Building Sustainable Microfinance Institutions in India  
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India is perhaps the largest emerging market for microfinance. Over the past decade, the microfinance sector has been growing in India at a fairly steady pace. Though no microfinance institution (MFI) in India has yet reached anywhere near the scale of the well-known Bangladeshi MFIs, the sector in India is characterised by a wide diversity of methodologies and legal forms. However, very few Indian MFIs have achieved sustainability yet.

Sustainability itself has to be seen in a broader sense than just financial sustainability. The sustainability of demand, of the MFI’s mission, of its ownership and governance structure and the legal and regulatory framework under which it works, are all contributory to overall sustainability of an MFI. Further, the sustainability of an MFI by itself may not be enough unless a full-fledged micro-finance sector (MFS) is established on sustainable lines. This paper tries to examine what comes in the way of making Indian MFIs sustainable and what can facilitate this. The paper is divided into three broad sections:

- A Three Track Approach for Building a Sustainable Microfinance Sector
- Multiple Dimensions of Sustainability and
- Suggestions for Building Sustainable MFIs in India.

1 A Three Track Approach For Building A Sustainable Microfinance Sector (MFS) In India

There is a huge unmet demand for micro-finance in India. Bridging the demand supply gap requires an environment that attracts large numbers of microfinance providers. There is a need to adopt a three track approach, using mutually complementary strategies:

- Incentivising existing mainstream financial service providers (apex financial institutions, such as NABARD, SIDBI and HUDCO, commercial banks, insurance companies, co-operatives, and NBFCs) to enter the microfinance sector as a serious business proposition.

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• Encouraging new microfinance institutions (MFIs) with a supportive policy and regulatory framework and financial resources to enlarge and expand their services.

• Building a strong demand system in the form of community-based development financial institutions (CDFIs), with the help of NGOs and others.

There are many aspects of the existing legal and regulatory framework, which discourage mainstream FIs from increasing outreach and achieving sustainability in microfinance. Further growth in microfinance can only be possible by redressing these limitations in the legal and regulatory framework. These constraints apply both to mainstream FIs (track 1) and to alternative MFIs (track 2).

Small loans have been historically seen by banks as a social obligation rather than a potential business opportunity. The leadership and managers of mainstream FIs see the small loan market as difficult to serve, risky and having a low or negative net spread. Contributing to this position has been the fact that poverty alleviation related small loans (IRDP, DRI, SC/ST)\(^2\) have been utilised historically as a tool for disbursing political patronage, undermining the norm that loans must be repaid. This has made bankers cynical about lending to the poor. However, over the last three years, some strides have been made to re-engage mainstream FIs into micro-credit.

The concept of Local Area Banks (LABs), with a lower start up equity of Rs 50 million, has not yet been operationalised by the RBI. The Regional Rural Banks Act does not permit any private shareholding in any RRBs, and the Cooperatives Acts of all states do not permit district level coop banks to be set up except by the state government. The result of these two laws together is that rural credit has been a monopoly of state owned institutions.

The only exception is private finance “companies” – so called, but not actually companies under the Companies Act. These entities are not allowed to take deposits, and thus their source of funds is the owners’ personal funds and borrowings from relatives. They can, however, extend credit and thousands of them are thriving doing so. Their interest rates are usually three to five percent per month. However, due to their unincorporated status, they cannot borrow from banks/FIs and grow substantially.

To incorporate, at the moment there are only two options – either be a co-operative or be an NBFC (non-banking finance company). If an MFI opts to be an NBFC, it finds it very difficult to mobilise the minimum start-up equity of Rs 20 million. Even where it does have any equity, borrowing from Indian financial institutions are highly restricted due to the negative image of NBFCs in general. Further, even deposit mobilisation is not possible at least for the first three to four years, till a satisfactory rating is obtained. That leaves the option of borrowing from foreign institutions, which is difficult in the first place. MFIs taking foreign currency loans are subject to exchange rate risks, which they would not be able to handle. Very few foreign institutions are willing to give rupee denominated loans. Thus, in summary, currently there is no facilitative framework to promote private sector, for-profit MFIs in India.

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\(^2\) IRDP-Integrated Rural Development Programme, DRI-Differential Rate of Interests, SC/ST-Scheduled Caste/Scheduled Tribe
Track 3 is grassroots up. It is desirable to build a strong demand system in the form of community-based development financial institutions (CDFIs), with the help of NGOs and others. Such a system is required to

- convert latent demand into effective demand,
- wean away microfinance customers from moneylenders,
- remove the expectation of low interest rate and capital subsidies that have spoiled borrowers over the years
- restore the repayment norm, and
- build local stake in grassroots financial structures

A member owned and member managed CDFI is possible when small groupings such as five person joint liability groups or 20 member SHGs federate into a CDFI without losing their character and autonomy. These CDFIs may be unregistered or registered. If registered, they may choose to be societies, trusts, mutually aided co-operative societies (MACS) or even non-banking finance companies (NBFCs). Such CDFIs require capacity building inputs to manage higher volumes and transactions. In certain states, there is a possibility to set up MFIs under progressive cooperative legislation, such as the AP Mutually Aided Co-operative Societies Act 1995, in Andhra Pradesh. Similar Acts have come up in Bihar, Jammu and Kashmir and are on the anvil in Orissa, Tamilnadu and Madhya Pradesh.

Having explained the three tracks for building the microfinance sector in India, we focus on track 2 (MFIs), as other presenters from India will be dealing with tracks 1 (mainstream FIs) and track 3 (CDFIs).

2 Multiple Dimensions Of Sustainability

Sustainability is not just financial, there are multiple dimensions of sustainability. We have to look at sustainability from the point of view of:

- Demand and Supply Characteristics and Their Impact on Sustainability of MFIs
- Sustainability of the Mission of MFIs
- Legal and Regulatory Framework for Promoting Sustainability of MFIs
- Ownership and Governance to Promote Sustainability of MFIs
- Financial Sustainability of MFIs

2.1 Demand and Supply Characteristics and Their Impact on Sustainability

2.1.1 Demand for Microfinance Services:

The demand for microfinance services – savings, credit and insurance – is apparently insatiable in India. In that sense, India is perhaps the largest emerging market for microfinance services.

Credit: With a population of 1000 million, India has nearly 400 million people below or just above an austerely defined poverty line. Thus, approximately 75 million households need microfinance. Of these, nearly 60 million households are in rural India and the remaining 15 million are urban slum dwellers. The current annual credit usage by these households was estimated in 1998 to be Rs 4,65,000 million or US$ 11 billion. This is based on the following:
• Annual credit usage by 60 million rural poor households at an average of Rs 6000 is Rs 360,000 million per annum - about two-thirds for consumption and one-third for production needs (Based on a 1994 study carried out for the World Bank. The number has been rounded off and adjusted for 1998 prices).
• Annual credit usage by 15 million urban poor households at an average of Rs 9000 is Rs 105,000 million per annum - about 55 percent for consumption and 45 percent for production needs. (Based on a 1995 study carried out for the SEWA Bank. The number has been rounded off and adjusted for 1998 prices).

Even though the unmet demand is large, the emerging “competition” from mainstream banks can overwhelm MFIs, which are still in their nascent stage. This is so as banks are able to cross-subsidize their micro-credit, and charge interest rates below cost and can out-price any MFI. This has major implications for the sustainability of MFIs.

Savings and Insurance: Apart from credit, there is an unfulfilled demand for savings and insurance services. In the case of savings services, while banks have provided access to a large number of small depositors, the demand is nowhere near being met, particularly for small, frequent “recurring” deposits. Hence the poor turn to other means such as chits, bishis and savings mobilisation companies like Peerless and Sahara. Many such companies are fly-by night and as a result, the poor lose their money.

The Reserve Bank of India (RBI) has tightened up deposit taking activity since 1997, but this has, perversely, also led to legitimate MFIs being not allowed to take deposits and thus provide savings services to the poor. Savings services by MFIs are essential as transaction costs of savings in formal institutions were as high as 10 percent for the rural poor, because of small average transaction size and distance of banks from villages. In addition, savings deposits make MFIs sustainable in terms of sources of funds.

The supply of insurance services to the poor has increased substantially over the 1990s, and there are a large number of low premium schemes covering them against death, accidents, natural calamities, and loss of assets due to fire, theft, etc. Livestock and asset insurance was extended to the poor along with the IRDP subsidized loans, and thus remained scheme driven, with little awareness among the customers. Crop and livestock insurance, however, is quite expensive and their reach to the poor is negligible, except when linked to government schemes.

2.1.2 The Supply of Microfinance Services and Competition for MFIs

The total outreach of the existing specialized microfinance service providers is quite limited. Starting with credit first, we see that there is no authoritative countrywide estimate of micro-credit disbursed or clients served. We have attempted a preliminary estimate in Appendix 1. The total barely crosses Rs 1500 million, which is not even 0.3 percent of the existing credit usage by poor families.

The banking system in India gives a very large number (56 million in 1994) of small loans, accounting for nearly 93.6 percent of all bank loans by number and 18.0 percent by amount. Further, of these, accounts with outstanding below Rs 7500 comprised 80.5 percent of the number of accounts and 49.5 percent of amount outstanding. In terms of purpose, 45.8 percent
of amount was for small agricultural loans, 20.2 percent for tiny manufacturing and 18.8 percent for trade. Thus banks have been engaged extensively in small credit. However, the manner in which this was done can hardly be called micro-finance. The procedures were cumbersome, the staff unfriendly and the transaction costs high. All this results in low repayment rates, leading to a vicious cycle of non-availability and non-repayment. Nevertheless, Indian banks are increasingly becoming more conscious of the potential of micro-credit, and they have started to compete with MFIs. This is particularly so in the case of lending to Self-Help Groups or SHGs.

SHG lending was initiated by NGOs in the mid 1980s. In 1992, NABARD and the RBI recognised this effort and launched a pilot project for linking 500 SHGs with banks. When those efforts began in 1992, there was not much response by the banks. The pilot project was reviewed by an RBI appointed Task Force in 1995 which issued guidelines to streamline this work and for the provision of refinance and promotional support by NABARD. Banks were encouraged by NABARD to lend to SHGs/NGOs. With enhanced training and exposure for bank staff, financing to SHGs/NGOs gained momentum in the last three years.

