The Role of Microfinance in Reducing Poverty

Introduction

This paper explores the topic of microfinance as a way to help alleviate poverty. The India trip illuminated the conditions of the poor in that country. During a visit to the Godrej Group, many of us were surprised to hear that the poor could not even afford to purchase basic necessities such as shampoo or soap, and that many did not earn more than $1/day. As the tour bus traveled between cities, there were miles upon miles of shantytowns, which made us reflect upon what could be done to improve conditions. Upon arriving back in the United States, I attended the International Development Conference hosted by Harvard, which included some panels on the topic of poverty and what could be done to reduce it. One of the most interesting discussions centered on the idea of microfinance, which has the promise of being a financially self-sustaining method for helping the poor. Rather than involving direct grants or subsidies to the poor, microfinance gives the poor much-needed access to capital with the expectation that the loan will be repaid in the future. The goal of a microfinance institution is to become self-sustaining so that it can use the interest from loans to cover its costs, and therefore not need to rely on outside funding. This goal of self-sufficiency has only been achieved by a limited number of microfinance institutions, but as this approach continues to evolve, there is a chance that these institutions will come closer to their goal. The purpose of this paper is to explore microfinance in more depth, describe examples of how
microfinance has worked successfully for specific individuals, and discuss both the benefits and limitations of the microfinance approach to reducing poverty.

**What is Microfinance?**

Microfinance includes providing a broad range of financial services such as loans, savings, and insurance to low-income households. Typically three sets of sources provide microfinance services: formal institutions such as rural banks, semiformal institutions such as non-government organizations, and informal sources such as moneylenders and shopkeepers. Microfinance has become an increasingly common method for alleviating poverty over the past 20 years. It is estimated that about 95% of an estimated 180 million impoverished households in the greater Asia region lack access to financial services. Microfinance can help ease poverty by smoothing the poor’s income consumption, enabling them to accumulate assets, and by promoting economic growth. It has also been demonstrated to empower poor women by giving them more control over financial resources. (Asian Development Bank, p 2-3)

**Past methods of Poverty Alleviation**

In the past history of India, there was more of a focus on a “direct-credit” approach to alleviating poverty. Poverty was mainly viewed as a consequence of the poor not earning enough money and therefore not being able to acquire enough food or assets to reach an acceptable standard of living. Alleviation strategies focused on creating jobs, developing skills, and at times redistributing income from the wealthy to the poor. As part of this view, the role of finance was mainly limited to providing loans. It was assumed that borrowing
households would be able to increase their production levels. As a result, the poor would benefit from increased consumption, while society benefited from the increased production generated by the loans.

The Indian government has utilized the direct credit approach for rural and agricultural finance. It created policies for banks to expand into rural areas, established obligatory lending quotas and interest rates lower than on the market for the priority sector, and permitted waivers of loan principal and/or interest. As a result, there has been improved rural access to financial services. However, there is some concern that “directed credit, loan waivers, subsidies, and the bailing out [of] nonperforming institutions weakened the financial system and contributed to a breakdown in the loan repayment discipline.” (Meyer, p 8).

In 1978, the government initiated the Integrated Rural Development Program (IRDP) to provide loans to the poor at subsidized rates via the banking system. Subsidies were provided along with the loans. There have some concerns about how effectively this program has impacted the poor, and the loan recovery rate fell to a low of only 31%. In 1992, the government began to distance itself from the direct credit approach as part of its reform of the financial sector. (Meyer, p 8-10) Microfinance institutions (MFIs) have emerged as an effective force in alleviating poverty, with strong rates of loan recovery and the potential for self-sustainability.

