Microfinance in India: An Overview

Indian Microfinance can be chronologically classified into four phases. The four stages are:

Phase I: 1900s – 1969 Cooperative Movement

Phase II: 1969 - 1991 State Driven through National Banks and emergence of NGOs

Phase III: 1992 – 2000 SHGs Bank Linkage program and Growth of NGO-MFIs

Phase IV: 2000 – today Commercialization of Microfinance

While each phase represents distinct features of its own, there are some overlaps and crosscutting themes among them. An overriding feature of Indian Microfinance throughout its evolution is its focus on poverty alleviation in rural areas. This focus has broadly determined the approach and operations of microfinance in India. In addition to this Indian microfinance is characterized by existence of both State and Civil Society Organization in delivery of microfinance services while private players joining the wagon during phase IV. In context of Indian Microfinance, it is important to note that each phase was influenced not only by learning from earlier phase but also from development discourse, government policies and international trends in microfinance eco-space among other things. The remaining section describes each phase in detail.

Phase I: Early 1900s – 1969

Credit Cooperatives

The earliest phase of Indian Microfinance can be described from early 20th century until 1969, when credit cooperatives largely dominated as an institution in provision of microfinance services. This phase began with passing of Cooperative Societies Act 1904, to extend credit in Indian villages under government sponsorship. This step was provoked by agrarian riots in the Deccan in the late 19th century that brought forth the issue of farmer indebtedness to moneylender to British Government. The agrarian riots prompted the British Government to give thrust to the system of Taccavi loans to farmers, regulate money lending and promote rural credit cooperatives as an alternative to money lenders. The rural credit cooperatives in India became a means of pooling the few resources of the poor and providing them with access to different financial services.

However, not much was achieved until independence when credit cooperatives were chosen by the government as an institutional mechanism for delivering credit to the farm sector. Choice of credit cooperatives was inevitable in immediate context of post independence. On one hand commercial banks had very low presence in the rural areas and on the other all commercial banks were in the private sector and political imperative of the time did now allow government to provide an appropriate set of incentives to commercial banks to venture into the rural areas. In such a situation, cooperatives were the only option given their spatial spread and penetration in remote areas. In terms of finance policy the approach was supply-
driven with provision of subsidized credit through state controlled or directed institutions to rural population.

However, rural cooperatives were riddled with plethora of problems. The 1945 Cooperative Planning Committee found that a large number of cooperatives were “saddled with the problem of frozen assets because of heavy over dues in repayment.” All India Rural Credit Survey in 1947 brought out that only 3% of the total borrowing of the cultivators was being met through the cooperatives. It also revealed that the share of Institutional agencies, comprising the government, the cooperatives and the commercial banks, in financing the borrowings of rural household was only 7.3 per cent in 1951-52 corresponding to the share of private money lenders which was as high as 68.6 per cent. With large scale failure of credit cooperatives the stage was set for some fundamental changes in microfinance institutional delivery.

Phase II: 1969 - 1991

State Driven Rural Finance through National Banks and Emergence of NGOs in microfinance space

The nationalization of Banks in 1969 along with a strong political emphasis towards poverty eradication led to a new rural finance policy that was directed at reducing the lending imbalances in particular sectors. This new policy resulted in among other things to establishment of Regional Rural Banks (RRBs) and adoption of priority sector lending by Banks under direct specifications of the Reserve Bank of India (RBI). A decade later rural financial delivery got further boast in 1980-81 with the government sponsored Integrated Rural Development Programme (IRDP), under which loans of less than Rs 15,000 (USD 330) were given to poor. In 20 years since its implementation the financial assistance of approximately Rs 250 billion ($5.6 billion) was provided to roughly 55 million families. However, underneath such aggregated figures, at the ground level IRDP led to large scale misuse of credit. This created a negative perception about the credibility of the micro borrowers among bankers further hindering access to banking services for the low-income people.

In addition to this State led large scale program, some civil society organizations successfully experimented with microfinance models that were more appropriate for the needs of poor households. Some prominent example of this are SEWA Bank(Ahemedabad), Annapurna Mahila Mandal (Mumbai), and Working Women’s Forum (Chennai). The first Self Help Groups (SHGs) started emerging in the country in 1980s as a result of NGO activities such as MYRADA. In 1984-85 MYRADA started linking SHGs to banks, when the SHGs’ credit needs increased and the groups grew large enough for the bank to have transactions with. SHGs idea was taken up on a large scale later by NABARD scaling up Indian Microfinance to new heights.

Phase III: 1992 – 2000

SHGs bank Linkage program and Growth of NGO- MFIs

By 1990s the problems with both State promoted institutional forms viz. credit cooperative and RRBs in delivery of rural credit were quite evident. The credit cooperatives were crippled with poor governance, management and the poor financial health due to intrusive state patronage and politicization. RRBs financial position deteriorated due to the burden of directed credit and priority sector lending and a restrictive interest rate regime. The share of rural credit in the total credit
disbursement by commercial banks, which grew from 3.5 to 15 percent from 1971 to 1991, has now declined again to 11 percent in 1998 (Sa-Dhan, 2004). For the first two decades of their existence, political pressure and focus on outreach at the expense of prudent lending practices led to very high default rates with accumulated losses exceeding Rs. 3,000 crores in 1999 (Rajesh, 2004). In this background various qualitative issues such as concerns about financial viability of institutions on account of high rate of loan delinquency, cornering of subsidy by well off people, continued presence of moneylenders, inability to reach the core poor came out in forefront and resulted in reorientation in thinking around the 1990s. In addition to inherent problems with existing institution, the external factors also influenced Indian Microfinance. The macroeconomic crisis in early 1990s that led to introduction of Economic Reforms of 1991 resulted in greater autonomy to the financial sector. This also led to emergence of new generation private sector banks viz. UTI Bank, ICICI Bank, IDBI Bank and HDFC Bank that would become important players in microfinance sector a decade later.