By March 31, 1999, banks have cumulatively financed Rs 570 million, comprising nearly 33000 SHGs all over India. NABARD has established a goal to help promote 1 million SHGs by 2008 AD. One million SHGs will absorb at least Rs 50,000 million worth of funds. To meet this goal, obviously, the banking system has to cooperate with NABARD in an unprecedented big way. Whether that will happen in an era of increasing commercial bank autonomy and bottom-line pressure, has to be seen. Banks may be attracted by the steady supply of below market price funds from NABARD (currently given at 6.5 percent), but whether that is a sustainable strategy for NABARD at the scale it is planning, again remains to be seen.

From the point of view of MFI sustainability, having a huge demand for credit, savings and insurance services is not enough. The users should be able to pay full cost for these services. Over the years, there has been a lot of subsidy/grant extended to the financial services sector through various government schemes. This included loans at subsidised interest rates, subsidy on principal and in some cases, loan waivers. This had a great impact on the minds of the borrowers and has spoiled the repayment culture. Similarly, in the case of insurance, most schemes offering insurance to the poor are highly subsidised and thus it is unlikely that an MFI can compete with mainstream insurance providers.

In order to make MFIs sustainable, the characteristics of demand need to be modified to ensure that diffused demand gets consolidated (such as by organising borrowers into SHGs) and users become willing to pay full costs of services (at efficiency levels).

### 2.2 Sustainability of Mission

MFIs are usually established to fulfil a mission – of reaching credit and financial services to the poor who are otherwise unreached by mainstream FIs. Thus MFI try to simultaneously achieve the twin goal of access (by the poor) and sustainability (of the institution or its micro-credit portfolio). This is illustrated in the diagram below.
**Twin Performance Measures: Access and Sustainability**

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<th>High Sustainability</th>
<th>Low Sustainability</th>
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<td>1. Sustainable financial services reach the target clients</td>
<td>3. Highly subsidised financial services reach the target clients</td>
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<tr>
<td>Low Access</td>
<td>Low Access</td>
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<td>2. Sustainable financial services with low access by the target clients</td>
<td>4. Highly subsidised financial services with low access by the target clients</td>
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The history of microfinance in India, as elsewhere, has been an attempt to move to the virtuous quadrant 1, starting from either of the other quadrants. However, the destination has not always been reached. Due to the effect of policy initiatives since 1969, commercial banks in India, which were in quadrant 2 (low access, high sustainability) before social banking initiatives by the government, moved 180° and reached quadrant 4 (high access, low sustainability).

This led to the reforms after 1993, focusing on financial prudence, which is taking them towards quadrant 3 (low access and low sustainability), perhaps on the way back to quadrant 2. This is obvious from the RBI data on small loans by banks, where the number of small loans has come down from 56 million in March 1994, accounting for 93.6 percent of all bank loan accounts, to 50 million or 90.1 percent of loans in March 1998. The amount of small loan outstandings to total loan amount outstanding has come down from 18.6 to 13.2 percent in the same period. The emphasis on poverty alleviation lending by banks has also come down in the last few years, and has not quite been replaced with the enhanced credit through SHGs.

NGO work in micro-credit begins in quadrant 3 (low access, low sustainability). The more successful ones grow in size and move to quadrant 4. One key debate that has yet to be resolved in India is whether it is at all possible to reach quadrant 1. The proponents of for-profit MFIs seem to think it is not possible for non-profit NGO-MFIs to ever reach quadrant 1 for a variety of legal, regulatory and organisational reasons. In contrast, the proponents of NGO-MFIs think that for-profit MFIs may abandon the poorest, if not the poor, in their quest for MFI financial sustainability. In between, there are the proponents of NGO-promoted, poor-owned, mutual-benefit MFIs. However, the issue of effective control of such entities remaining with the promoting NGOs is bothersome, from the point of view of sustainability as well participation.

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3 For a detailed exposition on this, see Vijay Mahajan and Bharti Gupta Ramola “Financial Services for the Rural Poor and Women in India: Access and Sustainability”, *Journal of International Development, Vol. 8, No.2, 211-224 (1996)*
2.3 Legal and Regulatory Framework to Promote Sustainability of MFIs

Regulation helps in long term sustainability, even though MFIs may chafe under it in the initial years. The need for regulation and supervision of MFIs arises from several considerations like protecting the interests of the small savers, ensuring proper terms of credit, instilling financial discipline and having a proper reporting and supervision system. Regulation and supervision ensure that MFIs are run prudently and cases of poor people losing their money due to fraud or incompetence, are minimised.

At present, most Indian MFIs are NGOs, and thus not treated as part of the mainstream financial sector. The question of their supervision and regulation from the financial angle has recently arisen. Reservations have been expressed about the legality of NGO-MFIs providing financial services, particularly savings and insurance. However, there has been a general acceptance of the social intermediation role of such institutions for the delivery of financial services to the poor. Various actions and announcements of the GoI and the RBI are indicative of the acceptance and recognition of the role of NGO-MFIs as part of the micro-finance sector.

While NGOs discovered micro-credit, due to the reasons cited above, NGO-MFIs find it problematic to work as financial intermediaries beyond a certain scale of operations. Moreover, NGOs do not have the appropriate financial structure for carrying out micro-finance activities. Because NGOs are registered as societies or trusts, they do not have any equity capital. Thus, they can never be “capital adequate”. The recent Microfinance Task Force set up by the RBI Governor has suggested that NGO-MFIs may carry on financial intermediation activities till a business volume (deposits plus loans) of Rs 5 million. Beyond that scale, there is a need to shift the activity to an MFI registered either as a co-operative or as a company. The latter are required to have a minimum capital of Rs 20 million at start-up.