The Microfinance Approach

Despite the expansion of banks into rural areas of India, many poverty-stricken people still lack access to financial credit. Commercial financial institutions often require that borrowers have a stable source of income and collateral to ensure repayment of loans, both of
which are often lacking. Moreover, commercial banks view the poor as high risk and find it
costly to administer a large number of small loans. Without the option of borrowing from
formal financial institutions, the poor are often forced to borrow from local moneylenders at
extremely high interest rates of 36-60%, or else to do without. (Tiwari, p6)

The purpose of microfinance is to provide financial resources to those who ordinarily
do not have access. There has been considerable expansion of the microfinance sector in the
1990s. India has not been as strong in this sector as the nearby country of Bangladesh,
considered to be a pioneer in microfinance. Within Bangladesh as of December 2000, 585
micofinance institutions (MFIs) had lent a total amount of over $US400 million to 8 million
borrowers. Most borrowers reside in rural areas. (Meyer, p5) The Grameen Bank in
Bangladesh has been used as a model for the development of microfinance institutions in
India and elsewhere. This bank has over 1000 branches and borrowing groups in 28,000
villages, with over 90% of the borrowers being women. Two important features of this bank
include its 98% recovery rate on loans, and its method of providing loans without requiring
any collateral.

An essential ingredient of the Grameen Bank’s approach involves group lending. To
qualify for loans, borrowers must organize themselves into groups of five, who convene on a
weekly basis. Seven groups are then organized into centers that convene on a weekly matter
to discuss loan approval and repayment structures. Loans are granted on an increasing scale,
with a maximum of 4000 rupees (US$95) given as a first loan to a maximum of 8000 rupees
($US190) in the fifth year. Borrowers also have access to additional loans, such as a housing
loan after the second year. Clients are required to save 5 rupees ($US.012) per week in order
to qualify as a member. (Meyer, p18 and Tiwari p7)
The groups enforce the high loan recovery rate. There is considerable group pressure to repay the loans on time, since default by any borrower jeopardizes the other group members’ ability to receive future loans. If a person does not attend the weekly meetings or misses or defaults on repayment, s/he may be fined or suspended by the other group members. The responsibility for repayment falls upon the group, whether or not individual members enter or leave the group. In the unlikely event that the entire group defaulted on a loan, the responsibility would still fall upon the center to which the group belonged. About 75% of the loans received by females were used for income-generating activities such as poultry raising, processing, and manufacturing activity, while about 50% of the loans received by males were used for trading and shop keeping (Tiwari, p8).

One of the major differences between the microfinance approach versus the “direct credit” approach is that the microfinance institutions strive to attain long-run sustainability. The MFIs’ goal is to be self-sufficient in such a way that they can continue to provide financial services even when they no longer have government or donor funding. This has been a difficult objective to achieve, although a few have been successful, especially in other countries such as the Bank Rakyat Indonesia or the BancoSol in Bolivia. Unfortunately, under one percent of all MFIs have been able to cover all their costs without external funding. More recently, MFIs have begun to rely more on savings as a way to generate funding for loans. (Meyer, p7)

Examples of Microfinance Institutions in India

Swayam Krishi Sangam (SKS) is a microfinance institution that operates in rural India, designed based on the Grameen Bank model. This organization was founded in 1998...
with the establishment of a woman’s banking center in the Medak District in the State of Andhra Pradesh, a region considered to be one of the poorest in India.

An example of a success story is the experience of Gangapur Beeramma, a blanket maker of Gangapur. Having lost her husband, she is the sole head of her household. Her family’s one acre of land is infertile, and does not yield crops nor income for the family. As a result, the family depended on the minimal income earned from making blankets from the wool of their five sheep. A year ago, Beeramma applied to SKS for a loan of 2000 rupees ($US 42), and used the funds to purchase extra sheep wool. As a result, her family was able to produce more blankets than they could have otherwise, and this significantly boosted their income as well as their ability to repay the loan. This success led her to pursue a second loan of 6000 rupees ($US 126) to generate further income.

Another example of how microfinance has changed lives is the case of Raipally Siddamma. As an agricultural laborer, she earned only 20 rupees ($US .42) per day. Siddamma used borrowed funds from SKS to take on a range of activities that more than quadrupled her daily income. She took loans to purchase a goat, a mango tree from which she can sell fruit, and fishing nets to bring in a daily catch. As a result she now makes a profit of 100 rupees ($US 2.12) per day.