An important development in this phase was SHG Bank linkage program by NABARD which greatly increased banking system outreach to otherwise unreached people and initiated a change in the bank’s outlook towards low-income families from beneficiaries to customers. The pioneering initiatives of MYRADA mentioned earlier, the SHG–Bank linkage program was scaled-up on a large scale by the NABARD in the year 1992 by giving guidelines to banks for financing SHGs through the banking system. With the success of this program RBI in 1996 took the policy decision to include financing to SHGs as a mainstream activity of banks under their priority sector lending. Since then the banking system comprising public and private sector commercial banks, regional rural banks and cooperative banks has joined hands with several organizations in the formal and non-formal sectors to use this delivery mechanism for providing financial services to a large number of poor. Following such attempts the face of the Indian financial sector changed and the focus changed from excessive subsidization of bank credit to lending at market rates.

This period also witnessed the entry of another set of stakeholders Microfinance Institutions (MFIs), largely of non-profit origins, with existing development programs. MFIs consist of Refinance Institutions, Banks, Non Government Organizations (NGOs) and Self Help Groups dealing with small loans and deposits in rural, semi urban or urban areas enabling people to raise savings, productive investments and thereby their standard of living (Nadarajan and Ponmurugan, 2006). (Jayasheela et at, 2007). International success of Microfinance in Bangladesh, Indonesia and in Latin America also influenced the thinking in Indian Microfinance towards commercialization.

Another remarkable achievement during this phase was the creation of a new generation of cooperatives viz. “Mutually Aided Cooperative Societies” (MACS), which lie outside the state control. This was done mainly in an attempt to reform the cooperative system.

**Phase IV: 2000 – today**  
**Commercialization of Microfinance**

Since 2000, the microfinance sector saw some radical changes in many aspects. While the prime objective remains poverty alleviation with new terms of inclusive growth or financial inclusion, sector moved from sole social return approach to double bottom line approach of social and financial returns. This change in approach
led to many changes in the functioning of microfinance. The emphasis on ‘bottom of the pyramid’ and good financial returns of some of leading MFIs, brought many mainstream commercial entities taking interest in the sector not only as part of their corporate responsibility but as new business line. One among prominent example in Indian context is ICICI Bank that adopted innovative ways in partnering with NGO-MFIs and other rural organizations to extend their reach into rural markets. UN declaration of Microfinance year in 2005 gave further impetus towards recognition of microfinance as a poverty alleviation tool and was able to attract a lot interest from large commercial entities such as foreign banks, investors, pension funds etc. This resulted in their participation in the sector for social and commercial return.

The MFIs side experienced similar appetite for increasing commercialization to scale-up its operations and profit. This translated into a number of changes. Increasingly NGO-MFIs began transforming into regulated legal formats such as Non-Banking Finance Companies (NBFCs) or section 25 companies to attract commercial investment and become eligible for deposit taking entity which could be an easy source of fund for lending but remains untapped. Today's MFIs, particularly those which were founded after 2000, look and think differently from those of the 1990s. Many of these “second generation” MFIs are promoted by entrepreneurs with mainstream corporate experience. Today, MFIs relate better to the market and see themselves as businesses in the financial services space, catering to an untapped market segment while creating value for their shareholders. This overriding shift in orientation from development to social entrepreneurship has brought about changes in institutions' legal forms, capital structures, sources of funds, growth strategies, and strategic alliances. Many first generation MFIs have subsequently transformed into regulated, for profit business models and legal structures. With increasing out reach and focus on profit, increasingly MFIs emerged as strategic partners to banks, consumers finance, retailers interested in reaching out to India's low income client segments. A parallel trend is the increased activity in the meso-level segment, which largely extends consumer credit. Lead by pioneers such as Citi Financial and GE Money, today this space has players such as HSBC's Pragati Finance, Standard Chartered's Prime Financials, Fullerton India, and DBS Cholamandalam.

At the policy level, government has recognized the microfinance as important player towards achieving Financial Inclusion. In 2006, government has also table a Microfinance Regulation and Development Bill which seek to promote and regulate the microfinance organizations. While the bill itself has come under severe criticism on account of some critical loopholes, this is a landmark step towards recognition of civil society organization in microfinance space.

Conclusion

Indian Microfinance today is a dynamic space with multitude of players offering various products and services to low income clients with different approaches. Banking system along with other legal forms such as NBFCs, Section 25 companies, cooperatives and NGO-MFIs all are approaching rural markets. Many new forms of relationships are emerging among these entities to leverage on each others strength. However, despite such new developments the penetration of microfinance remains low and spread highly skewed in Southern India. Indeed there are ample gaps to be filled and this would lead to further changes in Microfinance space in future.
Reference:


