**Product Mix and product Innovation of Microfinance in India**

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**Abstract:**

The main objective of this study is to conceptualize the operational methodologies for formal microfinance institutions in rural India. The study reflects the supply of customized financial products and the rational or irrational behavior of formal lending institutions. The study explains the clientele behavior on the strong belief in the superiority of the formal sector along with the misunderstandings of the nature, magnitude and role of the formal microfinance sector.

The study analyses the product design and product customization of microfinance products and the impact of penetration of microfinance product in inaccessible rural areas of India. The effectiveness of credit customization was proved under the study and an attempt was made to understand the concepts behind the credit customization.

Under the study, various microfinance product structure and innovations of various microfinance institutions were reviewed. The success or failures of product mix and product innovation were discussed. The study also reveals the success of SHG revolution and the degree of success contributed by product substitution and product innovation in Microfinance in rural India.

Under the study, the factors which created speculation in the Microfinance sectors in Rural India, were critically examined and the root cause, and cause and effect analysis were made. Regional and location specific factors, which governs the actual success or failure of microfinance, were found out and various situational methodologies to tackle critical problems were discussed under this study.
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**Introduction**

Microfinance is one of the few market-based, scaleable anti-poverty solutions. Microfinance refers to providing access to financial services to poor households in rural and urban areas. To most, microfinance means the provision of very small loans (microcredit) to help the poor to invest in or scale up their small business (microenterprises). Over a period, microfinance evolved a broader range of services like credit, savings, insurance, etc. This is because providers have realized that the poor, who lack access to traditional formal financial institutions, require a variety of financial products.

The innovation in microfinance sector is more based on rural and microenterprise environment, livelihoods and financial service preferences. For microfinance institutions, it is based on the survival strategies in the competitive markets. There were a lot of product and process invitations recorded in the microfinance sector in India. Rural financial services were made more available by customization of product and credit flow. Higher penetration of MFIs was possible in even the remotest pockets of India due to the process innovations and strategies. Different models of credit flows, repayment schedules, and financial products were designed based on the local demand and preferences, and more focused on socio-psycho conditions of the clients.

**Objectives**

1. To understand the innovations of the products and processes in microfinance in India.
2. To understand the success and failure of product and process innovation in microfinance.
3. To understand the strategies for penetration of microfinance products.

**Methodology of the study**

The study is made by extensive review of secondary information available at different sources. Apart from document and literature scanning, personal discussions were conducted with villagers, MFI clients and MFIs. Broadly this study is a qualitative study and based on document reviews.
Microfinance institutions

The microfinance market in India covers around 75 million potential poor households and this microfinance market in India is the largest in the world. The average household demand varies from Rupees 2000 to Rupees 6000 in Rural areas and Rupees 9000 in urban setting where 80 percent of the clients from rural areas and the total credit demand varies between Rupees 225 billion to Rupees 500 billion. Understanding the reality of the business, MFIs started developing in India.

MFIs are those, which provide thrift, credit and other financial services and products of very small amounts, mainly to the poor, in rural, semi-urban or urban areas for enabling them to raise their income level and improve living standards. These MFIs are classified as,

- NGOs, which are mainly engaged in promoting self-help groups (SHGs) and their federations at a cluster level, and linking SHGs with banks
- NGOs directly lending to borrowers, who are either organized into SHGs or into Grameen Bank style groups and centres. These NGOs borrow bulk funds from various donors.
- MFIs which are specifically organized as cooperatives
- MFIs, which are organized as non-banking finance companies, such as BASIX, SKS Microfinance etc.

Indian MFIs are mostly NGOs i.e., nearly 80 per cent of the MFIs operate under the Society/Trust form with a clear development agenda. Ten per cent of MFIs operate under the Company structure; five per cent are Section 25 companies of Indian companies act; two per cent as Cooperatives; two per cent as Non Banking Finance Companies (NBFCs); and one per cent as Local Area Banks.

