliking MFIs were group liability, inflexibility in repayment of instalments and lack of transparency in pricing of loans.

MFIs continued to make progress on governance. The reporting of data to Microfinance Transparency,

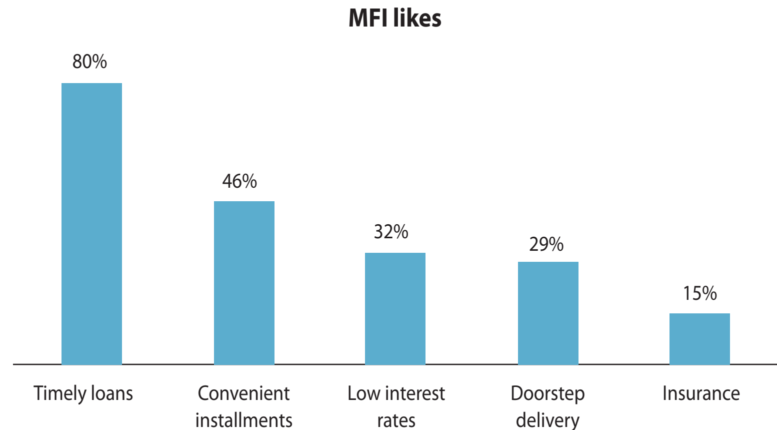

Figure 3.9 Why customers like MFIs

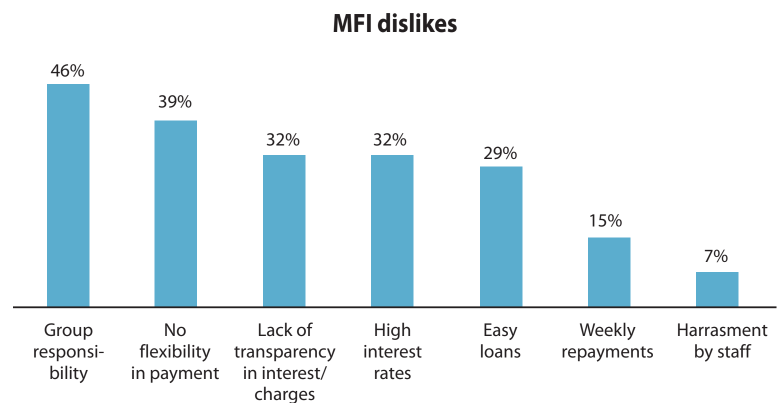

Figure 3.10 Why customers do not like MFIs

induction of independent directors, formation of audit committees, external assessments of governance quality and SIDBI-commissioned assessments of code of conduct compliance have all strengthened the governance processes. Still there is some way to go in governance for several MFIs. Promoters in some of these institutions look after neither shareholder interests nor that of customers. Some of the MFIs that have Mutual Benefit Trusts (MBTs) of customers as shareholders carry problems that emanated from the inappropriate manner of structuring of the MBTs which are bound to implode in due course. MFIs found it difficult to attract persons with the right credentials as independent directors. The eroding image of the MFIs and the stringent personal penalties on directors of MFIs imposed by law compounded the problems. Continued progress on several aspects of MFIs operations will be made with both RBI and bulk lenders driving the institutions towards desirable practices. A note of caution is that while the improvements in field practices and governance

are absolutely necessary, these also entail high costs in the short to medium term. The small and medium MFIs will benefit from one-time funding support and will be in a position accelerate the pace of revamp of their systems to conform to customer expectations and regulatory requirements. RBS Foundation had been supporting small MFIs with growth potential through a comprehensive capacity building programme which was implemented by MicroSave. The programme covering 42 MFIs over a three-year period entailed handholding support from MicroSave over a period of 18 months to each partner MFI. The programme was evaluated on completion and it was found to have significantly helped the MFIs to design their business strategies and set about implementing the same through improved processes, refined products and qualitative systems and controls. The full benefits of the capacity and competence improvements could not be realized on account of liquidity constraints that stalled expansion plans.

There are examples of MFIs continuing to progress in the midst of an unsettled market environment. The coping behaviours to respond to the crisis have ranged from shutting down operations, scaling down business, diversification into other businesses (such as gold loans, SME finance, vehicle finance, etc.) to merger and consolidation. Some small institutions reported significant initiatives in alternative approaches to microfinance. Rang De,[17] a web-based lender (Kiva type MF platform) that brings together individual retail lenders and individual retail borrowers, made progress. While its scale of operations is small it has been able to demonstrate a low cost to the customer model of microfinance. Its limitation would be that of building volumes on the back of scarce socially oriented venture capital. Another institution of the same type, Milaap, was set up in August 2010. Milaap has the aim of providing credit access to 2 million customers by 2015 and has the incubation support of Unltd India.[18]

Swarna Pragati Housing Microfinance,[19] a start up, has designed an innovative loan product that is customer-friendly. It is leveraging the grassroots community institutions to come up with a simple, flexible, cost-effective and fault-proof mechanisms for administration of housing finance. The company's model has made housing finance accessible for the marginalized sections. The housing loans are provided both for fresh construction and for renovation/repairs/upgrade of existing houses. Five unique features of the company's model which make it a pioneer in rural housing finance are:

1. A component for income-generating activities so that the borrowers can generate income for repaying the loans.
2. The concept of modular or incremental housing where a house is divided into numerous components, viz., roof, flooring, kitchen, toilet, well, work

Box 3.2 Web-based microfinance

Rang De is India's first online micro-lending platform. The web-based social initiative supports rural entrepreneurs with access to cost effective capital for business and education needs. Rang De raises social capital from individuals who can become social investors by lending as little as ₹100. Through this fundraising model, Rang De is able to reduce the cost of capital to the end user (details in Table 3.10) . Social investors get back their investments with a nominal financial return of 2 per cent flat *per annum*. They have the ability to track the progress of their investments and interact with the borrowers in whom they have invested. Rang De has reached out to more than 10,127 borrowers across India with the help of 2,906 social investors. The organization has raised and disbursed more than ₹5 crore to borrowers and has a repayment rate of 98.56 per cent. Rang De is present in the following states: Orissa, West Bengal, Manipur, Madhya Pradesh, Maharashtra, Karnataka, Tamil Nadu, Kerala, Jharkhand, Bihar and Gujarat. Rang De works with 25 field partners across these states.

Table 3.10 Rang De's interest pricing

Loan product	Field partner	Rang De	Social investor	Contingency	Total (flat)	Total (APR)*
Business	5.00%	1.00%	2.00%	0.50%	8.50%	15.33%
Education	4.00%	1.00%	–	–	5.00%	9.02%
Micro-venture	3.00%	2.00%	4.00%	1.00%	10.00%	17.97%

Note: *APR interest rates are calculated on a monthly repayment schedule.

shed, etc., and financing is done for one or more modules at a time keeping in view the psychology of seeking short-term loans with affordable repayment instalments (i.e., EMIs).
3. Worksheds, wells for water supply, toilets and renewable energy sources form an integral part of the product offering.
4. SHGs and JLGs are used as the delivery models.
5. The company uses paralegal titles to overcome the problem of lack of formal titles which is endemic in low-income groups. Under the Swarna Pragati model, low-income families build their houses one step at a time in a process known as *incremental or progressive build.* They add water and sanitation facilities to a basic house, improve roofing and gradually add new rooms. This incremental build concept is in the design of housing microfinance products. Loan amounts average ₹25,000 to ₹100,000 with average loan terms of 36–42 months.

Innovations seem to be the way forward both in products and customer acquisition strategies. After a protracted period of despondency for more than nine months, in the recent past there have been some reasons for hope. The gradual easing of liquidity situation, affirmation by banks to provide funds, action on code of conduct, RBIs regulatory framework for NBFC MFIs, conclusion of debt restructuring and the centre's move on microfinance regulation are some indications of movement forward. But it is not to conclude that all MFIs would find support or that the terminally sick MFIs would be revived. The sound and fit MFIs can look forward to reasonable support. For others, mergers and portfolio sale seem to be the way out. The future trends seem to be towards consolidation and transformation leading to cautious growth. But it would be a respite from the mindless growth sans customer focus that we had seen in the past.

ANNEX 3.1
Survey of MFIs—coping with crisis and new regulations[20]

		NBFCs	NGO-MFIs[21]
Total Number MFIs interviewed		15	17
MFI's views towards Malegam Committee's recommendations and RBI regulations			
Do you see the Malegam Committee recommendations as a positive approach towards the microfinance sector?	Yes	53% (8)	59% (10)
	No	13% (2)	6% (1)
	Neutral	33% (5)	35% (6)
Did your institution change the business strategy to fit into those recommendations?	Yes	53% (8)	18% (3)
	No	40% (6)	71% (12)
	No Answer	7 % (1)	12% (2)
Have any of the following steps been taken after the Malegam Committee recommendations came out?			
Closing down MFI branches		40% (6)	6% (1)
Staff lay off		27% (4)	6% (1)
Enrolling as many clients before March 2011		7% (1)	6% (1)
Waited for RBI Regulations		53% (8)	41% (7)
What kind of approach do you think the RBI has towards the microfinance sector?	Positive	87% (13)	59% (10)
	Negative	7% (1)	0% (0)
	Neutral	7% (1)	41% (7)
Will there be any change in business strategy in the near future to fit into RBI regulations?	Yes	67% (10)	35% (6)
	No	26% (4)	47% (8)
	No Answer	7% (1)	18% (3)

(Continued)

(Continued)

		NBFCs	NGO-MFIs[21]
Clients' choice of payment: RBI has stated that borrower should have choice of repayment.			
Does your institution have any flexibility in loan repayment?	Yes	33% (5)	53% (9)
	No	60% (9)	41% (7)
	No Answer	7% (1)	6% (1)
If your institution allows borrowers to have a choice of repayment, will it affect your current business model?	Yes	40% (6)	59% (10)
	No	40% (6)	12% (2)
	No Answer	20% (3)	29% (5)
Are you planning to inform borrowers about available choices of loan repayment?	Yes	60% (9)	53% (9)
	No	13% (2)	18% (3)
	No Answer	27% (4)	29% (5)
Loans for income-generating purpose: 75 per cent should go for income generating purpose			
How are you planning to address this?			
Getting a declaration in the loan agreement		67% (10)	47% (8)
Adopt appraisal system to understand the end-use of loan money		46% (7)	18% (3)
Asking clients' business plan before loan disbursement		40% (6)	35% (6)
Set up monitoring mechanisms to understand clients' business unit		27% (4)	41% (7)
Annual income of clients: Not exceeding ₹60,000 in rural and ₹120,000 in urban areas			
Go for a baseline survey in the areas of potential clients		20% (3)	24% (4)
Collect household annual income data from authentic sources (such as panchayat)		27% (4)	12% (2)
Collect a declaration letter from the clients stating their household income levels		53% (8)	29% (5)
Rely on clients' word without any declaration letters		27% (4)	18% (3)
Borrowers indebtedness: Not exceeding ₹50,000			
Do you think that the borrower can easily misstate their debt details?	Yes	47% (7)	53% (9)
	No	47% (7)	24% (4)
	No Answer	6% (1)	24% (4)
Funding scenario			
Any funding from any major source after October 2010? (data includes loans sanctioned before October 2010 and disbursed later)	Yes	53% (8)	59% (10)
	No	47% (7)	35% (6)
	No Answer		6% (1)
Are you optimistic that the funding scenario will improve after the recent RBI regulations?	Yes	53% (8)	65% (11)
	No	13% (2)	6% (1)
	Uncertain	33% (5)	29% (5)
In your opinion, how do you think the Venture Capitalist will act after the recent development in the sector?	positive	13% (2)	0% (0)
	Normal	20% (3)	24% (4)
	negative	60% (9)	35% (6)
Business sustainability			
Will 26 per cent cap in interest rate affect your institution?	Yes	60% (9)	0% (0)
	No	27% (4)	94% (16)
	Uncertain	13% (2)	6% (1)
Do you think the 12 per cent margin cap that the RBI has recommended is a reasonable margin to sustain your business?	Yes	27% (4)	65% (11)
	No	67% (10)	18% (3)
Will the new interest cap under priority sector lending affect your future business plan in terms of expansion into new areas?	Yes	40% (6)	35% (6)

ANNEX 3.2
Compliance with RBI caps—in APR terms[22]

Name of MFI	Product	APR India (Min.)	APR India (Max.)
SPYM	Income-generation Loan	17.10%	18.60%
Bandhan	Suchana Loan (Micro-loan) Type 1	21.30%	27.10%
Credible	Income Generation Activities	23.60%	24.20%
Share	Joint Laibility Group Loan (JLG Loan)	23.80%	30.00%
VFS	Pragati	24.90%	
BSFL	Samruddhi Micro Enterprise (NFS) Loans	25.10%	25.40%
Arohan	Saral Product- WB	25.50%	27.00%
Nano	AP-JLGD21T12ME	25.70%	
Cashpor	Income Generating Loan	25.80%	26.00%
Equitas	Primary Loans	25.90%	26.00%
Mahashakti	Small Business Loan	26.10%	28.90%
Saadhana	General Loan	26.20%	27.70%
L & T Finance	Gram Bandhu	26.70%	27.10%
Belstar	Micro-enterprise Loan	26.80%	30.20%
SKS	Income-generating Loan	26.80%	31.50%
Svasti	Pragati Group Loan	27.20%	28.10%
Ujjivan	Business Loan	27.20%	
Spandana	Abhilasha	27.70%	28.50%
FFSL	Monthly Loan	27.90%	27.90%
Asirvad	Income Generation Program Loan	28.30%	36.20%
Grameen Koota	General Loan	28.40%	29.40%
Chaitanya	BUSINESS LOAN JK 01	28.60%	28.70%

NOTES AND REFERENCES

1. While Sa-Dhan data has been used for overall numbers as was done last year, the analysis of performance of MFIs has been facilitated by the data provided by Mix. Sa-Dhan faced significant difficulties in data collection in a tough year for the sector; data reporting perhaps was the last priority for MFIs.
2. Data from 'Bharat Microfinance: A Quick Review 2009, 2010 and 2011', by Sa-Dhan.
3. Data provided by MIX Market.
4. The base for this analysis is MIX Market data which provided individual MFI data for 83 MFIs.
5. Equity and loan funders had rushed to promise and provide resources to Basix, which seems to be in a stronger footing now.
6. A separate chapter on Andhra Pradesh events has been carried in a latter part of the report.
7. The analysis is based on Sa-Dhan data which is available for all the years.
8. Calculated from data made available by MIX Market.
9. The classification of MFIs according to size differs from that of last year. In the previous years there were three classes: (*a*) Large, with portfolio exceeding ₹500 million; (*b*) Medium, with portfolio between ₹50 and 500 million; and (*c*) Small, with portfolio less than ₹50 million. Since many MFIs have gone far beyond the lower threshold of the Large category, in the current year a reclassification has been done.
10. The non-profit companies are also referred to as Section 25 companies; this refers to Section 25 of *Indian Companies Act* that facilitates the setting up of not-for-profit companies.
11. RBI has stipulated 26 per cent interest and 1 per cent service charge as the maximum permissible. Since service charge is a flat rate fee that ignores declining loan balance, the yield could be closer to 28 per cent and the MFIs would be compliant with RBI caps.
12. Interest Rate Study commissioned by SIDBI (through Access, assisted by Girija Srinivasan and Radhika Aghashe, 2011). Cited from: Sushil Munot, *SIDBI's Role in Financing and Development of Microfinance in India*.
13. An interest of 26 per cent on declining basis charge and 1 per cent service charge on a year-long weekly installment loan is equivalent to APR of 28.07 per cent.
14. Centre for Microfinance (IFMR), Chennai, carried out this study as a sequel to the A2F Andhra Pradesh study in 2009, excerpts from which were covered in *Microfinance India: State of the Sector Report 2010*.
15. MRAP is an intervention of CMF-IFMR to improve research and studies in microfinance through strengthening individual researchers and institutions. This survey was specifically taken up for the purpose of SOS 2011. The researchers engaged in this survey are Deepti K.C., Dr Debashis Acharya, Shailendra Bisht, Dr Indrani Roy Chowdhury, Dr Veerashekarappa and Dr Amita Dharmadhikary-Yadwadkar.
16. Siddarth Das of Highmark responded to email queries on the subject.
17. Rang De was featured in the SOS 2009 as it was commencing operations. This is intended as an update of alternative models of delivery. (For more information, see www.rangde.org)
18. UnLtd India is a social enterprise incubator that provides mentoring and funding support to innovative start-ups that aim at social impact.
19. Swarna Pragati Housing Microfinance is a Delhi-based start-up. (For more information, see www.swarnapragatihousing.com)
20. The researchers engaged in this survey were Deepti K.C., Dr Debashis Acharya, Shailendra Bisht, Dr Indrani Roy Chowdhury, Dr Veerashekarappa and Dr Amita Dharmadhikary-Yadwadkar, as part of MRAP initiative of CMF, Chennai.
21. NGO-MFIs include Society, Trust, Section 25 and Cooperatives.
22. The data is extracted from Microfinance Transparency. The rates indicated are for the dominant product in the loan portfolio, as reported by MFIs to MFT.

Andhra Pradesh—dream turns nightmare

4
Chapter

The state of Andhra Pradesh in several ways can be described as the microfinance capital of India. It accounted for more than 30 per cent of all borrower accounts and the outstanding loan portfolio in case of MFIs. In the case of SHG linkage programme, the state had 25 per cent of groups linked and 39 per cent of loans outstanding as at end of March 2010.[1] The state-run programme Indira Kranti Patham (IKP)[2] had successfully linked more than a million SHGs in the state. In their worst nightmares the promoters of MFIs would not have predicted the problems that unfolded for the sector in October 2010. To say that the MFIs were caught by surprise would be an understatement. The impression one gains is that the state government has also been surprised at the unfolding consequences. But the Andhra Pradesh crisis did not come without a warning. Warning signals had been plenty and attracted the attention of everyone else, but the institutions concerned. After the problems of Krishna district in 2006,[3] MFIs were already on notice to the risk potentials of highly concentrated lending in competitive markets; that too in a state where the government had a strong feel for customer protection and the experience of forcefully dealing with the same. The state government had in fact constituted district wise committees[4] earlier in the year to monitor the activities and operations of microfinance institutions and to investigate complaints and grievances from the customers. The microfinance institutions operating in the state ignored these moves by the government as of little consequence and pretended that they were beyond the jurisdiction of such committees.

On the part of MFIs the current situation is substantially of their making. Vigorous growth rates did not make the MFIs rethink their business strategies especially with regard to pricing of loans, the processes of lending/recovery and issues in customer protection. Some did not heed good advice both from within and outside. Multiple lending and associated problems faced in Guntur in Andhra Pradesh and Kolar in Karnataka[5] were not seriously internalized. High interest rates even in the face of declining operating costs and the resultant high return on assets have been criticized in this report over the last two years. The proposition that high growth rates and accelerated expansion of outreach require high profitability has been questioned. The need for patience in recovering investments and the nature of equity (patient capital) that would best fit institutions in the sector have been time and again debated. Regardless of the ability of customers to pay high interest rates, the underlying political economy issues of doing business with vulnerable customers have been consistently ignored by some MFIs. Even with the code of conduct in place from two networks, deviant behaviour was in evidence. While suicides might not be related to loans at all (and not MFI loans either), by the kind of market behaviour exhibited by some MFIs, the sector added grist to the cynics' mill.

The competition among MFIs assumed unhealthy hue with many institutions actively chasing the same set of customers several times. The overall numbers (number of members in borrowing SHGs and customers of MFIs) in Andhra Pradesh as at the end of March 2010 revealed that the number of loan accounts per poor household was more than 10.[6] This average did not take into account the several households that still did not get served either by banks or MFIs. If the averages could be worked out for only those households that had gained access to a bank or MFI, the number of loans would be higher and truly alarming. The average outstanding loan per poor household computed from the total

outstanding loans of SHGs with banks and customers with MFIs was more than ₹67,000 in March 2010 and this had increased to ₹71,000 by March 2011. At this level the loan burden possibly become unaffordable for servicing within short periods of a year or less; that too in weekly installments. Apart from this, a much larger contributor to the overall debt levels in households was the borrowing from informal sources such as friends, relatives and moneylenders. A study carried out by Centre for Microfinance in 2009[7] stated that while 93 per cent of households had contracted debt from some source, 82 per cent of households reported loans from informal sector at a significant level. Thus the ground level situation in Andhra Pradesh was that of a deluge of debt coming to households fuelled by competitive lending of MFIs and an unprecedented level of lending by banks through the SHGs. The following table provides a snapshot of the numbers involved.

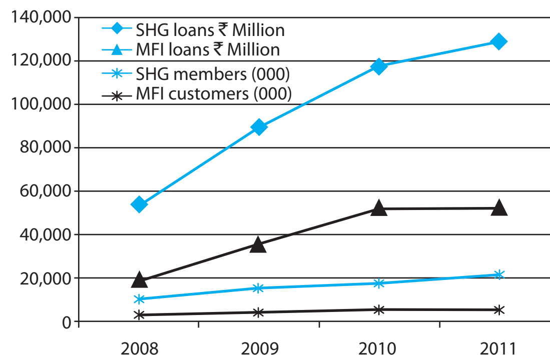

Figure 4.1 Growth of outreach and loan portfolio outstanding—comparison between SBLP and MFIs in Andhra Pradesh

TABLE 4.1 Progress trends of the sector in Andhra Pradesh[8]

	2008	2009	2010	2011
SHG loans (₹ million)	53,857	89,021	117,395	128,694
MFI loans (₹ million)	19,445	35,652	52,107	52,045
SHG members	10,506,639	15,819,427	17,310,000	21,891,909
MFI customers	3,635,115	4,949,393	6,244,648	5,751,000
Total MF clients	14,141,754	20,768,810	23,554,648	27,642,909
Total no of poor households[9]	2,520,000	2,520,000	2,520,000	2,520,000
Average loan (₹) per account	5,183	6,002	7,193	7,982
Average loan (₹) per poor household	29,088	49,473	67,226	71,721
No of loan accounts per poor household	5.6	8.2	9.3	10.9

The data shows that MFIs increased their client base at a steady rate of about 1.3 million in 2009 and 2010. The SHG programme added an unprecedented 5.3 million members during 2008–09, 1.5 million members in 2009–10 and 4.5 million in 2010–11. In all probability, this extraordinary growth in membership of SHGs in one year also had implications for the spike in debt levels and the consequences thereof.

The absolute growth of outstanding SHG loans has been steeper compared to MFIs in the four year period. Compared to 2008, by 2011 the MFIs had added 60 per cent more clients but 160 per cent more loans. SHGs increased clients by 108 per cent and loans by 138 per cent during the same period. The average loans per client increased by 54 per cent in 2011 compared to 2008. Around 70 per cent of the per capita microfinance debt was from SHGs.

THE SKS IPO

An important event that made the MFIs visible and brought the sector under intense media scrutiny was the successful IPO of equity shares made by SKS Microfinance at a high valuation. The IPO made at a premium of 98 times the face value of the shares surprised and shocked several sector stakeholders. The original investors in equity of SKS through private placement were able to cash out a part of their holdings.[10] The government no doubt had been influenced by the profits made by the investors. While the success of the IPO brought intense media scrutiny, the MFIs (SKS in particular) kept up a steady flow of negative publicity. The changes in governance level of Key MFIs, sacking of a high profile CEO, a non-executive chairman capturing the reins of the biggest MFI in the country, aspirations of other MFIs to seek stratospheric valuations in their IPOs, unethical

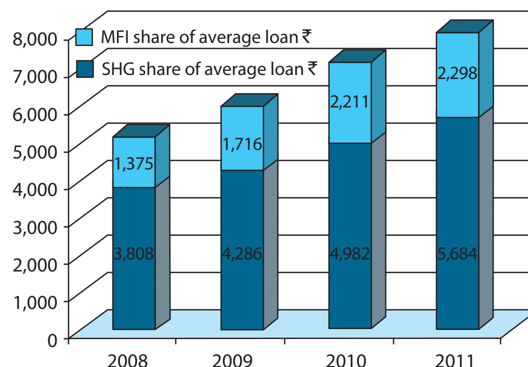

Figure 4.2 Share of SBLP and MFI to per capita average loan in Andhra Pradesh

practices in the field, resignation of independent directors on the board, exposure of high interest rates and the like were lapped up by a hungry media and projected it at times with significant distortions.[11]

The fact that the IKP was run by the state-sponsored Society for Elimination of Rural Poverty (SERP, a parastatal NGO) had some possible connections with the state regulatory effort. Despite the state government providing considerable support for livelihood promotion and income enhancement through a variety of real sector initiatives as also enterprise and employment facilitation to the members of SHGs, the MFIs continued to make headway in the rural areas. The popular loan scheme (*Pavala Vaddi*)[12] which charged 3 per cent per annum to SHGs on their loans from banks (the difference between their normal interest rates and the lower rate charged to SHGs was subsidized to financing banks by the state government) did not arrest the rapid increase in loan portfolio of MFIs which charged interest rates ranging from 24 to 55 per cent in the state.[13] An added feature of this high level of MFI lending in the state was the low default rates with portfolio at risk being less than 1 per cent for most of the MFIs. In contrast the SHG bank linkage programme reported much higher default rates despite the intensive handholding and other non-financial services offered through the IKP.[14] In contrast MFIs had been able to recover a high proportion of their dues on time with Portfolio at Risk being typically less than 1 per cent. While competition between the state-run SHG programme and the private sector MFI initiatives made the customers happy with an abundance of sources from which they could raise loans, the repayment rates under the government-supported programmes was low.

The nature of pressure that the government (and the bureaucracy) faced is not clear; but the government brought out an ordinance on the 15 of October 2010 with the following objectives. The objectives of the ordinance state that

> … whereas these SHGs are being exploited by private microfinance institutions through high interest rates and coercive means of recovery … and in some cases leading to suicide, it is expedient to make provisions for protecting the interest of the SHGs by regulating the money lending transactions by money lending MFIs ….

The preamble to the Act had prejudged the intent of MFIs as exploitative and laid the suicides at the door of MFIs. (A short note on 'Suicides and Microfinance' is provided in Annex 4.1). Based on this premise, the state set up its regulatory framework. The regulatory framework in turn provided for control over acquisition of clients, the number and extent of loans that could be provided by MFIs, rate of interest, terms of repayment, the places in which the customer could be met to transact business (especially recovery) as also the requirement that the MFIs should seek prior permission from the state government official at the district level before lending to any member of an SHG. In February 2011, the state issued a clarification to its law by stating that any member of the household in which there is at least one person who is an SHG member should not be provided loan by an MFI except in accordance with the law. Thus the state required the MFIs to seek prior approval even in respect of those people who are not members of SHGs for whom the act was originally intended. A detailed critique of the law is carried in Annex 4.2 at the end of this chapter. While the ordinance was challenged in a court of law (the matter is still being heard) the government replaced the ordinance with a newly enacted law in the state legislature.[15]

The initial response of the MFIs was that they would resist the government's attempts to stringently regulate the sector through legal means and by solidarity. With the arrest of a few staff of MFIs that ventured in to customers habitats and the stern warning that the directors of the NBFCs may also face arrest, the MFIs turned in to a compliant mode. The effect of the regulation was immediate on recoveries of MFIs. Without being able to hold cluster meetings and centre meetings in which the customers were usually required to repay the loan, the MFIs were unable to recover their loans. The recovery rates that were 99 per cent plummeted to 10 per cent. It seemed that the entire borrowing clientele was waiting for such a *relief measure.* Burdened by the extent of debt the customers were perhaps barely keeping the weekly repayment schedules. The state government's enactment was a boon for the people who could legitimately stay away from repaying the loans. The point to note is that the borrowers were not prohibited from repayment of loans. The MFIs had issued several requests and public notices to the customers asking them to come over to the MFIs, branches to repay the installments on time. But the customers took advantage of the fact that the MFIs staffs were unable to call them for cluster meetings or come to their residences/place of work to recover the loan.[16] There was no effective way by which the MFIs could enforce repayments and this became the major concern for the entire MFIs sector in the state. Collection of loans due in a meeting where borrowers assemble would have been viewed as a normal business activity under any circumstances. The state government

has indicated that it might allow the MFIs to recover their loans if they waived the interest due from the customers. While MFIs are reportedly willing to offer interest waiver[17] in the hope of recovering whatever is feasible, the probability of such an initiative succeeding seems remote.

Table 4.2 Loan portfolio of 10 large MFIs in Andhra Pradesh

Description	Amount (₹ billion)
Loans outstanding Oct 2010	108.39
Overdues March 2011	31.74
Borrowings March 2011	82.06

The effect of falling repayment rates on MFIs' business was severe and total. The first half of the year 2010–11 saw disbursements by MFIs in Andhra Pradesh to the tune of about ₹50 billion. The second half saw the disbursement declining to as low as ₹85 million which was a meagre 1.7 per cent of loans disbursed in the first half. This drastic fall in disbursement very clearly conveys the manner in which the business had been stunted by the rapidly falling repayment rates. The regulation in Andhra Pradesh thus brought MFIs to a standstill. As at the end of October 2010 a total of about ₹108.90 billion was outstanding in the hands of borrowers from 10 large MFIs. The funding of this large a portfolio had come significantly from the banks and financial institutions whose share is estimated to be over 80 per cent.

The borrowers felt that they had sufficient protection from the state government not to repay. The state government while introducing the ordinance and subsequently the law had stated that its SHG linkage programme would more than make up for any shortfall in credit flow in the state. Across the state, the IKP data showed that disbursements of ₹70 billion were enabled during the year. However the provisional data provided by NABARD indicates the disbursements to SHGs in the state at ₹63.5 billion. As per NABARD data, during 2010–11, the number of groups availing loans during the year declined by 0.18 million and disbursements also declined by ₹3.5 billion compared to the previous year. The amount of loans that have not been repaid to the MFIs by the customers is likely to amount to nearly ₹70 billion. Taking in to account the incremental credit flows possible in the state by MFIs during 2010–11, there was an estimated shortfall of about ₹30 billion to the households[18] which was not bridged. The loan capital circulating in the state had shrunk; the extent of shrinkage is yet to be estimated. The declining loan flows had affected the households as revealed in a survey carried out in two districts (covering 419 households in Cuddapah and Vishakhapatnam) during the period June–July 2011 by CMF, Chennai. The survey revealed that a large proportion of households experienced fall in expenditure over a range of needs. Almost a fourth to a third of households experienced large reduction in expenditure compared to the previous year (Table 4.3).

Table 4.3 Change in expenditure patterns between 2010 and 2011

	Consumption	Business	Education	Home repairs	Health
How difficult it has become to finance your needs after August 2010 (percentage of households reporting)					
Very difficult	53	31	47	40	50
Somehow difficult	32	33	34	32	33
Same	7	21	14	16	10
Less difficult	8	16	5	12	7
If it has become more difficult now, then has it resulted any fall in regular spending for this purpose? (percentage of households reporting)					
Experienced fall in regular spending	85	81	75	83	76
Did not experience fall in regular spending	15	19	25	17	24
If spending for a particular purpose has decreased then what is the extent of fall? (percentage of households reporting)					
Experienced LARGE fall in regular spending	33	35	25	29	34
Experienced MARGINAL fall in regular spending	67	65	75	70	66

The decline in liquidity had the unintended effect of increased resort to moneylenders in Cuddapah district as revealed in the survey. Table 4.4 shows that in Cuddapah between August 2010 and July 2011 the proportion of households having loans from SHGs went up by 1.5 per cent, whereas the proportion of households borrowing from moneylenders increased by 6.3 per cent. There was a reduction of 3.1 per cent in the proportion of households having loan from MFIs.

MicroSave in another study[19] (337 customers in four districts covered) of the customers of microfinance in Andhra Pradesh reported (Figures 4.3 and 4.4) that the top three reasons given by borrowers as to why they like MFI are: timely loan, convenient installments and low interest rates. The top three reasons given for disliking the MFIs were group liability, inflexibility, lack of transparency and high interest rates. A surprising finding was that 90 per cent of customers were willing to repay. Majority of the customers denied harassment by MFI staff.

The main reasons for their not repaying the loans were that no new loans were being offered, media

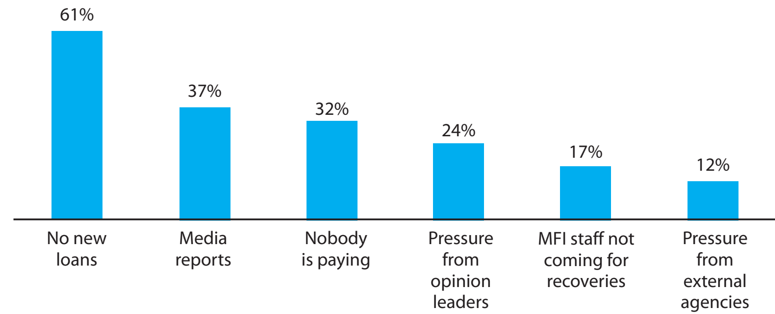

Figure 4.3 Reasons for not paying MFI loans

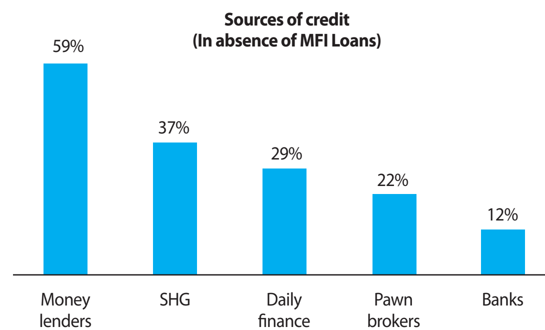

Figure 4.4 How did customers manage after MFIs became dormant

Table 4.4 Comparison of source of loans

Major source	Sub-source	Percentage of household with loan from a given source based on A2F survey 2009			Percentage of household with loan from a given source based on A2F survey 2011		
		All	Kadapa	Vishakhapatnam	All	Kadapa	Vishakhapatnam
Banks							
	Private Banks	0.2%	0.0%	0.4%	13.7%	14.1%	13.4%
	Public Banks	11.5%	8.9%	13.8%	8.7%	9.4%	8.0%
	Regional Rural Bank	11.8%	19.9%	4.9%	1.9%	2.6%	1.3%
	Cooperative/PACs	13.0%	5.2%	19.6%	10.8%	6.8%	14.3%
	Other formal	4.6%	2.6%	6.3%	3.4%	4.7%	2.2%
	Any Bank	34.1%	32.5%	35.7%	33.2%	33.0%	33.5%
SHG		55.3%	41.4%	67.0%	56.7%	42.9%	68.8%
MFI		9.1%	11.5%	7.1%	5.5%	8.4%	3.1%
Informal							
	Moneylender	17.8%	16.2%	19.2%	20.7%	22.5%	19.2%
	Friends (with interest)	56.5%	53.9%	58.9%	30.5%	30.4%	30.8%
	Friends (no interest)	17.3%	16.8%	17.9%	11.3%	14.7%	8.5%
	Employer	4.1%	5.2%	3.1%	2.6%	3.1%	2.2%
	Landlord	19.2%	23.6%	15.2%	14.2%	18.3%	10.7%
	All informal sources	82.7%	81.2%	83.9%	66.8%	73.3%	61.6%
Any loan source		90.9%	87.4%	93.8%	86.5%	83.2%	89.7%

reports dissuade them from paying back and no one else is repaying. As to coping strategies in the light of non-availability of loans from MFIs, 59 per cent reported availing loan from the moneylenders, 37 per cent from SHGs, 22 per cent from pawn brokers and 27 per cent daily loans.

The coping strategies of customers were to borrow from other sources, reduce scale of business, post pone expenditure or sell of assets. Overall, the customers have been driven to moneylenders and other exploitative arrangements. The following table provides an idea of the nature of alternatives used by the MFI customers.

Table 4.5 Alternatives to MFI loans

Type	Loan amount ₹	Effective interest rate
Moneylender/Pawn Broker	Up to 200,000	30% to 120%
Weekly Loan—Moneylender	2,000 to 10,000	160% to 225%
Daily Finance Corporations	2,000 to 10,000	78% to 120%

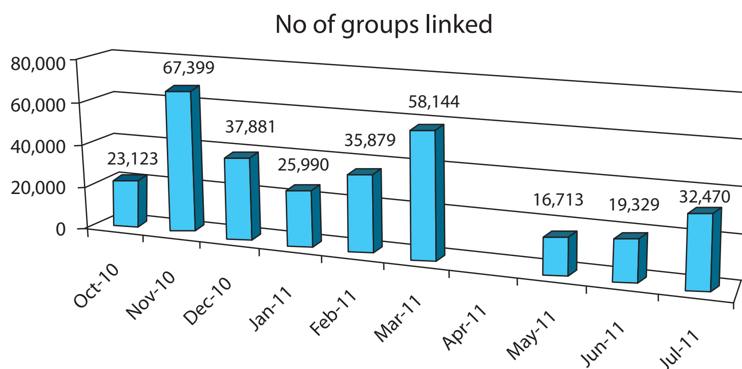

Figure 4.5 Month-wise number of groups linked post ordinance[20]

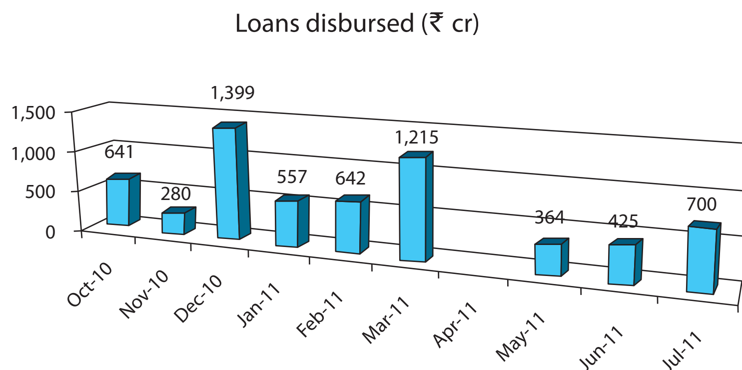

Figure 4.6 Month-wise disbursement of loans to SHGs in Andhra Pradesh post ordinance

The month-wise number of groups linked for credit (either fresh or repeat loans) as reported in IKP monthly progress reports showed a spurt in November 2010, immediately following the ordinance, but it was not accompanied by a high level of loan disbursement. December 2010 saw a spurt in loan disbursement. Barring these spikes no significant changes in linkage of SHGs was seen that could be construed as 'filling the gap' left by MFIs in the market. The month of March usually sees a spate of loan sanctions and disbursements in a bid on the part of banks to achieve annual targets. In Andhra Pradesh, the number of groups provided loans and amount of loans disbursed in March was less than the levels achieved in November 10 and December 10 respectively (Figures 4.5 and 4.6).