Apart from having a start up capital requirement beyond the reach of most MFI promoters, regulations related to interest rates come in the way of establishing sustainable MFIs. The RBI and in turn, apex financial institutions have been imposing restrictions on the interest rates that MFIs can charge to the poor. The spread is inadequate to cover operating expenses and loan losses. The interest rates should be deregulated so as to enable MFIs to meet their costs and earn a reasonable margin for it to sustain in the long run.

There is also restriction on the usage, volume of credit and channel of lending. For example, SIDBI restricts its loans to MFIs for the non-farm sector. HUDCO can only lend for housing. NABARD cannot refinance MFIs which lend in urban areas, or to MFIs registered as NBFCs. While the original rationale of such sectoral/spatial restrictions was valid for NABARD, SIDBI and HUDCO, it comes in the way of their support to MFIs.

2.4 Ownership and Governance to Promote Sustainability of MFIs

The pattern of ownership of MFIs and good governance are crucial to their sustainability. Ownership can be of no one (as in NGOs), of member-users (as in cooperatives), or of investors (as in companies). Each ownership pattern has its problems and plus points. Governance structures emanate from the ownership pattern, though it is possible to have a looser or tighter governance within the same type of entity.
2.4.1 Ownership of MFIs

As stated earlier, a vast majority of MFIs in India are non-profit NGOs, which are legally not “owned” by anyone. NGO-MFIs are registered as Societies or Trusts, under the Societies Registration Act, 1860 or the Indian Trust Acts, 1882. Accountability is structurally limited in case of these legal forms. These Acts provide relative ease of registration, have no minimum capital requirement, prescribe no capital adequacy, nor any prudential norms. Incentives to register as societies exist as they fulfil the legal requirement to access large amounts of low-cost funds from SIDBI, RMK and FWWB. Unfortunately there is little incentive or evidence by the boards of non-profit MFIs to monitor closely the loan portfolios, practices, and services, resulting in an unregulated expansion. This is not to deny some excellent NGO-MFIs in India, but those are run by exceptional individuals and it is difficult to think of thousands of such cases, though that is the number needed.

In case of mutual benefit type MFIs, (e.g. co-operatives and mutual benefit trusts) the assumption is that member control would ensure good governance. Co-operatives are more difficult to register in practice than Societies and Trusts, but are also subject to political interference through the Registrars (with the exception of Andhra Pradesh, which adopted a progressive Act in 1995). Similar Acts have come up in Bihar, Jammu and Kashmir and are on the anvil in Orissa, Tamilnadu and Madhya Pradesh. If a co-operative grows, it may apply for a banking licence as an urban coop bank, which is subject to the regulation by the RBI.

Member control in a mutual benefit gets seriously limited as soon as the size and distance of an MFI grows beyond a few hundred members and a few villages. Differences in income, literacy and exposure levels can also lead to the problem of oligarchic control in mutual benefit MFIs. Once again, there are some very good examples of member-controlled MFIs, such as the SEWA Bank, an urban cooperative bank in Ahmedabad, the Women’s Thrifts Cooperatives (WTCs) established by the Cooperative Development Foundation (CDF) in Andhra Pradesh, and the women’s Kalanjiams established as Societies by the DHAN Foundation, Madurai. However, there are also some cases of member-owned but outsider-controlled MFIs, where savings have been used by a few members and staff, and defaults have happened after that. Regulation on deposit taking by the RBI has not yet been extended to cooperative societies.

There is an absence of a supportive framework for encouraging entrepreneurs to provide micro-finance services on a for-profit basis. Indeed, the concept is looked at a bit suspiciously both within the sector and by policy makers. Yet, this will have to change if sustainable MFIs have to be established in large numbers. So far, BASIX is the only for-profit MFI in India and it has not fully resolved the issue of ownership. The promoters of BASIX see it as a public purpose entity and are committed to use the profits for furthering the cause of rural livelihoods. This enabled them to start BASIX with a small amount of their own funds (Rs 1.1 million) and later mobilise loans and equity from international and Indian financial institutions, to the extent of Rs 250 million. However, this has been a very difficult process.

2.4.2 Governance

Ownership issues can be resolved partly by making depositors and borrowers also shareholders, at least in cooperatives and companies, both of which have shareholders. However, none of the legal forms assure that the governance of an MFI would be with the “people”. We have to accept the conclusion that as MFIs grow larger, governance is likely to vest with professionals. This is true for the Grameen Bank, Bangladesh, Bank Rakyat Indonesia, Bancosol, Bolivia or even for the 100 year old Movement Desjardins in Quebec, Canada. The generic issues of good corporate governance also apply to MFIs, whether for-profit, mutual benefit or non-profit.
However, a governance structure comprising elected members/shareholders is feasible in a cooperative or a company, whose shares are largely held by its customers. Thus Ela Bhatt set up the SEWA Bank, which is an urban cooperative bank, and its Board is entirely comprised of poor women members/shareholders. The SEWA Bank is managed by Jayshree Vyas, a banking professional and her colleagues, with guidance from the Board. This is a sustainable model.

