

Microfinance and Strategy of Financial Inclusion in India

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Abstract

The main aim of this paper is to evaluate the role of microfinance for empowering the people and realization of government's policy of financial inclusion in India. However, there are certain concerns about the efficiency of Microfinance Institutions in handling public money, their targeted growth, achievement of policy goals and demand and supply management of funds. Today, the Microfinance Institutions demand the government to empower them for mobilizing public savings. With increasing demand for rural finance, and the inadequacies of formal sources of finance, the Microfinance Institutions have immense opportunities in the new incarnation of micro credit in India. However, in the light of recent experiences, and the need for qualitative economic growth, we suggest that Microfinance Institutions should be managed with better scrutiny in terms of finance and technology as well as social responsibility. This is to be of utmost importance in order to upgrade Microfinance Institutions from thrift and credit institutions to capacity-generating and livelihood- managing groups of people. Non Governmental Organizations have played a commendable role in promoting Self Help Groups by linking them with banks. There is, therefore, a need to evolve an incentive based package which should motivate these NGOs to diversify themselves into other backward areas.

Keywords: Microfinance, Financial Inclusion, Self Help Groups, Institutional Credit

Introduction

Microfinance is one of the very important input resources for the economic growth and development of India. Availability of microfinance at the right time, in the right quantity and at an affordable rate of interest, contributes to the economic welfare of the people particularly in the lower strata of the society. Thus access to finance, especially by the poor and vulnerable groups is a prerequisite for employment generation, economic growth, poverty reduction and social cohesion. Further, access to finance will empower the vulnerable sections of the people by giving them an opportunity to have a bank account, to save money and to invest, to partake in credit creation, thereby facilitating them to break the vicious circle of poverty. But India is lagging behind in this respect so it has become the matter of concern.

In 1947, the first survey of rural indebtedness (All India Rural Credit Survey) conducted by the Reserve Bank of India (RBI) documented that moneylenders and other informal lenders met more than 90 per cent of rural credit needs. The share of banks in particular was only about 1 per cent in total rural household debt. The ratio remained low until 1971 when it was 2.4 per cent, although the share of formal sources of credit in rural areas increased steadily to 29 per cent due to the rising share of cooperatives.

The Situation Assessment Survey of Farmers (Access to Modern Technology for Farming) NSS 59th Round, January- December- 2003, Report no. 499(59/33/2), indicated that out of the total 89.3 million farmer households in the country, 84 percent (750 million) households were small and marginal farmers and more than half (51.4 percent) of the total households were non-indebted. Further, out of the total 43.4 million indebted households, 20.3 million (46.8 percent) households had availed financial services from informal sources. The above said report also indicate that 45.9 million farmer households in the country that is, 51.4 per cent out of the total 89.3 million households do not access credit either from institutional and non institutional sources. Further, only 27 per cent of the total farm households are indebted to formal sources; in other words 70 per cent of the farmhouses do not have access to formal credit sources. Banking data reveal that credit exclusion is severe in 139 districts of the country. In these districts, only 10 per cent or less out of 100 persons have access to credit from the fact that the exclusion is large, there is also a wide variation across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion.

The results of the All-India Debt and Investment Survey of 2002, also indicate that the share of the non-institutional sources, in the total credit of the cultivator households, had increased from 30.6 percent in 1991 to 38.9 percent in 2002. The inference of these findings is that in spite of a large network of the institutional credit system, it has not been able to adequately penetrate the informal rural financial markets and the non-institutional sources continue to play a dominant role in purveying the credit needs of the people residing in rural areas. Thus, important challenge facing the banking sector is to extend financial services to all sections of society. Like others, the poor need a range of financial services that are convenient, flexible, and affordable and not just loans. At this juncture the introduction on "financial inclusion" comes from the recognition that this can

serve the interests of both society and the banking system. As a complementary to this, micro-finance, one can work as a powerful tool to fight poverty became the effective approach of financial inclusion. With the new philosophy and policies pertaining to micro credit, micro finance institutions, such as Self Help Groups have emerged and they now have a strong footing in the developing countries such as Bangladesh, India etc.

Objectives

The objectives for this paper are as follows:

01. To explain the role and importance of financial inclusion in Indian Financial System.
02. To analyze the different approaches of financial inclusion.
03. To examine the role of banking system in extending banking services for financial inclusion.
04. To enumerate the achievements and problems of SHG microfinance in including the excluded section of the society.
05. To suggest some policy prescriptions.