SKS’s mission is to provide “opportunity, not charity.” (SKS website) More specifically, they provide credit that allows the poor to initiate income-generating activities, rather than giving one-time grants that only ease their poverty in the short-term. They charge high-enough interest rates to cover their costs, in order to achieve a measure of financial sustainability that will allow them not to be overly dependent on donations. (SKS annual report, p11)
There are a multitude of other microfinance institutions. One of the fastest growing institutions is SHARE (Society for Helping Awakening Rural Poor Through Education). This institution was founded in 1989 by M. Udaia Kumar to help build skills among low-income entrepreneurs. Kumar grew concerned that the poor’s lack of access to funding hindered their skills development. After studying the model of the Grameen Bank in Bangladesh, he decided that SHARE should provide microfinance services such as credit and savings to the rural population of Andhra Pradesh. By 1996, SHARE had four branches operating throughout the region. One of its branches, located in the Guntur District, achieved financial self-sufficiency in 1997, covering all its expenses. As the rest of the branches strived for self-sufficiency, SHARE faced problems due to the fact that Indian law did not allow charitable institutions to earn a profit and did not acknowledge charitable institutions which undertook microfinance operations. As SHARE’s tax-exempt status was questioned by the government, they decided to incorporate as a public limited company affiliated with the Reserve Bank of India. Now that it had gained access to commercial funds, the organization was able to grow faster. As of February 2002, the organization had 57 branches operating in 13 districts, with 105,969 members, all poor rural women. The institution has a capital base of $US 3.3 million, of which $US 1.2 million was paid in by 26,034 women clients. 99% of total equity was contributed by the organization’s clients, with only 1% owned by external sources. Two representatives from their client group sit on the Board of Directors, and so SHARE considers itself to be unique in being a “microfinance institution which is truly owned and managed by poor women.” In order for a woman to qualify for a loan, she must have a family income under $7.50/month. The repayment rate for the institution’s loans stands at 100%, and the institution’s overall financial self-sufficiency is 96%. A study to assess SHARE’s impact
found that over 76% of its clients have achieved a remarkable improvement in their standard of living. Of the clients in this study, 64% had been labeled as Very Poor when they became members of the institution, with the other 36% considered Moderately Poor. After about four years, only 7.2% of these clients were still considered Very Poor, with 56.8% having achieved the status of moderately Poor, and 36% actually becoming Non-Poor. (SHARE website)

**Evaluation of Microfinance Institutions**

There are generally three dimensions used to evaluate microfinance institutions. The first dimension is outreach, measured by the number of clients reached. Next is whether the MFI has achieved financial sustainability, so that it can continue to operate even when there are no more funds available from donors or the government. The last criteria is the impact that the microfinance institution has had in terms of raising its clients’ incomes and reducing poverty. These dimensions may help reinforce each other. For example, MFIs that have significant outreach may serve a large enough number of clients that it leads to economies of scale and financial sustainability. On the contrary, these goals may get in the way of each other. For example, a MFI that focuses on outreach and impact may target the poorest clients, but in this case since savings are low and costs are high, it may prevent that MFI from achieving self-sustainability. (Meyer, p7)

Within India, the focus has been mainly on achieving a significant level of outreach, at the possible expense of achieving financial sustainability or impact. NABARD is a program launched by the Indian government which involved using the existing banking systems to provide credit to the poor, rather than setting up specific microfinance institutions. This program began in 1992 with the formation of SHGs (self-help groups) which were linked to
the banks. Small groups of the poor would aggregate their funds into a common savings account, whose funds would be loaned to specific individuals with the permission of the group. NABARD stated that as of March 2001, more than 260,000 self-help groups consisting of approximately 4 million poverty-stricken families were involved in this program. While the level of outreach appears to be high, it is not yet clear as to whether this program has achieved significant impact or whether the initiative was financially sustainable. (Meyer p 11-12) As the level of outreach increases, it will also be important for the Indian government to focus on measuring and improving the impact of these programs.