Currently, BASIX has a Board comprising eminent development workers and professionals from the financial sector, though most of them are not investors. Eventually, as the company becomes regularly profitable, part of its equity could be sold to its customers and employees. BASIX is managed by a team of professionals, who run it as a company with a specialised mission. This, we think, is another sustainable model.

Is institutional sustainability possible only in a model where the MFI is managed by professionals? It appears so, since the other option is to depend on exceptional charismatic leaders, whether of NGOs or cooperatives. It is not possible to build again and again, a Sarva Jana Seva Kosh, an NGO promoted MFI with over 120,000 members, on the assumption that a Loganathan will be available, nor to set up a Mulkanoor-type Cooperative based on the leadership of Viswanatha Reddy. Charismatic founders may be needed, but eventually have to yield to professional managers. Having said this, we have to stress that the microfinance sector in India at present badly needs a large number of microfinance entrepreneurs (MFEs), who can set up new MFIs. A systematic process for identifying and nurturing MFEs is required.

2.4.3 Human Resources

Human resources are the key to the long run sustainability of any organisation as they are the ones who bring difference in the manner MFIs operate and function. MFIs need, first and foremost, those who will establish them, that is, the Micro-Finance Entrepreneurs (MFEs). BASIX and Dr Reddy’s Foundation for Human and Social Development, Hyderabad, together have recently introduced a program, known as the Microfinance Entrepreneurship Origination (MENTOR) program, whose objective is to promote Micro-Finance Entrepreneurs (MFEs). The methodology proposed is “mentoring”, which means an intense personalised input by a senior guide to foster the personal and professional growth of the MFE.

The sustainability of an MFI depends partly on its ability to attract, retain and effectively deploy human resources at all levels. There is a shortage of good quality staff at all levels, from village level barefoot accountants to back office systems administrators. The more senior level staff usually have better alternative opportunities in the mainstream. Sa-Dhan, the newly established association of MFIs in India is offering training programs to senior MFI staff. EDA Rural Systems, the Micro Credit Support Group and BIRD are also offering such programs regularly. All this will help build sustainable MFIs in India, block by block.

2.5 Financial Sustainability

In this section so far, we have looked at various dimensions of sustainability and how these can be worked with to enhance the sustainability of an MFI. Now we focus on financial sustainability.

The key to MFI financial sustainability is by controlling costs and bad debts, increasing volumes and by offering other financial services such as savings and insurance. Most Indian MFIs are not yet financially sustainable. In this section, we examine what can be done to achieve that, using some examples from the BASIX experience.
2.5.1 Controlling Costs

2.5.1.1 Reducing Average Cost Of Funds

The primary source of funds for an MFI initially is institutional borrowings. In the long run, it could be deposits. However, to reach that stage, an MFI has to become a going concern. Till that stage, the MFI has to rely on borrowings. To be able to attract borrowings, the MFI has to have equity capital. Thus, it is only possible to establish a financially sustainable MFI either as a cooperative or as a company. Another way of reducing average cost of funds is borrowings from lower cost sources. However, if these sources are themselves subsidised, as they often are, then it does not lead to sustainability in long term.

2.5.1.2 Reducing Cost of Operations

If micro-finance services have to be extended entirely through salaried staff, it might become costly. Part of the operations can be done by agents who are paid commission based on the amount of savings mobilised, loans disbursed and its repayment rate. This lending methodology has been adopted by BASIX. Almost 60 percent of its loans are originated by its "Customer Service Agents", who work for BASIX full time but are remunerated only on the basis of repayments collected.

BASIX has also identified commercial intermediaries and extended about 10 percent of its credit through them. There are economic players in rural India who have transactions with rural people, such as the agricultural commodity traders, fertiliser dealers, wholesale yarn merchants and agro-processing firms. In order to increase their turnover, these intermediaries are involved in extending credit to their customers. BASIX extends credit to these intermediaries, who would in turn lend to their customers. This increases outreach, with lower transaction costs. Experience shows that the default risk and transaction costs of BASIX are low, when dealing with these intermediaries. At the same time, the sub-loans have reached poorer borrowers, in remoter locations, than BASIX has been able to serve directly.

Operating costs can also be reduced substantially, and monitoring improved, with the use of information technology. For example, credit cards and smart cards can be introduced by the MFIs to reduce cost of operations. This facility can be extended to repeat borrowers who have proven track record with the MFI. Even without smart cards, extensive computerisation can reduce transaction costs while providing a high level of information to the MFI. Once again, BASIX has invested heavily in computerisation and is experimenting with new software and hardware.

2.5.1.3 Reducing Cost of Bad Debts

It is important to establish screening mechanisms, for acquiring relevant information about potential borrowers. BASIX routinely uses collaborators, who are either local NGOs, agri-business firms or just commercial intermediaries. They have a lot of informal information about potential borrowers, which is factored in while making the first loan decision. Subsequent loans are based on the borrower's repayment history. It is also necessary to establish incentives for staff and borrowers that increase repayment. In addition to remunerating Customer Service Agents based on repayment BASIX gives an on-time repayment rebate to its borrowers. It is also important to use enforcement mechanisms that diminish possibilities of wilful default. BASIX extensively uses Joint Liability Groups (JLGs) of 5-6 borrowers engaged in the same occupation (farmers, weavers, vendors) to mutually guarantee each other's loans. All these methods help reduce defaults down to below 2 percent.
2.5.2 **Increasing Volumes**