Strategy of Financial Inclusion:

C. Rangarajan has recommended six approaches in the system of Financial Inclusion, they are, as follows.

- (01). Credit to the farmer households is one of the important elements of financial inclusion. Access of credit to the marginal and sub marginal farmers as well as other small borrowers is crucial to the need of the hour.
- (02). Rural branches must go beyond providing credit to the farmers. These branches should extend a helping hand in terms of advice on a wide variety of matters relating to agriculture.
- (03). In districts where population per branch is much higher than the national average commercial banks may be encouraged to open the branches.
- (04). There is need for the simplification of the procedures in relation to granting of loans to small borrowers.
- (05). Further strengthening the SHG-Bank Linkage Programs (BLP), as it has proved to be an effective way of providing credit to very small borrowers.
- (06). The business facilitators and corresponding models need to be effectively implemented.

Financial Inclusion: Meaning and Challenges

The banking industry has shown tremendous growth in volume and complexity during the last few decades. Despite making significant improvements in all the areas relating to financial viability, profitability and competitiveness, there are concerns that banks have not been able to include vast segment of the population, especially the underprivileged sections of the society, into the fold of basic banking services. So, this lead to the emergence of Financial Inclusion as a strategy to bring so called excluded people in to the mainstream.. Financial inclusion is delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups. As banking services are in the nature of public good, it is essential that availability of banking and payment services to the entire population without discrimination is the prime objective of the public policy. Although credit is the most important component, financial inclusion covers various financial services such as savings insurance, payments and remittance facilities by the formal financial system to those who tend to be excluded. In India, the drive for financial inclusion, initiated by the Reserve Bank of India, has thus far involved ensuring access to at least one zero minimum-balance 'no frills' savings bank account to every household. In this context, at least one district in each state has been brought under the purview of this drive with public sector banks in the region taking the lead to open at least one bank account per family in the district. The broad objective of Financial Inclusion is to extend the scope of activities of the organized financial system to include within its ambit people with low incomes. Through graduated credit, the attempts must be to lift the poor from one level to another so that they come out of poverty. Inclusive growth encompasses ideas related to basic needs and equity. It focuses on broad – based growth so that growth covers all strata of society. It seeks to bridge the various divides that may fragment the society. Reduction in poverty and disparities of income and ensuring everyone a basic minimum standard of living are the objective of inclusive growth. In this context access to finance by the poor and vulnerable groups has to be recognized as a pre requisite for poverty reduction and social cohesion. It has to become an integral part of the efforts to promote inclusive growth. In fact, providing access to finance is a form of empowerment of the vulnerable groups. Thus, limited access to affordable financial services such as savings, loan, remittance and insurance services by the vast majority of the population in the rural areas and unorganized sector is believed to be acting as a constraint to the growth impetus in these sectors.

Access to affordable financial services - especially credit and insurance - enlarges livelihood opportunities and empowers the poor to take charge of their lives. Such empowerment aids social and political stability. Apart from these benefits, FI imparts formal identity, provides access to the payments system and to savings safety net

like deposit insurance. Hence FI is considered to be critical for achieving inclusive growth; which itself is required for ensuring overall sustainable overall growth in the country. The financially excluded sections largely comprise marginal farmers, landless laborers, oral lessees, self employed and unorganized sector enterprises, urban slum dwellers, migrants, ethnic minorities and socially excluded groups, senior citizens and women. Inclusive financial system, one that allows broader access to financial services, can lead to faster and more equitable growth. Such a system allows poor households to save and manage their money securely, decreases their vulnerability to economic shocks and allows them to contribute more actively to their development. Increasingly, with the proliferation of micro finance initiatives, there is evidence that inclusive financial systems can empower poor households socially as well in other words financial inclusion is delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups.

Although credit is the most important component, financial inclusion covers various financial services such as savings insurance, payments and remittance facilities by the formal financial system to those who tend to be excluded. In the context of India becoming one of the largest micro finance markets in the world especially in the growth of women's savings and credit groups such as Self Help Groups (SHGs) and the sustaining success of such institutions which has been demonstrated by the success of Self Employed Women Association (SEWA) bank in Gujarat, low cost banking is not necessarily an unviable venture/proposition. One common measure of FI is the percentage of adult population having bank accounts. Going by the available data of 2005, on the number of savings bank accounts and assuming that one person has only one account, (which assumption may not be correct as many persons could have more than one bank account) we find that on an all India basis 59 per cent of adult population in the country have bank accounts – in other words 41 per cent of the population is un-banked. In rural areas the coverage is 39 per cent against 60 per cent in urban areas. The un-banked population is higher in the North Eastern and Eastern regions. The extent of exclusion from credit markets is much more, as number of loan accounts constituted only 14 per cent of adult population. In rural areas, the coverage is 9.5 per cent against 14 per cent in urban areas. Regional differences are significant with the credit coverage at 25 per cent for the Southern Region and as low as 7, 8 and 9 per cent respectively in North Eastern, Eastern and Central Regions. The extent of exclusion from credit markets can be observed from a different viewpoint. Out of 203 million households in the country, 147 million are in rural areas, 89 million are farmer households. 51.4 per cent of farm households have no access to formal or informal sources of credit while 73 per cent have no access to formal sources of credit.