Despite the averments by the state government the SHG programme did not seem to be able to step up to fill the void left by MFIs in the state. The number of groups financed during the year was less than the levels achieved three years back in 2007–08. However the average loan disbursed per SHG had increased continuously over the last four years. The decline in number of groups financed each year does not imply a decline in the number of groups that have an active loan, as the loans could be long term. The increasing average loan per group does point to increasing deepening and higher debt levels. The point to ponder is the inability of the SHG programme to step in and complete the financial services requirements in the wake of a vacuum created by MFIs failure to service almost 6 million customers in the state.

Customers in the state were sitting on a pile of cash amounting to ₹70 billion of un-repaid loans to microfinance institutions. In the short run this would dampen the credit demand and encourage credit indiscipline. CMF–IFMR carried out a survey on the lines of its 2009 survey of Access to Finance Andhra Pradesh, in two districts (Vishakhapatnam and Cuddapah) using the same respondents surveyed in 2009. The survey showed contraction in access to finance, drop in average household debt level, shrinkage of informal borrowings and increase in proportion banks loans.

The average loans outstanding at household level declined by 19.4 per cent in the sample surveyed. The reduction was mainly account of drying up of informal loans from friends and relatives. Direct bank loans had increased significantly. The business promotion effort of Andhra Pragathi Grameena Bank (APGB) in Cuddapah had a lot to do with this increase in direct lending.

Table 4.6 Progress of SHG linkage in Andhra Pradesh[21]

	2007–08	2008–09	2009–10	2010–11
No of SHGs that availed loans during the year	431,515	483,601	413,625	389,444
Loan disbursements (₹ billion)	58.82	66.84	65.01	70.92
Average loan per group (₹)	136,329	137,498	157,180	182,123

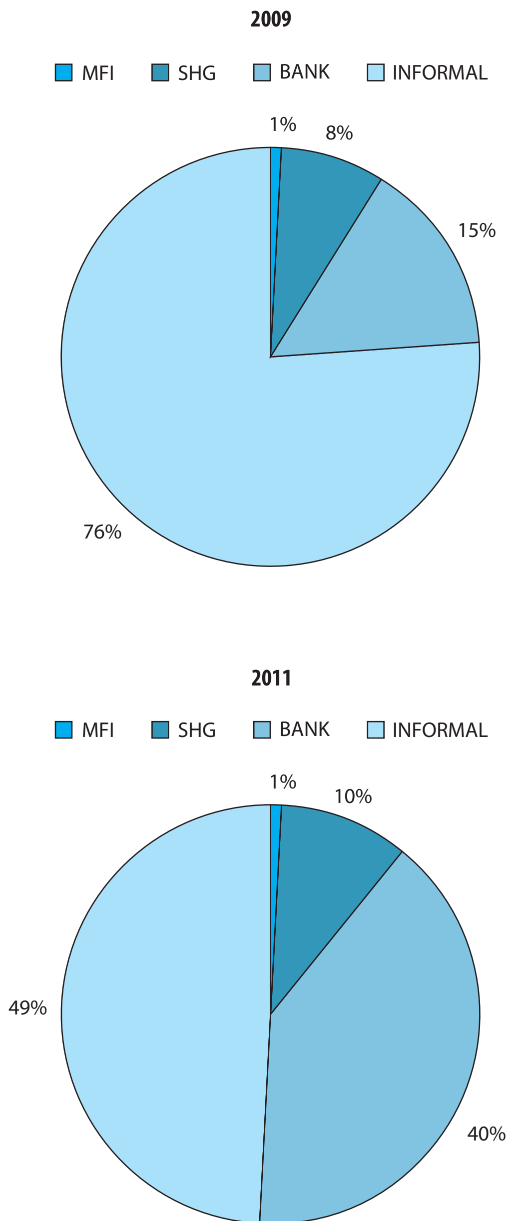

Figure 4.7 Household level loans—share of different sources[22]

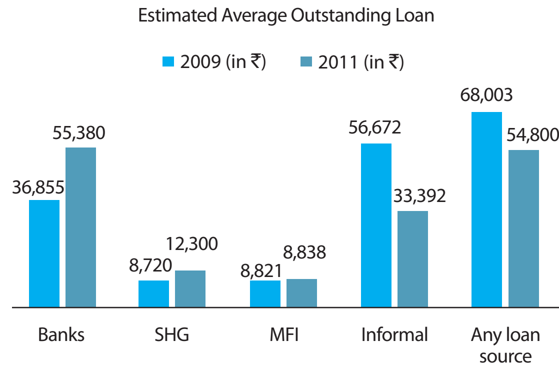

Figure 4.8 Estimated outstanding loans at household level—by source[23]

Table 4.7 Portfolio quality of SHG loans in Andhra Pradesh[24]

Description	March 2011	June 2011
Number of groups	1,683,993	1,342,738
Amount outstanding (₹ million)	169,039	137,186
Number of overdue accounts (percentage)	221,292 [13.1%]	228,927 [17%]
Amount of overdues (₹ million) [percentage]	4,350.2 [2.5%]	4,886.1[3.5%]
Portfolio at risk [percentage]	20,194.7 [11.9%]	22,982.3 [16.7%]

Reportedly the repayment rates in the case of SHG programmes have been declining. The matter came up for discussion in the State Level Bankers Committee (SLBC). As end of June 2011 the amount of overdues was of the order of ₹4.9 billion and the portfolio at risk at 16.7 per cent. Seventeen per cent of the borrowing of groups had defaults.

Out of the 17 district cooperative banks in the state three had 100 per cent recovery and the remaining banks reported recoveries between 59 per cent and 93 per cent.[25] APGB has 5.9 per cent of its loans at the end of March 2011 (compared to 5.6 per cent previous year) under either rescheduled accounts on account of previous defaults or as NPAs.

The implications of the ordinance on the credit discipline in the state can be quite telling. Banks have had to bear the brunt of the negative fallout of regulation of the state. Apart from the declining repayment rates from SHGs the banks have also to deal with defaults of MFIs. Facing a massive loan loss provision to the extent of about ₹75 billion in respect of the MFIs the banks took action to hammer out a corporate debt restructuring package in respect of the larger MFI exposures that they had. The large MFIs were targeted for the purpose; some had opted out of subscribing to such a package. SKS Microfinance and BASIX were two large MFIs that did not want to avail of debt restructuring package[26] offered by banks. Five other MFIs Spandana, Share, Asmita, Trident and Future Financial Services had availed of a debt restructuring package amounting to more than ₹7,000 crore.

Table 4.8 Loan exposure qualifying for Corporate Debt Restructuring (CDR)[27]

(Amount in ₹ crore)

Company	Total CDR exposure	Non-CDR exposure	Total debt
Asmitha	1,234.01	140.55	1,374.56
Future Financial	98.95	60.59	159.54
Share Microfin	2,160.32	241.51	2,401.83
Spandana Sphoorthy	2,854.02	471.91	3,325.93
Trident Microfin	125.70	23.47	149.17
Total	**6,473.00**	**938.03**	**7,411.03**

The finalization of the debt restructuring package took a long time on account of several problems relating to securing the loans and setting suitable terms. The deals had reportedly been concluded with five MFIs in early June, but yet to be formally signed. The restructured loan has to be repaid over seven years with one year's moratorium. The restructured loans will carry a rate of interest of 12 per cent. The CDR does not really clean up the problem. The underlying loans from customers have turned delinquent, with recovery rates low at about 10 per cent. The recovery rate of 10 per cent is not sufficient even to service the interest of 12 per cent on the restructured loans nor does it fully cover the operating costs of many MFIs in Andhra Pradesh. With no fresh business, MFIs incur costs on recovery of loans. The prospects of recovering any part of the principal appear very slim. It is indeed a brave attempt on the part of both MFIs and banks in Andhra Pradesh to conclude the CDR and hope that something will eventually work out. With a moratorium of one year, banks have bought themselves two years to manage their balance sheets and possibly make provisions for the restructured loans over a period of time. As far as the MFIs are concerned, this is slow death on life support systems. To avert such a situation three large MFIs (Share, Spandana and Asmita) are on the drawing boards to consolidate their operations and demerge the same in to three different entities.[28]

In the mean time small and medium MFIs that are not big enough to attract the attention of banks have already shut shop or are in the process of doing so. Reports of 80 MFIs in Andhra Pradesh closing down have been doing rounds in the media.[29]

Typically MFIs with a high concentration of portfolio in Andhra Pradesh are facing the problem, highlighting the dangers of portfolio concentration with shallow engagement of customers. As part of a multi-state survey of MFIs[30] (on how they are coping with the Crisis and the introduction of regulation), four MFIs in Andhra Pradesh were covered. The MFIs reported scaling down operations, putting off expansion plans, reducing staff and moving out of Andhra Pradesh for diversifying business. Funding was a problem that led to stoppage of fresh disbursements.

Box 4.1 Findings of survey of MFIs in Andhra Pradesh[31]

SURVEY OF MFIs (AFTER ANDHRA PRADESH EVENTS AND ISSUE OF RBI REGULATION)

State: Andhra Pradesh

Number of MFIs interviewed: 4

Legal structure: 2 NBFCs, 1 Society and 1 Cooperative.

View towards regulation: The representatives from all four MFIs reported that overall their institutions believed that the Malegam Committee's recommendations and RBI regulations are positive additions to the microfinance sector.

Change in business strategies: One NBFC that had loans outstanding worth ₹150 crores as of March 2011 had 109 branches as of the end of September 2010, has since reduced the branches to 84.

This institution was planning to bring down the number of branches further to around 50. Most of the closed branches were from urban areas, particularly in Hyderabad. The MFI was looking at individual lending option to sustain its business. The other NBFC that has ₹100 crores total loan outstanding at the end of March 2011 and has been operating in 28 districts of Andhra Pradesh, Maharashtra, Orissa and Tamil Nadu brought down its microfinance operation by 56 per cent. This NBFC started focusing on diversifying its portfolio to other states right after AP ordinance came out. The representative of this institution mentioned that he was waiting for the microfinance bill before changing strategy so that no further regulation risk affects their business as they changed business strategies. The representative of the cooperative MFI (loan outstanding of ₹21 crore as of March 2011) mentioned that the institution was planning to open new branches in 2010, but after the Andhra Pradesh crisis, this plan was discarded. The institution's portfolio decreased by 30 per cent after the crisis. The small-sized society that we interviewed had to completely shut down its microfinance operation right after the crisis in October 2010 and has switched to cooperative banking with only members.

Funding scenario: None of the MFIs interviewed got any funding from any major source after October 2010. One small sized NGO-MFI mentioned that it got ₹9 crores from NABARD; however, that loan was sanctioned before the crisis and disbursed after October 2010. The story, however, was different for the NBFCs. The NBFC mentioned that even though banks had sanctioned loans before October 2010, it did not receive the disbursement after AP ordinance came out. Almost all MFI representatives expressed that the microfinance sector in AP could have survived if the banks had continued to lend money so that they could disburse fresh loans. At the time of these interviews in June 2011, all MFIs had stopped disbursing new loans and were solely focusing on collecting payments.

Quite a few investors who have bought into the growth stories of MFIs and ignored issues in corporate governance, weak internal controls and customer discomfort stand to lose their investments. For some of them possibly these investments represent a tiny percentage of their portfolio and constitutes a small price for learning. But for some, the losses could significantly impact their future investment policy and keep them away from microfinance institutions for a long time.

What is a mystery to the sector observers is the reluctance of the banking system to present a cogent case before the state government to make it aware of its strangulating impact on MFIs in which the banks had the maximum exposure. The banks did not seem to have argued their case effectively before RBI and the Government of India. With a large loss potential the banks were expected to act swiftly to protect their interest by asking both the state and Central government to provide sufficient time and relax the regulatory rigour especially in relation to recoveries. The World Bank was placed in an uncomfortable position by the developments which involved two segments of microfinance both of which enjoyed the World Bank's support. It had sanctioned a loan of US$300 million last year to SIDBI for on-lending to microfinance and supporting several activities relating to the microfinance institutions sector. On the other hand, it had already supported the state of Andhra Pradesh in implementing its SHG programme (Andhra Pradesh District Poverty Initiatives Project [APDPIP]) in its earlier form (*Velugu*). In addition, a much larger loan was being discussed to support the NRLM that had been designed substantially on the basis of the IKP in Andhra Pradesh. One of the programmes that believed in subsidies supported through the public sector, actively worked to put out of existence another programme also funded by World Bank using sovereign power to make laws. The fact that the affected programme—involving the private sector to offer market based solutions to vulnerable people—was more aligned to World Bank's policies should make it uncomfortable for the Bank. Legatum Ventures[32] which has made investments in the Indian microfinance sector had this to say:

> If the World Bank provides the much discussed US$ 1 billion in funding to the government-backed SHG program in AP, it will be complicit in snuffing out the private sector from Indian microfinance.

RUSH FOR REGULATION

The RBI rushed to appoint a committee to examine the regulatory issues arising from the Andhra Pradesh government's law to take control over lending activities of institutions that were under its jurisdiction. The Malegam[33] Committee (in the latter chapter on regulation there are more detailed discussions on the committee and its work) made

recommendations based on which the RBI issued regulations addressed at commercial banks. The RBI chose to discipline the conduct of MFIs in customer acquisition, designing loan products, appraisal, disbursement and recovery processes. The discipline is to be enforced by linking it to the priority sector lending regulations (in the later chapter on regulation, the RBI's norms for MFIs are discussed in detail). But these efforts at introducing a regulatory framework for NBFC MFIs had come about in May, eight months after the Andhra Pradesh ordinance. While the time taken was justifiable, it was far too long to prevent the hardening of credit indiscipline among the borrowers. In any case the RBI regulations did not have overriding jurisdiction above the state law in Andhra Pradesh and hence the ground level situation did not change for MFIs in the state.

The Government of India in February during the annual budget exercise had indicated that the microfinance institutions had not fallen out of favour. It had set up an equity fund of ₹1 billion for carrying out investments in MFIs and it had signaled its intention to bring in a comprehensive legislation on microfinance. These announcements in the budget signaled a positive intent from the Government of India and its discomfort with the way in which the Andhra Pradesh law had been implemented. Following on its promise the government had engaged the stakeholders in a consultative process and had placed the draft microfinance law for discussion in public domain in early July (a commentary on the bill is part of a another chapter on regulation in this report).

The Government of India in its bill had in effect overruled the view of the Government of Andhra Pradesh that microfinance institutions can be the subject of a money lending law. But the critical point to note is that the draft legislation is pretty strong on customer protection and introduces not only an interest rate cap but also several process related controls over the operations of MFIs. A distinct beneficial fallout of the Andhra Pradesh ordinance has been that both RBI and Government of India have been rocked from their state of passive equilibrium to recognize that the microfinance sector requires regulation, especially in the interest of customers. The Government of Andhra Pradesh does not agree with the proposed bill saying that it is soft on MFIs, not clear on critical aspects and leaves too many things flexible. The Andhra Pradesh government also made the point that money lending is within the legislative ambit of the states and that the Centre cannot take away the power.[34]

The MFIs in the industry have had several problems arising from the Andhra Pradesh crisis. MFIs have become outcasts in the eyes of both the investor community as also the banks for almost one year now. Finding equity and on lending funds had become extremely difficult. Several MFIs with no connection to Andhra Pradesh found that banks are not willing to lend to them on account of a high risk perception. In many banks, the Andhra Pradesh events made the routine questions asked by their risk managers assume perspicacious proportions and the credit managers who approved of those proposals, had to take a backseat. The credit management departments of banks put on hold proposals for financing MFIs and stopped operations against sanctioned loans. The result was that new loan disbursement across the country had virtually come to a stop even in states outside Andhra Pradesh.

R. Subramaniam, Principal Secretary, Rural Development, Government of Andhra Pradesh, had articulated the reasons for the regulatory action in an article:[35]

> MFIs are flourishing under the regulatory deficit—where more than 80% are under no one's regulation, and the others claiming immunity from the money lending Acts in the garb of non banking finance companies (NBFCs). Using the SHGs formed over the last 12 years, MFIs have been engaging in multiple lending, non-transparent and usurious interest rates, illegal charges (in the name of insurance, application charges, joining charges and processing charges), and coercive methods of recovery. The fact that in the last two months, more than 30 rural poor have been driven to suicide unable to bear the coercion unleashed by their recovery agents; and equal number of women molested or kidnapped or forced into prostitution is a pointer to the seriousness of the situation. The Constitution has put the responsibility on the state governments to regulate money lending activities. Naturally, the state government cannot be a mere spectator to the malpractices of the MFIs.

Summing up the developments Vijay Mahajan described[36] the Andhra Pradesh event thus:

> Throughout 2009 and 2010, growth of microfinance portfolio, particularly in Andhra Pradesh, was led by the fact that SKS went for an IPO. They wanted to show high growth and high profitability. The way to maintain high growth and high profitability is by concentrating in the same geography and increasing the loan size to the same customers. Share and Spandana followed suit. This led to multiple lending, which in turn to over-indebtedness, which in

turn led to all kinds of problems including allegedly coercive recovery practices, alleged suicides by borrowers. That became politically very difficult for the ruling party to justify. They had to take stern actions against MFIs. That political mandate was then used by a group of civil servants who were in favour of the self-help group (SHG) model and introduced provisions resulting in a dramatic fall of repayment. Reacting to that, opposition leaders went to people and said, the ordinance is nothing, it has not reduced your interest rate, it has not reduced your debt burdens, you're supposed to get interest at 3% per annum and so on. People basically took that as a license for not repaying. The government action and secondly the fermenting of mass default by the opposition led to a situation where repayment rates have fallen down to less than 10%.

The economic survey 2011 put out by the Ministry of Finance cautioned that regulation should be intelligent and not forget that millions of customers are being served by the sector.

In regulating MFIs it has to be recalled that they have played a major role in drawing poor people into India's mainstream finance and enabling farmers to make useful investments and marginal workers to start up small self-employed enterprises. There are approximately 30 million people throughout India who have been beneficiaries of MFI lending. There is evidence that some of these people have been subjected to unfair threats to make them repay loans. Such practices must be stopped. However, to react to this by announcing blanket amnesties and encouraging farmers to default en masse will do more damage than good. Such practices would lead to the MFI sector disappearing since no MFI, whether it be a profit-making one or a non-profit NGO, would want to give out loans knowing that these will not be recovered. While we must recognize that borrowers in special situations have the right to plead bankruptcy and not pay back, we need an intelligent regulatory structure which protects borrowers and, at the same time, allows this sector to flourish.

Box 4.2 From tigers to cats!!![37]

One respondent quoted in the MicroSave study described the state of MFIs pre and post crisis as follows: '*MFIs used to be tigers before the crisis. After the crisis, they have become cats. Earlier we used to wait for them but now they wait for us. Earlier they will not accept a penny less, now they accept whatever we give, whenever we give.*' Telling testimony to the impairment of credit discipline in the state.

Andhra Pradesh had been the pioneer and leader in microfinance. It has the largest SHG programme in the country. It has the highest average loans for SHGs and the largest proportion of bank lending flowing to the SHGs. Most microfinance institutions operated out of Andhra Pradesh or had their origins there; many MFIs have their core staff with the initial experience having been gained in Andhra Pradesh. Andhra Pradesh today is providing the bitterest lessons to institutions on their assumptions relating to several types of risks. The institutions now know that while dealing with vulnerable people the state could come down heavily. The state action could be disproportionately excessive in comparison with the problems caused by a fast growing sector that is indifferent to customers. The institutions now know that the state could act to protect its territory not only through competitive action in the market but also use its authority to regulate competitors out of existence. The MFIs know enough now not to assume that their business is an unmixed blessing but potentially a public hazard that should be subject to stringent controls. In addition to the normal business issues in relation to starting up and running a business, MFIs have to prove to the government and the people that they not only do business but they also do it ethically and to the satisfaction of all stake holders.

The banks and equity investors have learnt that vigorous growth and profits are not reasons enough for leaving the promoters unquestioned. Specious arguments (such as autonomy to run business, protection of shareholder interests, free market pricing, borrowers are capable of taking wise decisions) do not really carry conviction with customers who swiftly change loyalties. Funders and investors have a right and duty to ask questions of business models, practices and the impact of business on vulnerable people. While the MFIs, banks and equity investors have learnt significantly, what is it that the state has learnt? It is too early to consolidate the learnings of the state; the impact of MFIs closure and withdrawal from the state will be felt with a time lag. It is difficult for a state programme to bring in the ideas, capacity and enterprise that private sector naturally adopts in business operations. The proposed new financial institution of the state government might find that the crater in the sector is too huge to fill. Andhra Pradesh today is the graveyard of many small MFIs and a few large ones. The clientele of more than 6 million that MFIs had at their peak would now have to look for other avenues. In a year or so even the residual hopes of recovery of some parts of badly damaged portfolios will vanish. The cash representing defaulted loans in

hands of the people would be spent and used soon, after which these 6 million clients would look for their next cycle of funding. But it's unlikely that MFIs would commence lending or any new institutions would set up shop in a hurry.

The question that has to be examined is 'what is the price of regulation of MFIs in Andhra Pradesh and who should pay it?' A rough reckoning is that the cost of regulation is about ₹60 to 70 billion in loan defaults and write-offs by banks. The price will be paid by the banks and the tax-paying public; not entirely by the MFIs or their promoters. Even well-intentioned moves at protecting vulnerable people should adopt appropriate strategies. The Andhra Pradesh regulation is right on intent, but wrong in its focus, coverage and application. Inappropriate regulation produces long-term damage that is difficult to remedy. No regulation is better than bad regulation.

Andhra Pradesh today is a pioneer for wrong reasons. Instead of regulation of the sector, its closure has been legislated. A sector wide penalty had been imposed on the basis of presumptions without an examination of different players and their market conduct. The learnings are a warning signal to institutions and markets elsewhere. At least this time the microfinance institutions would not be in deep denial to dismiss this as one more localized occurrence, as had been the practice in the past. The learning is serious enough to bring the industry associations to work together to spell out a code of conduct that would apply across the sector. The lenders to MFIs are getting together to enforce a common code of discipline on the borrowers. Lenders seek to take a more active role in ensuring that the borrowing MFIs in fact secure the objectives of customer protection and social performance. Finally the stakeholders at the sector seem to be coming alive to the fact that they did not do enough for the customers. The lessons have been impactful but the price paid had been a bit too high.

ANNEX 4.1
Suicides and microfinance

The basis of the Andhra Pradesh microfinance regulation was that the MFIs had caused suicides among customers through coercive recovery procedures. The government had cited the death of 54 customers by suicide. The media played up the suicide story to project an image of brutal lending and recovery processes by MFIs. A deeper examination of the suicide theory does suggest that microfinance may not be the major cause of suicides. Microfinance was just one more source of loans in a State in which suicides were endemic for a long time. The available data from national crime records bureau[38] showed that suicides among farmers in 2009 had increased with five states—Maharashtra (2,872), Andhra Pradesh (2,414), Karnataka (2,282), Chhattisgarh (1,802) and Madhya Pradesh (1,395)—accounting for nearly two-thirds of all farm suicides in the country. A total of 17,368 farmer suicides were reported in 2009, an increase of over 7 per cent over 2008.

Between 1998 and 2008, the National Crime Records Bureau (NCRB) says over 22,000 farmers killed themselves in Andhra Pradesh whereas the state government data is less than 8,000. Less than 4,700 of those suicides were treated as genuine or eligible for compensation that means just 21 per cent of the total suicides as per NCRB data.[39] The reasons for the suicides have not always been financial. Farmers suicides were registered in Andhra Pradesh in 2,414 cases in 2009. The data on AP for 2009 states that illness accounts for about 26 per cent of cases and family problems accounts for 17 per cent of the cases. Poverty is a cause in 10 per cent of the cases and bankruptcy or sudden change in economic condition is a cause in 6 per cent cases. It is difficult to link even the cases of poverty or bankruptcy with loans. Borrowing is a response that arises from inadequacy of resources; failure to repay is a response arising from unwillingness of borrower or inadequacy of income/assets or a combination of both. The failure of economic activities and the need to find funds to meet livelihood and emergent expenses often put pressure on repayments. While the pressure—of having to repay a loan—is faced by the borrower, it stems from failed economic activities or unforeseen shocks. Blaming the lender for policy infirmities, market imperfections and entrepreneurial failures is an easy escape for the state; but using the blame to terminate a legitimate business activity when a state-supported programme is in the same line of business is unfair and it militates against public welfare. A failed borrower is under stress whether the interest rate is 50 per cent or 3 per cent. If lender is the real cause then all lending activity should be brought under stringent regulation instead of picking and choosing some segments. There are at least 2,400 more farmers that committed suicides and some of these might have been on account of economic causes. Was their source of borrowing identified and action taken?

A seemingly unrelated development is the crop holiday[40] announced by farmers in East and West Godavari districts. The last paddy season has inflicted severe losses on farmers as the government could not procure the paddy at the Minimum Support Price (MSP). Some of the crop is still held by the farmers; many had sold off the crop at a loss. The likelihood that farmers will be unable to repay their loans is high and they would be under heavy pressure. The question is whether the lending banks (who have provided crop loans at 7 per cent) are to blame for the default loan build up or failure of government to implement its procurement policy? Behind every case of failure of enterprise such non-financial reasons are bound to exist that need remedying. Limiting the range and scope of financial services by institutions is not an answer; in fact such an action will compound the problems, remove options available to customers and drive them towards more exploitative informal arrangements.

ANNEX 4.2
The Andhra Pradesh Ordinance on Microfinance—a commentary[41]

The ordinance has laudable objectives. Protection of low-income clients from exploitative practices and enhancing levels of transparency are valid public policy objectives of a sovereign government. High debt levels, multiple operators providing loans as also pressure on repayment are legitimate causes for concern. The situation needed a remedy. The remedy being applied does not seem appropriate to achieve the objectives stated for introduction of the ordinance.

The drafting of the law leaves a lot to be desired. The definition of Microfinance institution as it stands in the ordinance includes all entities either 'providing loans to low-income clients or offering financial support to them'. Even charitable donors become subject to this law! The definition of low income client is not available either in the ordinance or anywhere else. This leaves wide scope for interpretation. The requirement of display of interest rates does not define 'interest rate'. Will flat rates, monthly rates and other confusing rates when displayed will be of help?

The stipulation that 'interest should not exceed principal' clearly exhibits the disconnect between the law and ground realities. Most MFI loans are of one year tenor and the stipulation in the Ordinance is seen willing to allow up to 100 per cent rate of interest. With practically no loans beyond three years, this stipulation seems redundant for MFIs, but will hurt bank loans of longer duration. In reality, the stipulation will tend to reduce the duration of loans in all institutions in order to escape revenue loss and incursions in to autonomy of pricing.

While the law prohibits a third loan being given regardless of the source of the two existing loans, the verifiability of information on existing loans (especially from informal sources) of borrowers has not been taken in to account. Given the fact that in Andhra Pradesh the numbers of microfinance loans are more than 10 multiples of poor households, neither banks nor MFIs have any scope of future operation in the state.

The stipulation that effective rate of interest should be made known to the borrower is a valid requirement.

The requirements of the law are that a list of borrowers with details of each loan should be provided to the registering authority at the end of each month. With more than 23.5 million microfinance clients in the state, information handling might become a nightmare.

The stipulation of returning the loans taken from a second SHG within three months could be harsh and might cause distress especially where the funds are used to part-finance income-generating activity. If the loan was applied for medical treatment or lifecycle needs such as marriage, the return of money within three months would be even more difficult. When loans of adequate size are hard to come by from any single source, forcing customers to refund the loans already availed might end up as disservice.

The threat of fines and imprisonment of directors and staff of MFI for coercive action (which includes repeated visits to the customer for recovery of dues—'frequenting the house or other place where such other person resides or works, or carries on business, or happens to be') is a sweeping one. Independent directors may not be willing to take board positions in financial institutions that have operations in Andhra Pradesh.

The fast track courts are a good idea. MFIs by and large do not have access to legal remedies against defaulters. The fast track court mechanism, if implemented well, would provide millions of customers and the MFIs with a judicial option for settlement of disputes.

The infirmities in drafting create a void between intent and application of this ordinance. Lack of definitions or precision in definitions, disconnect from ground realities of business and inadequate appreciation

of the volume of work involved in enforcement of the law would tend to make the implementation vexatious for all concerned.

The law creates an uneven playing field by making one of the competitors (the state's rural development machinery that drives the IKP) as the controller and arbiter. While the timelines for application for registration, second loan to SHG members, etc., are specified, no time lines have been specified for disposal of applications. A deemed approval at the end of a certain period from the date of application would have been appropriate. The application for no-objection for second loans and monthly lists of borrowers provide information to the competing institutions and could potentiality breach customer confidentiality, especially in the hands of banks. The basis on which no-objection for second loans would be issued is the information provided by MFIs. The district authority is vested with the responsibility of enquiring in to whether SHGs have understood the loan terms and whether the loan is likely to provide additional income before providing a no-objection. The likelihood that registering authority will have more information than the financial institution to take a decision on the appropriateness of the loan is remote. Restriction of members from joining more than one SHG militates against basic freedoms granted to people. The restrictions on providing loans to willing customers (whether second or third) erode the freedom given to enterprises to pursue legitimate business or commerce.

Regulation should have focused on rates of return, governance reforms, transparency in dealing with customers, grievance redressal, ombudsman mechanisms and framework for restructuring of debts of customers under stress. The state could have brought down the level of debt related stress by making available soft funds to MFIs for on-lending under conditions similar to those under which banks in the state lend to SHGs. Instead the state has chosen to adopt a combative stance towards MFIs. This impacts more than 6 million existing clients of MFIs and ₹10,000 crore of loans a substantial part of which is provided by banks out of depositors' money.

NOTES AND REFERENCES

1. Cited from N. Srinivasan, *Microfinance India—State of the Sector Report 2010* (New Delhi: SAGE, 2010).
2. This programme is a sequel to the poverty eradication programme named *Velugu* which had been supported by World Bank.
3. Prabhu Ghate had dealt with this extensively in Microfinance India State of the Sector Report 2007.
4. Chapter 3 of last year's State of the Sector Report carries details of this development.
5. Microfinance India State of the Sector Report 2009 has detailed coverage of the mass default coordinated by the Muslim clergy in the district of Kolar in Karnataka state. The defaults are persisting from February 2009 with no resolution in sight.
6. At the end of March 2011, the number of loans per poor household has almost reached 11.
7. 'Access to Finance in Andhra Pradesh 2009', by Centre for Micro Finance, Chennai, commissioned by Centre for Microfinance Research, BIRD, Lucknow.
8. Data on SHGs from Status of Microfinance In India 2008, 2009 and 2010 and provisional data 2011 form NABARD. Data on MFIs from Sa-Dhan Quick reports 2008, 2009, 2010 and 2011. Data on number of poor households from CSO database.
9. This is an estimate by planning commission relating to the mid-year 2004–05.
10. The promoters cashed out US$195 million worth of equity during the IPO. They had to retain 60 per cent of their pre IPO equity holdings for a period of three years after the IPO as per the listing norms.
11. This was an expected consequence of a high profile IPO. State of the Sector Report 2009 had pointed out such a possibility and cautioned that the valuations should be moderately sober.
12. *Pavala Vaddi* is a Telugu term which means quarter percent interest—that is the monthly interest rate charged by banks to SHGs on loans under a state government programme.
13. The transparent pricing data published by Microfinance Transparency in February 2011 provided details of the Annual Percentage Rates. (www.mftransparency.org)
14. The IKP operates an SHG loan recovery mechanism known as Community Based Recovery Mechanism (CBRM) through the District Rural Development Agency (DRDA).
15. The Supreme Court has decided to hear the case filed by SKS seeking a declaration that some provisions of the law are invalid. The hearing is fixed for the last week of September.
16. The state government subsequently allowed the MFI staff to go to the villages for rescheduling of loans on the condition that no other business will be transacted.
17. In a very recent development leading MFIs of Andhra Pradesh have approached the state government to restructure the loans given to the poor borrowers. The firms have offered to reduce the rate of interest and increase the repayment tenure. In lieu of, the MFIs want relaxation in lending and recovery norms for the sector in the state. Under the revised conditions, the lending rate may come down

to 15 per cent for the existing loans. For the fresh loans, the MFIs have proposed to charge 24.55 per cent rate of interest, without any additional processing fee. The repayment period for loans exceeding ₹15,000. Could extend up to 48 months. The scheme will provide interest relief to the tune of ₹15 billion to the borrowers and help MFIs recover ₹50 billion. Further, the MFIs have requested the Andhra government to waive the need for prior government approval for disbursement of fresh loans.

18. The MFIs had disbursed about ₹50 billion in the first six months of 2010–11. If the trend had continued they would have disbursed at least ₹50 billion in the remaining half of the year. The total possible disbursement that MFIs could have made in Andhra Pradesh is about ₹100 billion against which customers had retained loans of about ₹70 billion in default. The gap between the two is ₹30 billion.
19. How are the poor managing their affairs in the post AP-MFI crisis—an excellent Study by Microsave 2011.
20. Data source for two charts—Progress report of IKP.
21. Data as reported by IKP. This is at variance with data reported by NABARD.
22. Survey conducted specifically for the State of the Sector Report 2011 by CMF–IFMR, Chennai.
23. Survey conducted specifically for the State of the Sector Report 2011 by CMF–IFMR, Chennai.
24. Data from 175th (SLBC) meeting agenda notes. The number of borrowing groups for March 2011 is taken from NABARD data as it was not part of SLBC data.
25. Status of Microfinance in India 2010 by National Bank for Agriculture and Rural Development (NABARD).
26. This is frequently referred to as Corporate Debt Restructuring (CDR) by banks; RBI has norms in place for restructuring of debt.
27. Cited from 'The restructuring Dilemma',—*Dharashaw Market Pulse*, 1, No. 15 (April 2011).
28. One of the three entities will hold the Andhra Pradesh portfolio; the other will handle the non-Andhra Pradesh portfolio which remains unaffected and the third will look at opportunities outside microfinance—such as tractors, vehicles, gold loans etc. The financing banks' agreement to this merger and demerger is critical.
29. As told by Ernest Paul, CEO of Saadhana Microfin to Kumar Sharma: Blog in *Business Today*, 8 July 2011.
30. This survey in Andhra Pradesh was carried out by K.C. Deepti, researcher, CMF–MRAP, Chennai.
31. This survey in Andhra Pradesh was carried out by K.C. Deepti, researcher, CMF–MRAP, Chennai.
32. Legatum is a Venture Capital fund operating internationally.
33. The Committee was chaired by Mr Malegam, a member of the Central Board of RBI.
34. The Government of India is well within its right to legislate, as banking and financial institutions fall within its legislative powers.
35. The article appeared in *Business Outlook*, 13 November 2010.
36. Interview to the media carried in Forbes India, 13 August 2011.
37. Cited from the presentation of the study by Microsave on 'How are the Poor Managing their Affairs in the Post AP-MFI Crisis', 2011.
38. Suicide is a crime according to the law (despite the fact that perpetrator and victim are the same and the criminal when successful escapes prosecution) and hence registered as a crime with the police.
39. Article by NDTV dated 17 June 2010 on its website.
40. The farmers in the 'Rice bowl of AP' are upset a lot and have refused to take up cultivation in protest against the government's apathy towards their problems. Paddy in nearly one lakh acres has not been cultivated in East Godavari this *kharif* season, causing a loss of ₹3,000 crore. 'Over 5 mt of paddy is still lying in the hands of farmers in Andhra Pradesh with no takers,' says agriculture scientist and food policy analyst Devender Sharma, 'If there is normal rainfall, there will be another good crop, only to compound the crisis.' It costs ₹780–800 to cultivate 1 quintal, or 100 kg, of *sona masuri*, a premium-grade medium-size rice variety. The minimum support price for paddy set by the government was ₹1,080 per quintal, but farmers received only around ₹600–700 per quintal from rice millers who procure their produce, translating into a loss of ₹100–180 per quintal. If the loss is calculated on a per acre basis, it ranges between ₹2,200 and ₹3,600 on an investment of ₹19,500–24,000. (Media reports: Livemint, *The Hindu*.)
41. This is modified version of a commentary written by the author of this report immediately after the ordinance was issued.

Investment climate—fairweather partners[1]

5
Chapter

The crisis in Andhra Pradesh has affected access to capital, both equity and loans for MFIs. While equity funders seem to have hit the pause button on new investments while waiting for regulatory and market environments to stabilize, the loan funders within the country have been actively working on cleaning up the loan portfolios affected by the Andhra Pradesh crisis and improving the systems and practices relating to customer protection at MFI level. Funding requirements for MFIs growth plans are high. Mumbai Angels, an angel investment firm, indicated that they believed MFIs would need US$ 3–5 billion over the next 4–5 years.[2] ASSOCHAM has predicted that in the long run the Indian MFIs will need US$200 billion dollars of funding.[3] The shift from equity to other sources is driven by survival needs; growth does not seem to be the overriding priority in the current environment. Although much of the contraction in microfinance investment has been fueled by regulatory uncertainty, it is clear that investors worry about the overall health of the sector. There is evidence that many MFIs are unable to meet debt obligations and are restructuring loans, defaulting and being downgraded by rating agencies. The new RBI regulations may actually put a cap on profits and discourage further investment in the sector, worsening the credit contraction.[4] The Risk Coverage ratio reported to MIX Market decreased from a very healthy 87.1 per cent to a dismal 2.55 per cent[5] during the year. Likewise, the PAR—90 ratio has skyrocketed from 0.51 per cent last year to 23.24 per cent of the total portfolio. Almost 25 per cent of loans are not performing.[6] Several small MFIs with significant portfolios in Andhra Pradesh have been unable to meet loan repayment obligations. If they are unable to access continued bank finance, there is a high likelihood of default and bankruptcy.[7] There have been reports from the field that some MFIs have already closed down or scaled down their operations.

