Management of Microfinance Study Material

Course Teacher: Dr. Ramesh Kumar Chaturvedi
5.0 OBJECTIVES
After reading this chapter you will understand the:
- Recommendations of the Malegam committee governing MFIs in India
- RBI guidelines for MFIs
- Code of conduct for the MFIs-

5.1 INTRODUCTION
In the absence of a separate legal structure, each MFI takes the legal form as per the law/Act under
which it is registered. For example, if a MFI is registered under Companies Act, it is a company and a
MFI registered under the Societies Registration Act, will be a society and so on.

The process of bringing the microfinance sector under the regulatory regime has made significant
progress after AP crisis. Immediately after the AP crisis the RBI had constituted the Malegam
Committee. Based on this committee's recommendations, the RBI has issued a series of guidelines,
notifications and directives, starting with the creation of a separate category of NBFC-MFIs. The
regulatory guidance extends to capital requirement, qualifying asset category, asset classification and
provisioning norms, pricing of credit, fair practices in lending, transparency and disclosure in interest
rate, avoidance of multiple lending and excessive debt, recovery practices, corporate governance and
improvement in efficiency through information technology. The two microfinance industry
associations, namely Sa-Dhan and MFIN (Micro Finance Institutions Network) have evolved a unified
code of conduct for their members. The much-awaited Microfinance Institutions (Development and
Regulation) Bill, 2012 was tabled in the Indian Parliament in May 2012 and is referred to the
Parliamentary standing committee on finance.

5. 1.1 Legal Formats and Governance
In relation to the vast demand, there is limited coverage of potential microfinance clients. Credit to
the poor is provided through the formal financial system, semi-formal and informal institutions. In that
backdrop, it is important to understand the laws and regulations that shape the financial sector. Laws
and regulations cause costs as well as create opportunities for entrepreneurs and/or investors who
supply microfinance. Laws and regulations balance the interests of different groups of the
stakeholders. Stakeholders are all those concerned of a given enterprise. The most important
stakeholders of microfinance are actual and potential clients, supplying institutions/companies and
their owners (called "shareholders" because they put capital in the form of shares into the company),
their managements and their staff, and regulating agencies. The most important regulating agencies
are Reserve Bank of India (RBI), Government of India, Ministry of Finance, and State governments.

The Legal formats of MFIs that are provided by Indian laws can be classified by the profit motive. There
are Not-For-Profit Entities such as trusts, societies and Section 25 companies. The for-Profit enterprises
are Non-Banking Financial Companies (NBFCs). Co-operatives are also for profit but are Mutual-Benefit
enterprises. Cooperatives are formed and owned by members to support their own activities. This
includes Mutually Aided Co-operative Societies (MACs), Multi State Co-ops, credit and non-credit co-
operative societies, Producer Companies; Co-operative Banks (See Box 4 for details of Legal forms of
Indian MFIs). Laws are made by Governments. The formal and central law-makers are Parliament and
State Legislatures (elected representatives of the people). Debate on the law takes place inside and
outside Parliament. Ministries have an important role in formulating laws, as the officials are consulted
by the politicians. In view of this, practitioners — owners and managers of microfinance institutions
need engage in lobbying, i.e. consulting and counselling politicians and bureaucrats about what they feel important for the sector.

**Box 4: Snapshot of Legal forms of Indian MFIs (from SIJTSMA, 2007)**

Micro-finance institutions in India can have different legal forms. In this box the different legal forms are described:

**Societies:** These are membership organizations that may be registered for charitable purposes. Societies are usually managed by a governing council or a managing committee. Societies are governed by the Societies Registration Act 1860, which has been adapted by various states. Unlike trusts, societies may be dissolved.

**Cooperative societies:** These are registered under the State Cooperative Societies Act or Multi State Coop Society Act. These are supervised by the Registrar of cooperative societies. These cooperatives are generally formed by people who have a similar objective like farmers or workers etc. These work for sustainability and distribute profit to the member. The members elect the leaders among themselves as Board Members to run the cooperatives.

**Trusts:** The public charitable trust is a possible form of not-for-profit entity in India. Typically, public charitable trusts can be established for a number of purposes, including the relief of poverty, education, medical relief, provision of facilities for recreation, and any other object of general public utility. Indian public trusts are generally irrevocable. No national law (except the broad principles of the India Trusts Act 1882, which governs private trusts) governs public charitable trusts in India, although many states (particularly Maharashtra, Gujarat, Rajasthan, and Madhya Pradesh) have Public Trusts Acts.