One of the benchmarks employed to assess the degree of reach of financial services to the population of the country, is the quantum of deposit accounts (current and savings) held as a ratio to the population. In northern region out of 100 persons only 43 persons hold an account in a bank. While coming to the North Eastern Region it is quite low that is just 19. Access to bank services is low, as well as there exists, a large variation across the regions in credit accessibility. Another thing is while compared to the developed world; the coverage of our financial services is quite low. For instance, as per a recent survey commissioned by British Bankers' Association, 92 to 94 per cent of the population of UK has either current or savings bank account. The figures ultimately reveal that there is lack of outreach of banking services to the population, at this juncture micro finance services doing well in bringing excluded population to the main stream of formal banking system.

Reasons to the growth of Micro finance through Self Help Groups.

After independence, the structure of rural credit institutions, with co-operative bank and mortgage bank catering to short term and long term credit needs respectively. The assessment of performance of co-operative by All India Rural Credit Survey Committee in 1954 brought the fact that volume of credit supplied by the cooperative movement was insignificant, accounting only 3 per cent of the total borrowing of cultivators. It revealed that the share of Institutional agencies, comprising the Government, the co-operative and 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 was high as 68.6 per cent.

The Nationalization of SBI in 1955 had drawn in to rural banking. But other commercial bank kept away from it. The All India Rural Credit Review Committee appointed by RBI under the chairman, B. Venkatappaiah, submitted its report in 1969, showed the inadequacy of co-operative system alone to meet the credit requirements of rural sector. Committee prepared the multi agency approach to rural finance. It was only with social control banks in late 1960's and Nationalization of 14 commercial banks in 1969, followed by 6 more in 1980, that rural orientation of commercial banks started in a systematic way.

In 1980-81, the Government initiated Integrated Rural Development Program (IRDP) with objective of directing subsidized loan to poor self-employed people through banking sector. The financial sector developed in India by the late 1980s was criticized as largely target and supply driven. High default rates; corruption and high degree of suspicion among bankers about the credit worthiness of poor people were the major features of the time. Savings products were inflexible and inappropriately designed and appropriate insurance products few and far between. On the credit side the while the in the rural borrowing supplied by informal sources fell to 40 per cent

in 1991, household with the least assets were far more dependent on informal sources. Borrowers faced high transaction costs to secure subsidized loans, making their real cost 22 to 33 percent. Formal financial sector unsuccessful to recognize the divergence between the hierarchies of credit needs and credit availability. The result is the adverse use of credit. Credit use start with consumption purpose, which are only being met, through informal sources at high cost. Higher needs come in to play when the lower needs are satisfies. However credit (often subsidized rate) is usually available for new enterprises (i.e. for diversification). Money is fungible, loan therefore taken for diversification but used in lower rungs of hierarchy. This implies that any appraisal of loan is not taken.

The success of few Non Governmental Organizations (NGOs) like Mysore Resettlement and Development Agency (MYRADA) in-group lending, made the government in shifting the strategy of women development and empowerment. Under Development of Women and Children in Rural Areas (DWCRA) program through group based approach. Thus group based approach started in a very modest manner. However the first interest in informal group lending in India took shape during 1986-87 on the initiative of NABARD. This apex bank for rural development, took a research project on SHGs as a channel for delivery of micro finance in the late 1980s. Amongst these MYRADA sponsored research project on 'Savings and credit management' of SHGs was partly funded by National Bank for Agriculture and Rural Development (NABARD) in 1986-87. In the very next year, in association with Asia Pacific Rural and Agricultural Credit Association' (APRACA), the bank (NABARD) undertook a survey of 43 NGOs in 11 states, to study the functioning of micro finance Self Help Groups (SHG) and their collaboration possibilities with the formal banking system. Both these research projects threw up the encouraging possibilities and NABARD initiated a pilot project called SHG-bank linkage project.