BASIX reached breakeven in its very first year, but this was due to low cost funds. In its third year, BASIX has achieved breakeven with nearly commercial cost of funds. An MFI should be able to break-even in its third or fourth year of operations. Innovative channels such as intermediaries can be used to increase volumes as it reduces transaction cost to a great extent. The following are the ways by which BASIX increases lending volumes:

- Offer different loan products to suit the credit requirements of the poor. Adopt flexible repayment schedule to suit borrower’s cash flows. This is an important feature to attract more customers as the formal FIs have rigid product structure.
- Identify intermediaries to a number of small borrowers such as fertiliser dealers and yarn merchants who on-lend.
- Increase customer base in the areas of operation and expand in neighbouring villages. Also increases loan size for successive loans.

2.5.3 **Increasing Services – Savings and Insurance**

One sure way to enhance an MFI's financial sustainability is by broadening the range of financial services it provides. This reduces its transaction costs per service, and improves its customer base, apart from retaining customer loyalty. There are also advantages in terms of having better information on the customer's financial transactions. Finally, the services are complementary in terms of risk. For example, savings help reduce credit risk of a customer as she can use her savings to cover normal business risks; meet consumption requirements during seasonal lows in wage employment; and keep the saver from indebtedness to local moneylenders. Also, savings form an important source of funds for an MFI. Unfortunately, due to restrictions on NBFCs, BASIX is not yet allowed to take deposits and thus is not able to provide savings services to its customers. Moreover, it has to use only equity funds and borrowings to make loans. Once it can raise savings deposits, BASIX can reduce costs.

Insurance is another important financial service, which is required by the poor. This is because of their vulnerability to a variety of risks. In their efforts to provide financial services to the poor, MFIs offer both savings and credit related services. Some of the Indian MFIs like CDF and SEWA Bank have promoted risk funds to cover their credit operations. SHARE and ASA have an in-built mechanism for borrower insurance through risk funds. Efforts are also being made by BASIX to design community managed crop insurance services. The efforts are, however, still at an experimental stage.

3 **Suggestions For Building Sustainable MFIs In India**

In this section, we look at specific, detailed recommendations for establishing an enabling environment to promote sustainable MFIs in India. International readers may only want to look at the headings since the detail is specific to Indian laws.

3.1 **Need to Enact/ Amend Laws and Regulations**

3.1.1 **Amend the RBI Act, 1934 to add a Chapter on MFIs**

A Task Force on Micro-Finance Policy was set up by the Governor of RBI under the Chairmanship of the Managing Director of NABARD, with members drawn from leading MFIs and banks. BASIX made the following suggestions to the Task Force. A new Chapter IIID was suggested in the RBI Act, 1934. The highlights of the chapter are as follows:
The term micro-finance and MFI has been defined as “provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards”.

Regulation of micro-finance activity, particularly deposit taking has been recommended in a graded manner. The regulation could be light at the initial and small scale, rising to full regulation once business volume rises to Rs 20 million.

As micro-finance activity is largely promoted by NGOs, this activity can be carried out at small scale, by NGOs and people’s organisations, registered as Societies or Trusts. After reaching certain business volume (say Rs 5 million), it becomes necessary to shift the micro-finance activity of a Society or a Trust to a Co-operative or a Company.

With the likely large number of MFIs in the sector, self-regulation and supervision may be desirable. As self-regulation is a new concept, an intermediate stage of RBI recognised self-regulation has been proposed. RBI may carry out supervision through recognised self- regulatory organisations.

MFIs whose business volume exceeds a substantial level (Rs 20 million), should be regulated as per the normal regulatory framework, except for entry level capital, which should be smaller and capital adequacy, which should be higher. Such MFIs should be supervised by the normal supervision agencies.

Establishing a new form of NBFC – the Micro Finance Company

When an NGO or a microfinance entrepreneur starts a microfinance activity, it faces the problem of how to incorporate it. At a small scale, the work can be done as an unincorporated body, although it cannot take deposits. But as the size grows, an MFI has the choice to be either a cooperative or be incorporated as a company under the Companies Act and then become an NBFC or a Bank. In most states, with the exception of Andhra Pradesh, Maharashtra and Gujarat, co-operatives are politicised and state-controlled, and thus not an appropriate form of incorporation for an MFI. An NBFC is required to register with the RBI and have a minimum start-up equity of Rs 20 million. A Bank requires a licence from the RBI and a minimum equity of Rs 1000 million. The RBI established a new category of banks known as the Local Area Banks (LABs), with a lower start-up capital of Rs 50 million, in 1996 but no LAB has been licensed as yet.

Thus the RBI Act should make a provision for a new kind of NBFC – the microfinance company (MFCs). These MFCs may be allowed to start at a capital of Rs 2.5 million.

Permitting MFIs to take deposits from members/borrowers

NGO-MFIs are registered as Societies or Trusts, registered under the Societies Registration Act, 1860 or the Indian Trust Acts, 1882. The savers and borrowers of such NGO-MFIs are legally not ‘members’ of the NGO-MFIs, as membership in case of societies comprises the promoters of the societies who themselves cannot avail of any benefit from the societies. In case of Trusts, there are only Trustees and no concept of membership. Consequently, the ‘members’ of such NGO-MFIs can be classified at best as ‘clients’ or ‘beneficiaries’ of the various interventions of the societies. Hence, savings mobilised by NGOs are virtually collected from the members of the public. This is in contravention of the RBI Act, Section 45(S), which prohibits deposit taking by such entities, as they are not deemed to be “bodies corporate”.