EQUITY FUNDING

Equity deals in 2010–11 were few. There have been few reported Private Equity (PE) investments since the start of the Andhra Pradesh crisis. The only major deal reported this year has been the IFC's investment in Bandhan Financial Services for ₹160 crore. There has been a complete freeze on PE investments by Microfinance Investors after October 2010. This worrying trend was described by Mark Stoleson, CEO of Legatum, an investment firm, in May thus:

> Microfinance lending in FY 2011 went down dramatically in six months but no one has stepped in. The volume of capital that is required is huge and unless the AP Act is resolved, no investor in their right mind will invest in microfinance because they know they will be subjected to the vagaries of the state government's actions.[8]

The RBI brought some measure of relief to investors when they adopted most of the Malegam Committee's recommendations. The reaffirmation of the importance of microfinance was apparent in both the RBI's Annual Monetary Policy Statement and its statement on 'Bank Loans to Micro Finance Institutions (MFIs)—Priority Sector Status.' By setting new guidelines and regulations for MFIs and allowing them to retain their Priority Sector Status tag, RBI signaled that as an asset class and institutional class microfinance has not fallen out of favour. Between October and the release of the RBIs clarifications of rules for MFIs in May, there were two equity deals announced (a ₹100 million investment in Hope Microcredit by Incofin Investment Management and

a ₹133 million investment by Dia Vikas[9] in three separate firms). The investment amounts were quite small. Total investments (other than IFC) following the Andhra Pradesh crisis totaled less than ₹280 million. The last equity deal to take place before the Andhra Pradesh Crisis started was valued at ₹210 million, almost equaling total investments following the onset of the crisis. During the first half of the 2010 FY US$75 million was invested in seven separate transactions. In 2011 that number has dropped to US$69 million and four separate transactions.[10] Despite the lack of new investments in the industry, PE managers are actively trying to secure funding for their portfolio companies through international microfinance-focused funds and development funding agencies such as the IFC.[11] There is some evidence that, despite fears of negative press, socially motivated investments are funding MFIs and there is a rekindling of interest in equity investments.

Table 5.1 Selected equity investments, 2011[12]

Investor	Investee(s)	Amount (₹ million)	Date
Citi Venture Capital International	Janalakshmi Financial Services	650	June
BlueOrchard	Svasti	45	May
Dia Vikas	BWDA, Rashtriya Grameeen Vikas Nidhi, ESAF	133	April
IFC	Bandhan Financial Services	1,600	January
IFC	Shree Mahila SEWA	450	January
Incofin Investment Management	Hope Microcredit	100	December
Lok Capital and Assvishkaar Goodwell	Suryoday Microfinance	210	Aug
Elevar and SVB	Vistaar Livelihood Finance	400	June
Total		**3,863**	

The year 2009–10 saw equity investments of about ₹9,400 million. The current year equity investments are at about 41 per cent of last year's level. Of the investments made in the current year about ₹2,970 billion was made in the first quarter, before the Andhra Pradesh problems cropped up. JP Morgan and Consultative Group to Assist the Poor (CGAP) in their study of equity valuations in microfinance sector found a decline in price to book value ratios across the world. In India the price to book value which was 2.1 in 2009 declined to 1.7. This was lower than the four year median value of 1.8. The report (which is post Andhra Pradesh event) says:

> We believe that the Indian microfinance market will go through a difficult adjustment phase, with high delinquency rates, significant write-offs, and lower funding availability for MFIs, especially for those MFIs with a high exposure in AP. On the regulatory front, the outlook is improving but remains uncertain.

In an attempt to bolster investor confidence, the government announced its own equity investment fund. In the 2011–12 budget the finance minister announced the creation of the India Microfinance Equity Fund (IMEF) of ₹1 billion with SIDBI and the Women's SHG's Development Fund funded at ₹5 billion. IMEF will provide domestic equity, which should ease requirements under Press Note 2 of Department of Industrial Policy and Promotion (DIPP).[13] The guidelines of DIPP require MFIs with direct foreign equity investments to mobilize domestic equity upto a minimum extent, which is large for small and medium MFIs. These moves should help to increase available equity for MFIs and help the industry move towards greater regulatory certainty and control. The gesture is more symbolic as both funds are too small to be of significant influence. The funds need to be much larger to impact the liquidity of the market. If targeted well the IMEF could help many small and some medium MFIs. Despite expectations, Malegam Committee recommendations and the adoption of the recommendations in a practical form by RBI in regulatory guidelines, did not persuade banks to ease lending to the sector.

Bank lending to MFIs

Although equity has become an important source of funding in recent history, MFI funding in India is heavily weighted towards debt. The debt to equity ratio last year was 4.65, showing a sector weighted heavily towards debt. This year due to the decreases in the available debt financing, the ratio has decreased to 3.58.[14] Debt is financed in a variety of ways. The major form of funding remains loans from banks. When the asset book of MFIs comes under strain, the majority liability holders, i.e., banks suffer. The Andhra Pradesh events showed the close relationship between asset quality of MFI and the asset quality of banks. In effect the banks loans to MFIs turned out to be pass through funding, with the intervening institutional structure of MFIs with a balance sheet of their own becoming irrelevant. The default at customer level of MFIs turned in to potential (and in

some cases real) defaults to banks. In order to avoid this repayment crunch at the plea of banks, the RBI has eased debt-restructuring requirements for MFIs. Apart from banks there were other bulk lenders such as SIDBI, Ananya Microfinance, Rashtriya Mahila Kosh, etc. Outside of traditional loans, growing sources of borrowing are the securitization of loans, assignments, and the sale of non-convertible debentures. Some companies are also availing quasi-equity either in the form of subordinated debt of long duration or by issue of preference shares.

Table 5.2 Loans from banks, 2010–11

Category of banks	Loans disbursed by banks to MFIs during year 2010–11		Outstanding bank loans to MFIs on 31 March 2011	
	No. of MFIs	Amount (₹ million)	No. of MFIs	Amount (₹ million)
Public Sector Banks	282	2,846.2	1,661	5,048.0
Private Sector Banks	157	3,622.9	446	4,095.0
Foreign Banks	3	15.5	19	433.7
RRBs	1	0.1	9	0.3
SIDBI	59	843.8	139	3,041.8
Total	502	7,328.4	2,274	12,618.8

Compared to last year the loan disbursement by banks to MFIs was markedly less by about 30 per cent. Only private sector banks increased their disbursements by about 32 per cent over last year. Public sector banks disbursements was 66.5 per cent of previous year's level. SIDBI, the largest single funder last year disbursed less than a third of what it did in 2009–10. Loans outstanding declined by ₹11.8 billion between March 2010 and March 2011. Again only private sector banks increased the asset book on lending to MFIs. All others had reduced their exposure to MFIs. In fact limiting loan exposure to MFIs started earlier in the year much before October 2010 in response to RBI speak on the merits of providing Priority Sector Tag to MFIs borrowings from banks. With the class of asset in doubt and the admissibility of the exposure to the priority sector lending targets, banks shied away. The Andhra Pradesh events compelled banks to take a fresh look at the risks of lending to the sector and unfortunately pessimism prevailed over pragmatism in rerating of risks. Banks not only did not sanction fresh loans, but also stopped withdrawals from sanctioned loan accounts. Some banks recalled loans that were not due, well ahead of the maturity date. In one such case a writ was filed before the High Court forcing the bank to settle with the MFI. Some banks asked for additional collateral and even personal guarantee of promoters and directors on the board. Some of these exercises brought to surface the naiveté with which banks were managing credit risks.

An incongruous note was the demand for responsible finance and transparent pricing from some banks that were not models of responsible behaviour. The loan negotiations and terms offered by some banks did not reflect adoption of the same principles that they demanded in their customers. Decisions on loan applications could take months. Changes in dealing officials in banks could set back the approval process considerably. Interest rates have been continually pushed up with accompanying service charges and appraisal fees. The flat character of such fees increased the effective interest rates and the banks did not compute the borrower's costs of the loan and declare the same in loan documents. Even in the current context when banks ask MFIs to comply with 26 per cent interest and 12 per cent margin cap, the interest rates on recent loans to MFIs have been in the 14.5 per cent to 15.5 per cent range. Banks know well that MFIs cannot maintain their permissible margin at these borrowing rates, but little is being done to remedy the situation.

Other institutions such as Ananya Finance had comparatively subdued operations during the year. NABARD had stopped funding MFIs in the middle of the year as result of a reported policy decision that MFIs should be served by SIDBI. Andhra Pradesh government has recently set up an Apex Cooperative Society for financing to SHGs.[15] The loans will first be given to Mandala Mahila Samakhyas (MMS), which will then give loans to the Gram Samakhyas which distribute micro-loans to SHGs. The fund is designed to 'avoid any harassment or malpractice' which are attributed to MFIs.[16] The Ministry of Rural Development, Government of India, is on the verge of setting up a finance corporation to fund the SHGs and livelihood activities under NRLM.[17] The corporation is expected to supplement the support from banks.

Ratings

The credit rating agencies had downgraded many MFIs several times in the past year. CARE and Fitch Ratings have likewise said that they will watch

transactions carefully and are unlikely to give top ratings to MFIs due to sector-wide challenges.[18] The rating downgrades have been sector-wide on the assumption all MFIs will be affected similarly regardless of whether their loan portfolio is affected, adequacy of networth to absorb potential loan losses, adequacy of available funds to tide over reduced liquidity flows from banks, etc. Twelve MFIs (SKS Microfinance, Asmitha Microfin, Bhartiya Samruddhi Finance, Digamber Capfin, Equitas Micro Finance India, Grameen Financial Services, Sanghamithra Rural Financial Services and (SKDRDP)) were downgraded including some that did not have a presence in Andhra Pradesh. Some of the downgraded MFIs had no problems in carrying on their business and ended the year with reasonably good results. The question here is the role of a credit rating agency. If credit agencies resort to actions that are based on newspaper reports than a fundamental analysis of institutions and instruments that are rated, then the case for ratings as a risk management exercise is lost. RBI might do well to take cognizance of the behaviour of rating agencies that borders on negligence as they substituted analysis with presumptions. Sanjay Sinha in a recent interview stated[19]:

> The incursion of the large corporate ratings agencies into the world of microfinance must bear part of the responsibility for the current mess in the Indian microfinance industry.

The rating majors defended their actions stating that they understand the sector well and have competent personnel who specialize in microfinance.

Lowered ratings increase the cost of capital and as MFIs approach the BB rating they may lose access to capital entirely (BB signifies that the rating agency does not believe the instrument has adequate safety to pay financial obligations on-time).[20] Although this year has been tough on MFIs there has been evidence in late August of the ratings firms working with MFIs to upgrade ratings, especially of securitization deals.

Table 5.3 Loan deals[21]

Lender	Lendee	Amount (₹ million)
Microfin Private Limited	Suryoday Micro Finance Private Limited	35
Oikocredit	Grameen Koota	115
Oikocredit	Share MACTS	30
Oikocredit	Hope Foundation	25

SKS IPO and after

The successful IPO of SKS at 98 times the face value captured the imagination of many MFIs and the attention of media and political establishment. In the last year's report a reference was made to the high valuation

Figure 5.1 SKS equity price movement

with the caution that 'with neither the technical factors around business promising an extraordinary spike in income potential nor the market sentiments reflecting the urge to apply a higher discount ratio in terms of price to earnings, the valuation achieved would be difficult to defend.' The market prices of SKS equity after an initial honeymoon period with the market started falling from mid October onwards. Barring a small and short rally in July 2011, the movements in price have been one way. The current price of the scrip is about 22 per cent of the issue price and 16 per cent of the peak market price.

SKS apart from piloting the IPO through the market, did not do many things right. A continuing spate of negative publicity impacted the scrip in the market. Before the Andhra Pradesh crisis began to unfold, stories about SKS staffers featured prominently in the media and SKS began to reshuffle its leadership. In early September 2010, Vikram Akula took over as Executive Chairman. Suresh Gurumani, was removed in early October 2010 and replaced by M. R. Rao. In July Vikram Akula was appointed as Executive Chairman. In August 2011, the board reportedly suggested that Akula step down due to his busy travel schedule.[22] The reshuffling has continued with Independent Director Pramod Bhasin resigning from the board in August 2011 as well.[23]

External events such as the passage of the Andhra Pradesh Microfinance Ordinance negatively impacted growth rates and prospects for SKS. In October of 2010 SKS staff members were arrested for coercive recovery practices.[24] They have experienced significant losses in the short term and the overall financial position of the company has weakened. This caused JP Morgan Asia Pacific Equity Research to reduce the valuation assigned to the company in May 2011 by half before fourth quarter losses were announced.[25] A recent development is that Catamaran might sell its holdings in SKS as its price has fallen below the agreed threshold. The learning is that microfinance companies should be circumspect in approaching the capital market with tall claims and high valuation expectations. The customers of microfinance carry a political risk that is triggered from outside the clientele. Institutions that promise high profits to investors from out of such clients run much higher blatant and latent risks.

Debt restructuring

In order to ease the liquidity restraints created by reduced bank lending and increasing default rates, the RBI's CDR cell set guidelines for MFI debt restructuring. More than one-third of the industry's loans were restructured.[26] The CDR programme was only available to the major MFIs operating out of Andhra Pradesh. The CDR cell cleared cases of five MFIs, viz., Asmitha Microfin, Future Financial Services, Share Microfin, Spandana Sphoorthy Financial and Trident Microfinance. Two MFIs (SKS Microfinace and BASIX) that were invited to participate in the restructuring deal decided not to participate in the program. The program originally had strict requirements in place including personal guarantees for debt from promoters. This requirement, however, was relaxed when MFI promoters balked and instead was replaced by promoters pledging 100 per cent of their equity holding to the banks.[27] The RBI allowed for loans to be recast instead of being labeled as non-performing. If loans are labeled as non-performing the profitability of banks is reduced because they need to hold money apart to cover them.

Restructuring agreements vary between MFIs, but all include a one-year moratorium on repayment and seven years to repay loans. In addition banks will change part of the debt into convertible preferential shares, allowing banks to convert debt into equity if any of the five MFIs default.[28] Finally, banks will have several nominees (2–3) on each board and will have a significant impact of the operational control of the MFIs. Despite this, banks have rejected pleas to provide at least ₹200 crore immediate funding. For the most troubled MFIs with the greatest exposure in Andhra Pradesh restructuring debt has not been enough. Share, Spandana Sphoorty and Asmitha continue to debate a merger to consolidate their positions.[29] The plan is to first merge the three companies and then demerge the same in to three different verticals. One of the three entities will hold the damaged Andhra Pradesh portfolio and ring fence the same; the other will handle the non-Andhra Pradesh portfolio which remains unaffected and the third will look at opportunities outside microfinance—such as tractors, vehicles, gold loans etc.

Table 5.4 MFI CDR Debt Restructuring Programme[30]

(₹ in crore)

Microfinance institution	Total CDR exposure	Non-CDR exposure	Total debt
Asmitha Microfin	1,234.01	140.55	1,374.56
Future Financial Services[31]	98.95	60.59	159.54
Share Microfin	2,160.32	241.51	2,401.83
Spandana Sphoorty Financial	2,854.02	471.91	3,325.93
Trident Microfin	125.70	23.47	149.17
Total	**6,473**	**938.03**	**7,411.03**

NON-CONVERTIBLE DEBENTURES

As an alternative to traditional loans, many MFIs have started using non-convertible debentures (NCDs). NCDs have many of the characteristics of typical debentures but do not have the option to convert to equity. This means that they carry higher interest rates. NCD deals were on the rise. Reports of many NCD deals in the works from Bhartiya Samruddhi Finance Ltd. (a BASIX group of company) looking to raise 1,200 crores through NCD issuances or SKS Microfinance gearing to raise 5,000 crores in FY12.

Table 5.5 Major NCD deals[32]

Company	Amount (₹ million)	Date
Ujjivan Financial	230	July 5, 2011
Sahayata Microfinance	195	April 13, 2011
Grameen Koota	350	February 28, 2011
Ujjivan	45	Aug 4, 2010
Share	500	April 26, 2010

LETTERS OF CREDIT

Due to the lack of certainty in the market, several institutions have stepped forward to offer letters of credit to qualified MFIs to create more liquidity in the market. Letters of Credit are a secondary guarantee that loans to the MFI will be paid back. The Grameen Foundation, Grameen Capital and Grameen Jamal have pooled resources to provide socially responsible MFIs with guarantees. This represents a new avenue to reduce the cost of bank loans. The first deal that went through under the US$7 million round of funding in the form of bank loans for Cashpor Micro Credit, it was backed by US$980,000 from the Grameen Consortium.

SECURITIZATION OF LOANS

Despite the growing popularity of NCDs, they fell far behind securitization deals. In 2011 asset-backed, rated loans that went through an intermediary were the one real source of funds for lending. Different loans are pooled, often from different locals and sometimes from different MFIs, and sold to a Special Purpose Vehicle. The loans are then divided into pools and evaluated by a rating agency. Often, credit enhancements will be placed on the portfolio (first loss default guarantee by MFI and second loss guarantee by other investors). The portfolio is then sold.[33] MFIs are limited in the amount of their portfolios they can securitize by their accumulated earnings and equity.[34] SKS Microfinance completed the largest single rated pool assignment in Indian microfinance with two deals worth ₹5.5 billion.[35] IFMR Capital has securitized more than ₹5.2 billion loans this year.[36] There has been increased pressure by banks to have loans secured by assets and evaluated by an independent entity to reduce risk. Repayment streams that have been examined for robustness are more likely to be repaid and thus banks will buy these assets rather than giving unsecured loans, especially in the face of low repayment rates in Andhra Pradesh.

As more banks turn toward securitization to meet capital requirements, MFIs have lost their bargaining power. Instead of being protected by the Priority Sector Lending (PSL) targets, banks view them as having a much higher risk. This has increased the interest rates banks are charging by around two percentage points.[37] Although securitization represents a viable, if costly, path for many MFIs, those based in Andhra Pradesh have trouble meeting the requirements for a top-rated pool.

While this tool is expected to continue to increase in importance, it cannot replace other financial instruments. The cost of capital is increasing in the

Table 5.6 Major securitization deals in 2011[38]

Originator	Amount (₹ million)
Grama Vidiyal	108
Satin Creditcare Network	300
SKS Microfinance	500
Ujjivan Financial Services	173
SKS Microfinance	5,500
Utkarsh Microfinance	871
Grama Vidiyal Microfinance	120
Grameen Financial Services	153
Grameen Financial Services	250
Grama Vidiyal Microfinance	173
Grameen Financial Services	165
Janalakshmi Financial Services	370
Satin Credicare Network	792
Grama Vidiyal Micro Finance	449
Total	**8,019**

industry as well as through securitizations. Interestingly, the June Grama Vidiyal deal had the first tranche of investments bought out by private wealth investors, led by Avendus Capital, showing a shift towards less risky investments by private individuals. This could show a trend away from equity investments and towards securitized debt instruments not only for institutions but also for private investors. It shows an overall shift away from risk for all industry investors.

The industry has experienced a severe funding contraction since the Andhra Pradesh crisis. There have been news stories predicting that the credit crunch will reduce repayment rates as MFIs struggle to find loans to expand and spiral the industry into oblivion.[39] However, MFIs are already engaging in risk mitigating strategies and are examining new methods of funding their operations. Bank loans may be restricted in the short-term but non-traditional means of financing (securitization deals, etc.) are growing. MFIs are becoming more sophisticated with the type of investors they are accessing and the diversity of their capital structure is growing. Although the Andhra Pradesh crisis has curtailed growth in the short-term, it has forced the industry to pay more attention to the supply side of its financing and examine sustainable growth rates, forms of financing, and innovations in raising resources.

Box 5.1 Innovations in capital structuring

MEZZANINE DEBT—NEW POSSIBILITY WITH LOWER CAPITAL COSTS[40]

Mezzanine debt is subordinated to senior, unsubordinated debt capital but ranks ahead of equity in the capital structure. The subordination to senior debt happens in two ways—senior lenders are often times, secured and subordinate mezzanine debt is unsecured. Secondly, the tenure of subordinate mezzanine funds is longer, which provides a cushion to senior debt. This means that in case a business goes bankrupt, the senior lender recovers dues first, followed by the mezzanine provider and finally the promoter/equity provider gets his/her share. Obviously, since the risk is higher in mezzanine instruments, the cost of funds tends to be higher.

Mezzanine financing, while more expensive than senior debt, has the advantage of lower cost of raising capital—Mezzanine funds, due to their innovative structure are classified under Tier II capital. Micro-banking service providers can leverage this capital with banks to raise additional funds. This effectively reduces the total cost of funds. For example, Tier II capital can be used to leverage bank finance up to 5 times. Hence for every ₹1 of mezzanine debt raised, a maximum of ₹5 can be raised as senior debt from a bank. Mezzanine funds can also help MFIs in adhering to capital adequacy norms. For instance, if the total risk weighted assets of a micro-banking service provider is ₹100 and its networth is ₹10. The CRAR (Capital to Risk-weighted Assets Ratio) is 10 per cent, which is below the prescribed norm of 15 per cent (effective from April 2011). If the MFI were to raise mezzanine funds worth ₹10, the CRAR changes to 15 per cent, which is the prescribed, minimum CRAR. This is possible because the risk weightage for subordinated debt is 50 per cent and for equity it is 100 per cent.

The reduced equity flow and liquidity constraints stemming from banks' reluctance to increase exposure in an uncertain market led to contraction of business in many MFIs. But there were others which did manage to find funds through equity, quasi equity, securitization and in rare cases banks loans as well to fund their business. Those affected severely were the medium and small MFIs. In the second quarter of 2011–12 there are signs of a thaw in liquidity and equity flows. A large equity placement had been announced by IFC. Different banks have reported loan sanctions of varying amounts to select MFIs. Some banks have announced their commitment to the sector and indicated their disbursement budget for the year. There are signs of a revival of funding for good MFIs with a reputation, regulatory compliance systems and sound governance. The learning for the sector is that investors and lenders will be fairweather friends. Their investments do not indicate a commitment to the investee institution but to the short-term outlook for the safety of their investment. MFIs have to work on diversifying sources of funding and accessing alternative avenues and instruments to reduce the credit availability risk.

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Social performance management—beyond responsible finance and customer protection

6

Chapter

The year 2010–11 has been full of shocks and surprises. The laidback attitude towards social performance on the part of the sector took a turn towards the positive. The action taken by the Andhra Pradesh government and the negative media coverage that continued for a sustained period of time led microfinance institutions to initiate measures towards responsible finance and improving the social content of their business. More MFIs went beyond business to establish their social relevance than in the past. The last year had seen a number of initiatives at sector level as also at individual MFI levels to concentrate on the social aspects of doing business. The gaps in responsible financing practices in the sector brought the regulator's attention. The Andhra Pradesh regulation required MFIs to become selective in customer acquisition, appraisal of loan servicing ability, recovery practices and pricing of loans. The RBI regulations introduced quantitive definition of microfinance customer, a ceiling on loan amount, appropriate term for loans based on size, the number of loans per customer, ceiling on loan amounts per customer, interest caps, margin caps and grievance handling systems. These are business aspects that the institutions should have adopted on their own not just from a responsible finance framework, but as a risk management measure. Many of these were part of MFIs operational policy and processes, but not all MFIs had adopted all that regulation had introduced.

MIX Market and Imp-Act consortium brought a document on 'State of Practice in Social Performance Reporting and Management'[1] based on a survey of 405 MFIs from different regions of the world that reported Social Performance Management (SPM) data to MIX. The key findings of the study indicate that the drivers for SPM are market maturity, training in SPM, investor/funder orientation and support from local MF networks. SPM is not viewed as an option to be pursued by non-profits, but adopted by all MFIs regardless of form. A well-trained governance board is more likely to steer meaningfully SPM. While MFIs recognize the importance customer protection principles, only 15 per cent MFIs have adopted all six principles advocated by Smart Campaign. Few MFIs are able to focus on poverty targeting and tracking clients progress subsequently. MFIs find it difficult to balance social and financial performance aspects in setting staff incentives. Well-trained staff is a key to meaningful field practice in SPM. The report is an important addition to the sector's knowledge of actual conditions on the ground.

The work that was being done by Sa-Dhan and MFIN for implementing a voluntary code of conduct across their membership received a boost during the year. Not only was a code of conduct brought into being but also it was sought to be enforced over the member institutions. Going beyond implementation of code of conduct, compliance was also being monitored by the institutions. SIDBI, the World Bank and a couple of other lenders joined hands to implement a code of conduct compliance assessment (COCA). M2I[2] which designed the compliance tool (COCA)[3] has carried out the compliance assessment for eight institutions in the last one year's time. The assessments has concluded that most institutions have effective systems in place to ensure that the code of conduct is practised. The COCA examined dimensions such as client origination and targeting, loan pricing, appraisal, client data security, staff conduct, client relationship and feedback. It also examined compliance parameters such as approval, documentation, dissemination and observance proceses. The following table contains the scores awarded for the eight MFIs that have been assessed.

Table 6.1 Scores on compliance with code of conduct

Name of MFI	Score on COC dimensions (percentage)	Score on COC parameters (percentage)
Arohan	81	81
ASA	87	87
Bandhan	84	84
Cashpor	75	75
Equitas	88	88
Samruddhi	84	84
SKDRDP	73	73
Ujjivan	87	87

IFC and Dell foundation (MSDF) have taken the lead in bringing Sa-Dhan and MFIN together for harmonizing the codes of conduct adopted by these two networks. The work has been going on for quite some time and it is likely that the commonly agreed code of conduct will be in place soon. The revised and updated code of conduct goes beyond customer protection. The draft which is in an advanced stage fo adoption by both Sa-Dhan and MFIN comprises five parts—Core Values of Microfinance, Code of Conduct for MFIs, Additional best Practice guidelines, Customer Protection Guidelines for MFIs and Institutional conduct guidelines. The document brings to surface isues at three levels—first is the interface between the staff of MFIs and the customer, second is the interface between the MFI and its staff and the third is the market in which MFIs interact with each other. The conduct of MFIs in all these three levels is sought to be guided with what would be most appropriate to protect customer interests and adopt responsible practices.

Sa-Dhan had brought out a social performance report during the year consisting of issues that MFIs should deal with and also some of the practical examples of how institutions have dealt with this. The Andhra Pradesh legislation more than anything else had driven the responsible finance agenda forward. Within MFIs business processes have been redesigned to avoid multiple lending and excessive debts and at the same time reduce risks to the MFIs. RBI had issued regulations capping the rate of interest as also the margin on loans of MFIs. This has had a salutary effect on the sector with almost all the MFIs dropping their interest rates. However, the hardening interest rates in the market have began to put pressure on the margins of MFI and some of them will find it difficult to attain the 12 per cent margin allowed by RBI.

On the SHG bank linkage side, some undesirable practices found during the previous years still continue. The savers are unable to make use of their savings in a number of states. The amount of savings placed with banks by SHGs at ₹69.2 billion formed more than 20 per cent of loans availed by them from the bank. Why the SHGs should get a low return on their savings with banks while availing high cost loans in return? A socially responsible banking system would have ensured that SHGs used their savings first in intra-group loaning and then only take recourse to drawing loans from banks. The savings are being deposited with banks as a kind of informal collateral against loans availed by the groups from banks. The process of group formation and the kind of services that were promised at the initial stage are not being effectively sustained especially in respect of government programmes. The strength of groups working together has not been fully utilized. The trust level in groups in some states has not been high as seen from the tendency to distribute savings and the corpus of the SHGs almost on a yearly basis.

Sa-Dhan in its social performance report[4] had carried out an analysis of 109 MFIs' reported data on social performance and field analysis of the operations of 15 MFIs. The code of conduct had been adopted by the Board in 59 per cent of the MFIs. The code had been displayed in the premises of the branches in 40 per cent of the MFIs. Eighty-seven per cent MFIs had issued guidelines on staff behaviour but only 20 per cent MFIs carried out a check on the field behaviour of staff through internal audit. Forty-seven per cent MFIs had issued guidelines against abusive recovery to their staff. Several MFIs had done well in establishing transparency of their operations. More than 90 per cent MFIs had been placing their financial results in the public domain, making repayment schedule available to their clients and explaining loan terms to the customers. However, only 66 per cent of MFIs had revealed the effective rate of interest to the customers and had explained the method of charging of interest rates. The terms and conditions of loans were provided in writing to members only by 63 per cent of the MFIs.

MFIs had done well on some of the fair practices that have been laid down by the industry. The first of these relates to not taking physical collateral which was practiced by 94 per cent MFIs. Again 94 per cent MFIs maintained the KYC-related documentation of the clients. Ninety-four per cent MFIs reported that they do not discriminate between customers on the basis of caste or religion. In terms of

the composition of the Board, which could play a role in protection of the customers' interest, it was found that 76 per cent MFIs had independent directors on the Board. The Board was involved in policy formulation and strategic decision making in 71 per cent of MFIs. But the compensation of CEO was approved by the Board only in 55 per cent of MFIs. While training was provided to clients about the products in the case of 91 per cent MFIs, financial literacy was offered only by 48 per cent MFIs. Internal audit did not cover interactions with customers to verify what the customers had actually transacted with the MFI in 69 per cent of MFIs. This is a matter of concern as the customer interface of the organizations also needs to be brought under scrutiny. The Sa-Dhan report concludes that the MFIs should focus on avoidance of excessive lending and multiple loans, improve financial literacy among customers, enable feedback from customers, set up a grievance handling mechanism, avoid unhealthy competition, improve the products and services by giving wider choice to customers and institute appropriate loan recovery practices.

Customer acquisition is a key aspect of SPM as it determines whether the MFIs adhere to their mission of serving vulnerable people. A sample of 67 MFIs surveyed by the Sa-Dhan study revealed that 50 per cent MFIs had poverty reduction as the mission and 67 per cent had poverty outreach as part of their mission. When it came to the question of how the poor clients were targeted during acquisition or how their progress is monitored, very few MFIs had the mechanisms for the same. Seven MFIs reported using PPI as tool for measuring poverty level and benchamarking the same. Most MFIs reported that they collect the data on poverty level, but the data was not being collated or used. Grameen Foundation reports that 12 Indian MFIs use Progress Out of Poverty Index for poverty profiling of their clients at the entry stage and subsequantly to track the progress of the customer. Grameen Koota became the first certified user of PPI tool in its entirety.

The landscape of customer protection and responsible finance should see actions from the MFIs and networks on the following aspects. Scarcity of information from the MFI forcing the customer to take decisions on the financial service offered makes the customer feel that he/she is exploited. Disseminating adeqaute and relevant information to the customers and also informing them on how to make use of the infromation in taking a decision is a prime requirement. The product designs are by large tailored to suit the MFIs rather than the customers. The recent focus on long-term loans and livelihood financing by MFIs (mandated by the regulator) should make MFIs work on new designs that take in to account the kind of activities pursued by customers and the cash flows therefrom. Without such a redesign even small loans could become burdensome. The bundling of products—such as insurance with credit, water filters with loans, etc.—have not improved customer comfort. Every product and service should be offered as a standalone and the customer should have a say in taking up a product service. Customer refusal of one product, should not result in denial of another product or service required by the customer. Organizational processes that interface with the customer have to be reviewed and refined to improve customer comfort and reduce cost and time spent by the customer. The processes such as customer acquisition, loan appraisal and sanction, disbursement, customer contact meetings, customer training, repayment and recovery hold cost and time traps for the customer and often for the MFI as well. At times the processes might be efficient from the MFI point of view but could cause extreme hardship to the customer to go through the process. Process mapping, not only from productivity and efficiency angles, but also from the customer comfort and friendliness should be carried out.

The use of agents had been discussed in the last year's report. Several instances of agents causing difficultues to customers and MFIs have been reported. MFIs should ensure that the use of unauthorized agents in the field is totally avoided. In case the cluster leaders are to perform some basic tasks, the nature of their responsibilities and the manner in which they are compensated by the MFI should be disclosed to the customers in the local area. The idea is to prevent the abuse of the leadership position by such agents in the local areas. Group formation processes should provide more freedom and choices to customers to form their own groups. Since joint liability is involved, the group membership should not be forced on customers who are desparate for funds. Finally the MFIs should ponder over the fact that customers are not treated as well as if not better than the shareholders.

As an industry leader SIDBI has been playing a critical role in responsible finance and customer protection aspects. It has taken up responsible lending agenda comprising improved management, better governance, efficient and friendly operational practices and enhanced disclosures for implementation among the MFIs. The uneven spread of the sector in the southern states results in limited services in other regions. SIDBI has taken

up supporting MFIs in non-southern states for financing and has covered 80 MFIs so far. It has been at the forefront of the lenders forum comprising bankers that lend to MFIs to unify the disciplines and norms for voluntary adoption. The norms relating to good governance and best practices in operations are being made a part of the loan conditions so that the MFIs may be held accountable even in the absence of regulatory pressure. (The list of covenants agreed to by the Lender's Forum is provided in Annex 6.2.) SIDBI had persuaded more than 50 MFIs to reduce their rate of interest to customers. It had also commissioned a study of 30 MFIs to under their cost structures and pricing issues. SIDBI is also planning to set up MIX India platform for voluntary reporting of all types of financial and operational data by MFIs in a transparent manner. In close collaboration with Accion and Smart Campaign it enables dissemination of information and skill development. The work of SIDBI in responsible finance especially in recent times is noteworthy. The effectiveness of SIDBI nominees on boards of some of the MFIs has been questioned, with some justification. Some MFIs had been able to get away with unethical governance and market practices even with SIDBI being on the board. Disciplining MFIs through the loan conditions in coordination with other lenders is bound to be an effective way making the sector behave.

MicroSave on its part has been working in the social performance management sphere actively helping MFIs and donors to look at issues relating to business aspects of social performance. MicroSave provides a practical shape to SPM and offers implementable actions to MFIs so that they could integrate social aspects into business. Social Performance Management (SPM) practice in MFIs according to MicroSave is integral to business practice. The model of SPM implementation that MicroSave adopts in MFIs first looks at integrating SPM in to strategic Business Planning. Since vision and mission are at the core of the strategy, strategic business planning helps the MFI to evaluate the mission dimension and the social performance content thereof. The business strategy should be able to answer questions on how to achieve the social performance goals even when the business objectives are achieved. The balance between commercial considerations and social considerations and the trade-off issues if any are consciously dealt with in the process of planning. The result is clear perception of the goals of the organization comprising commercial and social aspects and means of achieving the goals. But apart from integrating SPM into business strategy, governance of the organization should should also be sensitized. The board typically ask itself about its responsibilities towards SPM and whether it has the orientatin and skills to filfill the responsibilities. MicroSave had worked with impact consortium to develop a governance training curriculum from SPM point of view. MicroSave works with partner MFIs of Dia Vikas on SPM implementation.

EDA rural systems Private Limited has been active in the social performance sphere for a long time. It started with poverty ratings and later designed social rating tools. Last year it had carried out assessments commissioned by Dia Vikas. The approach of Dia Vikas in facilitating implementation of SPM in its investee companies is an ideal one from which the sector could draw valuable lessons. With clarity on what it wants the investee institutions to do in SPM, Dia Vikas selects suitable partner institutions that would be willing to implement SPM if practices are already not in place. In last two phases of SPM implementation five MFI partners have gone through the piloting of PPI. The current phase of SPM project covers 11 partners.

Box 6.1 The step-by-step approach of Dia Vikas on SPM

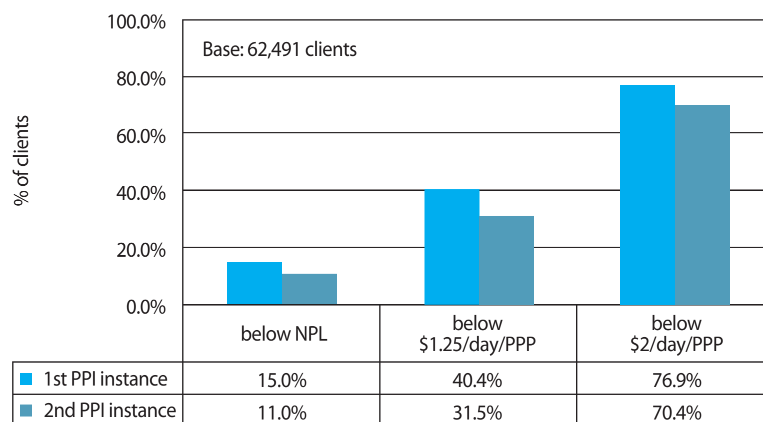
- Agreement on focus areas for SPM
- Selecting partners for SPM implementation
- Piloting PPI on sample basis while building MFI capacity to undertake it themselves
- Selecting additional well-being indicators to help profile the MFI clients and at a later date to measure change
- Conduct client protection assessments
- Introduce client exit indicators
- Provide feedback to the MFIs on the gaps in their existing systems and recommendations to improve systems
- Ensure reporting to Dia Vikas on selected social indicators quarterly
- Build capacities of the partners to report on MiX Social Performance Indicators and Sa-Dhan social metrics

There had been considerable work done on special programmes for the ultra poor. Bandhan after pilot testing a programme for ultra poor under which the households were supported to come up to

a level where they can avail loans from the financial institutions on their own. This programme has now been expanded by Bandhan in partnership with Axis Bank to cover 50,000 households. Similarly institutions like Ujjivan, Gramin Koota and Equitas had been quite active in providing other than financial services to their customers as part of their social responsibility. Equitas as part of its responsible finance framework has introduced a Client Friendly Repayment Practice that eases the burden of borrowers having a debt stress. (See Annex 6.1 for details.)

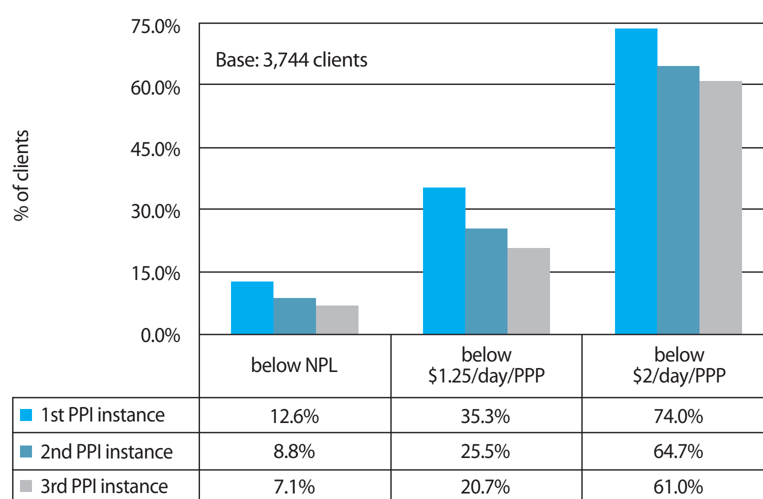
Table: 6.2 Social initiatives of select MFIs

Name of MFI	Initiatives
Ujjivan	Ultra poor programme, Health camps, scholarships and education loan interest support, financial literacy, Livelihoods support, through a group NGO–Parinaam Foundation
Grameen Koota	Socio Economic Development workshops, Enterprise development training, Education, solar lighting solutions in areas with limited power supply
Bandhan	Ultra Poor programme, vocational training, health, education
Equitas	Health camps, health helpline, vocational training, tuition classes for children of customers, schools for underprivileged children—through Equitas Development Trust



	below NPL	below $1.25/day/PPP	below $2/day/PPP
1st PPI instance	15.0%	40.4%	76.9%
2nd PPI instance	11.0%	31.5%	70.4%

Figure 6.1 Poverty tracking through PPI by Grameen Koota



	below NPL	below $1.25/day/PPP	below $2/day/PPP
1st PPI instance	12.6%	35.3%	74.0%
2nd PPI instance	8.8%	25.5%	64.7%
3rd PPI instance	7.1%	20.7%	61.0%

Figure 6.2 Poverty tracking through PPI by Grameen Koota using three cycles scores

Gramen Koota became the first fully certified PPI user in all stages of its customer related proceses. The data capture from the customer at the acquisition and subsequent stages in the PPI tool helped the tracking of progress of customer over time. With the help of the information gathered through PPI Grameen Koota has been able to discern the progress made by the customer and the possible contribution of microfinance to their lives.