In 1991, the macro economic conditions propelled the government to introduce structural changes in the economy, commonly referred to as economic reforms of 1991. There has been drastic fall in rural credit. The share of rural credit in the total credit disbursement by commercial banks, which grew from 3.5 to 15 percent form 1971 to 1991, has now declined again to 11 percent in 1998. Even after the institutional finance came in to being as banking sector emerged, the need for 'micro' credit characteristically for the poor section of the society was unmet by the formal banking sector. The nature of formal banking sector, with its emphasis on 'collateral based lending' could not cater the needs of smaller borrowers, especially women, who were typically resource poor and possessed negligible assets to offer as collateral. Given the male dominated rural society, prior to 1990s there were hardly any credit schemes designed for rural women. All these development resulted in a fall in the availability of credit from formal financial system, leaving informal sources as well as SHGs and MFIs to fill this gap. Even the government policies are also stared focusing from development towards empowerment of women through group-based approach.

Micro finance: Meaning and Concerns

The linkage between "self help groups" and banks has been highly successful in furthering financial inclusion. The cooperation between the formal banking system and micro-finance organizations has also been encouraging. Micro finance (MF) in the recent past has emerged as a potential instrument for poverty alleviation and women empowerment. MF intervention refers to provision of access to small loans without physical collateral to the poor, especially the women, while encouraging them to save regularly in order to combine thrift and self-help for their own development. MFIs consist of Refinance Institutions, Banks, Non Government Organizations 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 .

As already told one of the ways in which access to formal banking services has been provided very successfully since the early 90s is through the linkage of Self Help Groups (SHGs) with banks. SHGs are groups of usually women who get together and pool their savings and give loans to members. Usually there is a NGO that promotes and nurture these groups. National Bank for Agriculture and Rural Development has played a very significant role in supporting group formation, linking them with banks as also promoting best practices. The SHG is given loan against guarantee of group members. The recovery experience has been very good. Banks provide credit to such groups at reasonable rates of interest. However the size of loans is quite small and used mostly for consumption smoothening or very small businesses. In some SHGs, credit is provided for agricultural activities and other livelihoods and could be several times the deposits made by the SHG. Microfinance has drawn attention to an entire sector of borrowers who had been previously poorly served by the formal financial sector - and MF has demonstrated how to make lending to this sector a viable proposition. However the rates of interest charged are quite high, typically 12 to 30 per cent, mainly on account of the high transaction cost for the average loan size that can be quite small. Compared to the informal sector, perhaps the rates are lower, but issues are raised whether these rates are affordable - in the sense whether they would leave any surplus in the hands of

the borrowers and lead to higher levels of living. For commercial banks, the lower cost of funding, advantages of size and scale gives scope for cross subsidization and their interest rates are more competitive compared to the MFIs, but they have not been as successful in dealing with the last mile issue. The partnering with SHGs and MFIs with reasonable cost of funding by the banks has been seen as a more optimal approach till now.

The financial inclusion attained through SHGs is sustainable and scalable on account of its various positive features. One of the distinctive features of the SHGBLP has been the high recovery rate. However the spread of SHGs is very uneven and is more concentrated in southern states. This regional imbalance needs to be corrected and special efforts in this regard may have to be made by NABARD. SHGs also needed to graduate from mere providers of credit for non-productive purposes to promoting micro enterprises. However, there is no need to provide interest rate subsidy to the SHGs. Banks do provide them credit at reasonable rate of interest.

There have been several institutional innovations in financial services by including civil society. Followed by the success of SHG- BLP and Bangladeshi Grameen model, many of the NGO's have taken to financial intermediation by adopting innovative delivery approaches. MFIs have been playing an important role in substituting moneylenders and reducing the burden on the formal financial institutions. With the objective of ensuring greater financial inclusion and increasing the outreach of the banking sector, banks have been allowed to use the services of NGO's, SHGs, MFIs and other civil society organizations as intermediaries in providing financial and banking services through the use of business facilitator and correspondent models. Provision for this kind of financial intermediation has opened new and diverse avenues to address the issue of financial inclusion by banks. The SHG-Bank Linkage Program launched by NABARD in 1992 continues to be the predominant Micro-Finance (MF) model in the country. It represents the union of the banking system comprising the public and private sector commercial banks, Regional Rural banks (RRB), and Co-operative Banks with several organizations in the formal and semiformal sectors to facilitate the provision of financial services to a large number of poor clients. It is a proven method of financial inclusion, providing un-banked rural clientele with access to formal financial services from the existing banking infrastructure.