Non-Financial Impact of Microfinance

The impact of microfinance is not just limited to the actual income generated; there are also social effects. Microfinance has been shown to improve health and sanitary services, reduce violent incidents such as wife beating, and increase confidence and self-respect among clients. (Meyer, p 16) Institutions that follow the Grameen Bank approach have instituted a weekly chant of “16 decisions” which members repeat at their weekly repayment meetings. Members undertake a new code of conduct that involves investing in children’s’ education, using latrines and uncontaminated drinking water, not engaging in dowries for women, etc. (Tiwari, p8) As a result, many clients have experienced a change not only in their financial state but also in the overall way they conduct their lives.

How microfinance can be improved

Several recommendations have been advanced to improve the operation of microfinance institutions. First of all, microfinance institutions need to ensure that their
interest rates are high enough to cover the costs of lending. If rates are set too low, it prevents the institution from achieving financial sustainability and cripples its ability to provide additional capital to the poor. Therefore, the government should change regulations which set caps on interest rates, and allow the MFIs to set appropriate rates. A study of the SHGs (self-help groups) showed that when the poor had the decision-making power to set their own rates for lending to members of their groups, they recognized the need to set high rates to cover costs and compensate those who had invested their savings into the loan account. Also, the government should take care not to disburse subsidies and loans from the same financial institutions, in order to make a clear difference between grants and loans. One risk involved in providing both subsidies and loans is that the financial discipline of paying back loans may be lost, and this threatens the future sustainability of the microfinance system.

Next, certain proponents of microfinance argue that there is too much focus on providing only loans to the poor, and that they need a broader range of financial services such as savings and insurance (Meyer, p 3) By giving the poor access to savings accounts, it allows them to save for times when they are in even greater need, it helps instill a certain level of financial discipline, and it also provides additional funding for giving out loans. Government policies have typically only encouraged savings as a criteria for qualifying for a loan, but the government has not viewed savings as an important means in itself for bettering the conditions of the poor.

Another recommendation is that there needs to be better monitoring and evaluation of microfinance institutions to ensure that performance is at an optimal level. Some countries have been more active in tracking the progress of microfinance than others. It is worthwhile
to analyze best practices among MFIs to determine which methods are most effective for covering costs, and which services are most successful in aiding the poor. (Meyer p22-28)

**Conclusion**

Microfinance has become more widespread over the last couple decades, as it has been shown to be effective in alleviating conditions of poverty. The Grameen Bank has served as a model for what can be accomplished via microfinance institutions, in terms of the depth and breadth of financial services that can be provided to the poor. The success of such institutions has shown that it is possible to recoup payments on loans given to people who lack collateral, and that it is possible to cover enough costs to become, if not 100% financially sustainable, very close to that goal. The purpose of microfinance is to provide the poor with the opportunity to improve their lives by acquiring access to resources beyond what directly belongs to them.

Credit is something that is almost taken for granted in some countries. For example it is very common for college students in the United States to take on loans to pay for their education, and then pay back these loans with interest after they have acquired the skills necessary to make a living. Credit allows an individual to better leverage his/her skills and capabilities, because it can provide the extra income needed now in order to generate income in the future. Before the presence of a microfinance institution, there was no way for certain segments of the population to finance the skills and/or resources necessary to pull themselves out of an impoverished existence. Now that such institutions have been established, it opens up the possibilities for a blanket weaver to purchase more wool and thereby aspire to a family-supporting level of income, and it allows for countless other possibilities that are not feasible without a reserve of capital.
Besides the direct financial benefits of additional capital, there are also social effects. For example, the fact that women have been able to get involved in disbursing loans and handling finances has given them an opportunity to improve their status within the villages. Moreover, the microfinance institutions that provide the financial services also instill a sense of discipline in non-financial areas of life such as proper hygiene and the importance of education. Overall, microfinance has shown significant results in alleviating poverty within the rural areas where it has been established. While it still has a way to go in achieving self-sufficiency and in expanding its outreach and impact, it has made a difference in the lives of many individuals.
Sources


