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Microfinance and its future directions

Keynote Address by Dr. C. Rangarajan Chairman Economic Advisory Council to the Prime Minister

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It gives me great pleasure to be here with you all this morning and to participate in this Policy Conference on Microfinance in India. The growth of Microfinance in India has reached a stage when future policy options have to be carefully weighed so that this movement can become truly a strong one. I am happy that this Conference is being attended by senior officials from banks, NGOs, MFIs, government and academic institutions. An interaction among this select group should produce the desired result.

Microfinance has come to mean the provision of credit and other financial services to the poor so that they can reduce their poverty and raise their living standards. Microfinance has the potential to become an important component of successful and sustainable poverty alleviation programme. Microfinance has become a worldwide movement. By end-2003, about 80 million clients across the world were being serviced by approximately 2900 microfinance institutions. India's share in this global micro credit market is quite impressive. In India, Microfinance is being pursued through SHG-bank linkage model and Microfinance institution model.

The subject of providing credit to support people in rural areas and to the poor in particular has been explored extensively from time to time in India. The Indian credit system, as it has emerged, is a product of evolution as well as intervention. The broad objectives of policy innovations have been (a) to institutionalize credit, (b) to enlarge its coverage, and (c) to ensure provision of timely and adequate credit at reasonable rates of interest to as large a segment of the population as possible. The institutional innovations have been a continuous process with changes occurring, depending on experience. In providing credit to the rural sector, a multi agency approach has been adopted so as to take advantage of the strengths of different institutional forms.

Evolution of thinking, on growth and credit

As I had remarked on an earlier occasion, the evolution of ideas in relation to credit delivery system has some parallel to the evolution of thought on economic growth and development. In the first stage, the major concern was simply to accelerate economic growth. Growth was identified with the increase in the availability of material goods and services. Eradication of poverty was to be achieved through faster economic growth. In the second stage, a greater concern with the distribution, of income emerged. Development was seen as going beyond economic growth and bringing out changes in the structure of economy. Equitable distribution of the benefits of economic growth became an independent goal. In the third stage, the concept of equity was translated into the provision to everyone of what came to be described as "basic needs", which included the fundamental requirements of life, such as education, safe water and health services. In the current stage of discussion, the concept of

basic needs has been widened and the objective of growth is set as human development which means an improvement in the quality of the life of the people. Enhancement of human development implies on the one hand to the creation of human capabilities through improved health, knowledge and skills and on the other, the opportunities for the people to make use of these capabilities.

In the case of credit delivery system, one can set: a similar evolution of thought. While in the early stages, the emphasis was on providing more credit in later stages the emphasis shifted to ensure that credit went to all segment of society. Even the prescription of a proportion of total credit for priority sectors was not considered to be adequate. Despite the expansion of the organized banking system deep into the rural areas, a very large number of the poor continued to remain outside the fold of the formal banking system. The formal banking system with its systems and procedures was found to be inaccessible to the poor. This led to a search for an alternative delivery mechanism, which would meet the requirements of the poor and particularly the women among them.

Origin of SHGs and MFIs

It is in this background that the idea of organizing self-help groups began to take shape. A self-help group is a group of about 10 to 20 persons from a homogenous background who come together for addressing the common problems. They collect voluntary savings on a regular basis and use the pooled resources to make small interest bearing loans to their members. At a later stage, these groups are able to obtain credit from outside sources to support income-generating activities. Very often there is a self help promoting institution (SHPI), which enables the self-help group to function effectively.

A stimulus to the rapid growth of self-help groups was provided when the SHG-bank linkage programme was initiated in 1992. It was a pilot project for promoting 500 SHGs. As the idea gained acceptance from the banking system and the results were promising, the Reserve Bank of India encouraged this positive initiative by issuing instructions to banks in 1996 to cover SHG financing as a main stream activity under the priority sector lending portfolio. A working group set up by the RBI in 1994 came up with wide ranging recommendations on SHG and bank linkage as a potential innovation in the area of banking with the poor. I am happy to have played some role in initiating this development, when I was Governor of Reserve Bank of India. As on March 2005, 1.54 million SHGs comprising 22.0 million poor households were accessing credit through 35,000 branches of 560 commercial and cooperative banks under the SHG-bank linkage programme. The cumulative disbursement of loans by the SHGs has been Rs.5,674 crore.

Another approach to providing microfinance has been through the microfinance institutions. Even before the SHG method was perfected, many NGOs were using a variety of delivery mechanisms for providing credit services to the poor with financial support from external donors and later by apex institutions including the Rashtriya Mahila Kosh set up by the government, the SIDBI Foundation for Micro Credit and NABARD. Since 2000, commercial banks including regional rural banks are providing funds to MFIs for on-lending to poor clients. The exact number of MFIs functioning in the country is not available. However, it is estimated that there are around 800 private MFIs operating in the country with varied legal forms. While most are registered under Societies Registration Act, some are functioning as non-bank financial companies.

Progress of SHGs

The conceptual thinking behind the SHG initiative is that self help supplemented by mutual help can be a powerful vehicle in the upward socio-economic transition of the poor. Poor can save and are bankable. Collective wisdom of the poor and peer pressure are valuable collateral substitutes.

NABARD has played a key role not only in promoting SHGs but also in standing behind the SHG-bank linkage programme. The total re-finance released by NABARD so far has amounted to Rs.3130 crore. The performance of the SHGs has been extremely encouraging. Repayments by members to SHGs have been exceedingly high and on-time payments have hovered around 98 per cent. Many of the expectations behind the basic philosophy underlying the formation of SHGs seem to have been fulfilled. It has, however, to be noted that there is a concentration of SHGs in southern states. Our experience so far has shown that the poor can organize themselves and do things to promote the well being. It has also had a tremendous social impact. It has made women more self-confident. This impression is largely derived from -my experience in Andhra Pradesh.