However, one has to be very cautious about the attempts being made by the vested interest groups to substitute the need for expansion of formal banking structure to the hitherto un-banked areas with SHGs and NGOs, where complaints of high interest rates charged from ultimate borrowers and examples of coercion are not too insignificant. The Reserve Bank of India has identified large gap in the demand and supply of credit to the poor and suggests the urgent need to widen the scope, outreach and scale of financial services to cover the un-reached populace. Estimates reveal that the credit support for poor households in India is of the order of Rs.450,000 crore. Some micro level studies show that the poor still continue to depend on informal sources of credit, up to 60 per cent of the household demand. These initiatives, which were started as an outreach program, not only aimed to promote thrift and credit but made immense contribution towards empowerment of rural women. Micro finance still plays a modest role in India. At the All India Level less than 5 per cent of poor rural households have access to micro finance (as compared to 65 per cent in Bangladesh) with significant variation exists across the states. There is skewed growth of SHGs across the regions. The year 2006-07 witnessed the spread of the MF program in resource-poor regions of the country indicating a marked shift from its initial concentration in the southern region. The cumulative share of non southern regions rose from 29 per cent as on March 2001 to 48 per cent as on March 2007. This is mainly because of presence of large number of NGOs, operating in South Region.

Policy Prescriptions

It is becoming increasingly apparent that addressing financial exclusion will require a holistic approach on the part of the banks in creating awareness about financial products, education, and advice on money management, debt counseling, savings and affordable credit. The banks would have to evolve specific strategies to expand the outreach of their services in order to promote financial inclusion. One of the ways in which this can be achieved in a cost-effective manner is through forging linkages with microfinance institutions and local communities. Banks should give wide publicity to the facility of no frills account. Technology can be a very valuable tool in providing access to banking products in remote areas. According to Prof. M.S. Swaminathan, the noted agricultural scientist, "SHGs, will however, become sustainable only if they have backward linkages with technology and credit and forward linkages with processing and marketing organizations". ATMs cash dispensing machines can be modified suitably to make them user friendly for people who are illiterate, less educated or do not know English. The banks need to redesign their business strategies to incorporate specific plans to promote financial inclusion of low income group treating it both a business opportunity as well as a corporate social responsibility. They have to make use of all available resources including technology and expertise available with them as well as the MFIs and NGOs. NGOs have played a commendable role in promoting SHGs and linking them with banks. NGOs, being local initiators with their low resources, are finding it difficult to expand in other areas and regions. There is, therefore, a need to evolve an incentive package which should motivate these NGOs to diversify into other backward areas. Our banking system must be prepared to

deal with the opportunities of higher growth, and the challenges of ensuring more equitable growth. In dealing with the needs of rural enterprises and of small and medium enterprises in urban areas, banks have to look for new delivery mechanisms. These must economize on transaction costs and provide better access to the currently under-served.

To serve new rural credit needs, innovative channels for credit delivery will have to be found. A key requirement of greater “financial inclusion” would be a reduction of transaction costs. Till now, micro financing has been a grey area in the finance sector as the current laws allow only the entities registered with RBI to raise deposits and lending activities. In view of the rising micro-financing activities in the country, a need has been felt to regulate the unregulated business in this sector and also provide legal framework to facilitate the credit flow in rural areas. MFIs fear that regulation might stifle growth, but analysts say that it is important to put them under scanning. Micro-insurance is a key element in the financial services package for people at the bottom of the pyramid. The poor face more risks than the well off. It is becoming increasingly clear that micro-insurance needs a further push and guidance from the Regulator as well as the Government. Our study reveals that micro credit is not always the final answer or the best solution for unemployment or poverty or any other situation. Destitute and hungry people with no income or means of repayment need other kinds of support before they can make good use of the loans. Financial inclusion is but one species of a large genus of human capacity building. Prof. Swaminathan also suggests the establishment of SHG Capacity Building and Mentoring Centre. While the functioning of MFIs at the grassroots level ensures economic decentralization, for a complete empowerment such a measure must be supported by a broader human rights framework. Also, financial inclusion as a policy measure should be followed up by building up suitable database, which could serve as a guide to assess the impact of credit policies from time to time and reorient schemes of financial assistance to the targeted groups. The MFIs should be strengthened with the tools of managerial expertise, user-friendly technology and with the principles of good governance and social responsibility.

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