Growth of MFIs

The new generation microfinance institutions had demonstrated slow pace in coming to India. Low levels of grants to microfinance institutions, an unfavourable policy environment, substantial traditional banking infrastructure and a search for context specific solutions has constrained rapid scale up. The total outreach of the existing specialized microfinance service providers is though limited in states like Orissa, Chattishgarh and Jharkhand but demonstrated remarkable growth in the country as a whole. The major players existed in the market were Basix, KAS Foundation, SEWA Bank, Share Micro Finance, Sanghamitra, Sadhan, SKS Microfinance, Ashmita1. The coverage area of these playera are also limited. The reason was being late entry and less field works.

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1 Basix, Kas Foundation, Sanghamitra, Ashmita, SKS Microfinance are the Mainstream MFI.
During SHG revolution in India, rapid introduction of a range of savings-credit products was made by NGO based MFIs for expanding their microcredit clientele. At the early nineties, SHG concept was spread out by NGOs as SHG became a tool for initiating a developmental and livelihood project. NGOs were governed by grants and a part of that grant percolated as a grant for SHGs. The major focus was initiation of internal saving rather than provision of external credit. The external credit was generally geared by a grant from NGO or a bank loan from a commercial nationalized bank with the support of more than six month of internal saving. In this system, the provision of grant or loan was focus to the group rather than individual clients.

The scenario was changed by the invasion of new generation MFIs in the early 2000. Credit became the main theme and individual clientele became the main focus. Rural financial products like credits and insurance dominated conventional saving style. At the heart of this dilemma is the way people’s savings is viewed.

**Innovation and Penetration of Microfinance Product**

The efficient and effective penetration of Microfinance and Rural Financial Products in India was done through Federation of Self Help Groups. Self help groups were the launching pad for the microfinance product penetration and practiced by almost all the MFIs. Some of the NGOs/or MFIs that penetrated largely through SHG Federation are, PREM, BASIX, SKS Microfinance, KAS Foundation, BISWA, Ashmita, Sanghamitra etc.

One of the major initiations on the penetration rural financial product was taken by the Government of India in 1999 through the extensive network of the formal banking sector i.e., 196 Regional Rural Banks (RRBs) spread over 14,000 branches in 375 districts nation-wide, covering, on an average, about three villages per branch. The rural banking system demonstrated an even more impressive coverage touching the nook and corner of India. Together, the RRBs, the nationalized commercial banks and the credit cooperatives — comprising of Primary Agricultural Credit Societies (PACS) and Primary/State Land Development Banks (P/SLDS) — have one branch for every 4,000 rural residents (Bhatt and Thorat, 2001).

The effective microfinance product penetration by private and/or Non-government MFIs into remote areas and large number of clients was due to two important innovations,

1. Individual counseling/personal counseling to the clients by MFI/NGO
The two most specific strategies geared the microfinance in India was, (1) Self Help Groups, and (2) Structuring Repayment Schedule

I. Self Help Groups

During 2004, the mainstream MFIs came out of the concept of Women SHG (of NGOs) and started forming Male SHG for up scaling the business and it has been demonstrated that the repayment was regular and credit disbursal was also more. The reason being, the loan was to support their existing business. For Example, KAS Foundation, Ashmita and SKS Microfinance have disbursed small loans to small businessmen by forming a male SHG. The only problem in this model is that, the male SHG is only for business as the responsibility is individual, loan is individual and repayment is individual.

II. Structuring Repayment Schedule

This changed figures of pre active SHG and active SHG movement is certainly due to product innovation and product customization in MF Sector. MFIs now design the repayment schedules according to the income realization pattern of the clients. Different repayment schedules are structured for different clients and the portfolio at risk is minimized at higher scale. The main stream MFIs now used to commission independent impact studies to findout the missing links and loopholes there by increasing product customization and product innovation.

For the loan disbursal to the clients, MFIs used methodologies that were radical, subsequent innovations, especially in terms of broadening the range of financial service by designing more suitable financial products with a better fit with the livelihood opportunities and constraints of the clients. Methodologies are particular and specific innovation for the MFIs. Some MFIs work on the basis of peer pressure( Example: SKS microfinance, KAS Foundation, Ashimita, Sanghamitra, Share Microfin, FWWB, Spandand, Sa-dhan etc.) while, some other MFIs works on the basis of livelihood opportunity( For Example: BASIX, DHAN Foundation etc.).