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Many of the NGO-MFIs who are involved in microfinance are mobilising savings from their clients/borrowers with the objective of inculcating a savings habit among the poor and for enabling the use of such resources for acquisition of assets or linkage with banks. Till these NGOs convert to other legal forms such as co-operative, NBFC, or bank, they may have to be allowed to mobilise savings only from their poor clientele.

- This requires the RBI to notify that Societies and Trusts are to be treated as a “body corporate” for the limited purpose of Sec.45 S of the RBI Act.
- In the same spirit, the regulation prohibiting taking of public deposits by MFIs which have not been rated as investment grade, should be waived for deposit taking from members/borrowers for MFIs which are registered as NBFCs and regulated by the RBI as such.

3.1.4 Changes in the Acts governing NABARD, SIDBI and HUDCO

There are specific problems with legislation for apex institutions supporting MFIs: for example, the NABARD Act does not allow it to refinance any private sector FI nor do any direct financing (NABARD’s work in microfinance so far has either been out of donor funds or through refinancing commercial banks who lend to MFIs). NABARD, the pre-eminent SHG refiner, is precluded from refinancing banks lending to SHGs in urban areas. Similarly, the SIDBI Act restricts it from extending loans to the agricultural and allied sectors, whereas many of the members of SHGs are engaged in such activities. HUDCO is not allowed to lend for anything other than housing and urban/rural infrastructure.

3.1.5 Changes in the Income Tax Act

NGOs are registered as “charitable” entities under section 12A of the Income Tax Act. This allows them to accept grants and carry forward a surplus of income (including grants) over expenditure without the surplus being taxed. This provision is crucial to the financial survival of an NGO. Under section 11(4-A), an NGO can carry on business activities incidental to its main objects, which have to charitable, as defined in section 2(15) of the Act.

If an NGO earns a substantial part of its total income from lending activity, an Assessing Officer (AO) can take the view that it is the main activity and is not charitable, since lending to anyone, including the poor, is not defined as charitable. This is more likely to happen when the AO takes the view that lending at sustainable interest rates is not charitable. Thus an NGO can lose its charitable status under section 12A, which would then disable an NGO from receiving grants and carry forward its surplus without being taxed. To rectify this,

- The Central Board of Direct Taxes (CBDT) should issue a notification clarifying that NGOs can undertake microfinance at least up to some scale (Rs 5 million) without losing charitable status under section 12A. If necessary, this may be done by clarifying that microfinance very much falls within the purview of “charitable activities” particularly “relief to the poor”, as defined in section 2(15).
- To enable NGOs to establish or co-promote for-profit MFIs, they should be allowed to invest in the equity of such MFIs. This requires the CBDT to grant permission for such investments under section 11(5) (xii). Incidentally, in the US, non-profits are allowed to invest in the equity of any type of for-profit entities, and even in India, this was allowed before 1973. There is no reason to persist with this regressive restriction.
Those MFIs, which have borrowed under the external commercial borrowing (ECB) scheme are facing a problem getting a withholding tax exemption under section 10 (15) (iv) (g) because of definitional reasons (housing finance is covered but microfinance activities are not covered). The CBDT needs to clarify that no withholding tax applies to ECBs taken by MFIs.

3.1.6 **Tax benefits need to be extended to the microfinance sector**

- To enable MFIs to avail of tax benefits, a new Section 10 (23-H) may be introduced in the IT Act to exempt any income from dividends or capital gains from investments in the equity shares of MFIs, on the lines of the infrastructure companies.
- To encourage MFIs to adopt prudential norms in regard to provisioning for bad and doubtful debts the benefit of tax deduction available to banks may be extended to MFIs with due amendment to the Section 36 (1)(vii)(a) of the Act.
- Section 36(1)(viii) of the IT Act may be amended to include micro-finance to the list of admissible purposes for tax exemption to the extent of 40 percent of total income, if placed in special reserve, as in the case of long-term finance for housing, industrial or agriculture development.

3.1.7 **Making available more lending funds to MFIs**

- To facilitate bank credit to MFIs, the RBI should treat bulk lending to MFIs by commercial banks, particularly new private banks who do not have a rural low-income area branch network, as priority sector lending.
- SIDBI, NABARD and the HUDCO should consider extending refinance facilities or lines of credit to MFIs, which are incorporated as NBFCs or MACS. The interest rates can be nearly commercial – from 13.5 to 15 percent.

3.1.8 **Allow NGOs to give foreign grants as loans and grants to SHGs/CDFIs.**

Foreign grants accepted by NGOs must be reported to the Ministry of Home Affairs (MHA), FCRA (Foreign Contributions Regulation Act) every year till the amount is fully expended. In a meeting with the Microfinance Task Force, the Director, FCRA clarified that these foreign grants can be given by NGO-MFIs as loans to SHGs/CDFIs. The NGO has to report the utilisation of foreign funds as “utilised” at the end of the year the loan is disbursed. Any repayments of such loans by the SHG/CDFI must be reported as “receipts” of foreign funds by the NGO, at the end of the year the repayment is received. This has to be done in perpetuity.