An analysis of data relating to more than 62,000 customers of GK brought out that the proportion of customers below the poverty level declined from 15 per cent to 11 per cent over two cycles of loans. The proprotion of customer with income below US$ 1.25 a day decreased from 40.4 per cent to 31.5 per cent. The improvement of income levels for a significant proportion of customers is a matter of satisfaction to the MFI. While it is still too early to attribute the entire progress to the microfinance loans, the fact that customers have been able to progress even when they have contracted the 'high-cost' loans is worth noting.

A similar analysis for about 3,700 third cycle customers had been carried out. The income of a significant proportion of customers had recorded a consistent increase over the three cycles. Proportion of customers having income of less than US$1.25 a day fell significantly over the three cycles from 35.3 per cent to 20.7 per cent.

DOES A SOCIAL MISSION ENSURE PERFORMANCE THAT IS ALIGNED?

As in the case of last year a study by Centre for Microfinance[5] (exclusively for SOS 2011) examined the mission statements of leading MFIs and how

financial performance aligned with these mission statements. The objective was to assess the nature of the mission (financial or social) and to understand to what extent financial performance reflects the nature of the mission. Fifty leading MFIs (measured by number of borrowers) were used for this study.

To determine a 'social' and 'financial' rating for each MFI's mission statement, a survey was administered to individuals with no familiarity of the MFIs. Participants studied the mission and vision of each MFI, and rated each combined statement on a scale from 1 to 10 for the both 'social' and 'financial' factors. The respondent's intuitive understanding of the terms 'social' and 'financial', combined with basic guidelines highlighting parameters defining each term, formed the basis of the rating. The goal of the survey was to capture and quantify an objective perception of the social and financial intentions of an MFI. The reported ratings have been averaged over all respondents for each MFI.

A number of MFIs appear to place an equal emphasis on social and financial goals, where the 'social' and 'financial' ratings are equally strong. Table 6.3 gives the average rating given by the respondents based on their perception of the mission statements, as well as the rank ordering of MFIs. The form of the institution has been given in place of the institution's name so that scores can be examined without preconceived notions regarding specific institutions. The top 10 institutions ranked as the most socially oriented included five NBFCs and five NGOs. The last 10 institutions included seven NBFCs and three NGOs. The top 10 financially ranked institutions includes seven NBFCs, two NGOs, and a Credit Union ranked as the number one most financially oriented institution.

A second stage analysis rated whether financial performance was socially aligned by assigning ratings for ROA, Real Yield on portfolio, trends in costs and yields (whether the MFI achieved reduced yield when operating costs declined) and full disclosure of interest rates to customers. The scoring included two factors, with a high score of '2' assigned if the benchmark was achieved, and a score of '1' if the benchmark was not achieved.[6] The scores on financial aspects were compared with scores on mission content.

Table 6.3 Ranking of mission and performance in MFIs

MFI Classification	Mission: Social Orientation Score	Mission: Financial Orientation Score	Mission: Social Orientation Rank	Mission: Financial Orientation Rank	Socially Aligned Performance Score	Socially Aligned Performance Rank
NGO	8.60	6.00	1	34	7	8
NBFC	8.40	5.20	2	45	7	8
NBFC	8.25	7.00	3	19	6	28
NGO	8.20	5.60	4	39	5	43
NGO	8.00	5.60	5	39	7	8
NBFC	8.00	7.64	5	5	5	43
NGO	7.91	7.00	7	19	7	8
NGO	7.91	6.73	7	27	7	8
NBFC	7.91	7.18	7	14	5	43
NBFC	7.88	7.88	10	2	7	8
NGO	7.80	5.40	11	41	7	8
NGO	7.80	4.60	11	49	6	28
NBFC	7.80	6.00	11	34	6	28
NBFC	7.80	5.40	11	41	7	8
NGO	7.80	4.80	11	47	6	28
NBFC	7.77	6.58	16	29	8	1
NBFC	7.75	7.50	17	7	6	28

(Continued)

MFI Classification	Mission: Social Orientation Score	Mission: Financial Orientation Score	Mission: Social Orientation Rank	Mission: Financial Orientation Rank	Socially Aligned Performance Score	Socially Aligned Performance Rank
NGO	7.75	6.25	17	32	8	1
NBFC	7.75	6.75	17	25	7	8
NBFC	7.72	6.52	20	30	6	28
NGO	7.71	6.14	21	33	6	28
NBFC	7.70	7.20	22	11	5	43
NBFC	7.63	7.25	23	10	6	28
NGO	7.60	5.00	24	46	8	1
NBFC	7.60	3.80	24	50	6	28
NGO	7.60	5.40	24	41	7	8
Cooperative	7.50	7.00	27	19	6	28
NBFC	7.50	5.88	27	38	4	49
Cooperative	7.50	8.14	27	1	7	8
NGO	7.48	6.59	30	28	7	8
NGO	7.45	7.00	31	19	6	28
NGO	7.45	7.64	31	5	7	8
NBFC	7.41	7.12	33	17	5	43
Rural Bank	7.40	7.04	34	18	7	8
NBFC	7.38	7.13	35	15	8	1
NBFC	7.33	6.74	36	26	6	28
NGO	7.30	7.36	37	8	6	28
NBFC	7.30	7.27	37	9	7	8
Cooperative	7.30	5.93	39	37	8	1
NBFC	7.25	7.13	40	15	6	28
NGO	7.20	5.40	41	41	7	8
NBFC	7.20	7.80	41	4	4	49
NBFC	7.09	7.82	43	3	7	8
NBFC	7.08	6.92	44	23	5	43
NBFC	7.00	7.20	45	11	8	1
NGO	7.00	6.00	45	34	7	8
NBFC	6.80	4.80	47	47	8	1
NBFC	6.80	7.20	47	11	6	28
NGO	6.72	6.48	49	31	7	8
NBFC	5.60	6.80	50	24	7	8

The institution ranked first on mission social content was ranked 8th in socially aligned financial performance. Two institutions ranked 1st on socially aligned financial performance were ranked 16th and 17th in social orientation of the mission. A cooperative rated as having a strong financial orientation in the mission (1st ranked) was placed 8th in the socially aligned financial performance ranking. A comparison of rankings shows that a social orientation in mission statement by itself did not translate to mission aligned financial performance. There were more socially aligned best performers among MFIs with a strong financial content in mission. Strong social missions and aligned financial performance while not excluding each other, do not seem to go together.

Table 6.4 Does a social mission lead to socially aligned performance in business

Mission: Social Orientation Rank	Socially Aligned Performance Rank
1	8
2	8
3	28
4	43
5	8
5	43
45	1
45	8
47	1
47	28
49	8
50	8

A comparison of top six and bottom six scores in social content of mission and scores attained by the MFIs reveals that there is no connection between social mission and financial performance. In fact, the top six socially oriented MFIs by mission statement were, on average, had lower socially aligned financial analysis scores than the bottom six. The study also finds that the form of an organization does not indicate a certain type of performance.

The analysis was limited by available data and easily identifiable indicators of social performance. Also, the recent downturn in repayment and investment in MFIs most likely skewed some of the financial indicator results. The study is meant to explore the possibility that some aspects of financial performance can and should be used for measuring the social performance of an MFI. From this simple study, we can broadly conclude that:

- The mission statements of MFIs do not necessarily reflect the performance of MFIs.
- The classification of an MFI does not necessarily determine the social orientation of an institution.
- Many MFIs would benefit from revisiting their mission statements, and designing process for examining how their performance aligns with this mission.

Is social performance an objective in itself and why do MFIs have to spend their resources on the same? MFIs, especially those carrying on lending as a business have responsibilities to their customers and owners. The customers deserve fair and ethical treatment and the owners interests should be protected through appropriate business practices. MFIs deal with vulnerable people as part of their mission. While so doing they cannot ignore the fact the customers are impoverished and are weak contracting parties. Actions of MFIs would be presumed to be disadvantageous in the normal course on account of the weaker position of customers. MFIs should go the extra mile to take actions that protect the customers interest, even if there is no overt demand for the same. When the business is done ethically and with fairness, we do responsible finance. Customer protection becomes a part of responsible finance. But since the initiatives come from a party against whose actions protection is needed, external arbiters have to judge the process and outcomes on customer protection actions. While responsible finance is a voluntarily adopted self-imposed code, there could be demands for something different and better from outside.

Is there a duty beyond responsible finance? Responsible finance is an intra institutional issue. When MFIs choose customers well, deal with them well, market and service appropriate products and exhibit fair and ethical behaviour, they would have satisfied responsible finance principles. Should they then undertake health camps, build schools, provide vocational training and work with people who are not ready enough to be customers? The mission of organizations should provide an answer to this question. If the mission is noble and lofty, then the responsibility of the institution goes beyond the customer and in to the society. If poverty alleviation is the mission, the institution should actively acquire poor households first before taking up others. If mission aims at improving livelihoods and incomes, the MFI has to look beyond loans and ensure that it actually targets livelihoods through financial and non-financial means. Social performance is to be seen in the context in which institutions operate and whether they are relevant there. Institutions that work towards mission fulfilment need to do nothing more than responsible finance. Without a clear articulation in the organizational mission overt social actions of MFIs fall in the category of CSR actions. CSR obligations are mostly met outside of the customer base of corporates. But in MFIs social performance is demanded in relation to the current and potential future customers. MFIs will do well to strengthen customer protection and responsible finance practices. Social performance

that goes beyond responsible finance is a welcome addition, but should not be a necessary condition for doing business. The welfare load of vulnerable customers is that of the state. The state should not ask commercial institutions to take up the welfare load and regulate them in to doing so. If the state believes that institutions dealing with vulnerable people should deliver more than normal business obligations, then it should foot the bill and create an environment in which it becomes feasible.

Social performance is demanded of the MFIs as they deal with the poor and vulnerable. The state, central bank, lenders and equity investors demand that MFIs perform socially as well. Do these stakeholders have a social performance obligation? We witness irresponsible actions on the part of other stakeholders that impair the ability of MFIs to perform. A government that wants the sector to reduce interest rates to the customer does not facilitate a 'low finance cost' environment. At the same time it provides subventions on bank loans to segments of people who are better off than the typical microfinance client. The central bank, while stipulating regulations on margin caps and long duration loans, has not been able to ensure that the margin can be sustained by MFIs or that the lending banks provide resources that match the loan assets created. The lending banks stipulate transparent disclosure of interest rates, loan terms and compliance with RBI norms on service charge of 1 per cent and collateral free loans. But the banks are not transparent in their interest pricing, do not restrict their service charges to 1 per cent and even ask for personal guarantees from directors of MFIs as collateral. If the conviction is that MFIs deal with the poor and they need to be responsible, so it should be with all stakeholders. The stakeholders should create an all encompassing environment of responsible finance and create enabling conditions for MFIs to meaningfully fulfill their responsibilities towards the customers.

ANNEX 6.1
Client friendly repayment practice

Policy Statement: Equitas will stand by the following principles:

1. **Credit discipline:** The credit discipline among members will be encouraged and facilitated.
2. **Empathy:** Equitas will empathize with the members in case any of them have a problem repaying their instalments, understand the problem and thereafter take suitable steps in line with the unique situation of the member.
3. **Flexible support:** Where appropriate, Equitas will facilitate reasonable flexibility in repayment for members who are unable to repay due to genuine reasons. In extreme situations of permanent impairment in the ability of the member to continue her repayment, Equitas would take a call to give a much longer time frame to repay as well as absorb part of the loan outstanding as a write off, such decisions being done at the Area Manager level and above

Proposed Approach:

1. If the member has an outstanding overdue prior to the date of the waiver-triggering incident, she will not be eligible for any waiver as per this policy.
2. Issues impacting repayment will be classified as short-term or long-term.
   a. Short-term: Any issue due to which a member is temporarily unable to service her instalments for a month or less will be considered a short-term issue. However, if such temporary reasons impact more than 5 members in a centre, then it will be treated as a long-term issue.
   b. Long-term: Any issue due to which a member is unable to service her instalments for more than a month, the problem will be treated as a long-term problem.
3. In case of a short-term issue, the other members in the centre will be encouraged to pitch in, as per the joint liability group norms. In such situations the rest of the members of the group would be encouraged to pay the instalment and collect it from the affected member in the next couple of weeks.
4. In case of a long-term issue, the staff are empowered to provide relief to the members, as per the table as follows:

Scenario	Classification	Field staff response
Migration	1. If the member has either moved to her native place due to pregnancy OR if the member has moved to another place, but is expected to return within a month; it will be treated as a short-term issue. 2. If the member has moved to another place and is not expected to return within a month or her shifting was sudden and the rest of the group does not have an idea of where she has moved, it will be treated as a long-term issue.	1. In case of short-term issue, the RO should encourage the other members to pitch in. 2. In case of long-term issue, the Migration Policy will apply. This should be approved by the Business Head. Under this policy, the staff would discuss with the rest of the centre and exercise discretion to provide some support to the centre. The support could be in the form of either: a. waiving upto 50 per cent of the loan outstanding while the rest of the 50 per cent is repaid by the group members by an equal contribution in lump sum. OR b. waiving the last half of the instalments. (For example, if the migrated member had 18 installments due; the centre will pay for the first nine installments and the rest will be waived off).
Natural disaster (Floods, fire etc.) or demolition of house by government authorities	RO will consult with the BM to assess the damage due to the natural disaster as either short or long-term impact depending on how long the member will take to get back to her routine life including her ability to earn her normal daily/weekly income.	1. In case of short-term issue, the RO should encourage the other members to pitch in. 2. In case of long-term issue, the RO should inform the BM. The BM may meet the centre members and exercise his discretion on allowing the member to postpone payment of two fortnightly instalments within the loan tenure. The BM should file a report on the same day in pre-defined format and submit it to Operations. 3. The BM may recommend CM's approval to provide greater relief to the member. The CM, if satisfied after a visit, may postpone four fortnight instalment with a loan tenure extension of two months. Such extension would carry no additional interest.
Death (spouse or child)	NA	Currently Equitas does not offer an option to members to take life insurance for spouse. In such instances, BM should visit the member and file a report. The member will continue to pay the subsequent installments in full till the Death Certificate is handed over to the branch. After this date of submission of DC, the member will be required to pay at every centre meeting 50 per cent of the EFI due for that centre meeting. Equitas proposes to offer spouse life insurance to members on an optional basis for disbursements from January 2011 onwards. Subsequent to this, wherever a member has chosen to take life insurance for the spouse, then the principle outstanding would be deducted from the insurance claim amount and the remaining would be paid to the member. If the member has not chosen to avail of the spouse insurance option, then the member will not be eligible for the waiver policy. In case of death of member's minor child (less than 18 years of age), the BM may authorize deferment of two installments. Thereafter on submission of death certificate, only 75 per cent of the installment amount needs to be paid for the remaining centre meetings.

Accident or Chronic Illness (member, spouse or income-earning son/daughter)	This clause will apply only if the person affected is not expected to get back to normal earning capacity for a continuous period exceeding six months because of this accident or chronic illness. Any illness or accident preceding the date of loan disbursement will not be considered for this waiver.	Area Manager to conduct physical verification and, if satisfied, recommend write-off of the loan.

ANNEX 6.2
Impact Assessment Overview for the State of the Sector Report[7]

Santadarshan Sadhu

Microfinance has attracted a substantial amount of negative publicity in India. Over the past year, the media has portrayed microfinance in an increasingly unflattering light, using sentimental news stories, such as farmer suicides and cases of individual over-indebtedness. However, in such an atmosphere, it is necessary to examine the more academically rigorous studies that have been completed on the effect of microfinance on the average customer.

An impact assessment is a systematic analysis that measures significant changes caused by an intervention. Impact assessments are important because their findings can help improve microfinance services by indicating areas of success or those in need of improvement. Impact assessments also hold practitioners accountable, and they enable funders to better assess a given institution's ability to effectively achieve social improvement.

In order to measure the effects of an intervention, in this case the provision of microfinance services, on a group of people, it is necessary to have a counterfactual. A counterfactual provides information about what would happen to the same group of people if no intervention took place. As this is not possible, researchers have developed several ways of constructing counterfactuals that can be used to assess the causal effect of a given intervention. Broadly speaking, there are two main types of academically rigorous quantitative methods that researchers use. The most accurate method is a randomized control trial (RCT) in which researchers examine the effects of an intervention on a specific group. An RCT first identifies two groups of people in such a way that the groups are apparently identical in every aspect. The researchers then randomly assign the intervention to one group (the treatment) but do not assign any intervention to the other group (the control). These two groups are assessed at two points of time: before and after the treatment is applied. Therefore, an RCT can measure the causal effect of the treatment by comparing members of the treatment and control groups. RCT is substantially less costly in terms of time and resources, and is a quasi-experimental study. A quasi-experiment also compares a group of individuals who received a program, such as microfinance services, with those who did not. However, treatment is not randomly assigned. Commonly, researchers use methods such as comparing incoming and existing clients or matching program participants to non-participants using key characteristics, such as age, gender, and means of livelihood. The conclusions generated by the quasi-experiments might be biased in that unobservable characteristics, such as entrepreneurial ability, rather than program impact itself, might influence the observed differences in outcome variables. While quasi-experiments are less rigorous in their methodology, they are most widely used due to their lower cost and time requirements. Presently, few RCTs are have been completed in India. Not all researchers agree upon the best methodology for conducting impact assessments. There is a lack of consensus over what level impact should be assessed, in addition to the most appropriate methodology for conducting impact assessments within the field of microfinance research.

Regardless of methodology used, impact assessments rely upon a set of indicators, which serve as general areas in which changes can be measured. Commonly measured indicators include poverty and vulnerability, income, consumption and expenditure, enterprise development, savings, and asset accumulation. Yet, changes

in these areas can also have wider impacts in other areas, such as health, nutrition, women's empowerment, and collective action. In many studies, such wider impacts are also included as indicators. For the rest of this overview, findings from the main studies completed in India will be presented according to indicator.

In India, the results from the existing impact assessments have been largely mixed. Most of the findings come from quasi-experiments, which have been conducted all across India. One of the most influential studies was completed by Chen and Snodgrass (2001). In their study of SEWA Bank in Ahmedabad, Chen and Snodgrass compared participants that had taken at least one loan from SEWA to clients who just participated in SEWA's savings program without borrowing. Both groups were then compared to non-clients. Other recent studies include those completed by EDA (2005) and Deininger and Lin (2009). In their study, EDA Rural Systems published a study for Small Industries Development Bank of India (SIDBI) that compared 4000 existing micro-credit clients and 1400 non-clients across eight states. In their working paper for the World Bank, Klaus Deininger and Yanyan Lin compared existing and entering micro-credit clients, in addition to non-clients, in Andhra Pradesh. Recently, M.S. Sriram conducted a study on Kalanjiam groups in Karnataka and Tamil Nadu (2010). Since the study lacked benchmark data (and therefore does not claim causality), the researchers compared groups of different age maturity with the prediction that more mature groups would have experienced greater measured impact.

While the bulk of research has been completed using quasi-experiments, the introduction of RCTs in the past few years has greatly influenced the field of microfinance research. In 2009, Banerjee et al. published the first RCT conducted in India. The study sought to assess the impact of introducing micro-credit into the slums of Hyderabad by randomly opening MFI branches in 52 areas, while leaving 52 slums without access to microfinance services. The study produced notable results involving business development and consumption, which will be discussed below. Presently, the Banerjee study is the main impact assessment conducted in India using a RCT methodology.

Consumption and expenditure are two of the most common indicators examined in impact assessments. Banerjee and Duflo's influential RCT (2009) concluded that expenditure varies according to a household's propensity for entrepreneurship. Among households that did not own businesses before the intervention and had low-predicted propensities for entrepreneurship, there was only an increase in non-durable goods consumption. In comparison, households with a high-predicted propensity for entrepreneurship reduced spending on non-durables, particularly temptation goods, such as tobacco and alcohol. Existing business owners increased their durable spending. Therefore, clients who are unlikely to start a business are more willing to immediately spend their loans on goods, such as food, while clients who have a greater probability of starting a business are more likely to reduce immediate consumption in order to facilitate investment in future assets. Program participation led to higher spending on durable goods from ₹116 per capita per month before intervention to ₹138 after intervention. This effect was even more pronounced among business expenditures.

Chen and Snodgrass (2001) found further positive effects on consumption and expenditure. The study found strong positive effects on spending on improvements in housing, consumer durable goods, and school enrollment for boys. Additionally, the study found a larger degree of effect among repeat borrowers, who were more likely to spend more on household improvements, consumer durables, food, and girls' schooling than one-time borrowers. While assessing the impact of micro-loans, Klaus Deininger and Yanyan Lin (2009) found that access to micro-loans improved consumption levels, but there was little improvement in either income or assets. Sriram's study (2010) found mixed evidence of impact on consumption and expenditure. In Karnataka, household expenditure on food remained stable across participation in groups of different maturity levels. However, in Tamil Nadu, there was a positive association between group maturity and amount of expenditure on food. Equally inconclusive, the study found that total annual cash outflow increased from ₹20,000 to 30,000 as the groups increased in maturity in Karnataka, while there was no similar effect in Tamil Nadu.

Asset behavior is another useful indicator in studying impact because assets tend to remain stable over time and provide accurate annual estimations (Barnes 1996). In their study, EDA Rural Systems concluded that there is a positive correlation between investment in productive assets and participation in a micro-credit program. The study found that microfinance clients are more prone to invest in productive assets as compared to non-clients. For example, in the past two years, 37 per cent of clients invested in productive assets as compared with 17 per cent of non-clients. Furthermore, female clients are more likely to personally own assets if they directly avail micro-loans. In South India, 43 per cent of female clients personally owned productive

assets as compared with 22 per cent of non-clients. In the north, 31 per cent of clients owned such assets as compared with only 9 per cent of non-clients. Additionally, Sriram (2010) found that households containing members of more mature lending groups held greater number of assets. Furthermore, these assets were of higher average value than assets held by households containing members of less mature groups. Alternatively, Chen and Snodgrass' study (2001) found less evidence of impact on asset accumulation. In the study, it was found that increases in asset expenditure between survey rounds were only significant among clients who only participated in the savings program. There was also no impact on the value of fixed assets within the primary enterprises of respondents. Similarly, Deininger and Liu (2009) found no impact on asset accumulation.

It is believed that access to microfinance services will help facilitate increases in income, which will enable more funds to be placed into savings. Thus, savings is another crucial indicator for study. Chen and Snodgrass concluded in their study (2001) that access to micro-credit has a mixed effect on savings behavior, and the level of impact is variable among type of client. Female clients of SEWA Bank were more likely to have savings accounts in their own name than non-clients. Additionally, by the end of the study period, clients had higher average savings as compared with non-participants (₹2,981 vs. ₹1,612). However, between survey rounds, savings averages increased most substantially for individuals who only participated in SEWA's savings program and non-clients. Savings increased by 53.7 per cent for savers and 75.1 per cent for non-clients during the study period. Among borrowers, savings rose only by 13.2 per cent.

In a study in Jharkhand, which used a comparison of PRADAN clients against matched non-clients, Naila Kabeer and Helzi Noponen (2004) found that those who participated in the program generated larger savings than non-participants. For example, it was found that average savings among participants was ₹1,750.03 as compared with ₹803.08 for non-participants. Participants also adopted more diversified savings strategies, such as hoarding cash at home and investing in jewelry, as compared to non-participants. This saving diversification is expected to strengthen risk mitigation and reduce the chance of vulnerability. Furthermore, in EDA Rural Systems' study (2005), it was also concluded that clients had greater savings than non-clients. Specifically, 98 per cent of very poor clients had increased savings as compared with 28 per cent of non-clients. Access to micro-loans also positively impacts individual savings for females. The study found that 95 per cent of female clients had savings accounts in their own name as compared with 21 per cent of non-clients. While micro-credit can help increase levels of savings for members, particularly women, the savings requirements for certain programs may exclude poorer clients, who cannot save regularly. The study found that 50 per cent of dropout clients reported that they were unable to participate any longer in the microfinance program because of their inability to make regular savings deposits. Additionally, Sriram's study (2010) found that there was a positive relationship between group maturity and level of savings. Levels of savings in absolute terms were higher among participating households of mature groups. However, the longevity of the group did not have an impact on the preferences of savings location for members. In Panda's study (2009), the most positive measured impacts pertained to savings. The study concluded that participating households had 55.62 per cent higher annual savings than non-client households. Additionally, participating households had more consistent savings schedules.

Microfinance is commonly advertised as a poverty alleviation mechanism. It is important to measure whether access to micro-loans can help reduce vulnerability and facilitate movement across the poverty line. Various studies have attempted to explore the popular link between microfinance and poverty. Among these studies, Martha Chen and David Snodgrass' study of SEWA Bank (2001) reveals mixed evidence of this link. Between the two surveys, borrowers had the largest increase in the number of non-poor households, but they also had the largest increase in households falling into a lower poverty category. Additionally, there is a lack of evidence that participation with SEWA Bank enables clients to cope better with crisis.

Other studies have also found similarly mixed evidence of the impact of micro-credit on poverty. Priya Basu and Pradeep Srivastava (2005) concluded that microfinance has little impact on poverty and vulnerability as there does not exist a strong relationship between poverty level and the number of SHGs in a village. Conversely, Naila Kabeer and Helzi Noponen (2004) found that micro-credit participants were less likely to experience food shortages than non-participants. It was also found that participants were more likely to face a shorter duration of recovery period when they were faced with such shortages. Yet, Ranjula Bali Swain and Maria Floro (2007), concluded that consumption based poverty is the largest component of vulnerability for SHG members, although it is still more prevalent among non-SHG members. Furthermore, Guerin (2010) concluded that microfinance acts as a 'double-edged sword,' in that it can either reduce vulnerability or push a household into unmanageable debt. In their qualitative study, Olsen and Morgan

(2011) found that the promises of microfinance encourage clients to aspire to move up the social scale. However, this aspiration can lead clients to borrow beyond their ability to pay, consequently resulting in default and over-indebtedness.

Recent studies have also looked at the effect of access to micro-credit on individual employment. Sriram (2010) found that among members of more mature groups, individuals were less likely to be unemployed. Additionally, members of these more mature groups were less likely to be directly dependent on agriculture than members of less mature groups. By basing their livelihoods on non-farm enterprises, individuals were less likely to be affected by volatile and uncontrollable forces, such as climate, thus reducing their vulnerability. Panda also found a positive effect on employment in her study. Panda (2009) found that clients had 22.47 per cent more employment days per year than non-clients. This effect, Panda argues, results from the increased employability of female SHG members.

In regard to wider impacts of microfinance, health and nutrition is commonly studied. K.S. Mohindra (2008) found that SHG participants have a lower likelihood of reporting emotional stress or life dissatisfaction than non-participants. The evidence also suggests that this impact augments with length of membership. Yet, the study additionally found that women are significantly more likely to be stressed if they are engaged in paid employment, suggesting that the emphasis on female entrepreneurship within the microfinance sector may negatively impact emotional health by placing women under a 'double burden,' including both work and domestic duties. Yet, SHG participation does limit exclusion from healthcare for both female participants and other female non-participants who reside in the same households. Additionally, Deininger and Liu (2009) found strong positive correlations between micro-credit and nutritional intake. New and existing clients experienced improvements in nutrition through an increase in protein consumption, while new clients also benefited from greater caloric intake. For new SHG participants, there is a 9 per cent increase in caloric consumption and a 17 per cent increase in protein consumption. For old participants, there is an 8 per cent increase in protein consumption but no impact on caloric intake. This evidence suggests that microfinance can help diversify consumption and enable families to access higher quality foods. In Naila Kabeer and Helzi Noponen's study (2004), it was found that participants in PRADAN were less likely to experience food shortages, had better access to clear drinking water, and had higher levels of awareness of health and family planning issues, such as causes of malaria and diarrhea. However, Banerjee's study (2009) found that participants were no less likely to report a child with a serious illness than non-participants. Also, participants did not increase spending on sanitation or medical expenses.

In regard to more recent research, several studies are presently being produced to measure the impact of wider development programs, known as 'microfinance-plus.' The two studies discussed here focus on the 'Targeting the Ultra Poor' initiative, which prepares the poorest individuals to become future microfinance clients through the provision of productive assets. The preliminary findings from one of these studies led by Banerjee et al. were released in fall of 2010. The study focused on the impact of Bandhan's 'Targeting the Hardcore Poor' program in West Bengal. These initial findings suggest positive impacts on household consumption, assets, and health. Among households that were offered participation in the program, there was a 15 per cent increase in monthly per capita spending. Program participants also had higher levels of assets. In regard to health, participants and other members of their households were less likely to experience food insecurity. Additionally, these individuals were more likely to report they were happier and had experienced improvements in physical health. Presently, a second level of endline data is being analyzed, and further results should be released soon. The second study, conducted by Bauchet et. al, is examining the effects of the SKS Ultra Poor Program. The study is currently undergoing data analysis, and only preliminary results have been released.

As this overview suggests, the evidence from the completed impact assessments in India is mixed. Presently, it is impossible to draw any clear conclusions from the data. However, it is important to recognize that no study will produce universal results. Findings are variable across geographical locations and client groups, so one must be careful when attempting to generalize results across different contexts. Despite the likelihood that results are to remain varied, there is still much area for improvement among impact assessments. Given the current publicity and popular interest in microfinance, there are surprisingly few studies that employ quantitatively rigorous methodologies. Therefore, the sector will benefit immensely from an increased use of randomized control trials.

ANNEX 6.3
List of covenants agreed upon by the Lenders' Forum

The borrower shall agree:

1. To furnish financial and operational data in the specified format to IMFP within reasonable timelines and with accuracy.
2. To undergo a third party COCA with a view to assessing the degree of adherence to the voluntary microfinance Code of Conduct through accredited agencies for the purpose.
3. To undergo a Systems and Portfolio Audit involving detailed examination of operational systems and procedures, funds utilization, assessment of loan portfolio in respect of the risk parameters, finance as well as planning and control etc. by an external agency.
4. To ensure transparency and uniformity in calculating and reporting (to clients and in the public domain) the effective cost (on reducing balance basis) being charged to the ultimate beneficiaries.
5. To prepare a board approved note on recovery practices that would be displayed in local language at each branch and to give an undertaking to take steps to ensure responsible and non-coercive loan recovery practices at the field level.
6. To develop a board approved strategy to check multiple lending/over-indebtedness amongst clients and implement it thereafter and also obtain annual affirmation of the strategy by its board.
7. To put in place an effective grievance redressal mechanism and it is to be placed in the website of MFI and also displayed in the Branch Offices.
8. To take steps to ensure that some acceptable form of electronic, written or printed acknowledgement of financial transactions is left with the individual borrower or the group/its representative.
9. To furnish regularly, accurate and comprehensive data about beneficiaries to Credit Bureaus.

NOTES AND REFERENCES

1. Micol Pistelli, A survey of 405 MFIs reporting to MIX, 2009–10; Anton Simanowitz, Imp-Act Consortium; and Veronika Thiel, Mix Market, July 2001.
2. M2I is a consulting firm in the domains of microfinance management and investment advisory, based in Delhi.
3. Code of Conduct Assessment Compliance Assessment Tool: This tool requires scores to be assigned on the six Code of Conduct dimensions, i.e., Client Origination, Loan Pricing, Loan Appraisal, Client Data Security, Staff Conduct and Client Relationship and Feedback, across the four parameters—Approval, Documentation, Dissemination and Observance. While the tool does not measure adherence to any code of conduct in particular, the six dimensions have been drawn from a review of the norms prescribed for MFIs including Sa-Dhan's and MFIN's code of conducts, guidelines from the Reserve bank of India and CGAP's client protection principles.
4. Sa-Dhan report on Client Protection and Social Performance of Indian MFIs-2011.
5. Puneet Bhasin and Kenny Kline of CMF carried out this analysis; this was coordinated by Santadharshan Sahu. Author is thankful to the team for this contribution.
6. Benchmarks were based on a qualitative analysis of socially performing institutions by MicroSave, as well as inputs from industry experts. The benchmarks used were a ceiling of 3.5 per cent ROA and 27 per cent Yield on Portfolio—MFIs that had lower rates than this caused less pressure on their customers on account of pricing and hence considered as responsible in financing.
7. The author is grateful to Santadarshan Sahu of CMF, Chennai, for putting together this paper on the impact assessment studies in India on impact of microfinance.

Policy environment and the regulation—hard times ahead

7
Chapter

The year 2010–11 should be one of the most happening periods for regulation of microfinance. The year saw several unprecedented and quick developments in regulation of the sector than ever in the past. Some of these developments took place at breakneck speed compared to the lethargy that is traditionally associated with regulatory initiatives. This report has been pointing out over the last three years, gaps in regulation of the sector and the fact that the regulated institutions were not being supervized with regard to customer protection. During this year, the issues relating to customer protection came sharply into focus and thankfully have become the building blocks of the new regulatory framework as well as the attempted comprehensive microfinance bill. Andhra Pradesh had been leading the microfinance movement almost since its beginning. Commercial microfinance took roots in the state on the heels of a thriving SHG linkage movement. In case of regulation too Andhra Pradesh took the lead and the lead was taken by the state government. After having fired warning shots[1] in the earlier part of the year, the government moved with speed to promulgate an ordinance regulating the microfinance institutions in the sector. Within a short period of time thereafter (two months), the ordinance was duly passed as a law by the state legislature. The law was aimed at protecting the members of SHGs from exploitation and abusive practices of the microfinance institutions. One of the noteworthy aspects about the ordinance was the ease and the speed with which the state drafted the bill. The legislation was good in its intent and its focus on customer protection is a first in the Indian microfinance sector. The law did a signal service in pointing out the excesses in marketing and servicing of the customers of MFIs and trying to focus on such practices. MFIs were to register in each district of operation with the designated authority.[2] The law required the MFIs to take permission from the district authority before making a loan to a member of SHG or her/his household member. MFI staff was prohibited from transacting business with customers in the cluster meeting places near the habitat to avoid coercion in recoveries. MFIs were asked to hold meetings in the panchayat offices for their transactions. MFI staff was barred from visiting homes and place of work of borrowers again to eliminate coercion and high handed dealings. The interest levied in no case should exceed the principal. If MFIs fail to comply with the law, fines and imprisonment can be awarded, not only to the staff concerned but also to the directors on the board of MFIs.[3]

At the purpose level the law set out to protect one model of microfinance which happens to be espoused by the state from a competing model of microfinance that was led principally by the private sector and voluntary sector. The law hit at critical parts of operations of MFIs leaving the institutions with very little options of doing business. The law does not seem to conform to canons of good public policy and did not seem to subscribe to protection of constitutional freedoms allowed to people to exercise legitimate choices and enterprises to carry on business that was lawful. The law actually equates microfinance with hazardous or dangerous activity carried out on the fringe of legitimacy. In the eyes of the Andhra Pradesh Legislation, microfinance became a punishable activity if carried out as per the normal business models in practice (which MFIs continue to practice in other states). One of the criticisms against the legislation is that the state made the field uneven for the private and voluntary sector entities. In terms of the application the law covered MFIs, but not the state-sponsored federations and societies. The legislation

assumes that the SHG bank linkage programme carried out under IKP was an unmixed blessing and the customers do not face any kind of abuse or coercion thereunder.[4] However, this stance of the government as regards the customer protection levels available under the state run IKP does not standscrutiny in the face of evidence from studies carried out in the past.

The solutions offered by law were unworkable and resulted in the MFIs having to shut down operations by encouraging mass default by the customers. The law did not represent a long-term solution to the problems of either the customers or the MFIs. While the IKP has been able to build peoples' institutions and groups it does not have a sustainable model of continued support to the groups and people once the government chooses to withdraw at a future date. It is difficult to buy the logic of the legislation that put a virtual end to microfinance institutions that were willing to commit resources on technology, professional staff and systems in favour of institutions that did not have capacities to continue in perpetuity without support. Expectedly the bill faced a barrage of criticism from the sector. It had been challenged on the legality of the bill before the high court of Andhra Pradesh which is still being heard. The court case adds to the pending litigation before the Supreme Court arising from a different case in Kerala. But in the case of this bill the challenge has been from the point of view of whether it violates the fundamental freedoms given to citizens to carry out any lawful business and also to the ordinary citizens to enter into contracts that are legally valid. Another issue that was being litigated is the legitimacy of the state government to take action against institutions which are regulated by the RBI (being the regulator for non banking financial companies). The State has several reasons for having passed this piece of legislation and has been rigorously defending its stance and also the various provisions. In an apparent tightening of its stance in February 2011 the State clarified that even customers of MFIs who are not members of SHG but who belong to a household with a member in SHG will come under the provisions of this law. The law does not seem mindful of the larger proportion of informal lending and borrowing that takes place outside of both SHG programme and the MFIs customer base. The law also does not take cognizance of some of the practices within the SHGs that are coercive and which lead to elite capture of resources.

One of the key questions that needs to be answered is whether the price paid for bringing this piece of legislation and enforcing the same in Andhra Pradesh is worth the final outcomes. Regulation has a cost in terms of what impacts it causes in the constituents. In this case the impact that was caused is the encouragement to default on legally contracted loans, erosion of public funds, creating an increased risk environment for microfinance and providing the wrong kind of messages to the borrowing public outside Andhra Pradesh.