Over the time MFIs widened their cliental base by financing both individuals and group of individuals for productive uses as well as consumptive uses. Commonly the MFIs develop the business propositions by a cleaver scanning of the geographic location, socio-psycho behaviors and culture of people and specific business/activities. For example, KAS foundation and Ashmita has
financed for small business Kiosks, diary enterprises, beetle vein cultivation etc. and they have provided insurance for each of the loan. In fact the insurance deduction is done at the time of the loan disbursal. In almost all cases, the loaner gets the net amount equal to the loan minus insurance.

The basic fundamental behind the product designing and product innovation was,

- The MFI has a clear understanding of the market. The poor are nothing but clients and are willing to pay for access and convenience. Lending at the clientele doorstep, low transaction cost, small transition period and application procedures are simple and clearly understood by the clients.
- MFIs technique to bring down the administrative costs. Working procedures are simplified and approvals became decentralized.
- MFIs own technique to enhance the repayments by
  1. Self selection of the groups in which members guarantee each other’s loans
  2. Intensive motivation and supervision of borrowers by MFI by everyday visit/weekly visit/ fortnight visit etc.
  3. Incentives for borrowers, offers of progressively larger loans and compulsory savings requirements.

The supply of insurance services to the poor has increased substantially from 2000 onwards. There are a large number of low premium schemes, which covers against death, accidents, natural calamities, and loss of assets due to fire, theft, etc. Also MFIs extended insurances against crop, Livestock and other business along with the subsidized loans. KAS Foundation in Orissa has demonstrated its efficiency and effectiveness by bringing all the clients (Loan was disbursed against livestock enterprising) into livestock insurance.

One of the important innovations in Microfinance is bringing Non Timber Forest Products (NTFP) collectors into Self Help Groups (SHGs) and linking the Self Help Groups to Microfinance without physical collateral. This typical model was a innovation of small NGOs in Orissa working in tribal belts.

Adhikar, a NGO-MFI in Orissa set up an organization of oriya migrants (Workers Cooperations) and provided credit and saving services through cooperatives. Adhikar used remittance along with saving as an entry point activity.
The achievements by some of the major MFIs in India due their innovative strategies were,

- Membership of Sa-Dhan (a leading association) has expanded from 43 to 96 Community Development Finance Institutions during 2001-04. During the same period, loans outstanding of these member MFIs have gone up from US$15 million to US$101 million.

- The CARE CASHE Programme worked with small NGO-MFIs and community owned-managed microfinance organisations. Outreach has expanded from 39,000 to around 300,000 women members over 2001-05. Many of the 26 CASHE partners and another 136 community organisations these NGO-MFIs work with, represent the next level of emerging MFIs and some of these are already dealing with ICICI Bank and ABN Amro.

- The outreach of SHARE Microfin Limited, grew from 1,875 to 86,905 members between 2000 and 2005 and its loan portfolio has grown from US$0.47 million to US$40 million.

### Innovation of partnership model among MFIs, Banks and other Institutions/Organisations

The inter collaboration of MFIs has speed up the penetration of Micro Financial Products in to rural India. For Example, KAS foundation and BISWA have collaborated with ICICI Lombard. KAS Foundation and BISWA provide micro loan for Income generation activities to SHG/Groups/Individuals in groups or SHGs, and ICICI Lombard provides Micro Insurance on the business/income generation activities supported by KAS Foundation and BISWA. Similarly, SKS Micro finance had tied up with Life Insurance Corporation to provide health insurance and it covered 150,000 SKS clients and their spouses in the case of death. Loans provided by SKS will be written off and principal and interest paid will be returned to the client’s family in case of death of the clients. This is one of
the innovation and milestone for micro finance and micro insurance. Basix has partnered with ICICI for Micro Loan Securitisation (This is a buy-out of Basix’s crop loans by ICICI Bank).