However, if an NGO-MFI wants to pass on foreign grant funds as a grant to SHGs/CDFIs, then the SHG/CDFI must take prior permission under the FCRA, which is a difficult process. Section 31 of the FCRA empowers the MHA to make exemptions in public interest.

- The MHA should allow NGO-MFIs to give grants to SHGs/CDFIs without taking prior permission. Similar exemptions have been given to watershed committees at the village level.

3.1.9 **Simplify foreign investment regulations to enable MFIs to raise foreign equity**

Once an MFI is registered under the Companies Act, for it to undertake micro-credit activities, it needs to be further registered as either a NBFC under the RBI Act, 1934 or licensed as a local area bank (LAB) under the Banking Regulation Act, 1949. The RBI requires that a new NBFC must have a minimum start up capital of Rs 20 million, while a new LAB must have a minimum
start up capital of Rs 50 million. As most MFIs are not in a position to raise this level of start-up equity because the people’s equity can be only Rupees one or two million, it becomes essential to raise the balance equity from development finance institutions.

Start up equity capital is difficult for most promoters of MFIs because most of them come from a developmental background. Yet, it is prudent to have reasonably high start up capital requirements to ensure that MFIs are established as serious institutions.

• Thus SIDBI, NABARD, and HUDCO should also consider making an equity investment in MFIs so as to strengthen their capital structure as well as give greater supervision.

While development finance institutions in India are getting interested in micro-credit, for various reasons they are not yet in a position to provide equity funding to MFIs. For example, NABARD is not allowed to invest in equity under the NABARD Act, 1982. SIDBI though allowed to invest in equity, it has recently established a special foundation for micro-finance but it is mainly for providing loans and capacity building funds. HUDCO also has similar limitations. Thus, foreign development finance institutions, become an important source of equity finance for MFIs.

• FIPB guidelines for foreign investment in financial services may be modified to include micro-finance activities. No additional restrictions should be put beyond what RBI as the regulator already prescribes.

• Further, the minimum level of foreign equity should be reduced from the level of US $ 500,000 to US $ 50,000, to enable smaller developmental investors to subscribe to the equity capital of an MFI.

Many foreign donors have taken a policy decision to experiment with funding mechanisms other than grants – soft loans, commercial loans, guarantees and equity. One of the issues related to loans from foreign donors is that of exchange rate risk. Most MFIs can not bear or even get cover for long term exchange rate fluctuations. Thus, many donors are willing to give loans which are denominated and repayable in Rupees.

• Donors, who are accustomed to give grants, should develop alternative mechanisms to provide equity support. This should be encouraged by the Government of India. The Department of Economic Affairs, Ministry of Finance, which deals both with donors and foreign investment, should take a view on this matter.

• Also, considering the lower cost funds that are available internationally, it is necessary that appropriate legislation be introduced to facilitate their flow. A new scheme, possibly called “External Developmental Borrowings (EDB)” may be established on the lines of the External Commercial Borrowings (ECB) scheme and powers given to RBI to administer it under the Foreign Exchange Regulation Act (FERA).

4 Conclusion

Micro-finance is one of the ways of building the capacities of the poor and graduating them to sustainable self-employment activities by providing them financial services like credit, savings and insurance. To provide micro-finance and other support services, MFIs should be able to sustain themselves for a long period.
A three track approach should be adopted to promote the microfinance sector
• by incentivising existing mainstream financial service providers,
• by encouraging new microfinance institutions with a supportive policy and financial resources to enlarge and expand their services, and finally
• by building from the grassroots up, a network of community-based development financial institutions (CDFIs).

In this paper, an attempt has been made to look at sustainability from multiple dimensions such as demand, mission, legal and regulatory framework, ownership, governance and human resources and financial sustainability.

The paper asserts that India is the largest emerging market for microfinance. However, the demand needs to be organised and converted into effective demand. The need for credit by the poor should be backed by willingness to pay the price for the financial services. Only then demand is sustainable. MFIs should offer sustainable financial services and reach a stage of high access and high sustainability, which is the desired level. There is emerging price competition from mainstream banks as they are able to cross-subsidize their micro-credit operations and charge interest rates below cost.

The paper argues in favour a graduated regulatory framework for MFIs in India, starting with light regulation at the small scale to full prudential regulation above Rs 20 million business volume. MFIs should be regulated but regulation should not hamper financial sustainability. It is possible to provide micro-finance services to the poor at reasonable cost provided use is made of certain methodologies – group lending, peer guarantees, and matching repayment terms with borrower cash flows. The key to MFI financial sustainability is controlling costs and bad debts, increasing volumes and by offering savings and insurance services.

The ownership pattern and governance of an MFI are crucial to its sustainability. We examined all three options of ownership – “no owners”, “member-user owners” and “investor-owners”, along with the relative merits and demerits of each pattern and its impact on governance. The paper asserts that irrespective of the mode of ownership, professional management is key. While all human resources are the key to the long run sustainability of any organisation, there is a serious shortage of microfinance entrepreneurs.

The paper ends with a set of very detailed and specific recommendations to bring about changes in various laws and regulations in India and for changing the guidelines to apex financial institutions such as NABARD, SIDBI, and HUDCO, so as to provide a supportive environment for MFIs to emerge and become sustainable.
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