Despite this encouraging picture, as of now the total disbursement of credit is very limited and per household credit made available is very small. As on March 31, 2003 the average loan was Rs.28,600 per SHG and Rs.1760 per household. If a serious impact on the economic conditions of the rural poor has to be made, a much larger flow of credit to support a much broader production base is required. It is in this direction the movement has to travel. Self help groups have to graduate into promoting micro enterprises. Though' micro enterprises are not a panacea for the complex problems and chronic unemployment and poverty in rural and urban areas, yet promotion of micro enterprises is a viable and. effective strategy for achieving significant gains in income and assets for poor and marginalized people.

We can thus see the evolution of Self Help Groups at three levels -

- At the first level households use microfinance *to* meet 'survival' requirements where small savings and loans serve as a buffer in the event of an emergency or to smoothen consumption or even service previous debt to give itself more liquidity during lean times.
- At the second level, 'subsistence' needs are met through microfinance, where a household begins to utilize microfinance to diversify its basket of income-generating activities, or to meet working capital requirements in traditional activities.
- At the third level as households reach a stage where they can assume a higher degree of risk, microfinance would be used to invest in setting up an enterprise or facilitating entry into employment in one way or the other in order that the household becomes 'sustainable'.

I had seen how Self Help Groups have gone through these three stages in Andhra Pradesh. The annual exhibition of self-help groups at Hyderabad has been a tremendous success. However, it has not been possible to obtain any data at an all India level about the total value of the output produced by the SHGs. Some studies have shown that 70 per cent of the credit is being utilized for production purposes. For the year 2004-05, taking the annual flow of credit to SHGs and assuming that output is three times the flow of credit, we can derive that the total value output was in the range of Rs.6200 crore. I do hope that NABARD will

initiate a study on the value of output produced by SHGs as well as the kind of products that are being produced. This information is absolutely essential for understanding the economic impact of SHGs.

At least in Andhra Pradesh, from pure thrift institutions, SHGs first graduated to producing simple products such as pickles and papads. Then they have moved on to produce a wide variety of commodities using simple machines. The scope for expanding the productive activities: remains large. For example, readymade garments have a market even in rural areas. Thus, the choice of products becomes extremely important. The SHPIs (Self Help Promoting Institutions) have thus a dual role to play. Not only should they facilitate the availability of credit from the formal sector to the self help groups, they should also assist the self help groups to identify suitable products which they can manufacture and sell, They need to impart the necessary skills. These institutions are in very real sense friends philosophers and guides. Yet another requirement for the success of SHGs is the provision of effective marketing outlets. These are the issues, which need to be addressed at the present stage in the evolution of self-help groups. There are interesting examples of successful. SHGs who have graduated to the second and third levels. We need to replicate these successes, if the microfinance movement is to have a true impact.

Future Directions

As the SHGs grow in number and in diversity, we need to be clear about the legal status of SHGs. At the moment, as I understand, they are not registered as any form of organization. The second is the issue of how to combine different SHGs into a much larger organization which can command greater credibility and therefore greater credit. In Andhra Pradesh, the Mutually Aided Cooperative Societies established under a separate Act were intended to provide a route for this. The expectation was that these societies could be federated at sub district and district levels facilitating the tapping of finance from outside sources better. These issues need to be addressed squarely, if the SHGs are to become organizations, which can provide support for income generating activities.

Banks, as formal credit agencies, have the necessary resources. There is also the willingness on their part to provide credit to people with limited means as the experience has been good. The voluntary organizations should, therefore, provide an effective link between the formal financial system which has the ability to provide credit and the poor who need credit and have shown their ability to organize themselves. That is, in a sense there are three partners in this movement. Banks and other financial institutions who have the ability to provide credit, the poor who need credit and the voluntary organizations who can establish the link between these two.

In relation to the MFI model, it is quite clear that many microfinance institutions have played a pioneering role in organizing the poor to obtain credit. They have played an excellent role in guiding the poor in undertaking appropriate productive activities. As indicated earlier, there are around 800 private MFIs operating in the country with varied legal forms. The overwhelming majority of MFIs have 500-1500 clients and a few MFIs have reached an outreach of 100,000 micro finance clients. A multi agency approach even with respect to microfinance is useful. However, some thinking has to go into determining the appropriate legal form of microfinance institutions.

Microfinance can change the lives of the poor. There may not be a quantum jump in income but it is still possible to ensure a reasonable rise in the income of the poor. In meeting the challenge of widening the scope of microfinance, we need to pay attention to the following:

- (i) As microcredit expands, as it must, banks need to introduce appropriate organizational changes in the various branches in order to play a pro-active role in bringing more and more SHGs under the bank linkage programme. NABARD in consultation with RBI must also play a part in initiating this change.
- (ii) Self Help Groups must transform themselves from pure thrift institutions into groups promoting micro enterprises. In that situation, the Success will depend upon the choice of products to be produced and the markets to be served and the creation of an appropriate marketing mechanism.
- (iii) The legal form of Self Help Groups needs clarification. This assumes importance if the SHGs are to get federated into much larger organizations which can command greater credibility and, therefore, greater ability to borrow and
- (iv) The legal form of microfinance institutions also needs clarification.

I am sure that this Conference will discuss these and other issues so that microfinance can become an instrument for pulling the poor out of the trap in which they are caught.