This reason behind this particular innovation of intercollaboration of MFIs was mainly to reduce transaction cost per service, improving customer base, retaining customer loyalty, better and effective information sharing on customer’s financial transaction.

In 2002, BASIX and AVIVA jointly designed a group life insurance product to provide life insurance to all BASIX credit customers, where the sum assured was up to one and a half times the loan amount. BASIX entered into an agency relationship by December 2003 with non-loanees too. Thus, the local area bank, KBS, which was a part of the BASIX group, could offer life insurance to all deposit holders of the bank. For livestock and health insurance, BASIX worked with Royal Sundaram. BASIX started the distribution of livestock insurance in 2002 and worked with the insurance company towards product and process simplification and began to offer health insurance to all its credit customers. BASIX, in collaboration with ICICI Lombard and with technical assistance from the Commodity Risk Management of the World Bank, piloted the sale of rainfall-indexed weather insurance to 230 farmers during the monsoon season of 2003. Within a span of three years, this pilot programme has become a full-scale weather insurance programme. In the monsoon of 2005, BASIX sold 7,685 policies to 6,703 customers in 36 locations across Andhra Pradesh, Karnataka, Jharkhand, Madhya Pradesh, Maharashtra and Orissa.

Economies of scale and imaginative uses of technology and effective innovations have brought costs and interest rates down for MFIs. Analysing and understanding the vast opportunity, SKS Micro finance has planned to offer more micro financial product not only to rural household but also to urban poor. These includes additional loan products, such as housing, auto and education, new insurance schemes for health, life and assets and unique services like remittances.

Reduction of the cost of bad debt is done by intercollaboration of MFIs and providing on time rebate. For Example, BASIX has collaborated with local grassroot level non Government Organisations, agribusiness firms, and commercial financial institutions. These partners have better informal information about the potential borers and clear understanding on the borrower’s repayment history. Also to remunerate customer service agent based repayment, BASIX gives on time repayment rebate to its’ borrowers.
The most successful operation of MFIs is through strengthened linkages with their formal sector counterparts. The mutually beneficial partnership is based on comparative strengths of each sector. MFIs (Mainstream MFI and NGOs) have comparative advantage in terms of small transaction costs achieved through adaptability and flexibility of operations as they are the locational and situational leaders. They are better equipped to deal with credit assessment of the client and the transaction costs associated with loan processing. On the other hand, formal sector institutions have access to broader resource-base and high leverage through deposit mobilization.

ICICI Bank, the second-largest private commercial bank in India, has aggressively doubled its rural microfinance and agri-business loan portfolio over a period of nine months by April, 2006. The outstanding in group’s total rural microfinance and agri-business portfolio has increased to Rs 10,000 crore in 2006 compared to Rs 5,200 crore in 2005. This comes from an outreach of 3.2 million low-income clients. Simultaneously, the bank has also increased its partner strength of microfinance institutions (MFIs) to 102, from 49, from 2005 to 2006. The bank plans to partner with 200-250 MFIs, each serving three districts in the country, thus reaching out to 600 in all across the country, through a mix of its products and channels.

ICICI’s microfinance portfolio has increased from 10,000 microfinance clients in 2001, to 1.2 million clients through its partner microfinance institutions, and its outstanding portfolio has increased from Rs. 0.20 billion (US$4.5 million) to Rs. 9.98 billion (US$227 million). The rapid growth of ICICI was due to its partnership model of action, where,

- MFI act as a collection agent instead of financial intermediary. Micro loans are contracted directly between the bank and the clients, so that the risk for the MFI is separated from the risk inherent in the portfolio.
- Securitisation: Another way to enter into partnership with MFIs is to securitize microfinance portfolios.

Microfinance became a priority sector for banks due to high risk adjusted returns and many banks (Private and Government) tied up with MFIs with varieties of innovative models. Some of these innovations are,

- Lending wholesale loan funds.
- Assessing and buying out microfinance debt (securitisation).
- Testing and rolling out specific retail products such as the Kissan (Farmer) Credit Card.
- Engaging microfinance institutions as agents, which are paid for loan origination and recovery, with loans being held on the books of banks.
Equity investments into newly emerging MFIs.