The unintended fallout of the Andhra Pradesh legislation had been one of its redeeming features. Both RBI and the Government of India had been pushed in to action to have a relook at regulation of the sector from a very different point of view. RBI shook of its passive stance that credit only institutions should really not come under regulation and supervision. The RBI set up a committee of the board under the chairmanship of Y.H. Malegam[5] with a few other members of the Board who were well versed with different aspects of the financial sector. The committee went into the issues in the microfinance sector including those highlighted by the Andhra Pradesh government in its legislation. The committee adopted a consultative process to gather a variety of views and put out its draft recommendations for public discussion and based on the feedback finalized its report. The sum and substance of the committee's report was that the microfinance institutions deserved to exist and some of the excesses in their operations needed to be rectified. The committee brought in a breath of fresh air in to the ongoing debate within the central bank by firmly asserting that customer protection is a valid basis for regulating institutions that did not accept public deposits. It also provided a framework for such regulation which would result in higher levels of customer protection and the more orderly behaviour on the part of MFIs. The committee advocated the continuance of microfinance as an eligible asset class for coverage under priority sector lending. The committee had recommended the creation of a new class of institutions called NBFC-MFIs within the larger non banking financial companies segment. The specific regulations of RBI were to apply to this NBFC-MFIs class. However, it has to be noted that the committee's recommendations and subsequent regulation that was issued by RBI apply only to NBFCs that have been licenced by the RBI and did not apply to all other forms which carried out microfinance as a business. The committee laid down clear norms for selection of customers from vulnerable sections of population through income limits, prescribed the ceiling amounts of loans that could be given to the microfinance customers, stipulated rates of interest and maximum margins that

could be availed by the MFIs, provided a framework for curbing multiple lending practices and suggested several other desirable practices for the sector to follow. The committee also suggested that the RBI should use its powers of defining the priority sector to make these regulations enforceable. That is if the MFIs do not conform the suggested regulations then bank loans to such institutions will not be treated as priority sector lending.

The RBI on its part reviewed the recommendations given by the committee held further hearings from the sector stake holders before taking the final view. In the month of May, RBI came out with the regulations applicable to the sector. The differences between Malegam recommendations and RBI regulations have been listed in Annex 7.2. In fact the regulations were not issued directly to the MFIs[6] (despite these institutions having been registered by RBI for carrying out business) but on the lending banks. The banks had been advised that unless the MFIs follow the norms and rules provided in the RBI's regulation, the lending to such institutions cannot be considered as part of priority sector lending. In a way the monitoring of the MFIs' adherence to RBI regulations had been left to the banks. The RBI had also advised the banks that certain aspects of compliance with the regulations should be certified by chartered accountants to the satisfaction of banks.

The RBI had created a separate class of NBFCs as MFIs and made regulations applicable on this class of institutions. The RBI had moderated and toned down the severity of some of the suggestions of the Malegam Committee. However, the basic principles underlying its recommendations had been fully adopted by the RBI. An interest rate cap of 26 per cent and the margin cap of 12 per cent were the chief instruments through which the pricing abuses were sought to be curbed. RBI also restricted the MFIs from charging any other charges except a service charge of 1 per cent. The number of loans that a customer could taken from an MFI had been limited to 3 with the onus on the MFIs to ensure that they do not give a fourth loan. The total loan that could be availed by any single customer had been limited to ₹50,000 and not more than ₹35,000 in the first cycle. The regulations also required the MFIs to provide a longer repayment period in case of loans that exceeded ₹15,000. The customers were to be given a choice on the most suitable instalment (weekly, fortnightly or monthly) based on their own income flows and domestic situation. While the regulation introduced by RBI responded to several problems in the field and signalled its intention to micro-regulate the MFIs in terms of their business operations and practices the overall outcomes in the short and long run do not seem to be very favourable. First of all the RBI's chosen instruments that specify business practices, product categories and pricing, reverses some of the hard work that RBI had done in the case of the banking sector from the early 90s. The provision of autonomy to banking sector greatly improved its functioning and its solvency. In the case of MFI regulation RBI is seen moving away from autonomy and free enterprise to controls and restrictions of a micro nature. But the necessity for introducing this is well understood by all the players in the sector including the MFI themselves which have overwhelmingly supported the moves by RBI.

The next major issue is that of interest and margin caps. While making the interest rates to the ultimate borrower look reasonable, the caps would result in denial of services to very small borrowers and to remote locations. Microfinance institutions carry very high operating costs because of the small size of loans, the extensive logistics and staff intensity in expanding services to sparsely populated remote areas. If the operational costs have to be met out of a margin of 12 per cent, the MFIs would cut down on high cost loan segments as also high cost geographies of their business. This means the vulnerable customers who require very small loans. It would be difficult to provide small loans with a margin of 12 per cent as the staff overheads remain fixed and cannot be reduced in proportion to the size of loan. Similarly the high cost of intermediation in remote areas cannot be absorbed within a margin of 12 per cent. A third issue in relation to pricing is that the rising interest rates has been pushing up the cost of borrowings of MFIs. Today there are loans made by banks at more than 15 per cent which would make it very difficult for MFIs even to carry the permissible 12 per cent margin as the ceiling interest rate has been pegged at 26 per cent. The issue is that alongwith regulation of ultimate borrower level rates of interest, the central bank should have introduced a mechanism of funding that provides viable alternatives which then would ensure that the MFIs are able to charge lower rates of interest at the client level. Unless regulation on the pricing is accompanied by effective resource support at lower cost it would be difficult to meet the twin objectives of borrowers sustainability and institutional sustainability in the microfinance sector.

On the specifics of RBIs regulation the difficulties that would be faced by the MFIs relate to verification of absolute income levels of customers both in rural and urban areas as also the number and amount

of loans already borrowed.[7] The customers tend to graduate in terms of their incomes over a period of time. Once small customers have been helped to improve their income levels and become qualitatively better customers, they would be required to leave the MFIs for other financial institutions. The regulation should allow MFIs to retain customers if they have grown with the MFI over a period of time regardless of their income level as long as the customer was originally acquired within the limits prescribed. The loan service capacity has been looked at carefully by RBI and it had tried to ease the instalment burden of larger loans by asking for a minimum repayment period of 24 months if the loans exceed ₹15,000. RBI also has stipulated that 75 per cent of the loans given by MFIs should be for the purpose of income generation. This is a very loosely defined requirement. Income-generating activities entail higher investments and it is difficult for borrowers to meet the investment cost with the small loans envisaged. However, the regulations brought in by RBI are a considerable improvement over the conservative recommendations made by the Malegam Committee. The sector is happy as the RBI regualtion provides a framework under which they could operate and be immune from State's control. It also stipulates certain good practices across the sector in terms of focus on small customers, focus on income-generating loans, reasonable interest pricing, avoidance of excessive debt, but at the same time freedom to operate any different model that the institution might choose. But the changes introduced on account of the regulation would entail high cost for refinement of products, processes, training of human resources and in some case the MIS system.

The first time recognition of customer protection as the more primary concern is a significant achievement for the microfinance clients. The regulation makes responsible finance not only possible but also a mandate in order to ensure continued existence of institutions in the sector. The regulation of RBI would be more welcome for underlining the legitimacy of MFIs in the overall financial system and providing them the space to operate. The stringency in the conditions that are currently stipulated is likely to be lightened in future with improved performance on the field by the MFIs.

The Andhra Pradesh government in an unprecedented reaction has criticized the RBI regulations as not sufficient to secure the interest of customers and had stated that nothing short of what the Andhra Pradesh government has adopted as law would satisfy its expectations. The Andhra Pradesh government also stated that it would not refrain from enforcing its microfinance law in Andhra Pradesh despite the regulations brought into force by RBI in case of NBFC-MFIs across the country.

The Government of India signalled its stance on the sector through an announcement in the budget for the year 2011–12 that it is setting up an equity fund for providing equity support to needy MFIs and also promising to bring in a legislation for the microfinance sector. This announcement in the budget was like oxygen to the MFIs which were gasping for breath. As promised the government constituted a drafting committee for the microfinance bill which held consultations with several stake holders in the sector. Finally a draft version of the proposed microfinance bill had been placed for public discussion in early July by the Department of Financial Sector, Ministry of Finance, Government of India. The differences between this bill and the earlier version of the microfinance bill 2007 are listed in Annex 7.3.

The draft microfinance bill is a considerable improvement over every other previous attempt at regulation including the regulations announced for NBFCs by RBI in May. The draft bill announced by the government of India has made an attempt to fix several problems that had been identified and tried to address a number of concerns from the customers' point of view. While the stipulations made by RBI have by and large been taken on board, the bill encompasses the entire sector including MFIs in different forms such as companies, trusts, societies and associations. The bill recognizes that MFIs have a key role to play in financial inclusion. RBI is being charged with the duty of promotion and orderly growth of the microfinance sector unlike in the 2007 version of the bill. A departure in this bill is the provision for allowing MFIs to mobilize thrift from its constituents. The bill requires every MFI to register with the regulator and provide periodic information to the regulator on its business operations. The bill takes a graduated approach to regulation by making the regulator's supervisory actions stringent only on institutions that are deemed 'systemically important'. RBI already has a definition of systemically important NBFCs[8] by relating it to their asset size. The bill empowers RBI with flexibility to use different measures on the sector or a class of institutions or a particular MFI. The powers of RBI over MFIs seem to exceed the powers of RBI over banks under the Banking Regulation Act. The bill requires the MFIs to be transparent by declaring an all inclusive annual percentage rate that's comparable across institutions in the sector. Microfinance Development Council at the national

level has been proposed with a role in policy and development of the sector and also State Development Councils to look into certain areas of the microfinance sector within the states where microfinance is mainstreamed. A number of activities for promotion and development of the sector such as setting benchmarks and standards, development of credit rating norms, maintenance of appropriate database, institutional development of groups and institutions, customer education, research, documentation and dissemination of fair practices have been made a part of RBI's responsibility.

Some parts of the bill could still be tightened to make it stronger and closely relevant to the needs of the sector. The law should bring under its ambit the federations and societies formed to implement government sponsored programmes through SHGs and other such mechanisms. The customers in such groups and institutions are not free from unethical, corrupt and exploitative practices. The ambiguity in coverage of cooperatives should be removed. The entry level capital for thrift taking entities should be raised from the present level of ₹0.5 million, which is too low. The stipulation that MFIs that become 'Systemically Important' should transform in to Companies should be reviewed. Community-based MFIs may be allowed to become cooperatives, which might be better suited for closer member relations and participation in governance. The National Level Advisory Council should have a role in regulation as well on the lines of boards of supervision set up for commercial banks. The state level council should be linked to the national council through some means and its role should be stronger than what has already been offered. The creation of an ombudsman mechanism is a welcome one and it should be tied up with the industry's own efforts for handling grievances of the public. While the interest and margin caps have been mentioned as instruments, the exact amounts have been left to RBI's discretion. Thus it makes way for RBI to use the caps flexibly in accordance with the money market and credit market conditions. An interesting development in the legislation is the provision for RBI opening a refinance facility either by itself or through another institution. The bill also provides RBI the powers to delegate supervision to NABARD in respect of all or any MFIs. The bill thus has several redeeming features which when made into law should make it possible for the sector to work more orderly and enable RBI to do meaningful regulation.

The supervisory load on RBI and the costs are likely to high and it is only fair that the load is shared with other institutions engaged for the purpose. One of the critical things would be the recognition of associations of MFIs for the purpose of self regulation especially through codes of conduct. But the best outcome from the bill when it is converted to law is contained in Section 42 which states that MFIs that are registered under the Act with RBI will not attract the provisions of the money lending laws from state governments. The Andhra Pradesh government was also critical of the microfinance bill. It felt that the regualtion does not go far enough in customer protection. It also pointed out that this law cannot over ride the powers of State to regulate conduct of money lending. In a sector where millions of vulnerable people have been provided badly needed access to financial services by a set of institutions, regulation should seek to improve the practice on the field and introduce protection to the customer from abuse of the dominant position by the MFIs. The possibility of abuse and misuse of their position by the MFIs should not be a reason for closing them down. It should be the cause for the state to undertake measures to protect the customer.

Regulation has seen frenetic activity during the year. The government of Andhra Pradesh bringing out an ordinance and later a law, the RBI appointing the Malegam Committee and later coming out with its regulations of NBFC-MFIs and the Government of India placing for discussion in public domain a draft microfinance bill within a short span of time of 10 months are developments which the sector would not have dreamt of. The Andhra Pradesh law in particular triggered the quick response from RBI and the Government of India. In doing so, it has rendered a signal service to the sector. The prayer that the sector and the customers have is that the draft bill should become law. And once it becomes law, all states including Andhra Pradesh should strictly adhere to this and ensure that the sector grows under regulated orderly conditions. The views of RBI and NABARD on the regualtory and supervisory arrangements proposed are not known.

OTHER REGULATORY DEVELOPMENTS

RBI had introduced provisioning for standard assets to NBFCs at 0.25 per cent of the outstanding standard assets as a measure of prudence and building up of a buffer to counter cyclical risks. Under the payments systems and settlements Act, 15 non-bank entities have been authorized to issue semi closed prepaid instruments. This has ushered in innovative payment products in e-commerce and

m-commerce channels. The semi closed m-wallets can be issued for value up to ₹50,000 bringing them on par with other semi closed prepaid instruments. Banks have also been permitted to facilitate mobile banking transactions without end-to-end encryption up to ₹5,000.

RBI had set up two working groups relating to financial sector issues. The working group on introduction of Financial Holding Companies[9] concluded that a holding company model may be more suited in the Indian context. It, however, was conscious of the fact that regardless of the organizational forms, banks cannot be totally insulated from the risks of non-banking activities undertaken by their affiliates. Three important recommendations made by the committee that are relevant to MFI groups are 1) The Financial Holding Company (FHC) model should be pursued as a preferred model for the financial sector in India; 2) The FHC model can be extended to all large financial groups irrespective of whether they contain a bank or not. Therefore, there can be Banking FHCs controlling a bank and Non-banking FHCs which do not contain a bank in the group; and 3) There should be a separate regulatory framework for financial holding companies. MFIs belonging to groups and those with more than one entity in financial sector business can use the holding company concept to reorganize their businesses.

The other committee examined the issues and concerns in NBFC sector.[10] Its important recommendations were that the supervision framework of NBFCs should be enhanced and large NBFCs with assets in excess of ₹10 billion should have an enhanced comprehensive supervision approach with annual inspections. Off-site surveillance and periodic information reporting should supplement on-site supervision. The staff strength and skills of NBFC supervison function in RBI should be strengthened. About 10 large NBFC-MFIs by end of March 2012 will be subject to more rigorous physical inspections. The returns to be filed with RBI are likely to become more detailed and frequent.

The Global Microscope 2010[11] ranked India at 14th place on the regulatory environment based on the previous version of the bill. The position is likely to improve in the next assessment if the current version of the bill is passed. The regulatory framework has arrived for NBFC-MFIs sooner than anticipated. The other MFIs that borrow from banking system will also have to abide by these norms as part of priority sector requirements that would be enforced by banks. The number of MFIs that come up for registration under the new regualtion could be between 500 to 800 according to varying estimates. The regualtory bandwidth for such a large number is low. There was a suggestion for a four pillar approach to MF regulation. The four pillars comprise code of conduct compliance by the MFIs, Industry association based self-regulation, external verifications and assessments such as by Chartered Accountants and on-site and off-site surveillance by regulator. The capacities of the regulators in terms of understanding the sector has to be strengthened. Compliance with regulation is likely to prove expensive and consume time in the initial stages. This might slow down business and recovery from the slump. These are hard times. Both the regulator and regulated institutions have a steep learning curve ahead. MFIs would gladly spend the time and effort to comply; the alternative had already produced unpleasant consequences.

ANNEX 7.1
Key recommendations of Malegam Committee[12]

Committee on the MFI Sector (Malegam Committee)

The Malegam Committee in its January 2011 report, *inter alia,* recommended (i) creation of a separate category of NBFC-MFIs; (ii) a margin cap and an interest rate cap on individual loans; (iii) transparency in interest charges; (iv) lending by not more than two MFIs to any individual borrower; (v) creation of one or more credit information bureaus; (vi) establishment of a proper system of grievance redressal procedure by MFIs; (vii) creation of one or more 'social capital funds'; and (viii) continuation of categorization of bank loans to MFIs, complying with the regulation laid down for NBFC-MFIs, under the priority sector.

Based on the feedback received, the broad regulation framework recommended by the Committee has been accepted. The SCBs have accordingly been advised in May, 2011 that bank credit to MFIs extended on or after April 1, 2011 for onward-lending to individuals and also to members of self help groups (SHGs)/joint liability groups (JLGs) would be eligible for categorization as priority sector advance under respective categories *viz.,* agriculture, MSE, and micro credit (for other purposes), as indirect finance, provided not less than 85 per cent of total assets of MFI (other than cash, balances with banks and financial institutions, Government securities and money market instruments) are in the nature of "qualifying assets".

In addition, aggregate amount of loan, extended for income generating activity, is not less than 75 per cent of the total loans given by MFIs.

- A 'qualifying asset' shall mean a loan disbursed by MFI, which inter alia satisfies criteria such as (i) the borrower's household annual income does not exceed ₹60,000 in rural areas and ₹1,20,000 in non-rural areas; (ii) loan does not exceed ₹35,000 in the first cycle and ₹50,000 in the subsequent cycles; (iii) total indebtedness of the borrower does not exceed ₹50,000; (iv) the loan is without collateral; (v) loan is repayable by weekly, fortnightly or monthly installments as per borrower's choice.
- Further, banks have to ensure that MFIs comply with the stipulated caps on margin and interest rate as also other pricing guidelines, to be eligible to classify these loans as priority sector loans:
  i) Margin cap at 12 per cent for all MFIs. The interest cost is to be calculated on average fortnightly balances of outstanding borrowings and interest income is to be calculated on average fortnightly balances of outstanding loan portfolio of qualifying assets.
  ii) Interest cap on individual loans at 26 per cent per annum for all MFIs to be calculated on a reducing balance basis.
  iii) Only three components are to be included in pricing of loans *viz.,* (a) a processing fee not exceeding 1 per cent of the gross loan amount, (b) the interest charge and (c) the insurance premium.
  iv) The processing fee is not to be included in the margin cap or the interest cap of 26 per cent.
  v) Only the actual cost of insurance *i.e.,* actual cost of group insurance for life, health and livestock for borrower and spouse can be recovered; administrative charges to be recovered as per IRDA guidelines.
  vi) No penalty for delayed payment.
  vii) No security deposit/margin to be taken.

- The banks should obtain from MFIs, at the end of each quarter, a Chartered Accountant's Certificate stating, *inter alia,* that (i) 85 per cent of total assets of the MFI are in the nature of 'qualifying assets', (ii) the aggregate amount of loan, extended for income generation activity, is not less than 75 per cent of the total loans given by the MFIs, and (iii) pricing guidelines are followed.
- Bank loans to MFIs, which do not comply with above conditions and bank loans to other NBFCs, will not be reckoned as priority sector loans w.e.f. April 1, 2011. The bank loans extended prior to 1 April 2011 classified under priority sector will continue to be reckoned under priority sector till maturity of such loans.

ANNEX 7.2
Malegam Committee recommendations and RBI regulation—a comparison[13]

Aspects	Malegam Committee recommendation	RBI regulation
Basis of regulation	Creation of a separate category of MFIs and use Priority sector lending norms	Accepted
Prudential requirements	Capital standards to be imposed	Not mentioned
Market conduct	Centralized place for transacting business	Not mentioned
Income limit for eligible borrowers from MFIs	₹50,000 household income for all	Rural: ₹60,000 Urban: ₹120,000
Loan amount (maximum)	₹25,000	First cycle: ₹35,000 Subsequently: ₹50,000
Indebtedness of borrower	₹25,000 (max.)	₹50,000 (max.)
Tenure	Minimum 75% of MFI portfolio for income generation	Same
Repayment frequency	Weekly, fortnightly or monthly at the choice of the borrower	Same
Pricing cap	Interest cap 24% Margin cap 10% and 12% for large and small MFIs+ processing fee, 1%	Interest cap 26% Margincap 12% + processing fee, 1%
Collateral and group mechanisms	No collateral, group loans only	No collateral, individuals as well as SHGs and joint liability groups (JLGs)

ANNEX 7.3
Comparison of 2007 and 2011 versions of the microfinance bill[14]

Aspects	Microfinance bill 2007	Microfinance Institutions (Development and Regualtion) bill 2011
Scope and application	Only NGO-MFIs registered as societies, trust and cooperatives (i.e. excluding NBFCs an 25 companies)	All MFIs in all forms
Structure of the sector	One tier, MFOs only, (apart from NBFCs and S 25 companies, but no provisions applicable to them)	Two tiers—MFIs and Systemically Important MFIs
Savings mobilization	Only 'thrift' for MFO from members	Thrift mobilization possible
Supervisor	NABARD	RBI—with powers to delegate to NABARD
Advisory council	Advisory, with majority consisting of officials representing specified agencies exofficio	Advisory with no role in regulation Both at National and State levels
Grievances handling and appellate authority	MFDC 'may' set up ombudsman	Ombudsman provided for
Capital norms	NOF of at least ₹5 lakh and a capital adequacy ratio of 15 percent	₹5 lakh as minimum entry capital—RBI to stipulate prudential norms
Instruments	Registration for thrift taking MFOs and information reporting for all	Registration for all, information reporting and interest rate caps
Customer protection	through Ombudsman	Norms for customer selection, size of loans, interest disclosure, process controls and interest/margin ceilings
Powers of regulator	minimal	Power to cancel registration, order for winding up, merger and acquisition, imposition of penalties, delegation of powers, issuance of directions

ANNEX 7.4
Commentary on the new microfinance bill[15]

The Government of India promised new draft microfinance legislation, and it has delivered. The consultative process adopted, the work done by the Malegam Committee, and the regulations issued by the Reserve Bank of India (RBI) and the participation of the lenders, practitioners and others have made the draft comprehensive and well-rounded. The Andhra Pradesh statute seems to have triggered this comprehensive response from the Union government. The need to regulate the microfinance sector in customers' interest and also the need to avoid a multitude of microfinance legislation in different states has led to this bill which keeps registered MFIs out of the ambit of money lending laws.

The chief features of the bill are that every institution in microfinance should register with the regulator, transform into a company when they attain a significant size, be subject to a variety of prudential and operational guidelines that are introduced by the regulator, provide periodic information to the regulator and face penal action for violation of law or any rules framed. The bill provides flexibility of RBI to apply different measures, vary the same and delegate the powers to regulate to NABARD.

The grievance redressal procedures, mandatory enrolment to credit bureaus and code of conduct enforcement through industry associations will improve customer protection. The creation of national and state councils should provide wider sector participation in policy making. The proposed microfinance fund that would not only provide grants but also bulk finance to MFIs is a very welcome proposition.

Requiring all institutions, regardless of form, to register as an MFI is a critical and necessary step toward effective regulation. The reason for excluding cooperative societies accepting deposits from members only from the definition of an MFI is not clear. There are MFIs which are cooperative in form that deal with members only. That does not make the members any better protected. If the cornerstone of the bill is customer protection, it should be extended to cooperative MFIs as well.

National vs. state level supervision

While the proposal to set up a strong advisory council at the national level is welcome, the council should be vested with a role in regulation and supervision. It should be asked to consider periodic reports prepared by the regulator on the state of practice in the sector and compliance with regulation by the institutions. In addition to other functions described in the bill, the council could perform the functions that Board of Supervision (set up by RBI in respect of commercial banks and financial institutions and NABARD in respect of cooperative banks and RRBs) performs in respect of banks. The State councils are a good way of involving the state governments. But the councils should be linked to the national council and given a role with content rather than just creating them. Without a significant role and participation in some manner in the activities of the national council, the state councils will become either defunct or deviant. The proposal for appointment of an ombudsman is a welcome measure and will boost the industry's own effort to handle grievances better.

The step of keeping MFIs outside the purview of money lending is a forward looking step that would improve availability of financial services in the hinterland. Officials in AP have taken exception to a particular provision in the draft bill that seeks to keep MFIs outside money lending law. This is nothing new, as banks regulated by the Banking Regulation Act are kept outside the purview of state jurisdiction. Only when the institutions are unregulated and the practice is exploitative and coercive that the States' powers under money lending Act become enforceable. The bill introduces regulation relating to form, business, processes, products, pricing and provides a high degree of flexibility to RBI to adopt measures to enforce customer protection practices of a kind not seen in banking regulation.

The requirement of systemically important MFIs to become companies should be strengthened by taking away the option to transform in to a not for profit company under section 25 of companies Act. The existing regulatory framework of RBI is lenient towards section 25 companies; in fact there is no regulatory effort spent on such companies. When MFIs become systemically important they should be actively regulated.

Pricing and interest rates

Sections 23 and 24 of the proposed bill contain the substance of RBI's regulatory powers. There is a duty cast on RBI to engage in promotion and development of the sector so that it can play a role in financial inclusion. The powers of RBI to issue directions under section 24 are comprehensive and cover almost all

aspects of functioning of the MFIs. For the first time the concept of APR is used in the industry to demystify the pricing of loans. While there seems to be a provision for recognition of Self-regulatory Organization of MFIs, the process of recognition has not been spelt out. The industry associations have a critical role to play in assisting the regulators. In Section 25, the bill has chosen to implement margin caps rather than interest rate caps. Absolute interest rate caps are anti-market and introduce rigidities. However RBI has been given the powers to impose an APR cap. The specific mention of margin cap under section 25 leads one to believe that the margin cap will be imposed across the sector and the APR cap will be used only in exigencies.

An interesting insertion is the possibility of RBI refinance to MFIs. The proposed Microfinance Development Fund is intended to provide loans, refinance, grants, capital and any other form of financial assistance. The size of the fund and the RBIs stance on financing microfinance sector will be eagerly awaited. The refinance facility (whether offered by RBI or arranged through financial institutions) will be a significant step forward for the resource starved sector.

The bill proposes penalties for MFIs of a maximum of ₹5 lakhs (almost US$11,000) which seem paltry in comparison with the size of MFIs and the damage potential of ill-advised actions. There is a need to raise the maximum penalty and relate the same with the nature of violation of law or regulatory advice, and possibly made proportional to the size of the MFI. Section 38(1) facilitates RBI to delegate powers under the Act to NABARD. The wording is carefully done to offer flexibility to RBI to delegate powers in respect of select class of MFIs. This will ensure that regulatory load can be distributed between RBI and NABARD. SIDBI could have been brought on board and offered space in regulation. Perhaps the high level of its financial support to MF sector has restrained the government from including SIDBI on account of the potential for conflict of interest.

Post Andhra Pradesh

Section 42 should provide a sense of relief to the sector reeling from the aftermath of the State legislation on MFIs in Andhra Pradesh. The registration with RBI effectively protects MFIs from state government action under money lending laws. This is a long overdue requirement for conduct of business in microfinance. The proposed bill restores the freedom of enterprises to run a business in financing vulnerable people, subject to reasonable regulations.

MFIs and deposits

The bill, without overtly saying so, hints at the possibility that MFIs will be permitted to mobilize thrift (small illiquid savings). If the regulations are introduced for this and MFIs permitted to mobilize thrift it would be an exciting development as it makes meaningful financial inclusion possible. The tough task of ensuring depositor protection remains unexplained. Whether the bill could have gone a step further and mandated coverage of MFI mobilized thrift under deposit insurance as is the case in some other countries?

The strong customer protection content reflects a significant change in stance on part of the government that even borrowers are entitled to protection. The actual measures indicated in the proposed legislation mostly take in to account potential abuses in pricing, competition, and irresponsibility on the part of lender. The bill requires implementation and enforcement in some cases. The regulatory capacity has to be ramped up and the small and medium MFIs' capacity to comply with regulation will also need to be strengthened. The bill is an important first step; several more steps in translating the bill to action are required before we reach a stage that restores the vitality of the sector.

Right now the bill is just a draft and needs to be passed by the Indian Parliament. More than a 100 million people are keeping their fingers firmly crossed.

NOTES AND REFERENCES

1. Andhra Pradesh government had set up district committees in May 2010 to enquire in to grievances of MFI clients.
2. The Director, DRDA, was the designated authority. This was already burdened with several other projects for implementation.
3. Within the first fortnight of promulgation of the ordinance, staffs of some MFIs were arrested for visiting the habitats of borrowers.
4. Studies of the IKP have pointed out that the poor are excluded and that elite capture of groups and institutions is in evidence.
5. An eminent long-term member of RBI central board and a chartered accountant by profession. The other members of the committee included Sashi Rajagopalan, Kumaramangalam Birla, K.C. Chakrabarty, U.R. Rao and V.K. Sharma.
6. The guidelines addressed to MFIs are likely to be issued in due course.
7. MFIs have been enrolling with credit information bureaus to access data of number and amount of loans availed by borrowers from other MFIs and banks. While this is not a foolproof measure as it excludes SHG loans and informal borrowings, it is the best available verification means today.
8. NBFC with assets exceeding ₹100 crore are deemed systemically important by RBI.
9. Report of the Working Group on Introduction of Financial Holding Company Structure in India, 2011—chaired by Shyamala Gopinath, DG.
10. Working Group on the Issues and Concerns in the NBFC Sector Chaired by Mrs Usha Thorat, Ex Dg RBI.
11. Global Microscope on the Microfinance Business Environment 2010, Economist Intelligence Unit.
12. Cited from RBI Annual Report 2010–11.
13. Modified and expanded from a earlier version authored by Sanjay Sinha, MD, M-Cril.
14. For a detailed critique of the Microfinance Bill 2007, see Prabhu Ghate, *Microfinance India: State of the Sector Report 2007* (New Delhi: Access Development Services, 2007).
15. Modified from a blog written for CGAP by the author of the report.

National Rural Livelihoods Mission—will it go beyond finance?

8
Chapter

The Ministry of Rural Development, Government of India, has commenced implementing the National Rural Livelihood Mission (NRLM) with a formal launch earlier this year in Rajasthan. The NRLM is a sequel to the SGSY,[1] being implemented by the Ministry of Rural Development during the 10th and 11th Five Year Plans. SGSY was modeled after a programme implemented in Andhra Pradesh when Integrated Rural Development Programme (IRDP) was in existence. Now NRLM has been modeled on the current poverty alleviation programme being implemented in Andhra Pradesh under the name Indira Kranti Patham (IKP). The Andhra Pradesh programme was designed when World Bank supported a poverty alleviation project[2] in Andhra Pradesh some time back. The chief features of IKP are that mobilization of rural poor especially women would be done through SHGs. These groups will then be federated into village level and mandal level entities. These federations will guide the SHGs and also to some extent attend to their financial services requirements. The staff of the federations assisted by the staff of the state level government-sponsored NGO, i.e., Society for Elimination of Rural Poverty (SERP), will facilitate financial linkages with banks. Further, the state government through SERP and the federations will engage in different activities that would improve the livelihoods of the rural households. These are investments in improved agriculture and capacity building in improving productivity and efficiency of agriculture, training of youth in employable skills and placement in suitable jobs, capacity building in enterprise development after identification of suitable enterprise activities, ensuring social security through pension schemes of the government as also a health insurance scheme and provision of a subsidy through bank to ensure that loans to groups are given at an effective rate of interest of 3 per cent per annum. In addition, the other features of SGSY such as providing corpus funds, revolving fund and the like also existed. Based on this programme and the fact that Andhra Pradesh managed to form and link more than a million SHGs with the banking system leveraging considerable resources from banks, the Government of India thought it fit to remodel its poverty alleviation programme on the lines of the AP model.

NRLM thus would aim at rural poor and ensure that their livelihoods are stabilized. The mission of NRLM is to focus on a demand-driven strategy that would target outcomes and time bound delivery of services. It also envisages monitoring against targets of poverty outcomes. The mission[3] of NRLM aims at enabling states to autonomously plan for poverty eradication initiatives in their area. However on a deeper examination there are indications that proportional ceilings on allocations will be prescribed by the centre and the states will prepare their own plans without any insistence on collaborating with local rural communities in the preparation. While participatory planning has been provided for at grassroots and a statement has been made that poor will draw up the agenda, practical ways in which this kind of participation will happen have not been articulated. The Andhra Pradesh experience also does not very clearly bring out that participatory planning at the village and mandal levels actually takes place to help the government to synthesize the overall livelihood development plan.

The NRLM has the following key initiatives to propel its agenda:

1. Universal social mobilization especially of the Poverty Line families and women.
2. Promotion of institutions of the poor i.e. SHGs and their higher-level federations, livelihoods

collectives, producer cooperatives, etc. While existing institutions are to be strengthened, the existing staff will continue to be used.

3. Skills and capacity building of rural poor households and institutions of the poor.
4. Provision of revolving fund and capital subsidy only in those SHGs where 70 per cent or more are from BPL families.
5. Universal financial inclusion implying linking the SHGs with banks for loans and savings and with insurance companies for managing their life and other risks.
6. Interest subsidy will ensure that SHGs can obtain their loans at a rate not exceeding 7 per cent.
7. Study of the existing livelihoods to facilitate diversification of the activities of rural poor.

Apart from the foregoing intervention agenda, NRLM would also focus on infrastructure creation, development of employable skills and placement of people in jobs and setting up and support to rural self-employment training institutes (RSETIs) and innovations.

From a reading of the mechanics of how NRLM will work, it seems that it would try and do everything, which has a connection with the rural livelihoods. However, a clear role for the federations of SHGs has not been indicated. If these federations are supposed to be financial intermediaries, then the need for creating and linking with business correspondents and business facilitators should not have been there. The federations can act as BC to the extent they are unable fulfill requirements of members. If the members of SHGs are to attain loans at 7 per cent rate of interest as contemplated in the mission document what would be the role of SHGs has to be spelt out. If low cost loans are delivered to members of groups then the groups will no more be able to decide on which members require the loans most and to what extent. A low cost loan is seeing as a benefit given by government to members and members want to share the same equally. The experience of the *Pavala Vaddi* scheme in Andhra Pradesh very clearly shows that groups tend to divide the bank loans equally among all members notwithstanding the differential needs for the resources that exist among the members. Those who receive these low cost loans without an identified need use the same for onlending it to others in private money lending operations leading to significant abuse of the entire scheme.

Capital subsidies however would necessitate investment in capital assets by members and if carefully chosen livelihoods activities would get promoted. So the government should look more closely at the financial services support part of NRLM. The allocation of budgets, for example, 20 per cent for infrastructure creation, 15 per cent for skill development and placement projects (of which 7.5 per cent is to be held back by the centre for multi state projects), 5 per cent for innovations etc. introduces rigidities in the programme and might result in the programme being centrally directed rather than being demand driven. The linkages with Panchayati Raj institutions comes more as an afterthought towards the end of its agenda. The people's institutions such as PRIs should get a major say. NRLM says that the support structures that would guide and counsel the different project functionaries and project implementing institutions would be autonomous and professionally manned. This is a key requirement in order for the programme to succeed and to be free of biases of different kind.

The programme has the following large mandate: *Reach out to 70 million below poverty line households in 600 districts of the country covering 0.25 million gram panchayats*. While the Centre is committing to provide 75 per cent of the funds required the states have to mobilize the remaining 25 per cent (the north east states have to mobilize only 10 per cent of the overall budget and the centre would provide remaining 90 per cent). The implementation has been phased over the 12th Plan period and no attempt to simultaneously start the programme in all the districts and blocks has been seen. The objective is that NRLM should cover all districts and blocks by the end of the 12th Five Year Plan which gives sufficient time for the programme to move from the initial districts to the newer districts based on the incremental experience gained from year to year. The state governments have been given one year for transitioning from their current SGSY methodology to the new NRLM principles in poverty alleviation.

Since most of the mechanics of NRLM continue from the SGSY and the intervention of SHG federations and state supported implementation machinery are the new innovations that come in, it was felt necessary to look at how SGSY had performed.[4] The group mobilization was of the order of 3.5 million in the period 1999 to 2009. Of these 2.3 million groups graduated into Grade-I while 1.1 million groups were in Grade-II. Livelihood economic activities were adopted only by 0.8 million groups out of the total of 3.5 million. The swarojgaries assisted were 8.2 million which is roughly of 0.8 million SHGs. Individual swarojgaries to the extent of 4.5 million were also assisted. Of the total funds available from 1999 to 2008 only 74 per cent had been utilized, i.e.,

₹119.60 billion out of an available allocation of ₹161.88 billion. Most of the money utilized went for disbursement of subsidies (65.4 per cent). Training and capacity building which was a key component of the SGSY strategy received only 6.18 per cent of the total funds spent. In terms of ground level impact the best of states i.e. Andhra Pradesh showed in a sample survey that the average income per customer worked out to ₹1,228 per month, which was about 40 per cent of minimum wages payable in the state. This low level of income after huge efforts on the part of states does not sound promising and NRLM would have to rethink several of the past strategies in order to make realistic income enhancements that would support people's effort to come out of poverty. Of the total credit target of ₹298 billion only ₹164 billion had been mobilized in the first nine years. The ratio of credit to subsidy was a multiple of 2.1 times. The target investment per beneficiary assumed at ₹25,000 did not materialize. In real terms, the investments were ₹22,995 per beneficiary on an average. The planning commission in its mid-term appraisal had the following to say about the SGSY programme:

> Impressive figures of fast growth of SBL model hide a lot of poor quality work. Many of the groups largely remain on paper and suffer high rates of mortality. Performance of SGSY was unsatisfactory in states with high incidence of poverty such as Assam, Madhya Pradesh, Orissa, Jharkhand, Chhattisgarh, West Bengal and Bihar.

The weakness that was observed was in the delivery systems. The focus on subsidy disbursement took attention away from finding appropriate livelihoods for the rural people. The insufficiency of bank credit was not seen as a programmatic issue and was not seriously dealt with in several states.

Since NRLM would be forming higher level federations and working through the same to provide a host of services including financial services to the SHGs, it is necessary to look at the performance of SHG federations so far. While thousands of federations are reported to exist by APMAS, there are very few successfully run federations that have been seen and studied. A recent study carried out by Bankers Institute of Rural Development (BIRD), Lucknow,[5] had brought out that most of the federations are promoter driven at the initial stage. SHGs at a much later stage appreciate the need for the federations. Mostly the federations play a non financial role and federations tend to take away decision making from SHGs in key aspects such as the interest rates to be charged to the members, charges to be paid to the account keepers, the penalties on members for breaching the disciplines and also the user service charges for a range of services. However, federations were found not to interfere in credit decisions within the groups. Fifty per cent of the federations' studied were not sustainable. Thirty per cent were having strong sustainability and 20 per cent of the federations were weak on sustainability. The problems faced by the federations related to lack of clarity in the Board of Directors, lack of a second line of command, low capacity of human resources, low availability of funds and issues in sustainability. The study recommended that NABARD should initiate a federation bank linkage programme on the lines of SHG bank linkage programme. It further said that NABARD should provide bulk loans to federations where SHGs are unable to get the next cycle of loans from banks.

A suggestion for providing a grant for federations to take care of the initial expenses was also made. Building the capacity of staff requires support. A comparison between SHGs that belong to a federation and those which are independent brought out that on some aspects such as the financial aspects, the federation supported groups were better. But groups which did not belong to a federation had good governance, good book keeping and also less dependent on external agencies for their continued work. The foregoing only points to the learning from past programmes based on which NRLM has been designed. While there are credible assurances that the design will take care of several infirmities of the past, we do need to pause and ponder over whether NRLM at the design stage offers a superior solution to issues of finding a variety of livelihood for rural households. Bulk of the literature available on NRLM and the operational guidelines available so far in public domain indicate that a lot of attention has been paid to the financial aspects. In terms of identifying, developing and promoting livelihoods, there are very few thoughts that start and end with studies, training, capacity building and placement after training. The job of identifying the most suited livelihood for rural people is taxing and complex. Institutions like Bhartiya Agro Industries Foundation (BAIF), Pune, have after long period of trial, perfected the family business plan concept which they are able to use in order to identify and plan the future requirements of families in a geographical area. These kinds of approaches have to be undertaken after detailed study and extensive training of staff concerned. Without this initial investment, NRLM would perpetuate what the

previous programmes did, that is, provide 50 per cent of funds to livestock sector where the assets are easily transferred and beneficiaries can discontinue the livelihood activity at any time. The Andhra Pradesh experience also shows that marketing is a very important aspect of stabilizing livelihoods. The present arrangements in Andhra Pradesh while better than the rest of the country still do not constitute an adequate solution for the rural households. If the incomes realized from pursuing livelihood activities under the guidance of the state agencies is just 40 per cent of what the normal wage levels are then the programme can not be called a success.

A role for the federations has to be found. Before that how to make the federations really member driven, demand responsive institutions has to be thought of. The federations that exist in AP for the most part give the impression that they depend on the staff of SERP for guidance entirely. The federations themselves do not have a vision of where they would like to go. Under these kinds of circumstances and given that several federations are not sustainable, how NRLM would ensure in the other less developed states the success of federation as a concept. Federations to be sustainable in the long run should be able to secure member loyalty (of SHGs), be able to charge for services rendered (such as audit, accounting, facilitating linkages with banks) and have a complement of staff who could provide quality services to members which will then result in revenues through service charges. Without making investments in adequate systems and human resources the federations cannot hope to compete in the market with other players and provide adequate support to the affiliated SHGs.

NRLM thus seems short on designs in organizing livelihoods and accessing the markets on behalf of the poor. It is ambitious on the financial services to the extent of stating that universal financial inclusion is one of its objectives. For a livelihood project to be successful, universal financial inclusion is neither necessary nor sufficient condition. Identification of livelihoods, identification of skill and knowledge gaps, identification of markets and ways of accessing these markets and ensuring that the market access produces higher income in the hands of the members are the basic requirements. One hopes that NRLM will attend to the later set of tasks that result in high incomes. Financial services for such people and total financial inclusion should be incidental to this basic task of stabilizing livelihoods. Shri Vijay Kumar, an architect of the NRLM spoke on some of the issues. (His interview is carried in Annex 8.1.) He emphasized the fact that NRLM is an evolving concept and the design is not cast in stone. While expressing an appreciation of the problems of the past, he pointed out that implementation would be gradual, calibrated, introduced in compact blocks and the learning and success used to expand the programme. The critical departure in NRLM from the past is that there would be a dedicated professional implementation machinery to impart the momentum required. Livelihood choices would be made by people and not by the project and that is the reason why not too much is documented about the same. The thrust on institutions of the poor is what would make the difference.

NRLM is both ambitious and bold. The scale is large and it seems to facilitate a larger volume of bank funds towards livelihoods. While the past performance of such schemes have failed on account of weak delivery capability of field functionaries who were not fully equipped, NRLM promises to usher in professional implementation capabilities. Persuading banks, developing more sources of financing customers' livelihood enterprises and facilitating market access are the challenges before the programme. The promised gradual and methodical approach to implementation is an encouraging sign. The programme should have mechanisms to internalize learning even as it gets about implementation and flexibility to undertake course correction if warranted. A large number of poor have hitched their wagons to the promise of NRLM. Success would be determined by how their aspirations are met without weakening the financial institutions and eroding the discipline among institutions of the poor.

ANNEX 8.1

Interview with Mr Vijay Kumar, Joint Secretary, Ministry of Rural Development, Government of India

Mr Vijay Kumar spared time on a Sunday afternoon to talk to the author of the report on issues relating to NRLM.

Question 1: NRLM is influenced by the IKP model of AP livelihoods and financial linkages that uses people's institution in delivery and implementation. What significant design features have been adapted from IKP?

Answer: The NRLM design is still not frozen. It is a living, evolving kind of a design that will continue to be flexible and dynamic throughout the project's life. The working group set up by the planning commission for the making of the 12th plan also is expected to provide significant inputs to NRLM. The design of NRLM takes inputs not only from IKP in Andhra Pradesh but also from other successful projects such as Kudumbashree in Kerala, Mahalir Thittam of Tamil Nadu and other states. The NRLM design uses certain generic principles for its poverty eradication effort. The first principle is that the institutions of the poor are needed to enable poor overcome their initial handicaps. At the building block level these institutions should be in the ownership of people and they must experience this ownership very closely. The second principle is that long term handholding of the poor households is required as poverty can be persistent and transient even as people move up the ladder. The institutions of the poor have the patience and capacity to provide this long-term handholding. The third principle is that the poverty eradication effort cannot come only from within the institutions of the poor and the poor people themselves. Sensitive external institutions will have to provide resource and technical support. These institutions could be NGOs, government, technical organizations or banks. The fourth principle is that financial support for a variety of needs at different intervals would be required during the lifetime of the groups and institutions of people. A seamless financial inclusion plan is required for the SHGs. The SHGs should understand their members and undertake quality appraisal of their requirements before taking appropriate decisions even as they engage in financial intermediation. This means that about five to eight years of nurturing of groups and other higher-level people's institutions would be required and an amount of ₹100,000 by way of external finance would also be required to meet the small and big needs of the rural households. NRLM is built on the premise that poor are capable and that there are heroes among the poor. The rest of the programme should be built around the capacities of poor and the heroes who are visible. How to transfer the ownership of the livelihoods mission to the institutions of the poor over time is the biggest challenge.

Question 2: A large measure of bank support has been assumed in the programme. Other than AP and Tamilnadu banks have not come forward to lend to government programmes and even SHGs. Even in the southern states there has been noticeable deceleration of bank lending to SHGs. How does NRLM propose to get bankers on board?

Answer: Bank financing is a challenge and the project will have to work very closely with banks to persuade them to take a different view with regard to financing livelihoods. There were multiple ways in which NRLM would ensure that financial resource support is available to the groups and their activities. First is that of catalyzing bank lending to SHGs by strengthening the demand side of credit through providing support to SHGs and building them into a qualitative and responsible users of finance. From the supply side more options will have to be opened up. One option that would be examined is that of working with cooperative banks and primary agricultural credit societies that are being revamped under Vaidyanathan committee reform package at a cost of ₹150 billion. Financing models such as that of NABFINS and Sangamitra would be examined to see whether this could be replicated in different pockets of the country to supplement the efforts of the bank. Such dedicated institutions could give the first loans to SHGs and thereafter once the risk and credibility issues are sorted out, banks can take over such accounts. Community institutions could be set up and encouraged to take up financial intermediation. Federations of SHGs could emerge at the base level as a bank. Andhra Pradesh has already set up an apex cooperative society for financing SHGs and the Ministry of Rural Development at Delhi is contemplating setting up a corporation for the same purpose. These institutions would focus on establishing linkages for finance to SHGs through different modes such as taking care of banks' risk of lending to SHGs, viability gap funding and financing new financial products.

Question 3: The mid-term appraisal of the planning commission has not been very charitable regarding the performance of SGSY. Radhakrishna Committee was also critical of the low incomes generated by livelihood linkages even in AP. Given that the same state officials and machinery would be involved in decisions (despite the dedicated implementation structure that's being envisaged under NRLM) how does one expect a qualitatively different performance?

Answer: The envisaged implementation machinery for NRLM is a dedicated one comprising of professionals drawn from outside and contracted for the specific purpose of implementation under the project. We recognize that delivery was the weakest point of SGSY. The Central government used to provide the resources to the district directly and the DRDA attended to implementation of SGSY along with several other responsibilities in its hand. The results were not altogether good across the country though there have been states in which because of dedicated action by the existing machinery the performance and outcomes were exemplary. Under NRLM external support will be necessary and exceedingly useful. The institutional architecture for implementation therefore provides for external professionals to be part of the implementation machinery. However the keenness of states and the kind of persons who would be in charge of these programmes in the state administration would determine how comfortable they are in using the proposed new institutional structure and implementation techniques. We expect that NGOs wherever they have been successful would continue to be involved in the programme implementation through appropriate partnership arrangements. Well managed community based organizations will be used as implementing partners. Since the implementation itself is phased over five years and would build on successful implementation from the initially selected blocks to entire districts and the state. The focus on select geographical areas for initial implementation would produce superior results and models for other blocks and districts to follow. We are acutely aware that this involves a lot of efforts in the first five years.

Question 4: While NRLM rightly focuses on institutions of the poor, what measures it has proposed to ensure that the institutions remain insulated from politics and elite capture?

Answer: Peoples institutions especially of the poor are always subject to political influence and elite capture. Keeping this mischief potential in mind, NRLM seeks to provide a set of good norms and byelaws governing the setting up and running of the federations. The forward looking enactments such as the Mutually Aided Cooperative Societies (MACS) Act in different states would be used to ensure that the principles of autonomy in decision making and responsibility of members towards their institutions are fully incorporated. Capacity building required making the office bearers in these institutions and the members to understand that it is their own institution and should be kept free of any extraneous considerations would be undertaken. A functional relationship with the Panchayati Raj Institutions (PRIs) at the local level would also be enabled so that the people's institutions have their rightful place in voicing member's issues within the Panchayati Raj Institution (PRI). But one of the key issues is also that the external support structures that will do the handholding and the guidance of peoples institutions should be prevented from influencing decisions. This happens very silently but NRLM proposes to have monitoring and review systems.

Question 5: NRLM is fairly descriptive on the financial services linkage and the funding of the programme but it is short on livelihoods identification, linkage and support. With the present level of detail NRLM appears to be a financial sector intervention rather than livelihoods intervention. How do you react to this view?

Answer: Poor people have an abundance of livelihood ideas; given an opportunity and appropriate support they would be able to implement them. They do not really require professional support of an advanced nature to determine livelihoods and income opportunities. The working group that has been set up by the planning commission is already addressing the livelihoods issue and giving shape to the manner in which NRLM should enable people to pursue what they feel as potent ideas that would improve their incomes. NRLM basically tries to build strong institutions of the poor and make these institutions the nucleus from which the other activities of people and groups would be supported. This is a departure from the SGSY type of intervention where the income generation activities were prioritized with the result the actions that followed were neither cogent nor fully effective in terms of results.

Question 6: The mission document of NRLM says that it would be a demand driven programme and would not use centralized allocations to influence its planning. However a deeper reading of the document shows that the state governments do the planning and demand funds from the centre with no effective integration

of ground level demand and aspirations into the plan. How NRLM will ensure that the households' perspective is taken into account when preparing the plans?

Answer: In the case of SGSY the planning and the guidelines were very detailed and the states had to implement the same in the manner in which the guidelines were given. A few states had imaginative personnel that made localized additions and brought considerable meaning to the implementation of SGSY. In the case of NRLM the attempt is not to provide detailed guidelines and stifle local initiatives. NRLM provides a framework for each state to prepare its own long-term perspective plan and based on that submit annual action plans which would be approved from budget point of view. Micro business plans that are prepared at the household and SHG levels appraised duly by the SHGs and institutions of the poor would become the basis for state level plans. The household plans would be appraised by SHGs and the SHGs will identify the persons who will access resources first and the kind of activities that deserve priority support. Livelihood streams of 3 different types would be supported under this demand driven planning, the first is that of existing livelihoods that are around agriculture and livestock. The second stream of livelihood activities relate to micro-enterprises which would be facilitated through qualitative capacity building and other support through the RSETIs and the third stream would be through developing skills in youth so that they could be placed in jobs. Overall the skill sets, the aspirations and the activities identified by people in their groups would be the basis for the action plan of the states.

Question 7: What is the message that you would like to give out to the people in the sector?

Answer: I would like to give a message of hope. Believe that poor people are capable and if we build a good eco system in which economic development of the poor can take place it will certainly work for the poor. We should send out a strong message that we need not be charitable towards poor but we should make them partners in economic development and take them along.

NOTES AND REFERENCES

1. Swarna Jayanti Gramin Swarozgar Yojana (SGSY) is a rural self-employment programme for poor families that was introduced in 1999 by Government of India.
2. Andhra Pradesh District Poverty Initiative Project.
3. Cited from the Mission Document of NRLM, published by Ministry of Rural Development, Government of India, 2011.
4. This section uses material from the mid-term appraisal of Planning commission, Report of the Radha krishna Committee that carried out an assessment of the programme and the study carried out by BIRD, Lucknow.
5. Sunil Kumar, *Study on SHG Federations—Challenges and Opportunities* (Lucknow: BIRD, October 2010).

Financial inclusion—march of the banks

9

Chapter

The efforts of financial inclusion from the Government of India and the RBI have been continuing with increased vigour. While the pace of inclusion seems to have increased, the task completion for this effort is still not in sight. The RBI has gone beyond the opening of no-frills accounts with overdraft facility in its understanding of what constitutes financial inclusion. The most recent annual report of the RBI[1] states that financial inclusion 'refers to the process of ensuring access to appropriate financial products and services needed by vulnerable groups ..., in a fair and transparent manner by mainstream institutional players'. The important statements coming out of this definition of financial inclusion are that it is basically focussed on vulnerable people, it entails providing appropriate financial products and services (not just one or two) and it should be provided by mainstream players at an affordable cost. With this, RBI continues to insist that financial inclusion of people can legitimately take place only when services are provided by banks. This is a laudable objective at the level of intent but does not look feasible on the ground with several thousands of vulnerable households distributed, at many locations sparsely, over the country. The RBI also acknowledges that 40 per cent of all rural households and 50 per cent of rural households in the eastern and non-eastern regions are yet to gain access to financial services. RBI also subscribes to the finding that financial inclusion is a reflection of social exclusion as countries with low GDP per capita, high income inequality, low rates of literacy and poor connectivity appear to be financially less inclusive. Financial inclusion as a policy objective seeks to ensure that its population joins the mainstream of the development effort.

Principally the RBI has been persuading banks to focus on 4 different products in expanding financial services access to the excluded people. These are: (*a*) a savings cum overdraft account, (*b*) a remittance facility either aligned to or independent of electronic benefits transfer, (*c*) a pure savings product that helps people accumulate money for the future such as a recurring deposit and (*d*) an access to credit through instruments like a general credit card or a Kisan Credit Card.

At the end of the year 2010–11, 74.4 million no-frills accounts (NFAs) had been opened by the banking system. The outstanding balance of savings in these accounts was of the order of ₹65.6 billion. Banks had also opened 4.2 million overdraft accounts in select NFAs. The amount outstanding in these overdraft accounts was of the order of ₹2 billion. A total of 0.95 million general credit cards had been issued for a value of ₹13.08 billion. Of the NFAs of 74.4 million that were open 50 per cent, i.e., 37.2 million had been through the use of information and communication technologies. It is to be noted that SHGs numbering 7.54 million (almost a 100 million members) had saved ₹69.25 billion with banks, and at the same time achieved deeper service levels on account of the regualrity of savings and access to credit. SHGs had outstanding credit of ₹306 billion covering 62.5 million members compared with the 4.2 million overdraft accounts opened. A comparison reveals that SHG model is a superior option in both access and inclusion aspects. But official acceptance of the inclusion potential of group based financial intermediation is some distance away.

In a far reaching move, as reported in the State of the Sector Report 2010, last year the RBI had mandated that banks through the mechanism of the district level bankers' committee and the state level bankers' committee prepare a financial inclusion plan that would indicate how the banks will provide

a point of presence in each village having a population of more than 2000. The RBI had pursued this agenda very closely and today banks have prepared plans in each and every state that targets 72,800 villages with a population of more than 2,000 that are not currently served by any mainstream financial institution. The banks also provided their plans as to whether they will open branches in these 72,800 villages or will extend services through a business correspondent. Currently 58,361 business correspondents appointed by banks serve 76,801 villages. With another 72,800 unbanked centres allocated to banks, the RBI has asked concerned banks to invest in brick and mortar structures even if they are of the kiosk type. Each such kiosk will have the ability to service 8 to 10 business correspondents within a radius of 2 to 3 kilometers from the kiosk branch. If this is implemented then the banking system would have extended its network to the rural hinterland. But going further, RBI in the next step intends to make banks prepare a plan for each village having a population of more than 1,000. This, it is reckoned will bring in 120,000 villages additionally in to the banking map through a point of presence that would offer financial services.

The plan would achieve incremental coverage of about 100 million customers through NFA and KCC (ignoring the overlap between the two sets of accounts) by 2013. This might be still be short of the numbers required to achieve inclusion to all those currently excluded. The adult population in the country is about 840 million and about 400 million of these might currently be excluded. Hopefully the next stage of financial inclusion plan will take care of the remaining excluded who desire to be part of formal financial services.

During the year, several regulatory initiatives relating to financial inclusion had been taken. Corporate entities with a for profit objective had been allowed to function as business correspondents. The Know your Client (KYC) requirement had been relaxed in case of job card holders under MGNREGS. Even letters issued by the unique identification authority containing details of name, address and Adhar number have been made as suitable documents based on which the KYC can be carried out by banks. Opening of branches in centres with a population of less than 50,000 (covered by tier III to tier VI centres as per RBI's classification) has been simplified. The RBI has made opening of branches in the north eastern states and Sikkim a very easy task by waiving the prior permission requirement. The banks need only to apprise RBI of the opening of branches in these states. More initiatives through improvements to payments and settlement systems have been made to make mobile enabled remittances and payments possible.

The quality of inclusion in banks has been a continuing question. Opening of bank accounts has been seen as the end and the numbers of NFAs taken to be an indicator of the extent of a bank's commitment to the inclusion plan. While banks and RBI have made all these efforts to try and provide services to the rural and urban populations to ensure better financial services coverage, problems still continue to hinder accelerated inclusion. One of the concerns that had been expressed was the low level of usage in relation to the large number of accounts of the no-frills category that had been opened. The number of active NFAs reported by different banks varies between 3 and 20 per cent.[3] MicroSave India had carried out a recent study on dormancy of no-frills accounts. The study covering four states (Uttar Pradesh, Delhi, Rajasthan and Tamil Nadu) found that 20 per cent or less NFA holders actually use it for savings. 72 per cent of the sample were agricultural wage labourers. Fifty-eight per cent of people who opened these accounts had reportedly done this to receive the MGNREGS payments. Financial literacy did not seem to be an issue in operating these accounts as MicroSave found 75 per cent of respondents to be conversant with basic features of the NFAs as also banking. This low level of usage of bank account had implications for

Table 9.1 Commercial banks and financial inclusion[2]

Particulars	March 2010	March 2011	March 2012 Target	March 2013 Target
BCs and CSPs Deployed	33,042	58,361	125,988	187,972
Villages covered through branches	21,499	22,684	24,618	25,694
Villages Covered through BCs	33,158	76,801	197,523	320,441
Villages Covered through other modes	100	355	1,361	2,177
Total Villages Covered	54,757	99,840	223,502	348,312
No-frills A/Cs (nos. in millions)	49.55	74.39	109.62	153.31
No-Frills A/Cs savings (₹ billion)	48.95	65.65	93.11	113.23
KCCs (nos. In millions)	19.52	22.48	32.25	40.73
KCCs—Credit (₹ billion)	1,075.18	1,438.62	1,521.13	1,792.54
GCCs (nos. In millions)	0.63	0.95	4.68	8.11
GCCs—Credit (₹ billion)	8.13	13.07	32.29	56.69

bank profitability. Each transaction was estimated to cost ₹13.40 to the bank and each account cost ₹50.45. Overall it cost ₹250 to open and maintain an account to a bank branch and if less than 20 per cent of account holders actually saved money then the banks would be hard put to recover their costs.

Banks may not be able to take up financial inclusion as a public service obligation for a long time. Financial inclusion should result in business that covers costs, if not contribute to profits. The perceived low capacity of excluded people to pay and the reluctance of banking system to price its services to such clientele on account of the majority public sector character have hindered the quality and extent of services offered to the people. The excluded people understand the compulsions of the bank and are able to realize that unless they are willing to pay a price, they may not be able to access reliable financial services over sustained periods of time. The obvious conclusion that emerges is that the customers should be charged a transaction fee which the RBI had allowed last year. However, not many banks have proceeded further in levying charges on customers who are serviced through business correspondents. The question for the banks to look at is whether the customers in low-income segments would be willing to pay the service charges and even if they are willing whether they would be able. MicroSave studied[4] the aspect of willingness on the part of customers to pay for services rendered by the bank through the business correspondents. Out of 784 respondents' surveyed, 70 per cent were willing to make a payment for transactions put through by the bank. There was a mixed preference in the choice of basis of payment. Some preferred a flat rate fee while others preferred a percentage of the value of transaction as the fee. The customers indicated the top three considerations behind their willingness to make payment for transactions: (*a*) the opportunity cost of saved time, (*b*) convenience of banking at doorstep and (*c*) the savings made on direct costs in visiting a bank branch to transact. The customers also indicated three prominent categories of transaction barriers that held up the customers from visiting the bank. These are (*a*) the amount of time spent in the bank, (*b*) the long distance to the bank involving cost both in terms of travel and in time and (*c*) the staff behaviour which was not felt to be appropriate. The conclusions reached by the MicroSave study were that the NFAs could be converted into quality savings account with significant transactions if the quality of service is improved by offering easier access to cash withdrawals and deposits as also a reliable and predictable doorstep service. The study also recommended that incentives for higher savings in the accounts and for maintaining higher balances in the account should be made available to the customers. Finally, if access were to be provided through mobile phones and other portable instruments to the customers, then their willingness to transact more frequently and for higher volumes through the NFA might improve.

Financial Information Network & Operations Ltd (FINO) reported that it had linked 30 million customers with the banking system through 15,000 transaction points in 300 districts. Zero Mass Foundation has linked 4 million customers to banks through 8,000 customer service points in 16,000 villages. Zero Mass Foundation has tied up with SHGs for the last mile services in some locations. While banks hired BCs to accelerate inclusion, they have not been diligent in making paymet for their services in time. For start-up BCs, which already invest significant amounts at the time of start-up, if the service charges are not paid by the bank, it would result in a liquidity crunch. Reportedly several BCs in the field are suffering on account of delay in payment of charges by banks. This is likely to lead to withdrawal of BCs from the field leading to denial of service to the account holders. There have been reports that some banks are unilaterally revising contract terms to the disadvantage of BCs. Some of the BCs appointed to cover certain villages before the financial inclusion plan of the banks came in to existence are being asked to service a different village on the plea that the banks has been allocated other villages under the financial inclusion plan finalized by SLBC. The resultant withdrawal of service is likely to lead to loss of credibility of BC led model of inclusion. Banks should tread this field carefully.

In insurance, 28 new micro-insurance life products by 14 insurance companies (15 individual life products and 13 group products) were being offered. Premium collection was about ₹2 billion in which LIC's share was 94 per cent. The private sector insurance companies had a token presence in the micro-insurance market for life products.

Table 9.2 New micro-life insurance business contracted during 2009–10[5]

	Individual		Group		
Insurer	**Policies**	**Premium**	**Schemes**	**Lives covered**	**Premium**
Private	998,809	839.78	17	1,895,143	1,472.09
LIC	1,985,145	14,982.51	5,190	14,946,927	22,869.72
Total	2,983,954	15,822.29	5,207	16,842,070	24,341.81

A total of 19.7 million lives have been covered under micro-life insurance of which 85 per cent had been under group schemes. Lives covered constitute a very small proportion of the market potential. Lack of marketing and servicing, inability to raise awareness among people and difficulties in dealing with institutions that deal with the vulnerable communities in rural areas are some of the problems faced by the sector. In some cases the initial policy is written, but continuing service is not offered. When claim settlements are delayed or denied, the credibility of the arrangement suffers in the local area.

The insurers, in an effort to deal with the problems, have been hiring specialized micro-insurance agents. The attrition rates have been around 13 per cent. The number of agents seems too small to be able to make a significant difference to insurance penetration.

Table 9.3 Micro-insurance agents of life insurers[6]

Insurer	As on 1 April 2009	Additions	Deletions	As on 31 March 2010
Private	603	309	142	770
LIC	6,647	2,071	812	7,906
Total	7,250	2,380	954	8,676

India Post had sold 4.02 million Rural Postal Life Insurance (RPLI) policies during 2009–10 for an average sum assured of ₹33,900. The number of active RPLI policies as at the end of March 2010 was 9.92 million with insurance coverage of ₹595 billion. The average sum assured per policy was ₹60,000. Post office without getting in to terminological debate on what is micro-insurance has silently been active in rural areas for insurance inclusion.

The macro numbers with different financial institutions show that the total number of accounts with the formal financial system and other financial transaction entities such as SHG, MFIs and primary cooperatives by far exceeds the adult population of the country. However the biggest contributor to the number, the banking system has multiple accounts per customer, within the same bank and across banks. If we reckon that the NFAs are the contribution of banks to inclusion, then we have a total of 387 million savings accounts and 272 million loan accounts. With an adult population of 840 million, the conclusions are for us to draw. The space in the market for inclusion is still large. In a developing country with good growth rates, the excluded people are good business prospects for the financial sector.

Table 9.4 What remains to be included[7]

No. of adults	840 million[8]
No. of deposit accounts—Banks (March 2010)	734.9 million
No. of NFA accounts —Banks (March 2011)	74.4 million
No. of deposit accounts—Post office (March 2010)	88.6 million
No. of NREGS accounts—Post office (October 2010)	46.7 million
No. of accounts—Primary cooperatives (March 2010)	126.4 million
No. of borrowers—Primary Cooperatives (March 2010)	59.8 million
No. of loan accounts—Banks (March 2010)	118.6 million
No. of loan accounts—MFIs (March 2011)	31.4 million
No. of saving SHG members (March 2011)	98.1 million
No. of borrowing SHG members (March 2011)	62.5 million

NABARD has been working on the theme of inclusion by supporting innovations in field practice as also technology testing and adoption. NABARD contributed ₹700 million to Financial Inclusion Fund (FIF) and Financial Inclusion Technology Fund (FITF). The policy initiatives were to permit Primary Agricultural Credit Societies to function as BCs of commercial banks, approval for Farmers Clubs to act as Business Facilitators of banks and raising the level of support for approved projects under FIF and FITF in 256 disadvantaged districts to 100 per cent of project cost. NABARD had approved of a scheme to fund 40 per cent of the cost of installing Core Banking Solution software in 28 weak RRBs. A pilot for introducing micro-pensions using the IIMPs model has also been sanctioned.

Table 9.5 Utilization of Financial Inclusion Funds, 2010–11 (₹ million)

Name of the fund	Disbursement Target	Sanctions	Disbursements
Financial Inclusion Fund	220	190	92
Financial Inclusion Technology Fund	280	1,010	540
Total	500	1,200	632

A review of the use of the two inclusion funds shows improvement over the previous years. The total disbursements exceeded the target, though the pace in FIF is slower compared to the Technology fund.

Banks have set up customer service points in a bid to extend financial services through their business correspondents. The number of such points increased to 58,350 from 13,077 in March 2009. A majority of the customer service points are in the rural area (almost 90 per cent). The Ministry of Information Technology (MIT), Government of India, had reviewed the operation of some of the existing pilots which use common service centres with IT capability in the rural areas to act as business correspondents of banks. As per information provided in the report,[9] Madhya Pradesh has 496 Common Service Centres offering BC services followed by Jharkhand which has 250 such centres and Chattisgarh with 59 centres. As per the review, the Customer Service Centres (CSCs) are able to earn between ₹2,600 to ₹50,000 a month as income mainly on account of disbursement of wages under MGMNREGS. The key success criteria identified by the MIT study was that the internet connectivity should be reliable and robust. The training and motivation of the agents working in the CSC should be very strong. The linkage with the government scheme should also be ensured so that the kiosks have a volume of business based on government payment. The awareness building of local communities and sensitization for opening bank account and putting through transactions using the services of CSC should be carried out. The review also recommended the kiosk banking model of State Bank of India as the most suited one that could use the services of the CSC as a BC on the saving side and as a business facilitator on the loan side.

Last year a study[10] was carried out commissioned by Bill & Melinda Gates Foundation on whether the corporate network can be used as business correspondents of banks. Among other things, the study looked into the cost of operation and the possibility of breakeven of the model for the BCs. The study found that if banks are willing to offer a full range of services including that of credit and remittances through the BC, then the BCs would be in a position to breakeven by the fourth year after three years of build up. The study also compared different types of networks operating in the rural area and their suitability or otherwise to function as business correspondents. The study concluded that ITC's E-Chaupal model and petroleum products distribution agencies such as the oil pumps in the rural areas have the best suitability on account of their financial strength, ability to handle cash as also the capacity to act as agents. The study found that the critical problems were of settling cash transactions within 24 hours as also dealing with physical cash by the agents and the banks. One of the points made by the study was that appointing numerous small individual BCs is fraught with not only risks but also makes management of the individual BCs somewhat cumbersome. The preferred mode for selecting and appointing BCs should be that they belong to a network whereby the management of the network could be from a single point rendering the overall monitoring and supervision of the arrangement by branches easy. In case where such network management does not independently exist, then the bank should invest in a network manager who would do the job so that banks concentrate on banking.

While the financial inclusion measures are being actively carried out, there are problems in relation to the practice on the ground. State Bank of India with the largest number of BCs and customer service points (almost 40,000 Customer Service Points or CSPs) have significant problems of different kinds. For example, the business correspondents were found to be indulging in malpractices and unauthorized money transactions. State Bank of India found that the customers of the bank were being over charged especially for remittances and also for transactions which were required to be put through emergently. While the valuable customers of CSPs were exploited, the image of State Bank of India also took a beating. While no evidence has been found, there is also a growing apprehension that the business correspondents who were small time operators may not always be passing on the money collected from depositors to the bank. The money might in fact be used as float money for carrying out short term money lending activities or working capital support for other businesses. While State Bank of India cognizant of this misuse and abuse potential has written to its branches to be more vigilant in monitoring the functioning of BCs, whether the other banks as have detected such problems and have initiated steps is a question.

Last year saw the announcement of two big ticket tie-ups between telecom operators and banks. Vodafone announced a tie-up with ICICI Bank and Airtel announced a tie-up with State Bank of India. More such arrangements have been concluded during the year. But none of the mobile banking partnerships with telecom companies have taken off. Their proposals are being examined by RBI from the security, customer protection and systemic risks angles. Eko, one of the early movers in mobile based banking services has made considerable progress.

It has commenced operations in Bihar. Eko intends to ramp up its customers to 1 million through 1,500 counters. The remittance scheme 'Tatkal' has proved to be a revenue line that has the potential to subsidise the savings accounts related business. Eko has also tied up with Cashpor for enabling the customers of Cashpor to open accounts with banks.

The contribution of the electronic benefits transfer to the viability of both banks and the BCs cannot be underplayed. During the last three years there had been continuing growth in the number of NFAs that were opened by banking system and post offices specifically for the purpose of disbursing wages under MGNREGA. From 68.60 lakh accounts in 2009 the number of account holders went upto 94.65 lakh by end March 2011. The volume of payments disbursed to these accounts increased from ₹108 billion in 2008–09 to ₹220 billion in 2009–10. 2010–11 saw a decline in disbursement to ₹184 billion which is on account of overall decline in disbursement under MGNREGA. However, the proportion of payments made through EBT increased from 58 per cent in 2009 to 84 per cent in 2010 only to decline to 80 per cent in 2011. Continued focus on covering all government payments through the EBT route would provide more meaning to the financial inclusion drive and also inculcate a banking habit among people. But savings of money in these accounts and enhancing the propensity to save in the minds of people will depend on effective design of suitable goal oriented savings products by banks as also a concerted marketing drive that emphasises the importance of banks as credible institutions.

The RBI while formulating its electronic benefit transfer scheme had used the concept of one district one bank as the model through which government payments would be handled. But with passage of time several difficulties have been experienced with one district one bank model. The inadequacy of branch network to cover the entire district, the inability to provide other complimentary financial services apart from disbursement of the benefits and the inability to offer the freedom of choice of bank to the public are some of the issues faced. In order to fulfil the objective of financial inclusion and make full use of the potential of government's benefits payment to induce people to open bank accounts, a convergence model was felt to be necessary. RBI had asked the banks to open a point of service in each village with a population of more than 2,000 to address the financial inclusion needs. If such branches or points of presence are opened they should not be denied the opportunity for extending banking services based on available business potential. In fact the convergence between Electronic Benefits Transfer (EBT) and Financial Inclusion Plan (FIP) models should ensure that any branch or a point of service open is able to offer all the services whether relating to banking or benefits transfer from the government account. RBI has now decided that *one district–many banks and one leader bank*[11] as a model for EBT implementation. All the banks in the district will participate in EBT while for administrative convenience, the state government will deal only with one leader bank which will be selected in consultation with RBI and the SLBC. The leader bank will obtain all the funds from the state government and will in turn transfer these funds to the other banks for credit to the accounts of beneficiaries on a commission basis. However, if the one bank one district model is already working satisfactorily and the chosen bank is in a position to meet all the service requirements of all the account holders in the district, then there is no prohibition on continuation of such a model.

This rethink on the model of EBT will go a long way in ensuring that all the banks in the district get involved in financial inclusion with the added benefit of electronic benefit transfer from government accounts strengthening the deposit base. This was a critical missing piece in the earlier scheme which is much more relevant and required in the context of the new financial inclusion plan which envisages opening of more than 70,000 points of presence in the rural areas with another 1.20 lakh points of presence being envisaged beyond March 2012.

INDEX OF FINANCIAL INCLUSION

In a working paper an RBI researcher[12] had proposed a methodology for a state wise index of financial inclusion based on banking data relating to three key aspects. The first is that of penetration, the second is that of availability and the third is that of usage. The banking *penetration* in the index refers to the size of banking population having a bank account as a percentage of overall population in the geographical area. *Availability* of banking services has been measured as the number of bank outlets per thousand population and the number of ATMs per thousand people or the number of bank employees per customer. However, in the Indian context, the number of bank branches per thousand adults and also the numbers of branches per square km. geographical area have been used to measure availability. The *usage* refers to the extent to which bank accounts are used by people. It is not merely having a bank account that matters but the reliance on the bank accounts by people to put through transactions has to be measured. As a measurement

criteria the volume of outstanding deposit and credit as a proportion of net district domestic product has been used. Based on the computation of data, the index has placed Kerala at the top of the table with a financial inclusion index score of 0.54 against a possible score of 1. Predictably north eastern states i.e. Assam, Nagaland and Manipur make up for the last three places. The surprising entry is that of Sikkim which is placed eighth overall in the list of states. The all India average score in the index is 0.33. That only 6 states figure in the list with scores above the all India average and the 20 states figure below the all India average in a telling comment on the unequal state of inclusion in the country. (The state-wise index is provided in Annex 9.2.) While there could be a debate on the relevance and appropriateness of this index to measure state wise inclusion levels, it is a useful tool to understand in a fundamental sense the extent to which financial services impact people. However, it has to be remembered that this index has a banking view of inclusion and any data relating to customers availing financial services through post offices, MFIs, SHGs and even cooperative societies would be out of the reckoning. In fact among the excluded vulnerable and poor households the use of non-bank channels of finance have been much more than bank accounts. Post offices carry a significant load of those who find it difficult to open bank accounts. If the index is reconstructed with the further information from all formal institutions which offer financial services, one might find that some of the states figuring lower in the list might improve their position. Surprisingly Manipur which is among the last three palces in the financial inclusion index among states, figures in the top in Microfinance Penetration Index (MPI).

MICROFINANCE PENETRATION INDEX

As in the previous years the penetration of microfinance in different states has been computed. The analysis shows Manipur has surprisingly taken the top position with a score of 4.23 in MPI and 7.26 in Microfinance Poverty Penetration Index (MPPI). Andhra Pradesh, the top ranking state in penetration in the previous years is now placed second. Puducheri (Pondicherry) has entered the list at the third place. Sikkim has entered the top five list under MPPI. The population data has been sourced from the latest Census 2011 and this might one of the reasons for some changes among states in terms of MPI. The changes in spread of SHG linkage and MFIs customer base have caused some changes to the MMPI rankings of states. The

Table 9.6 Ranking of select states based on MPI and MPPI

State	MPI	State	MPPI
Top Five			
Manipur	4.23	Manipur	7.26
Andhra Pradesh	4.20	Andhra Pradesh	7.03
Pondicherry	2.57	Pondicherry	3.36
Tamil Nadu	2.00	Tamil Nadu	2.47
Orissa	1.63	Sikkim	2.12
Last Five			
State	**MPI**	**State**	**MPPI**
Jammu & Kashmir	0.03	Mizoram	0.11
Mizoram	0.05	Jammu & Kashmir	0.15
New Delhi	0.13	New Delhi	0.24
Punjab	0.18	Bihar	0.30
Meghalaya	0.24	Uttar Pradesh	0.31

MPI and MPPI scores for all the states is provided in Annex 9.2

Madhya Pradesh has climbed out of the bottom five list under MPPI. The bottom of the list in case of MPI has only two states from the last year, Jammu and Kashmir and Punjab. The other three states have been replaced by new entrants. The low MPPI ratio in states like Bihar and Uttar Pradesh with a large proportion of households under poverty line indicates that considerable work has to be done in these states both by SBLP and MFIs.

Box 9.1 MPI and MPPI

These two indices are presented every year for the last three years. The calculation of the index was carried out as follows:

The number of credit clients of MFIs and members of SHGs with outstanding loans to banks were computed and each states share to the country's total microfinance clients was worked out. The intensity of MPI was computed by dividing the share of the State in microfinance clients with share of population. Intensity of MPPI was derived by dividing the share of the state in microfinance clients by share of the state in population of poor. Since the microfinance clients are in the numerator, a value of more than 1 indicates that clients acquired were more than proportional to the population. Higher the score is above 1, better the performance. Lower the score from 1 which is the par value, poorer is the performance in the state.

REMITTANCES

Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH, Eschborn, Germany, had commissioned different studies into the pattern of migration remittances and the payment system in the country. Based on the studies, a synthesis report had been brought out 'Remittance needs and opportunities in India'.[13] The report suggests that remittances being a critical component of overall financial inclusion, significant steps are needed to ensure that domestic migrant workers and their families are benefitted. The report recommends that the remittance structures should build on existing models and institutions with large outreach and also the current products that are in line with the regulatory framework. The strategy recommended by the report included a strong and effective steering structure chaired by RBI to drive the remittance movement forward. Development and piloting of models of institutional inter-institutional money transfer for two sets of financial institutions, i.e., regional rural banks and their sponsor banks and the cooperatives banks and their constituent primary societies have to be first developed. Related to this, the business correspondent models should adapt to the opportunities and the nature of individual banks whose services are used by the remitters. The primary agriculture cooperative societies, SHGs and microfinance institutions which are in a position to service their members and customers in a much more involved manner should also be brought in to the mainstream of the remittance and payments model. The development of demand oriented remittance product suited to migrants should be linked with other financial services. A large scale programme on financial literacy on the demand side and capacity building of bank staff and business correspondent staff should be taken up to ensure that socially responsible business behaviour and customer protection continued to prevail.

UNIQUE INSTITUTIONS IN INCLUSION

In 2009, the case of Kshetriya Gramin Financial Services (KGFS) as an institution with promise to develop as a full service institution in financial inclusion was mentioned. KGFS has made considerable headway. It has positioned itself as a rural financial institution covering all segments of the people and did not choose to describe itself as an MFI. As of March 2011, three KGFS's are operational in three different geographies; Pudhuaaru KGFS in Thanjavur district, Tamil Nadu; Dhanei KGFS in Ganjam district, Orissa and Sahastradhara KGFS in the hilly areas of Tehri Garhwal district, Uttarakhand. All three put together have an extensive network of 106 branches with more than 1.62 lakh enrolled customers and 462 member strong team including 357 Wealth Managers. More than 100,000 customers access liability products from KGFS. The offering is a complete suite of products such as short term money market mutual fund, personal accident insurance, group term life insurance, livestock insurance and National Pension Scheme. Under loans KGFS offers a variety of lons to suit the requirements of the customer. JLG loans, livestock loans, gold loan, retailer loan, salary loan and education loan are offered with different features and maturities. The rate of interest is at 18 per cent on a declining loan balance. The branches are in a position to break even in about 12 months more though some branches might take a little longer. The contribution of liability products to income stream is critical in this.

KGFS has invested in state of the art technology for front and back end processes. A Core Banking System and Customer Management System drive the business processes that are on-line and real time. Scope for Mobile Payments in the payments ecosystem is being examined by the MFI. Opportunities in Person–to-Business Payments (National Billers), Business-to-Person (Payments for Procurements), Government-to-Person (NREGA), Person-to-Person (Domestic Remittance) are being explored and tested before launch. Its unique approach to customers involving preparation of a household specific Family Well Being Report has been a comprehensive and unique attempt at understanding the customers financial situation, their aspirations and needs and for preparation of a plan for meeting the future needs.

KGFS has in the last three years demonstrated the concept of a stand alone local rural financial institution. The institutional viability of the model has to be frozen so that the model can be rolled out in many states and locations. KGFS is exploring potential collaborations with some of the Scheduled Commercial Banks in offering their suite of products through the KGFS Model process in other geographies. It is pursuing product level replication of partnerships with existing MFIs and NGO entities mainly in the space of Pensions. It is open to partnerships, at product level or entire KGFS model level to enable it to move closer to the mission of ensuring complete access to financial products to people excluded from the financial system.

Box 9.2 All-out effort in inclusion[14]

SOUTH MALABAR GRAMIN BANK

South Malabar Gramin Bank (SMGB), headquartered in the northern part of Kerala is a public sector insitution that has made financial inclusion its mission and a business proposition. SMGB's activities in financial inclusion involve awareness creation on financial literacy, mobilizing the rural poor, NFAs with inbuilt OD facility, micro-credit, debt redemption, capacity building, livelihood loans, micro-savings, business facilitator model of RBI/NABARD, ICT solutions for financial inclusion and credit plus services. During the last one year the bank had financed more than 4,000 SHGs and 600 JLGs. It has opened more than 260,000 NFAs many of which have a built in overdraft facility for emergent needs. More than ₹235 million has been saved in these accounts. Its general credit cards are in use by about 13,000 customers. It has a debt redemption scheme under which loans are given to eligible households to repay their high costs debts elsewhere. The selection of such households is made through its financial inclusion survey. The bank has also issued Kisan Credit Cards (22,000 last year) to farmers and Swarozgar Credit Cards (15,600 cards so far) to self-employed. It has appointed Business Facilitators and Business correspondents and employing smart card technology for transactions. It has set up 250 farmers clubs and 8 village knowledge centres. The bank has undertaken enterprise development training, capacity building of SHGs and financial literacy campaigns as part of its credit plus activities. The bank has a long profit record and presently has balance sheet assets of more than ₹40 billion. Given its large size with 230 branches and 1500 employes, its work on financial inclusion is noteworthy.

The financial inclusion space today belongs to banks. But banks are reluctant owners of this sapce and they have to be continuously persuaded by government and RBI to prioritize the excluded population. A policy view on what constitutes inclusion is not uniform across all the policy establishments. While RBI insists that financial inclusion is achieved only when banks provide services to excluded customers, the government seems to have slightly different view. The economic survey states, '*Another constituent of financial inclusion,* which could potentially benefit from Swabhimaan, *is the extension of the reach of microfinance.*' The budget speech of the Finance minister stated, '*The Microfinance Institutions (MFIs) have emerged as an important means of financial inclusion.*' The draft microfinance bill in Section 3 states that the purpose of Microfinance Development Council is 'development of the microfinance sector and MFIs to promote financial inclusion'. Subsequently in Section 23 it again states 'It shall be the duty of the Reserve Bank to promote and ensure orderly growth of the microfinance sector … *for the purpose of promoting financial inclusion*'. The annual report of the RBI states, '*Financial inclusion broadly refers* to the process of ensuring access ... *by mainstream institutional players*.' The rest of the chapter on financial inclusion in the annual report of RBI is addressed at banks only. This does not seem to be an omission, but a clear divergence of views. In the chasm between the two views lay several institutions including the post office that have the capacity to link people with finance. Should financial inclusion fail to include all available institutions? How to justify the cost involved in setting up new infrastructure and networks given the existence of other systems and institutions in the same space?

The cooperative banking system is being reformed at a cost of about ₹150 billion. The sunk investments in the system would be many times more. The primary agricultural societies will be able to offer immediate and relevant services to members. So is the case with post office, which has embarked on a modernization plan that would make it technologically capable to offer banking services. MFIs have demonstrated capabilities to deliver credit and if permitted some of them would also be able to deliver savings services under an appropriate regulatory framework. The investments made and human resources harnessed in such institutions can be put to good use and the pace of inclusion accelerated. These institutions could work in partnership with banks and not necessarily in competition. According to H.R. Khan, Deputy Governor, RBI, the game changers in the inclusion sphere are the entry of non-banking institutions in the payments system (currently 31 such entities have been permitted to operate); the operationalization of UID (AADHAR) and expansion of services of National Payments Corporation of India (NPCI), which will enable operators offer payments and remittances as a revenue model. This will separate banking from payments services and separate the competencies required, making it possible for faster and easier remittances.

ANNEX 9.1
Interview with H.R. Khan, Deputy Governor, Reserve Bank of India

The Deputy Governor agreed to answer a few questions on how payments and settlements matter in inclusion of excluded peoples and technology options in financial inclusion. This is an exclusive interview for the SOS 2011.

Question: What aspects of a modern, technologically driven payments system is relevant for low-income households? What contribution can payment and settlements make towards inclusion?

Answer: Admittedly despite several efforts made to expand banking network a large portion of households in rural and urban slum areas still do not have access to banking services, as the brick and mortal model could not be extended to them. Also the income earners in several households, particularly from rural areas, are located away from their homes and often receive wages in cash. The problem is how can they remit the money back home. Such problem of financial inclusion is not limited to rural areas only though the magnitude of the problem is higher in these areas as compared to urban areas. This underlines the urgent need to develop a viable system, which will enable saving along with quick, safe and inexpensive mode of remittance besides catering to the small credit needs. With a mix of technology such as smart cards and mobile banking and the Business Correspondent (BC) models, it has now become possible to scale up the banking services among the unbanked population in a cost efficient manner.

Having identified the grey areas and also the limitations of the existing systems, there is a need to adopt innovative models within existing infrastructure and modern technology to achieve the goal of financial inclusion. One such technology is the communication technology. Communication technology has seen a rapid progress in recent years and has enabled connectivity to bank accounts. Another technology that has the potential of ushering a revolution is the Micro-ATM. This device could be the instrument for initiating banking transactions. These devices could be installed at the BC's place/kiosk or carried by the representative of the BC of a bank. The reach of mobile telephony across the country and development of mobile based payment applications can make this mode a very convenient way for meeting the receipt and payment needs of the financially excluded.

RBI as the regulator of the payment and settlement system has in the recent past taken significant initiatives in facilitating transfer of funds, for example, a bank customer using the mobile banking platform can transfer cash up to ₹5,000 to a beneficiary not having bank account to receive cash from ATM or a BC. Development and propagation of acceptance infrastructure in the unbanked regions would be another important area to be focused upon.

It is pertinent to mention the 5 A's which are determinants of the success of any payment system for financial inclusion in a country:

Availability combines the notion of a level playing field for the service providers along with the availability of choice of products for the consumers, particularly those at the Bottom of the Pyramid.

Accessibility as a concept should be the cornerstone to expand the reach of the banking system, in both branch and branch-less modes, and the various payment products to all the sections of the society including the '*aam aadmi*'[15] as part of the financial inclusion plan and efforts.

Acceptability is the thought process, which enables the customers to embrace the newer products and technology such that these become ubiquitous in nature just as mobile telephony has become in the country.

Affordability is a key corner stone, which should guide the product offering as being value for money for the customers with technology and innovation being the important drivers for providing cost effective and quality services by the service providers.

Awareness creation through financial literacy (including familiarity with use of technology available for branchless banking) campaigns is necessary to increase the volumes in the payments business and generate the necessary network effects for the successful operationalization and implementation of newer technologically cost effective sound payment products. It is also necessary to simultaneously create awareness for inculcating security consciousness among the users of the various payment products to prevent instances of fraud and misuse.

Question: Are the risks of high technology and outsourcing of services too high for newly included customers of banking system?

Answer: Risk of technology and outsourcing are factors to be reckoned while adopting different models of operations. Way back in 2006 through the guidelines on managing risks and code of conduct in outsourcing of financial services banks were advised to retain ultimate control of the outsourced activity. They are required to manage the risks in outsourcing of any kind of financial services. Simply put, outsourcing of any activity by a bank does not diminish its obligations, and those of its Board and senior management, who have the ultimate responsibility for the outsourced activity.

Question: Why we do not have a MNO run banking service in India as is seen Kenya, South Africa and other countries? What are the regulatory concerns in pure telecom play financial services and how these are mitigated in mobile-based services offered through a bank?

Answer: I would say that if financial inclusion has to be achieved then it could not be by way of ensuring smooth remittance facilities only. It has to offer all possible financial products, and this is possible only if we have a bank led model. Bank led model also ensures compliance of Know your Client (KYC)/Anti-Money Laundering (AML) norms and very importantly minimum levels of customer service. We have, however, been actively been watching the models followed abroad including the Kenyan model. Based on these models, Indian banking system has started offering facilities through business correspondents and remittance facilities through mobiles.

In the non-bank led model provided by MNOs, the focus is on providing remittance facility. Person-to-person remittance is a high-risk activity from the point of view of money laundering, and the safety and security of the transactions. The MNO led model would have concerns on these aspects. On the customer service front, the use of multiple agent networks and the use of mainly SMS channel for transactions have led to associated customer service issues in the jurisdictions where they are operational. MNOs generally perceive this as a value added service mainly with the intent of customer retention and do not focus on risk management aspect affecting customer service. It may be necessary to evolve a tiered cost structure based on the value of the transactions, which could be a catalyst for further growth of the mobile payments. This could attract more and more participation in the payment system through the mobile interface especially for the financially excluded population who may be happy to transact low value transactions at a reasonable cost through the ubiquitous mobile.

Given that India is still far from being cash-less society, the cash-in/cash-out arrangements in any mobile-based model play an important part for scaling up. This can happen only if banks and mobile operators/card operators work together as partners. It is gratifying to note that the high level Inter-Ministerial Group anchored by the Department of Information Technology, Government of India that went into the issue, after extensive discussions, have reached more or less the same conclusion. The recent relaxations in the BC guidelines issued by RBI enabling appointment of mobile operators as BCs of banks should give a further fillip to these efforts.

Question: Some large tie-ups between telecom companies and banks were announced some months back (such as Airtel–SBI and Vodafone–ICICI Bank). But no services have yet been rolled out. What are the reasons for the delay in implementation?

Answer: Reserve Bank is required to examine various regulatory/policy issues involved in such cases before granting approval. Some of the banks have already commenced pilot programs. It is just a matter of time for these baby steps to graduate into leaps.

Question: There is a lot hope of hope invested in UID and Aadhar. Does a simple identity number have the potential to achieve so much?

Answer: *Aadhar* has been accepted by the Government as a valid document for fulfilling the KYC norms. This card will enable citizens to open bank accounts and avail banking facilities. It certainly has the potential to expand the financial inclusion programme in big way.

Question: There are views that India is always late in adoption of technology in banking and payments and as a result is unable to make its payment and settlements systems work for the millions of excluded people. How would RBI respond to this view?

Answer: In the last decade or so there has been a dramatic transformation in the manner banking services are delivered to the public at large. Banks in India have been able to adapt to modern technology to provide

banking services through the ATMs, Internet, and mobile phones. Today, most of the banks in India are in a position to offer a range of products through optimal usage of technology using the platform of core banking. It is important to consider the geographical spread of the country, the size of the population in the country and the need for a variety of payment products to cater to the requirements of various segments of the society before making any judgment.

RBI has actively pursued adoption, implementation of technology for various payment systems being operated by it. The introduction of MICR technology in the mid-1980s followed by INFINET, Electronic Funds Transfer (now NEFT), ECS, RTGS and Cheque Truncation System, etc. bear testimony to the timely adoption of technology in the payment systems. In fact, RBI has also been endeavouring to continuously evaluate and upgrade technology to meet the increasing transaction levels and the security needs. For example, RTGS was introduced in 2004 but we are already about to commission the Next Gen RTGS soon. It may be of interest to know that India is perhaps the first country which has introduced a second factor of authentication for card not present transactions and mandating credit confirmation to originators of NEFT transactions by understanding and exploiting the potential of technology to address security concerns.

The ATM and Card Acceptance Networks (POS) have been growing rapidly and more and more customers are using credit/debit/prepaid cards for their day-to-day requirements of cash and goods and services. Consumers now have multiple options for making payments for their utility etc. bills. The mobile Banking operating guidelines have been relaxed in December 2009, facilitating transactions up to ₹50,000 both for e-commerce and money transfer purposes. Further banks have been permitted to allow transactions upto ₹5,000 relaxing the end-to-end encryption of messages criteria. Leveraging on the technology and interoperable acceptance infrastructure put in place at the POS, banks have been permitted to allow customers to withdraw cash upto ₹1,000 at these POS with the use of debit cards (POS acting as an ATM for a limited purpose).

We need to reckon with the geographical spread, the population of our country and the need for a variety of payment products before arriving at any conclusions. In the last decade or so, there has been a dramatic transformation in the areas of both technology and the manner of delivery of the banking services. Banks in India have adopted modern technologies such as ATMs, Internet and mobile phones. From the perspective of tapping the potential of technology based banking to provide momentum to the pace of financial inclusion, we have identified the capabilities of a stored value instrument. We are also seriously considering the interoperability of micro-ATMs, which could prove to be a game changer, especially for promoting financial inclusion.

ANNEX 9.2
Microfinance Penetration Index (MPI) and Microfinance Poverty Penetration Index (MPPI)

State	MPI	MPPI
Northern Region		
Haryana	0.33	0.66
Himachal Pradesh	0.62	1.67
Punjab	0.18	0.57
Rajasthan	0.35	0.45
Jammu & Kashmir	0.03	0.15
New Delhi	0.13	0.24
Northeastern Region		
Arunachal Pradesh	0.47	0.80
Assam	0.66	0.92
Manipur	4.23	7.26
Meghalaya	0.24	0.39
Mizoram	0.05	0.11
Nagaland	0.33	0.41
Sikkim	1.60	2.12
Tripura	0.84	1.21
Eastern Region		
Bihar	0.43	0.30
Jharkhand	0.47	0.33
Orissa	1.63	0.95
West Bengal	1.53	1.67
Central Region	0.51	0.37
Chhattisgarh	0.66	0.46
Madhya Pradesh	0.46	0.33
Uttar Pradesh	0.36	0.31
Uttarakhand	0.55	0.39
Western Region		
Goa	1.14	2.06
Gujarat	0.59	0.98
Maharashtra	0.57	0.50
Southern Region		
Andhra Pradesh	4.20	7.03
Karnataka	1.46	1.61
Kerala	1.06	1.77
Pondicherry	2.57	3.36
Tamil Nadu	2.00	2.47

ANNEX 9.3
State-wise index of financial inclusion[16]

State	DI (Penetration)	D2 (Availability)	D3 (Usage)	IFI	IFI Rank
High Financial Inclusion (0.5–1)					
Kerala	0.70	0.81	0.28	0.54	1
Maharashtra	0.62	0.29	1	0.53	2
Karnataka	0.72	0.47	0.46	0.53	3
Medium Financial luclusion (0.3–0.5)					
Tamil Nadu	0.70	0.43	0.38	0.48	4
Punjab	0.45	0.69	0.29	0.45	5
Andhra Pradesh	0.56	0.30	0.41	0.41	6
All-India	0.27	0.22	0.55	0.33	7
Himachal Pradesh	0.42	0.40	0.18	0.33	8
Sikkim	0.28	0.33	0.34	0.32	9
Haryana	0.39	0.50	0.12	0.32	10
Low Financial Inclusion (<0.3)					
West Bengal	0.24	0.38	0.23	0.28	11
Gujarat	0.32	0.30	0.16	0.26	12
Uttar Pradesh	0.28	0.31	0.15	0.24	13
Meghalaya	0.21	0.28	0.14	0.21	14
Tripura	0.31	0.22	0.08	0.20	15
Orissa	0.26	0.23	0.11	0.20	16
Rajasthan	0.25	0.22	0.12	0.19	17
Arunachal Pradesh	0.20	0.16	0.14	0.17	18
Mizoram	0.13	0.26	0.09	0.16	19
Madhya Pradesh	0.18	0.21	0.08	0.16	20
Bihar	0.15	0.24	0.08	0.15	21
Assam	0.17	0.17	0.07	0.13	22
Nagaland	0.03	0.04	0.07	0.05	23
Manipur	0.00	0.01	0.01	0.01	24

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13. The report (June 2011) was synthesized by Dr Y.S.P. Thorat and Dr Howard Jones from six other studies commissioned by GIZ.
14. Author is thankful S.S. Nagesh, NABARD, for bringing this bank's work to notice.
15. A term in Hindi, means 'an ordinary person'.
16. Reproduced from: Sadhan Kumar Chattopadhyay, 'Financial inclusion in India—A Case Study of West Bengal' (RBI working paper series, July 2011).

Global trends in microfinance

10

Chapter

The trends in microfinance in different regions across the world over the last six years have been compared to understand the direction of movement in the sector. Region specific variations in performance as also the direction of movement independent of what is happening in the other regions have been noticed. As in the last year a comparison is made of microfinance in different regions such as Africa (SSA), East Asia and the Pacific (EAP), Eastern Europe and Central Asia (ECA), Latin America the Caribbean (LAC), Middle East and North Africa (MENA) and South Asia (SA). MIX Market data[1] (disaggregated region wise) for the period 2003–09[2] has been used to analyse the developments. The overall trends show that microfinance has not been performing as well as it should have been. The growth rates have abated and in fact there was a decline in the number of active borrowers in two out of six regions. In two others, the growth rates had plateaued out and only in South Asia there was continuing growth in number of active borrowers.

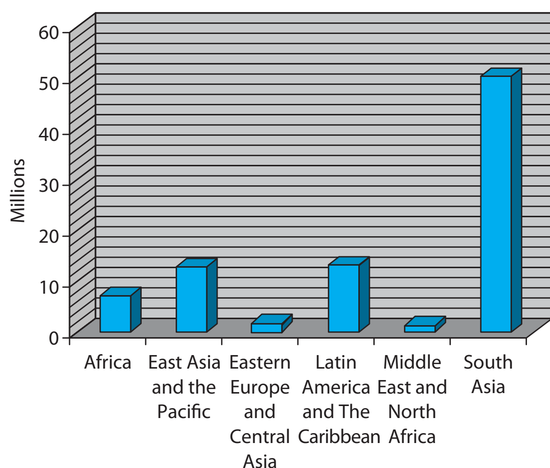

Figure 10.1 Number of active borrowers, 2009

In the case of depositors too there was a continuing decline in number over the last three years in East Asia and the Pacific. In 2009 ECA recorded a decline in number of depositors. During the period 2003 to 2009, MENA region recorded the highest growth rate of 337 per cent in terms of number of active borrowers. This was followed by Latin America and the Caribbean at 311 per cent. However, the maximum number of customers of microfinance institutions were in South Asia region. East Asia and the Pacific recorded a decline in absolute numbers of borrowers as also Eastern Europe and Central Asia during the year 2009. Africa, which stands to benefit most from active microfinance institutions (on account of the low levels of spread of banking), had the least share and also a relatively low growth rate in borrowing customers. The number of depositors in Africa however was quite high at 20.5 million, which was the second best placed region after South Asia, which had 33 million depositors. In terms of gross loan portfolio, there had been significant changes in the year 2009. East Asia and Pacific almost doubled the gross loan portfolio in 2009. While the ECA region underperformed the rest of the world in gross loan portfolio from 2005 to 2008 there was resurgence in portfolio accretion during 2009.

South Asia increased the portfolio by about five times between 2003 and 2009. The largest microfinance portfolio was in the Latin America and the Caribbean region followed by the South Asia region. Eastern Europe and Central Asia had the lowest growth rate in terms of gross loan

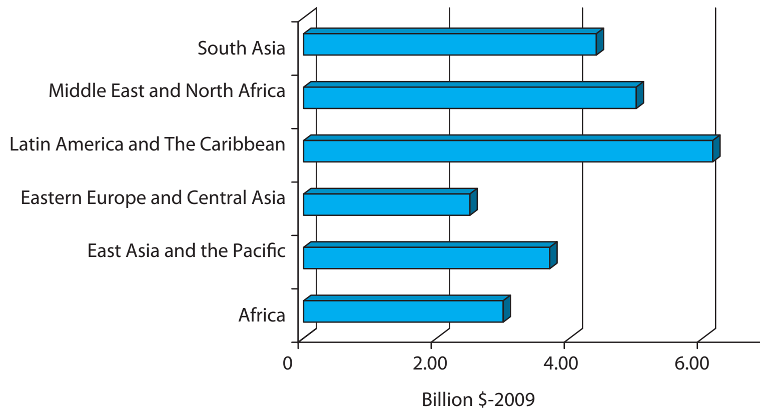

Figure 10.2 Comparison of outstanding loan portfolio

portfolio. A positive trend was noticed in terms of portfolio build up in this region in 2009 after a two-way movement in the preceding five years.

In terms of operating expenditure, South Asia region carried lowest cost but a rising trend was visible over the last two years. Except the Africa region, in all other regions a declining trend in operating cost was in evidence. In the case of Africa region, there was a secular increase in operating cost in the last six years and in 2009 it was 80 per cent higher than South Asia, the lowest cost region. The cost efficiency in South Asia enabled competitive pricing of the loans.

It had been known that the South Asia region traditionally attains lower yields. The yields reported have been hovering between 23 to 24 per cent in South Asia from 2003 till 2009. In the rest of the world the yield rates had been higher but the trends show that there is a continuing decline in the Latin America, East Europe and East Asia and the Pacific regions. However Africa reported a continuous increase in yield rates over the period. The low yields in South Asia make it difficult for practitioners to understand the concerns expressed in these markets on the pricing of loans by MFIs.

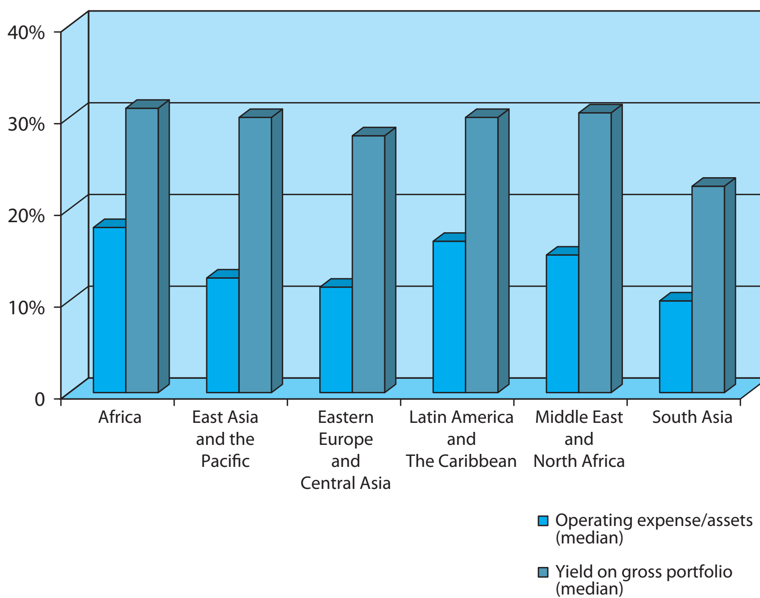

Figure 10.3 Operating costs and yields, 2009

Almost all the regions had reported Operating Self Sufficiency (OSS) in excess of 100 per cent indicating that the sector is self sufficient, recovering all operational costs. The Latin American region was quite stable in terms of OSS and the MENA region was comfortable. The Eastern Europe and Central Asia region showed a rapidly declining trend with OSS falling from 121 to 109 per cent over the last six years. The East Asia and the Pacific also had a comfortable OSS ratio but there was a gradually declining trend. Africa just managed to be above the 100 per cent mark in terms of OSS given its high cost of lending and the low average loan sizes.

One of the worrying trends has been in the deterioration of portfolio at risk. The PAR-30 ratio worsened over all the regions except South Asia.[3] This hardening default rates tend to indicate that the sector is tiring. While region specific reasons are there, the default rates have tended to increase as the markets approach maturity. Average loans in Eastern Europe showed a declining trend over the last three years. Perhaps this is the response to the crisis in some of the countries concerned. The lowest average loans have been reported in South Asia at US$ 141 and the highest average loan in Eastern Europe and Central Asia at US$1781. The ECA loan averages are 12 times higher the ones reported in South Asia. Africa has more than double the average loan size of South Asia; so is the case with the average loan sizes in East Asia. Latin America reported average loan sizes that are six times more than the South Asia averages.

However the average loan as a proportion of per capita gross national income which is a better indicator to determine adequacy of the loans and utility of the loans in local context shows that in East Asia and Pacific it is pretty low. In Middle East and North Africa and South Asia also the average loans were 15 to 20 per cent of the gross national income per capita. The Eastern Europe and Central Asia had average loans as a proportion of gross national income that was four times higher than in the case of South Asia.

One of the significant factors in operating cost are the salary levels obtaining in the different regions as also the per staff case-load (number of

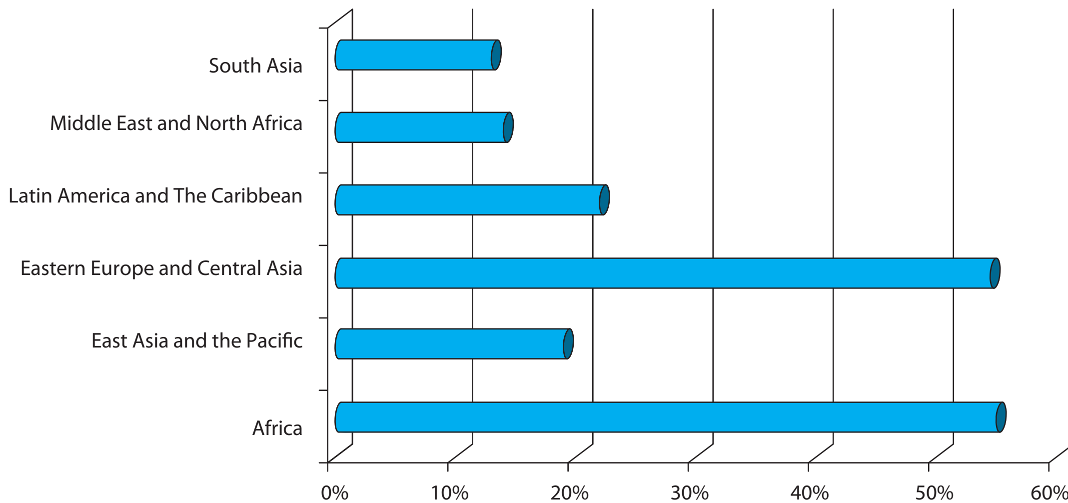

Figure 10.4 Size of loans as proportion of per capita national income

borrowers per staff). Across the world there has been a continuing decline in salary levels as a proportion of per capita national income. Currently the highest salary levels are in Africa. The average salary in Africa is about 8.9 times the per capita gross national income. East Asia and South Asia reported the lowest average salaries as a proportion of per capita gross national income at around 2.2 to 2.3 times. Europe and Central Asia reported the steepest decline in salary levels. The salary level in 2009 as a proportion of per capita gross national income was just 45 per cent of the level seen in 2003. The declining cost of staff across the regions would improve the profitability and sustainability of microfinance institutions.

A connected issue had been the workload in terms of number of borrowers dealt with by staff of MFIs. South Asia had the highest number of borrowers at 163 in the year 2009. This was three times the caseload handled by staff in Eastern Europe and Central Asia. The cost per borrower similarly was US$19 in South Asia which was less than 8 per cent of the cost incurred in ECA region. But the costs in South Asia are seen to be increasing steadily. Latin America had cost per borrower that was 10 times higher than the ones obtaining in South Asia.

The steepest increase in per borrower cost took place in Africa where the cost went up by 115 per cent whereas the average loan size increased by only 75 per cent during the period 2003 to 2009.

The overall trends show that over the last six years, there have been many changes for the better in the financial profile of the microfinance sector in different regions—decline in operating cost, stable and satisfactory levels of operational self sufficiency, higher load of customers per staff and decline in the

Table 10.1 Caseload and salary levels

Region	Average salary/ GNI per capita (Multiples)	No. of borrowers per staff
Africa	8.7	93
East Asia and the Pacific	2.2	112
Eastern Europe and Central Asia	2.8	56
Latin America and The Caribbean	2.8	101
Middle East and North Africa	2.7	113
South Asia	2.3	163

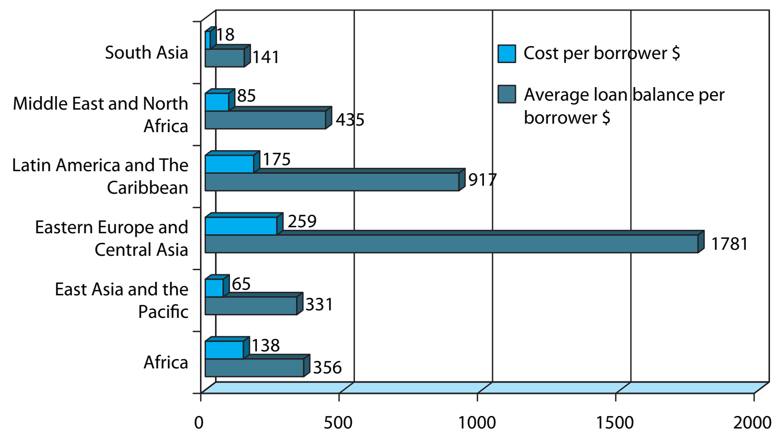

Figure 10.5 Size of loan and cost per loan

salary levels as a proportion of gross national income per capita. The average loan balance per borrower as also been either stable or gradually increasing except in two regions which had very specific underlying reasons.

In a study of the investment climate across the world carried out by MicroRate,[4] the improving fundamentals of MFIs, increased demand at the ground level and also stabilization of the institutions in countries which had earlier faced crisis were seen as positive factors that helped the growth of equity investments. Government regulation was rated as the top most factor that hinders the growth of the sector. Negative publicity and lack of demand from microfinance institutions also impacted the flow of equity into the sector. The asset composition across the world showed that equity formed 18 per cent of the assets invested in MFIs and 82 per cent was in the form of loans. The overall level of assets held by investment vehicles (47 MIBs participated in the survey) was of the order of US$4.8 billion in the year 2010, which was US$3.8 billion in the year 2008. The outlook that the survey projected was positive as it anticipated recovery from crisis in several parts of the world. The survey also has projected a growth rate of 30 to 35 per cent in assets.

The Economist Intelligence Unit[5] had brought out its second edition of global microscope of the MFI sector for the year 2010. The study covered 54 developing countries as against 55 that were covered in the previous year. The countries had been ranked on the basis of three different parameters namely regulatory framework, investment climate and institutional development. Peru was ranked as the country with highest score followed by Philippines and Bolivia.

In the top 10, two new countries Pakistan and Kenya have entered displacing Nicaragua and Uganda. India has secured the eight place whereas it had the fourth place last year has slipped down not only because of the improvements taking place in other countries but also because of the worsening regulatory framework and investment climate in India. In terms of the regulatory framework, Cambodia, Pakistan and Philippines have been placed first on account of the positive environment available in these countries that helps the institutions to enter or exit under orderly conditions. India has been placed at 14 in terms of the soundness of its regulatory framework. India secured the 14th place in investment climate. Chili tops the ranking in investment climate followed by Turkey. In institutional development framework Bolivia occupies the first place followed by Equador and Peru. India has a comparatively higher ranking here at the seventh place. The bottom of the list is brought up by Vietnam, Trinidad and Tobago and Venezuela. The conclusions given by the EIU are that the countries should have a favourable regulatory environment and should invest in the institutional development initiatives. The investment climate, apart from market demand, possibly is a function of both the regulatory framework and the facilities and institutions available for microfinance institutions development. In the case of East and South Asia, the finding was that eight countries struggle with regulatory conditions in particular. Bangladesh well known for its contributions to microfinance development across the world is placed 33rd in the list of 54 countries and in fact occupies a lower rank than it did last year. The survey report was completed before the problems in Andhra Pradesh came to a head. Perhaps the regulatory environment might seem to be even more of a dampener and the murky investment climate would place India much lower than the 8th rank that it currently enjoys in this list.

Table 10.2 Top ten countries in microfinance

Rank	Country	Score 2010	Change from 2009
1	Peru	74.3	+0.5
2	Philippines	71.8	+3.3
3	Bolivia	69.6	–2.2
4	Ghana	64.9	+4.0
5	Pakistan	64.8	+8.3
6	`Ecuador	61.3	+1.7
7	El Salvador	61.3	+3.8
8	India	59.1	–3.0
9	Colombia	56.8	–1.8
10	Kenya	55.0	–0.8

The banana skins survey relating to the microfinance sector had been released for the year 2011. This survey was carried out after the Andhra Pradesh regulation had been brought into force with all the unfolding consequences. The banana skins survey found that globally credit risk continued to be at the top of the list of the major risks. This was followed by reputation risk, competition risk, the corporate governance related risk and political interference as the most dominant risk in the view of those who participated in the survey. Of these reputation risk, competition risk, governance risk and the political risk were not very highly placed in the last year's reckoning. The fastest rising categories of risk globally related to competition, credit, institutional reputation, political interference and

mission rift. Here too three of the identified rising categories of risks were not seen as major ones in the last year's assessment. The risks which were assigned heavy weights in the last year but which are no more a matter of dire concern in the current year are the macro economic environment, liquidity, scarcity of funding, foreign exchange related risk and interest rates.

In the case of Asia, the banana skin lists the key risks as political interference (occupies the first place) followed by reputation, credit, liquidity and inappropriate regulation. Very clearly the risks reflect the reactions to the problems faced by the microfinance sector in the state of Andhra Pradesh as also the developments in Bangladesh. The fastest rising categories of risk in the Asian context are credit, competition, political interference, mission drift and liquidity.

While credit risk seems to occupy a predominant place in the minds of institutions, practitioners and other stakeholders, the perceptions relating to the nature of risk has changed. While last year the credit risk was more in relation to the problems of borrowers who were unable to repay loans in the current year the risk perceptions are driven by increased competition, economic stress in several local economies and poor credit management by the MFIs themselves. As stated earlier in this chapter the increasing portfolio at risk already indicates that globally MFIs are unable to manage their credit portfolios as well as they did in the past. The concerns surrounding credit risk have been expressed to be over indebtedness of borrowers, competition in close geographies driving inappropriate lending and recovery methods. The problem of multiple lending to same borrowers eventually resulting in over indebtedness and weak internal controls. Political interference in some countries was also seen as a major problem that aggravated the credit risk. The reputation risk moved up 15 places from the last year's survey and was in the minds of most stakeholders in the sector. To quote from the report, 'microfinance is becoming a punching bag from all sides, accused of exploiting the poor with burdensome debt, of losing sight of its social mission, of putting profits ahead of poverty reduction, and in AP notably of driving people to suicide through tough loan terms and strong arm debt collection practices.' Reputation risk has several aspects such as commercialization of microfinance making it out to be a sector that is not social any more, unethical practices as seen in the build up of excessive debt and consumption lending in place of lending for livelihood activities. All these tend to erode the image of MFIs and the social orientations of these institutions become suspect.

JP Morgan and CGAP[6] had carried out a global microfinance valuation survey looking at how the equity of microfinance institutions is being valued. The survey found that there was a global decline in valuations from what was prevailing in the previous years. The price to book value multiples averaged at 1.6 with a median at 1.4. The price to earning ratio similarly averaged at 20.1 with a median value being at 23.4. In India where the price to book value multiple was traditionally higher than other countries had declined during 2010. Actually the current Indian valuations are lower than the four-year median value. Out of the six countries that were analyzed as part of the survey, the microfinance valuations had declined only in India for obvious reasons.

In an article on the impact of global financial crisis[7] on the microfinance sector the risk potential inherent in MFIs and their ability to cause systemic shocks had been analyzed. The major conclusions drawn are that the MFIs are much more closely linked with domestic economic conditions and also with international capital market changes. The growth rates of about 40 per cent per annum over the last decade has vastly increased the scale of operations of MFIs and have made these institutions a significant part of the financial sector operations both in terms of number of clients as also in terms of volume of loans in quite a few countries. This increase in the size and scope of MFIs has increased the systemic risks in such countries. The study identifies that the Central Asian countries and the European Region are much more prone to risks arising from the MFIs whereas the Asia and the Pacific region is less prone to risks. In terms of institutions, banks, non-bank financial institutions, for profit firms and relatively small MFIs are more prone to risks. NGOs, matured MFIs and not-for-profit firms are less likely to be affected by risks. One of the insightful observations was that the mission shift has been taking place over the last 10 years in the microfinance sector, it is driven more by the shift in the nature of source of funding which is no more social but more commercial. In a comment on the nature of regulation that is required the study concludes that the regulator should provide enabling market environment to ensure that the market structures take care of the needs for reasonable cost funds for non-MFIs so that they are able to offer services to excluded sections of population.

The micro-credit summit campaign is to hold its global meet during the current year. As part of the preparatory work a state of the micro-credit summit campaign report[8] had been brought out. The report mentions the global microfinance sector is

well on its way to achieve targets taken up by the micro-credit summit that 175 million poor families would be linked to financial services from the microfinance sector and 100 million poor households would be facilitated to raise their income levels beyond US$1.25 per day (PPP). These goals were to be achieved by the end of the year 2015. The data assembled by the campaign shows that by end December 2009, about 3,500 MFIs have reported providing credit services to more than 190 million households of which a very large proportion are very poor households. In fact more than 128 million households are reckoned to belong to the poorest sections across the world. The campaign is likely to take up finalizing the award of a seal of excellence to MFIs that comply with social performance responsible finance and ethical customer protection practices. The groundwork for this, which has been in full swing, is likely to be completed and the scheme of the award of excellence is likely to be unveiled in the campaign summit in Spain in November 2011.

Globally the microfinance industry has come under adverse criticism on several counts. Not the least of these criticisms is that of its failure to create a favourable impact in the livelihood of the poor. While studies have been carried out as to the nature of the impact MFI financing has had on rural households, there had been no undisputed evidence that microfinance is a cure for poverty. In some cases, studies have concluded that livelihoods in fact have improved which have later been contested as to the methodology and the quality of underlying data, which led to these conclusions. Randomized Control Trials have been used in some locations and are likely to be used in larger numbers in the next few years to find the true state of impact of microfinance programmes on the poor. Some critics claim that microfinance can make no difference to poverty. There is also a view that more legitimate and appropriate work lies in micro-enterprises and small industries promotion rather than providing small sums of credit to very poor people. Those who argue for microfinance state that the opinion of the customers matters more than the findings of researchers. If people who use the services of microfinance feel distinctly benefitted and are much more comfortable than in the past then the MFIs are playing a positive role in their lives.

However, the issue here is to distinguish between claims that poverty can be cured with small doses of money regardless of the fact for whatever length of time that this money is made available. But the pain of living in extreme poverty without access to any kind of resource during periods of hunger, unemployment and ill health is certainly cured by access to small loans. In some cases the small loans also facilitate small economic activities which in themselves may not provide a complete solution to the problems of the family but can offer a partial or a supplementary solution to the constrained cash flows. The other issue is to look at the non-microfinance programmes that have taken up poverty alleviation as their goal. Many of the other programmes have also not failed to achieve poverty reduction but have not even ensured flow of resources to the poor families. In the case of microfinance the resources have been received by the designated poor and they have actually used these funds. On this question there has been no dispute. Instead of trying to find whether microfinance institutions cure poverty, a better use of time could be to find how to make microfinance institutions more effective in serving the poor. Public institutions and donors providing subsidy and grant funds might like to question whether the impact on poverty is positive. But then most of the microfinance sector today is funded by commercial sources and not by public or social resources. As microfinance matures into the next phase of its evolution, the underlying commercial considerations must be balanced by social considerations.

NOTES AND REFERENCES

1. The data was sourced from MIX Market website, using their excellent Data Analytics tool.
2. This could in fact mean different dates. Depending on the date on which MFIs close their books during the year, the data could relate to any quarter ending during the period 1 July 2009 till 30 June 2010.
3. The position has changed drastically during the last year after the Andhra Pradesh crisis.
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Future—beginning again?

11

Chapter

As we try to see through the opaque crystal ball in to the future, the quote 'Today is the tomorrow that we did not plan for yesterday' rings loud. The last year's report while commenting on the future had made three key points. The first is that the MFIs need to show that they are relevant and appropriate institutions for dealing with the problems of the poor. The second was that they should resist the temptation of being swayed by commercial considerations and market valuations so that the focus on the customer is not lost. The third is the need for revisiting the mission and vision of organizations and resetting the expectations. These not only continue to be the key agenda for the sector but they seem to be even more relevant than in the past.

Over the last five years, the microfinance sector comprising SBLP and MFIs had registered a 100 per cent growth in customer base and a 240 per cent growth in the loan portfolio. Notwithstanding this high rate of growth the sector is not possibly in a position to reach the ambitious projections held out by Sa-Dhan in 2009 that the sector would be covering 440 million clients with a loan portfolio of ₹2,000 billion. But the current level of business both in terms of volumes and in client numbers is impressive. But the quality of growth is being questioned with no satisfactory answers forthcoming. The sector is challenged to meet the high initial expectations and tall claims made earlier. The deliverables by the sector had been fixed so high both in qualitative and quantitative terms that it has been found very difficult to live up to those expectations. Had the microfinance institutions stuck to their original mission of dealing with the vulnerable clients in a fair and responsible manner, regardless of the profits earned they would not have been at the receiving end of negative publicity. As stated over the last three years in this report, today's problems are mostly of the institutions' own making. When customer loyalty is eroded on the excuse of a law, it does not say much for the quality of relationships that MFIs had with their customers. Strong institutions built on the basis of customer confidence do not wither away because of rigorous regulation. They are able to comply with the regulatory requirements and still continue in business as the corporate history in the country shows. Customers who feel that they are being exploited and are under control of the lender take the first opportunity to ditch the lenders and look for alternatives, which is precisely what has happened in the case of Andhra Pradesh.

But one of the best things that could have happened to the sector in its evolution has been the Andhra Pradesh episode. It has several significant lessons for the different stakeholders. For the MFI the lessons are that customer focus cannot be compromised; not only good products and practices but also transparent communication to stakeholders is a critical requirement; governance of institutions should reflect the intent of the mission and vision of the organization; participation of customers in the processes of institutions should not be ignored; institutions can ill-afford to ignore the political and bureaucratic establishment even if they have noble objectives; self-regulation goes beyond mere lip service; lenders and investors are at best fairweather friends and are likely to part ways during crisis; and responsible finance is not an optional extra but an accompanying condition for business with vulnerable sections of people. As for the lenders the lessons are that the risks cannot be packaged and placed at the doors of on-lending institutions; the banks should take care to monitor the activities of the on-lender; banks have a responsibility to ensure that ultimate customers benefit from appropriate products and business practices; not only competition but also

partnership could introduce significant risks in financial services; risk management is not merely about financial and credit risk but also about political and sovereign risk. For the regulator, the lessons have been that when millions of vulnerable people are involved the normal financial sector norms alone do not work. Regulation in the interest of customers is a prime need, if there is a regulatory void someone will step in if the appropriate sector regulator does not do the job. The lessons for the state government are that inappropriate regulation could do more damage than failure to regulate; customers do not discriminate between a good institution and a bad institution if they are introduced to financial indiscipline and moral hazard.

With the help of these lessons one hopes that the microfinance sector would grow more responsibly in the future taking into account the customer related issues as also fair practices. However, to regain the confidence of equity investors it might take a while. The fast paced growth that was evident in the last five years may be replaced by a more measured moderate growth, which will better serve the interests of the sector. However, the regulatory approach to the sector comprising of price controls and process related restrictions might constrain the institutions to operate in more favourable areas with dense population so as to be able to control costs and manage within the margins that are permitted. It is difficult today to argue against any kind of regulatory restriction on account of what has happened in the immediate past. Irresponsible conduct begets unreasonable regulation. MFIs would have to develop patience and persist with good work so as to be in a position to negotiate with the government and the regulator for a more favourable set of regulations that would ensure their orderly and sustainable growth of their customers along with their own.

As we look into the future there are questions that have to be answered. These questions are not new ones but have been asked several times in the past. The first is that of sustainability. Whose sustainability matters more in microfinance—whether it is that of the institutions or of the customers. The next is whether the institutions are of the poor or they are for the poor. While it may be argued that if institutions are sustainable then only they are in a position to serve the interest of the poor. However, the experience of the largest microfinance institutions in India has shown that once institutional sustainability becomes a priority, it can go beyond reasonable limits and look at fancy market valuations as a part of ensuring sustainability. The sector should prioritize sustainability of the customer of microfinance and then based on that build sustainability of institutions. The next question is about what is reasonable return. Last year's report did make a mention of having a range in return on assets and return on equity to guide the institutions and keep them out of the temptation of earning super profit at the expense of customers. As part of a voluntary code or even as an informal understanding MFIs should set about adopting such voluntary benchmarks. Building institutions of the people seems to be a better way of ensuring that institutions work for them. The profits and losses of such institutions accrue to the poor, as they would own these institutions. However, the policy framework is not very favourable for institutions of the poor. The negative bias that exists among banks, investors, rating agencies and even the government should first be removed. Institutions of the people must be recognized for their potential contribution and their member relevance and allowed to grow and flourish. Unless this model becomes an effective alternative to the commercial MFIs it might be difficult to create a situation in the market for a market based discipline.

Where does the microfinance industry seem to be going? The MFIs had certain business models that were found to be easy to scale up, with several supporting hands providing equity, technology and on-lending funds. But when we look at the future, the sky is chaotic with a riot of dark hues. There is heavy competition in the offing. The first set of competing forces will emanate from the banking system through the appointment of business correspondents in all villages with population of more than 1,000 from the year 2013 and onwards. These business correspondents will be backstopped by brick and mortar branches and will extend the network of banks in the rural hinterland. The mobile-based financial services are set to take root and would offer a technology based effective option for customers. Both business correspondents and mobile-based financial services will have the potential of offering savings and remittance services as well as credit. These extra features would certainly make them more attractive to the customers. Further the NRLM is intending to invest a large amount of money and resources in improving the financial intermediation aspect of the SHGs and their higher tier organizations. The replication of Andhra Pradesh IKP model would introduce several block and district level federations of SHGs which could potentially act as financial intermediaries. Their services in both saving and credit side would come at much lower cost than what the MFIs are able to

deliver. This would be another major competing force that would evolve over the next five years in all the districts of the country. NABARD's own plan for introducing SHG 2 with additional features of savings and improved credit facilities would also attract customers and might take them away from the MFIs. All this competition would put the customers in a much happier situation. The customers would for the first time have a real choice of service providers in financial services. Whether this would lead to excessive lending and debt build-up in the hands of people in a few locations is an issue that has to be carefully examined.

Already there are initial moves at consolidation of MFIs through portfolio buyouts or mergers. Some MFIs are also exploring the holding company concept taking advantage of the RBI's Working Group recommendations that in the financial sector holding companies are a much better way of managing business. There are also moves on the part of some MFIs to diversify into other areas of financing apart from continuing their involvement with microfinance. This would deemphasize their focus on microfinance and take them towards niche areas and unoccupied market spaces in financial sector both in urban and rural areas. On the whole it does seem that mission-driven commercial microfinance might be on the way out. There might be institutions that are set up in the not for profit forms that might continue to do business in the manner that they had been doing but the new microfinance bill on becoming law would make even these institutions perform to the rigour required of a regulation that would demand customer satisfaction.

Institutions dealing with the poor when backed by commercial capital will have recovery in return on capital and return of capital as part of their corporate mandate. It is unrealistic to expect such institutions to work at a loss or sub-optimal return. Where the State is unable to make investments required to serve the poor then it should create an environment that enables other institutions to make these investments. The burden of welfare of vulnerable people cannot be shifted to private investors. If institutions have to carry out core welfare measures with vulnerable sections of population then it is only fair that the State compensates them for the same. In practical terms if commercial institutions have to provide loans at lower effective interest rates and on liberal credit terms then funding for the same should come from the state. As in the case of subsidized loans to farming, it is entirely feasible that MFIs can make available low cost loans to their customers if subsidized by the government. The government has some policy thinking to do. Apart from regulation which protects the customer the policies relating to delivery of services on a social welfare platform needs to be relooked. The poor cannot help themselves. They need external help to a significant extent before they could stand up on their own. This external help comes at a price. Are the governments willing to pay? It is unrealistic to expect private enterprise to be willing to pay this price and not recover the same at all whatever be the nature or form of the enterprise.

Box 11.1 Vision of microfinance and inclusion—stakeholders have a duty

According to CGAP:
A vision of financial inclusion that truly addresses the needs of poor clients dictates that responsibility lies not just with the providers, but also with policy makers, donors and investors, and the global microfinance community to ensure appropriate governance, operational policies, and incentive structures at all levels, with appropriate client safeguards, to offer high-quality services. As local markets mature, the delivery model for financial services for the poor must evolve to support healthy outreach and the growth of a broad range of products that poor people need.

The microfinance market is changing. The customers and market place that existed five years back have changed significantly. People are fatigued with groups and the pressures of meeting frequently and laying bare their financial position in public. With economic growth and schemes like the MGNREGS, the opportunity cost of their time has increased. Groups-based processes demand more of their time and impose higher costs than before. Aspiration levels of people are increasing. The small rationed loans from MFIs do not seem satisfactory; the customers make up their requirements by borrowing from many MFIs. The demand for savings of different types has been increasing, looking for safe and easy avenues. Credit only institutions mostly ignore this need of their customers. Women-led models are viewed with disfavour by men; and institutions do not entirely understand this opposition from men as they deal exclusively with women. The small palliative loans to women are seen as interfering with the large and more important finance required for livelihoods. The shift in customer preferences is discernible. The shift is from group finance to individual finance;

in credit it is from small consumption loans to livelihood loans; it is from women to households; it is from credit-only to other products such as savings and investments; It is from single products to baskets; in sum the shift is from mere access to meaningful inclusion. These changes in customer mindset warrant that institutions should go back to the drawing boards. The institutional mindset should be on managing change and managing external risks of the political kind.

In the last years report the conclusion what that establishing and sustaining sector relevance to customers' lives and livelihoods is the best mitigation against political risk and unfavourable attention from policy. There is a need to reiterate this once again in the current context. Unless institutions work harder with greater patience to ensure that they matter to the lives of customers they invite political risk. *The institutions on the ground, whether MFI, SHGs or their federations need to revisit their mission; redesign their business model; retool the products and services and reengineer the processes and communication strategies. A fresh start is needed on many fronts, taking in to account the changes in the market and the customer*. Provision of financial services to the poor despite all the inclusion initiatives underway is not an easy task. Banks might still take time to effectively establish their services. Nimble-footed institutions that can focus attention on the vulnerable customers will continue to be in demand. Whether the policy and the institutional framework to facilitate and regulate the same are in place would be the critical questions that we need to answer. When government, the sector regulator, the lenders, the investors and the institutions involved in finance come together it would be possible to ensure that customers get adequate and good quality services. Let us, for the sake of the poor and the vulnerable customers who remain excluded, sit together and forge a strong alliance.

Appendix

Table A.1 Fact sheet on coverage and growth of SHGs and MFIs, March 2011

Outreach

1	Total number of SHG members, currently linked (million)	62.5
2	Total number of MFI borrowers (million)	31.4
3	Growth of outreach of the SHG programme	2.9
4	Growth of outreach of MFIs	4.7

Loan outstanding

10	Loans outstanding under the SHG programme (₹ billion)	306.27
11	Loans outstanding under the MFI model (₹ billion)	207.56
12	Growth of loans outstanding under the SHG programme (₹ billion)	33.61
13	Growth of loans outstanding of MFIs (₹ billion)	24.12
14	Average loans outstanding, SHG members (₹)	4,900
15	Average loans outstanding, MFI borrower (₹)	6,610

Estimate of broad microfinance clients

Class of agency/ type of product	Number of accounts/ clients
No. of deposit accounts – Banks (March 2010)	734.9 million
No. of NFA accounts with – Banks (March 2011)	74.4 million
No. of deposit accounts – Post office (March 2010)	88.6 million
No. of NREGS accounts – Post office (October 2010)	46.7 million
No. of accounts – Primary cooperatives (March 2010)	126.4 million
No. of borrowers – Primary Cooperatives (March 2010)	59.8 million
No. of loan accounts Banks (March 2010)	118.6 million
No. of loan accounts MFIs (March 2011)	31.4 million
No. of saving SHG members (March 2011)	98.1 million
No. of borrowing SHG members (March 2011)	62.5 million

Note: The data relating to SHG members as on March 2010 has been updated on the basis of latest data from NABARD. Commercial Banks Small Loan accounts data on the basis of RBI data—Basic Statistical Returns 2010.

Table A.2 **Loans from financial institutions to MFIs**

Name of the bank	Loans disbursed during year 2010–11		Outstanding loans as on 31 March 2011	
	No. of MFIs	Amount	No. of MFIs	Amount
Commercial Banks—Public Sector				
Allahabad Bank	5	13,724.10	20	13,142.35
Andhra Bank	1	5,000.00	9	32,134.00
Bank of India	14	24,499.67	17	27,097.72
Bank of Maharashtra	1	100.00	1	70.00
Canara Bank	15	9,289.67	96	17,585.62
Central Bank of India	9	2,428.45		
Corporation Bank	30	78,230.01	44	70,115.56
IDBI Bank				
Indian Bank	13	2,323.00	69	5,989.00
Indian Overseas Bank	23	15,459.00	119	60,096.00
Oriental Bank of Commerce	2	2,300.00	14	12,368.12
Punjab & Sind Bank	3	10,000.00	6	15,068.00
Punjab National Bank	10	1,733.04	977	16,710.43
State Bank of India	54	43,292.00	123	94,603.00
State Bank of Mysore	1	3,750.00	8	26,576.72
State Bank of Patiala	2	4,822.89	2	6,855.14
State Bank of Travancore	58	20,393.79	52	15,499.56
Syndicate Bank	13	7,902.00	16	24,455.91
UCO Bank	1	10.28	5	299.35
Union Bank of India	18	10,615.00	43	20,609.26
United Bank of India	2	14,000.00	23	16,414.56
Vijaya Bank	7	14,750.00	17	29,114.20
Sub Total—Public Sector Banks	282	284,622.9	1,661	504,804.5
Commercial Banks—Private Sector				
AXIS Bank	24	57,392.86	76	103,554.65
City Union Bank Ltd.	2	340.00	7	712.24
Dhanalakshmi Bank	47	3,618.74	179	7,868.14
HDFC Bank	33	76,434.11	53	59,355.85
ICICI Bank	8	132,000.00	52	102,427.74
IndusInd Bank				
ING Vyasa Bank	0	0.00	22	29,563.32
KBS Local Area Banl	5	49.80	11	47.15
Karnataka Bank	18	16,463.00	18	45,821.62
Karur Vyasa Bank Ltd.				
Kotak Mahindra Bank	3	41,447.01	4	41,914.12
Ratnakar Bank Ltd.	1	150.00	1	133.18

(continued)

Name of the bank	Loans disbursed during year 2010–11		Outstanding loans as on 31 March 2011	
	No. of MFIs	**Amount**	**No. of MFIs**	**Amount**
South Indian Bank				
Tamilnad Merchantile Bank	0	0.00	1	68.14
The Nainital Bank Ltd.	0	0.00	1	14.00
IndusInd Bank	11	33,000.00	11	15,492.00
Catholic Syrian Bank Ltd.	5	1,390.00	10	2,527.79
Yes Bank				
Sub Total—Private Sector Banks	157	362,285.52	446	409,499.94
Commercial Banks—Foreign Banks				
The Royal Bank of Scotland				
BNP Paribas	3	1,550.00	9	5,550.00
Citibank NA	0	0.00	10	37,815.65
Standard Chartered Bank				
Sub Total—Foreign Banks	3	1,550.00	19	43,365.65
Regional Rural Banks				
Andhra Pragathi Grameena Bank	0	0.00	7	14.77
Manipur Rural Bank, Manipur	1	6.00	2	18.75
Sub Total—RRBs	1	6.00	9	33.52

Source: Based on provisional data of NABARD 2011. Data of some banks not received such as IDBI bank, IndusInd Bank, South Indian Bank, Royal Bank of Scotland, Stan Chart.

Appendix A.3 UN Solutions Exchange—State of the Sector Report query: Summary of Responses

The author had posed a query to the microfinance community of practitioners on the expected content, coverage, new developments and innovations in the sector. This is done to ensure that the sector provides ideas and points to field happenings to influence the making of the report. The responses received have been consolidated by UNSE. The same is reporduced below.

Summary of responses

For the past five years as part of Microfinance India Summit, SOS report has become an important annual initiative. While the report highlights the present status, gaps existing in the sector and future strategies, it also identifies knowledge gaps that require further research. Considering the changed microfinance scenario this year, members suggested for incorporating the following in the State of the Sector Report 2011:

- Regulatory environment for Microfinance—suggestions and comments of various agencies/MF practitioners and experts on *Micro Finance Bill 2011* including possible impact of the bill on community-based MFIs.
- Coverage of global/regional trends in microfinance sector.
- Business Correspondent/Business Facilitator model—operational challenges.
- Annual macroeconomic data and events such as bank interest rates, inflation figures, agriculture GDP growth rates, exchange rates, mobile money, etc.
- Mobile technologies and their impact in enabling access of financial services to the poor.
- Efficacy of various models of lending—SHG bank linkage programme, Grameen model, joint liability groups lending, individual lending by new generation MFIs, etc.
- Experiences of the MFIs working in the sectors like housing, health insurance, leasing, health services.
- Corporate governance, transparent pricing in microfinance, equity raising in MFIs and code of conduct for microfinance institutions.
- A critical review of innovations and experimentation in microfinance lending.
- Impact of microfinance lending on gender empowerment, family health, education, financial literacy and well being, poverty alleviation, reduction in social evils and undesirable practices and social equality, etc.
- Cases on transformation of organizations—from not-for-profit organization (registered as a society or a trust) to a commercial organization.

Besides coverage of the abovementioned areas in SOS 2011, members also suggested incorporating separate chapters on Crisis, including financial and political crisis; micro financing through cooperatives; and Microfinance in north-east region. Quoting the provisions given in Microfinance (Development and Regulation) Bill—2011, members informed that as per the bill, MFIs identified as 'systemically important microfinance institutions' (SIMFIs) will have to compulsorily convert themselves into companies. This issue is more important in the present scenario as there will be many more transformations in future.

Members shared a *note* on NABARD Financial Services Limited (a subsidiary of NABARD). They informed that NABFINS endeavors to share the risk of their clients by partnering with BCs who are involved in programs that provide additional services making the investment profitable and sustainable by lowering the risk of the clients.

Another important issue raised by the members relates to microfinance arrangements for the skills development of female sex workers and financing for the establishment of their enterprises/ventures. In this context, members informed about a USAID funded initiative of improving the quality of life of some of the most disadvantaged women in community, viz., Female Sex Workers. Hand in Hand Micro Finance Private Limited (HiHMFPL), the consultancy associate of Hand in Hand India, is working with AIDS Prevention and Control Project of VHS on this project.

Members gave example of CASHE project of CARE India regarding promotion of SHG federations and their apex federations in context of sustainability options for the microfinance programs. The arrangement was also seen as a good withdrawal strategy wherein Apex MACS takes up the entire

microfinance program and portfolio from promoting NGOs. With reference to the federation model, they quoted examples of three partner organizations of CARE from Andhra Pradesh—Pragathi Seva Samity, MARI and Navjyothi. Members also informed that there are two identified functions that require support of promoter NGO: (i) negotiating and arranging bulk loans from financial institutions; and (ii) maintaining accounting and MIS system. Referring to the coverage of various aspects of SHG federations in SOS report, 2007, members suggested including some new dimensions in SOS 2011 such as governance, management of political risks, efficiency and range as well as economics of providing MF services.

Additionally, members suggested doing an inquiry to assess: whether these models offer a better governance option for delivery of financial services; whether they are better positioned to bear the risk of onslaught from the political establishment; whether operating costs and efficiency of these models are better compared to other models.

Elaborating the changes taken place in the lives of the poor through effectively implementing SHG bank linkage programme by a branch manager of a regional rural bank in Punjab, members gave a message to the sector about the importance of 'human factor'. Sharing the success stories of the poor clients, members also informed that poor need multifaceted microfinance services that can be provided through an effective microfinance system owned by the banks. Members emphasized on the emerging need of 'Village Resource Centres' (information collections and dissemination centers on microfinance) in rural areas, especially remote areas.

Sharing details of a *global initiative* of CARE being implemented in 11 countries, members informed that in India, three districts of Tamil Nadu are covered under implementation of the programme. The programme focuses on building and sustaining SHGs and their federations to intermediate financial, livelihood and development services to their constituent members. The programme envisions achieving impact at three levels—client, SHG and SHG Federation and Promoting NGO MFI.

Giving logic of key role being played by financial cooperatives in providing MF services, members suggested a separate chapter on 'Present scenario of financial cooperatives' in SOS 2011. Quoting the reference of various committees that have recommended various measures for cooperatives reforms in context of microfinance, members enumerated the developments taken place in cooperative sector with reference to microfinance. A good range of financial cooperatives in terms of numbers, type and levels exist in rural as well as urban areas to cater to the needs of MF sector.

Members also quoted successful examples of financial cooperatives functioning at various levels and registered under different Acts. A number of successful cases of financial cooperatives serving specific target groups such as minorities, sex workers, Dalits and tribals have also been quoted by the members.

Members suggested incorporating a fact that majority of lending by financial cooperatives is below ₹50,000 per borrower so such lending needs to be considered under MF. The key issues that are still to be addressed in cooperatives include provisions of MF services in sub-sectoral cooperatives, financial support of the government to self-reliant cooperatives, and enhancing financial inclusion through urban cooperative banks and thrift and credit cooperatives.

Referring the new Microfinance (Development and Regulation) Bill 2011 in context of microfinance, members informed that as per the new bill, cooperatives that are taking deposits only from their members will not come under the purview of the MF Bill. Hence societies registered under MACS and self-reliant cooperative Acts will be out of the purview of the MF bill 2011.

On various chapters of SOS 2011, members also felt need of a chapter that can provide a comparative analysis of microfinance industry with other relevant data sets—economic and financial. This might help in highlighting the scale/value of the sector on certain counts.

In the nutshell, members expect State of the Sector Report 2011 to be more a clients oriented report covering MF regulatory issues; examples of successful federation models; present and future role of co-operatives and community-based MFIs; effective role of the human resource available in banks for SHG bank linkage programme; efficacy of various models of MFI lending; analytic review of BC/BF model; Code of Conduct for Microfinance Institutions; learnings of transformation process; Impact of MF programmes and innovative and proven technologies for enhancing financial inclusion.

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Subhransu Tripathy, Subrata Sarkar, Sugandh Saxena, Mani A. Nandhi, G.K. Agrawal, Prabhat Labh, A.P. Fernandez, R. Ashwin Kumar and Hemantha Kumar Pamarthy, Resham Singh, Umesh Chandra Gaur, Sashi Kumar, Navin Anand, Sushanta Kumar Sarma, Alka Parikh, Ritesh Dwivedi, Veerashekharappa, N. Jayaseelan.

ACKNOWLEDGEMENTS

The consolidated reply is compiled by Navin Anand and Monika Khanna of United Nations Solutions Exchange—Microfinance Community. The author is grateful to UNSE and all the contributors. Author regrets that due to constraints of time and space, some of the suggested aspects and areas could not be covered in the report.

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Index

Andhra Pradesh, 87
  Apex Cooperative Society, 8
  appointment of committee, by RBI, 55
  borrower accounts, 47
  CDR, loan exposure qualifying for, 54
  expenditure patterns, change in, 50
  Indira Kranti Patham (IKP) (*see* Indira Kranti Patham [IKP])
  Integrated Rural Development Programme (IRDP) (*see* Integrated Rural Development Programme [IRDP])
  Krishna district, problems of, 47
  MFIs
    alternatives to, 52
    loan portfolio of, 50
  microfinance sector in, 2
  progress trends of sector, 48
  share
    of MFIs, 48
    of SBLP, 48
  SHGs
    month-wise loan disbursement to, 52
    portfolio quality of, 53
    progress, 53
  source of loans, comparison of, 51
Andhra Pradesh Grameena Vikas Bank (APGVB), 52–53
Andhra Pradesh Microfinance Ordinance, 4, 52, 59–60, 67
Annualised Percentage Rate (APR), 37
  compliance of MFIs, with RBI caps, 45
ASSOCHAM, 63

Bandhan, 33–34
Bankers Institute of Rural Development (BIRD), 101
banking penetration, 112
bank lending, to MFIs, 64–65
banks, performance in ending, 16–17
Base rate concept, 2
Bill & Melinda Gates Foundation, 111

Centre for Microfinance (CMF), xvii, 5
  survey on Access to Finance, 38
client friendly repayment practice, 79–80
Code of conduct compliance assessment (COCA), 71
  scores on compliance with, 72
Commercial banks, 14, 108
  base rate concept (see Base rate concept)
  customers in 2010, 4
  foreign banks, 135
  outstanding loans, of SHGs, 16
  private sector, 134
  public sector, 134
  saving of account by SHGs, 14
Corporate Debt Restructuring (CDR), 54, 67
costs, comparison of MFIs, 37

credit flow, to economy, 2
Credit Information Bureau (India) Limited (CIBIL), 8
customer protection principles, of MFIs, 71
customer status, in MFIs, 39

debt crisis, European countries, in, 1
debt restructuring, 67
default rates, in SHGs programmes, 5
Dia Vikas, 64, 74

eastern regions, rural households in, 10
E-Chaupal model, 111
e-commerce, 91
economy, of India 1–2
electronic benefits transfer, RBI guidelines on, 7
Equifax Credit Information Services Private Limited, 8
equity funding, 63–64

Financial Holding Company (FHC) model, 92
financial inclusion, 108
  index of, 112–13
  institutions under, 114–15
  meaning of, 107
  state-wise index of, 120
  utilisation of funds, 110
Financial Information Network & Operations Ltd (FINO), 109
financing, concentration of, 6
food inflation, 2
Ford Foundation, xviii

Global Microscope 2010, 92
Grameen Bank, xiii
3G spectrum, 1

Highmark, 8
households indebtness, to SHGs, 39

Indira Kranti Patham (IKP), 47
Initial Public Offer (IPO), 9
Institute of Financial Management and Research (IFMR), 68
Insurance Regulatory and Development Authority (IRDA), 9
Integrated Rural Development Programme (IRDP), 99
International Finance Corporation (IFC), xviii, 8
  investment in Bandhan Financial Services, 63

Know your Client (KYC), 108
Krishna crisis, in Andhra Pradesh, xiii
Kshetriya Gramin Financial Services (KGFS), 114

lenders forum, list of covenants agreed upon by, 85
letters of credit, 68

life insurers, micro-insurance agents of, 110
loan portfolio, of MFIs in Andhra Pradesh, 50

macroeconomic environment, in India during 2010–11, 1
Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS), 7
Malegam Committee, 6, 37
  continuance of microfinance, 88
  customer protection, 88
  key recommendations of, 93–94
m-commerce, 91–92
Mezzanine debt, 69
MFIN, 8
Michael and Susan Dell Foundation (MSDF), 8
microfinance
  global trends in, 123–28
  vision of, 131
microfinance bill
  commentary on
    MFIs and deposits, 96
    national *vs.* state level supervision, 95
    post Andhra Pradesh, 96
    pricing and interest rates, 95–96
  comparison of 2007 and 2011 versions of, 94
microfinance credit clients
  estimate of, 4
Microfinance India Summit, xiv
microfinance institutions (MFIs), xiii, 2, 5, 129
  classification of, 35
  clients of, 4
  comparative performance of top five, 34
  compliance with RBI caps, in APR terms, 45
  coverage and growth of, 133
  credit rating agencies impact on, 65–66
  customers of, 41
  form-wise distribution, of loan portfolio, 35
  growth in client outreach, 35
  institutions size and yield on portfolio, 37
  loans
    from financial institutions, 134–35
    portfolio of, 3
    securitization of, 68
  non-convertible debentures (NCDs) (*see* Non-convertible debentures (NCDs))
  progress of, 33
  quality of growth, 41–43
  range-wise distribution of
    ROA, 36
    ROE, 36
  ranking of mission and performance in, 76–77
  regional distribution of, 37–40
  share of loan values, 35
  SKS IPO (*see* SKS IPO)
  social initiatives of, 75
  survey of, 43–44
  top ten, 33
Microfinance Institutions Network (MFIN), 37
Microfinance Penetration Index (MPI), 113, 119
Microfinance Poverty Penetration Index (MPPI), 113, 119
Microfinance Researchers Alliance Programme (MRAP), xvii
Microfinance Researchers' Alliance Programme (MRAP), 39
microfinance sector, 2–5
Microfinance Transparency (MFT), 8
micro-life insurance business, 109–10
MicroSave study, 51
Ministry of Rural Development, 8, 99
MIX Market, xvii, 33, 35

National Bank for Agriculture and Rural Development (NABARD), xiv, xvii, 26–27
  refinance
    to banks, 6
    to SHGs, 6
  role and performance of, 21–24
National Crime Records Bureau (NCRB), 58
National Payments Corporation of India (NPCI), 7, 115
National Rural Livelihoods Mission (NRLM), xiv, xvii, 8. *See also* Swarna Jayanti Gram Swarozgar Yojna (SGSY)
  implementation of, 99
  key initiatives of, 99–100
no-frills accounts (NFAs), 107
Non-banking Financial Company (NBFC)
  loan taken by MFIs, 35
  RBI guidelines
    on interest rates, 36
    standard assets, 91
Non-banking Financial Company (NBFC)-MFIs, 88
Non-convertible debentures (NCDs), 68
non performing assets (NPA), 2

Pavala Vaddi, 49
Post Office, 8
Private Equity (PE) investments, 63

Rashtriya Mahila Kosh (RMK), 8
regional rural banks (RRBs), 14
remittances, 114
repo rate, 2
Reserve Bank of India (RBI), 91, 116–18
  committes on microfinance industry, 7
  expansion of financial services access, recommendation for, 107
  financial inclusion (*see* Financial inclusion)
  financial sector issues, working class groups for, 92
  inflationary pressure, 1
  non performing assets (NPA) (*see* Non Performing Assets (NPA))
  operational policy rates, 1
Return on Assets (ROA), 36
rural households, 107
Rural Postal Life Insurance (RPLI) policies, 8, 110

Sa-Dhan, 8, 129
  social performance report, 72
  voluntary code, of conduct, 71
self-help groups (SHGs), xvii

average loan size of, 3–4
credit to savings ratio across states, 31
comparison of disbursements in loans, 29
coverage and growth of, 133
increase in number of, 2
loan portfolio of, 3
outstanding loans, 14–15
comparison of groups, 28
overlap of customers between MFIs and, 3
pre-budget economic survey support to, 5
region wise ending programme, 15–16
savings performance of, 14–15
state-wise savings performance of, 30
SHG bank linkage programme (SBLP), 2–3, 86, 129
growth trends in, 13
quality of implementation of, 17–21
SKS IPO, 48, 66–67
Small Industries Development Bank of India (SIDBI), xv, 4
code of conduct compliance assessment (COCA) (*see* code of conduct compliance assessment (COCA))
role in finance and customer protection aspects, 73
support to MFIs, in non-southern states, 73–74
Social Performance Management (SPM)
customer acquisition, 73
trained staff, 71
Society for Elimination of Rural Poverty (SERP), 49
South Malabar Gramin Bank (SMGB), 115
State of Practice in Social Performance Reporting and Management, 71
State of the Sector (SOS) Report, xiii
impact assessment overview for, 81–84
Stree Nidhi, xiv
Swarna Jayanti Gram Swarozgar Yojna (SGSY), 17, 99

UID (aadhar), 115
United Nations Development Program (UNDP), xviii
UN Solutions Exchange, 136–37

World Bank
code of conduct compliance assessment (COCA) (*see* code of conduct compliance assessment [COCA])
poverty alleviation project, 99
world GDP, India's contribution to, 2

XII Five Year Plan, 2

Technical Partners

Incorporated in 2002, **MIX** is a non-profit organisation headquartered in Washington, DC with regional offices in Azerbaijan, India, Morocco and Peru. MIX collects and validates financial, operational, product, client and social performance data from MFIs in all regions of the developing world, standardising the data for comparability. This information is made available on MIX Market (www.mixmarket.org), a global, web-based, microfinance information platform, which features financial and social performance information for approximately 2,000 MFIs as well as information about funders, networks and service providers. MIX produces analysis to provide the microfinance industry with a context to view the performance data that MIX collects from MFIs.

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MicroSave is a consultancy firm and training provider that focuses on the needs of financial institutions targeting under and un-served populations and enterprises. It also assist institutions such as telecom operators, technology service providers, fast moving consumer goods companies, livelihood institutions and development agencies serving the bottom of the pyramid. MicroSave has nearly 80 financial services professionals assisting the clients to achieve their business objectives with practical, market-led solutions.

About the Author

N. Srinivasan has three decades of experience in development finance in RBI and NABARD as Chief General Manager. He had been providing professional support to many high powered committees on 'Agricultural Finance and Microfinance', 'Price Stabilisation for Plantation Crops' and 'Cooperative Sugar Mills' as well as expert committees on 'Financial Sector Reforms' and 'Rural Credit'. He has also been a part of Expert Group on Farmers Indebtedness, Committee on Financial Inclusion and Vaidyanathan Committee I and II on Cooperative Banking Reform. He was member secretary of the task force on Agricultural Credit for the Xth Five Year Plan.

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