With technical and financial support from SIDBI, ICICI Bank, HDFC, Citigroup, Grameen Foundation (and its new joint venture, Grameen Capital India), Friends of Women’s World Banking (FWWB), Unitus, and others, three MFIs, i.e, SKS Microfinance, Share Microfinance and Spandana have served more than 1.5 million families, most of them very poor when they started accessing micro-financial services by 2006. Sa-Dhan, one of the MFIs have alone had achieved an outreach of 6.5 million families and the sector-wide loan portfolio is Rs 2,500 crore.

Comparison of interest rates of various sources after adjusting for transaction cost

<table>
<thead>
<tr>
<th>Sources/Types of loan</th>
<th>Quoted interest rates</th>
<th>Effective interest rates including transaction cost</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank loan to SHGs</td>
<td>12-13.5%</td>
<td>21-24 %</td>
<td>Numbers of visit to banks, compulsory saving and cost incurred for payments to animators/staffs/local leaders</td>
</tr>
<tr>
<td>MFI Loan to micro borrowers</td>
<td>15-24 %</td>
<td>15-24 %</td>
<td>No transaction cost except time spent in meeting</td>
</tr>
<tr>
<td>Money lenders, land lords, traders</td>
<td>36-120 %</td>
<td>48 -150 %</td>
<td></td>
</tr>
</tbody>
</table>

Contribution of Different Segment of Financial Institutions (Excluding the private MFIs) for SHG Financing

<table>
<thead>
<tr>
<th>Sources of MFI Funding</th>
<th>Cumulative Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Loan</td>
<td>62%</td>
</tr>
<tr>
<td>Self Generated Fund</td>
<td>21%</td>
</tr>
<tr>
<td>Donor Fund</td>
<td>9%</td>
</tr>
<tr>
<td>Members Saving</td>
<td>8%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>of SHGs Provided with bank Loan up to March 2001</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>Total Public Sector Bank</td>
<td>118855</td>
</tr>
<tr>
<td>Total Private Sector Bank</td>
<td>5391</td>
</tr>
<tr>
<td>Total RRBs</td>
<td>84775</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>12773</td>
</tr>
<tr>
<td>Total</td>
<td>221794</td>
</tr>
</tbody>
</table>

*By, 2006, under the SHG- Bank linkage programme, 560 banks including 48 commercial banks, 196 RRBs, 316 cooperatives were actively involved.

Credit Mechanism adopted by HDFC, India for funding the low income group was found to be interesting. HDFC had collaborated with organisations, both, Governmental and Non-Governmental. Such organisations have acted as coordinating agencies for the projects involving a collective of individuals belonging to the Economically Weaker Sections. The projects could be either in urban or rural areas. The security for the loan is generally the mortgage of the property being financed. The purpose of the loan is regularly monitored by the coordinating agencies and HDFC. The loans from HDFC were disbursed based on scanning of the various parameters for the purpose of the loan. To date, HDFC has experienced 100% recovery for the loans disbursed to various projects.

**Securitization of Micro Loans: a successful innovative strategy**

Micro loan securitization benefited MFIs in several ways. It decreased financial products to interested investors (such as other banks that can register such a security as a priority-sector investment). In a securitization deal, the MFI is still responsible for collecting the micro loans from its clients but the risk of repayment default is not backed by any of the MFI’s assets.

As collateral, the bank uses a first-loss default guarantee financed by the excess spread on the MFI portfolio (which is the difference between the rate of return expected by the bank on the microfinance portfolio and the rate charged by the MFI to its clients) or provided by a third party, such as the Grameen Foundation funding of the guarantee their cost of funds, provides a new source of off-balance sheet funding, and thus allows an MFI to expand lending operations.

In 2004, the largest ever securitisation deal in microfinance was signed between ICICI Bank and SHARE Microfin Ltd, a large MFI operating in rural areas of India.

Under this agreement, ICICI purchases SHARE Microfin Ltd ‘s portfolio and re-
sold it as a package in the SHARE deal. ICICI had purchased a part of SHARE's microfinance portfolio against a consideration calculated by computing the Net Present Value of receivables amounting to Rs. 215 million (US$4.9 million) at an agreed discount rate. The interest paid by SHARE is almost 4% less than the rate paid in commercial loans. Partial credit provision was provided by SHARE in the form of a guarantee amounting to 8% of the receivables under the portfolio, by way of a lien on fixed deposit. This deal frees up equity capital, allowing SHARE to scale up its lending. On the other hand, it allows ICICI Bank to reach new markets. And by trading this high quality asset in capital markets, the bank can hedge its own risks. In another case ICICI Lombard partnered with BASIX and running a programme on Weather – Index Crop Insurance.

**Limitations in the operations of MFIs**

The product innovations were different and specific to MFIs, but all focus on one feature that is all geared towards providing the clients a wider range of financial products and intermediation options. These innovations are competing strategies and competitive advantage for the MFIs. But most of the time people get confused about these innovations and there are circumstances when people wrongly manipulate these innovations as faulty practices. Even sometimes the missing links lead to a conflict and street fight.

Over the time, the clients differentiation on NGO based MFI from pure mainstream MFI is viewed based on their strategic innovation. Although the financial services are more flexible and tailored closely to the preferences of the clients still in many cases people feel that the loan from MFI should be a grant or a loan with out interest. These differentiations become a dilemma and subsequently led to conflicts in many situations.

**Conclusions**

The innovations in Microfinance sector has made a dramatic change in the supply of credit to the most needy, neglected sector by formal financial institutions. The most important innovation that has come up is that societal upliftment and social development is no longer grant based. People have realized that the formal credit is more important and yielding than grants. The most important impact of this innovation is the development of confidence among poor and their realization to grow according to their own plan rather than the grant/assistance provider.

The results of innovations in microfinance sectors were,
1. Data mining: Analysis of data which acted as a decision-support tool to increase the accuracy, efficiency and effectiveness (credit scoring, promotion of mass customization of products and services, and target adjustments to maintain customer loyalty.

2. Transaction costs of credit products were reduced: Some examples include reduced transaction costs for rural credit, as these are on a fixed term and require a simpler "back-office." With this innovation, less time is required from the teller as there is only one installment for the reimbursement and so it is not necessary to make a payment notification or a book of coupons.

3. Transition period of loan disbursal was reduced.

4. Poor is made bankable: Microfinance transforms the lives of the poor and the high success rate has attracted formal financial institutions. The poor need financial services beyond credit like savings, insurance etc. Insurance companies have joined hands with MFIs and MFIs are focusing to provide inclusive financial service.

5. Institutionalization of MFIs in the formal banking sectors

6. Remittances: people receiving remittances are already microfinance clients, mainly parents, children, and relatives of the remitter and are dependent on remittances. Funds transferred can be used for food, education, health needs, and working capital for small businesses, construction, and savings by migrants

7. Securitization models were developed:

8. Micro-insurance products were developed

9. Collaborative models among MFIs and between MFIs and commercial Banks, were developed.

10. Development organizations were turned to MFIs.

The average loan per SHG members increase from Rs. 4282 to Rs. 8341 during the period 1998 to 2005. In the same period, the average share of burrowed fund reported to be used for production purpose increased from 72% to 85%. The share of the loan used for consumption purpose came down from 28% to 15%. The share of loans borrowed from moneylenders with high interest rates was significantly reduced from 42% of the total loan amount to 3%. Also the overall loan repayment by members of the SHG improved from 84% to 94%.
Abbreviations

DFID: Department for International Development
FWWB: Friends Women World Banking
MFI: Microfinance Institution
NABARD: National Bank of Agriculture & Rural Development
NGO: Non-Government Organisation
RRB: Regional Rural Banks
SIDBI: Small Industry Development Bank of India
SHG: Self Help Group

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