**S25 companies:** A section 25 company is a company registered under companies Act with limited liability that may be formed for "promoting commerce, art, science, religion, charity or any other useful object", provided that no profits, if any or other income derived through promoting the company's objects may be distributed in any form to its members. These companies cannot distribute the profit or redeem the capital and as such cannot be listed in the Stock Exchange.

**Non-Banking Financial Companies (NBFCs):** These are companies registered under the companies Act and licensed by RBI as non-bank institutions known as loan companies, housing finance companies, investment companies etc. These institutions are permitted to lend, hire-purchase or lease. Deposit mobilization is permitted only if they are rated by an approved credit rating agency, and only time deposits of 1-5 years are permitted. In addition, most deposits are allowed only in the province where the NBFC is registered. Furthermore they are prohibited from providing micro-insurance and/or fund transfers.

As the political debate results in such a number of laws covering various types of financial institutions, the legal provisions of one law are sometimes contradictory, to the provisions of another law. The understanding of following important laws/Acts may be useful to the microfinance professionals.
5.2 RECOMMENDATIONS OF MALEGAM COMMITTEE

Microfinance institutions in India have made significant progress during the last two decades in terms of outreach and penetration in unbanked areas. Over the last decade the for profit model of microfinance Institutions have grown at impressive speed. These MFIs have attracted large volume of bank credit support and also an increasing interest in equity investments.

The advent of NBFCs in the Microfinance sector appears to have resulted in a significant increase in reach and the credit made available to the sector. Between 31' March 2007 and 31' March 2010 the number of outstanding loan accounts serviced by the MFIs is reported to have increased from 10.04 million to 26.7 million and outstanding loans from about Rs.3800 crore to Rs:18,344 crore. While this growth is impressive, the specific areas of concern in the Indian context have been identified. They are as follows:

Areas of concern

- Unjustified high rate of interest
- Lack of transparency in interest rates and other charges
- Multiple lending
- Upfront collection of security deposits
- Over-borrowing
- Ghost borrowers
- Coercive methods of recovery

This high growth of MFIs has encountered serious setbacks in the last few years due to adverse consequences of the Andhra Pradesh crisis (see Box for further details). The MFI sector, more particularly the for profit model, which was in limelight for its rapid growth and success in Financial Inclusion was suddenly seen in a bad light because a wide spread criticism of MFIs. The reason for the criticism was due to the exorbitantly high profits earned by MFIs, which was on account of high leverage of bank loans and high rates of interest. But what pushed the sector to the crisis are the coercive money collection practices. It was seen that certain MFIs which followed the Grameen model had incentivized collection which ran into unethical practices. These practices got highlighted with the media reporting of suicides among microfinance clients in AP- the state that has the largest chunk of
MR lending. This prompted the Andhra Pradesh Government to bring in the Andhra Pradesh Microfinance institutions (Regulation of Money Lending) Ordinance 2010. As a result, repayment of all MFI in Andhra Pradesh almost came to a halt. As more than 50 per cent of MFIs exposure is in AP alone, the business of MFT got adversely affected. Banks and SIDBI had about Rs.19000 crore exposures to MFIs which came to risk under circumstances. Ranks had extended CDR to the MFI's which has been of little avail as the loan losses has been almost total.

**Box 5: Background to Andhra Pradesh MF Crisis 2010**

MFIs have emerged as important stakeholders in the Microfinance sector in lending to the poor people. The advent of the Microfinance sector appears to have resulted in a significant increase in outreach and the credit made available to the sector. Bet%Veen 2007-10 the number of outstanding loan accounts served by MFIs was reported to have increased from 10.04 million to 26.7 million and outstanding loans from about Rs.3800 crore to Rs.18344 crore. The incessantly flourishing MFI industry providing credit to the doorsteps of the poor has however also been correlated with excessively high interest rate, use of coercive methods for recovery, number of suicides by the credit beneficiaries etc. It was alleged that in Andhra Pradesh many microfinance clients committed suicides because of high handedness of MFT staff to recover loans. This led the state government of Andhra Pradesh to enact the AP MFI Act 2010 which had suddenly put brakes to the expanding MFT industry. The provisions of the ordinance requires that each MF1 to register themselves with district administration to keep records of all their clients, not to give loan to SIIG members if they have already taken loan from other SHGs (to control over indebtedness) without prior permission of district collectors and so on.

In view of the above mentioned development, RBI had set up a committee of its Board members under the chairmanship of Shri.Y.H. Malegam to study the issues and concerns in Micro finance sector. The committee reviewed the definition of MF and MFI, examined the alleged malpractices by MFTs especially with respect to high interest rate and methods of recovery, specified the scope of regulation by RBI of these MFIs and suggested a proper regulatory framework. It also examined the prevalent money lending legislation and other relevant items at the state level, and suggested redressal machinery.

The Committee has recommended that a NBFC --MFI may be defined as "a company (other than a company licensed under section 25 of the Companies Act, 1956) which provides financial services predominantly to low income borrowers with loans of small amounts, for short terms, on unsecured basis, mainly for income generating activities with repayment schedules which arc more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified".

The committee has also arrived at the concept of qualifying asset of NBFC which will decide if it is an MFI. Accordingly not less than 90 per cent of its (NBFC-MFI's) total assets (other than cash and bank balances and money market instruments) are in the nature of 'qualifying assets' it will be deemed all NBFC-MFI. Qualifying asset shall mean a loan which satisfies the following criteria:

- The loan is given to a member of a household whose annual income does not exceed Rs.50,000/.
- The amount of loan does not exceed Rs.25000/ and the total outstanding indebtedness of the borrower including this loan also does not exceed Rs.25000/.
• The tenure of the loan is not less than 12 months where the loan amount does not exceed Rs.15000/ and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases.
• The loan is without collateral.
• The aggregate amount of loans given for income generating purposes is not less than 75 per cent of the total loans given by the MFIs.
• The loan repayable by weekly, fortnightly or monthly installments at the choice of the borrower
• The income it derives from other services is in accordance with the regulation specified.

An NBFC which does not qualify as a NBFC-MFI should not be permitted to give loans to the microfinance sector which in the aggregate exceed 10 per cent of its total assets.

**Interest rate related recommendations:** The committee has recommended that there should be a interest 'margin cap' of 10 per cent in respect of those MFIs which have an outstanding loan portfolio at the beginning of the year of Rs: 100 crore and a 'margin cap' of 12 per cent in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding Rs.100 crore. There should also be a cap of 24 per cent on individual loans. This means that the NBFC-MFIs cannot charge more than 22% or 24% p.a ROI and that on a reducing balance method too.

**The committee recommends that (Transparency related issues)**
• There should be only three _components in the pricing of the loan namely (a) a processing fee not exceeding 1 per cent of the gross amount (ii) the interest charge and (iii) the insurance premium.
• Only the actual cost of insurance should be recovered and no administrative charges should be levied.
• Every MFI should provide to the borrower a loan card which shows (i) the rate of interest (ii) the other terms and conditions attached to the loan (iii) information which adequately identifies the borrower and (iv) acknowledgment by the MFI of payments of installments received and the final discharge. The card should show this information in the local language understood by the borrower.
• The effective rate of interest charged by the MFI should he prominently displayed in all its offices and in the literature issued by it.
• There should be adequate regulations regarding the manner in which insurance premium is computed and collected and policy proceeds disposed of. a There should not be any recovery of security deposit. Security deposits already collected should be returned.
• There should be a standard form of loan agreement.

**Committee also recommends that (About multiple lending, over borrowing and ghost borrowers)**
• MFIs should lend to an individual borrower only as a member of a JLG and should have the responsibility of ensuring that the borrower is not a member of another JIG.
• A borrower cannot be a member of more than one SHG 1 JLG.
• Not more than two MFIs should lend to the same borrower. This would require the NBFC to have full details of the borrower.
• There must be a minimum period of moratorium between the grant of the loan and the commencement of its repayment.
Recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid. Ghost borrowers generally arise in two sets of circumstances: When the borrower on record is a binami for the real borrower and

Fictitious loans are recorded in the books

The first type of Ghost borrower is often used as a device for multiple lending or over borrowing. This can be cured only by a better discipline in the system of identification and creation of data base of borrowers and better follow up by the field worker.

The second type of Ghost Borrower can pose much greater systemic problem as it would create fictitious repayments and thus hide the actual level of delinquencies.

The committee recommends that all sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition there should be close supervision of the disbursement function.

The committee has recommended that a Credit Information Bureau be established for MFI

One or more Credit Information Bureaus be established and be operational as soon as possible and all MFIs be required to become members of such bureau.

In the meantime the responsibility to obtain information from potential borrowers regarding existing borrowings should be on the MFI.

As regards Coercive Methods of Recovery the committee recommends that

The responsibility to ensure that coercive methods of recovery are not used should rest with the MFIs and they and their management should be subject to severe penalties if such methods are used.

The regulator should monitor whether MFIs have a proper Code of Conduct and proper systems for recruitment, training and supervision of field staff to ensure the prevention of coercive methods of recovery.

Field staff should not be allowed to make recovery at the place of residence or work of the borrower and all recoveries should only be made at the Group level at a central place to be designated.

MFIs should consider the experience of banks that faced similar problems in relation to retail loans in the past and profit by that experience.

Each MFI must establish a proper Grievance Redressal Procedure.

The institution of independent Ombudsmen should be examined and based on such examination, an appropriate mechanism may be recommended by RBI to lead banks.

Customer Protection Code

The regulator should publish a Client Protection Code for MFIs and mandate its acceptance and which observance by MFIs. This Code should incorporate the relevant provisions of the Fair Practices assign Guidelines prescribed by the Reserve Bank for NBFCs. Similar provision should also be made Where a applicable to banks and financial institutions which provide credit to the microfinance sector.

Improvement of efficiencies
• MFIs should review their back office operations and make necessary investments in Information Technology and systems to achieve better control, simplify procedure and reduce cost.

Support to SHGs/JLGs
• Under both the SHG Bank Linkage Programme (SBLP) model and the MFI model, greater resources funding of should be devoted to professional inputs both in the formation of SHGs and JLGs as also in the imparting of skill development and training and generally in handholding after the group is formed. This would be in addition to and complementary to the efforts of the State Governments in this regard. The architecture suggested by the Ministry of Rural Development should also be explored.

Corporate Size
All NBFC-MFIs should have a minimum Net Worth of Rs 15 crores.

Corporate governance
Every MFI be required to have a system of Corporate Governance in accordance with rules to be specified by the regulator.

Maintenance of solvency
• The provisioning for loans should not be maintained for individual loans but an MFI should be required to maintain at all times an aggregate provision for loan losses which shall be the higher of (i) 1 per cent of the outstanding loan portfolio or (ii) 50 per cent of the aggregate loan installments which are overdue for more than 90 days and less than 180 days and 100 per cent of the aggregate loan installments which are overdue for 180 days or more.
• NBFC — MFIs be required to maintain Capital Adequacy Ratio of 15 per cent and all of the Net Owned Funds should be in the form of Tier I Capital.

Need for Competition
While regulations are important they cannot by themselves be the sole instruments to reduce interest rates charged by MFIs or improve the service provided to borrowers. Ultimately this can only be done through greater competition both within the MFIs and from other agencies operating in the Microfinance Sector.

The Committee therefore recommends that bank lending to the Microfinance sector both through the SHG-Bank Linkage programme and directly should be significantly increased and this should result in a reduction in the lending interest rates.

Priority Sector Status
The MFI should continue to enjoy "priority sector lending" status. However, advances to MFIs which do not comply with the regulation should be denied 'priority sector lending' status. It may also be necessary for the RBI to revisit its existing guidelines for lending to the priority sector.

Assignment and Securitization
• Disclosure should be made in the financial statements of MFIs of the outstanding loan portfolio which has been assigned or securitized and the MFI continues as an agent for collection. The amounts assigned and securitized must be shown separately.
• Where assignment or securitization is with recourse the full value of the outstanding loan portfolio assigned or securitized should be considered as risk based assets for calculation of capital adequacy.

• Where the assignment or securitization is without recourse but credit enhancement has been given, the value of the credit enhancement should be deducted from the Net Owned Funds for the purpose of calculation of capital adequacy.

• Before acquiring assigned or securitized loans, banks should ensure that the loans have been made in accordance with the terms of the specified regulations.

Funding of MFIs

• Creation of one or more "Domestic Social Capital Funds" may be examined in consultation with SEBI.

• MFIs should be encouraged to issue preference capital with a ceiling on the coupon rate and this can be treated as part of Tier II capital subject to capital adequacy norms.

Monitoring of compliance

• The primary responsibility for ensuring compliance with the regulations should rest with the MFI itself and its management must be penalized in the event of non compliance.

• Industry associations must ensure compliance through the implementation of the code of conduct with penalties for non compliance.

• Banks also must play a part in compliance by surveillance of MFIs through their branches.

• The RBI should have the responsibility for off-site and on-site supervision of the MFIs but the on-site supervision may be confined to the larger MFIs and be restricted to the functioning of the organizational arrangements and systems with some supervision of the branches. It should also include supervision of the industry associations in so far as their compliance mechanism is concerned. Reserve Bank should also explore the use of outside agencies for inspection.

• The RBI should have the power to remove from office the CEO and / or a director in the event of persistent violation of the regulations quite apart from the power to deregister an MFI and prevent from operating in the microfinance sector.

• The Reserve Bank should considerably enhance its existing supervisory organization dealing with NBFC-MFIs.

Moneylenders Acts

NBFC-MFIs should be exempted from the provisions of the Money-Lending Acts as interest margin caps and increased regulations are recommended.

The Micro Finance Institutions (Development and Regulation) Bill 2012

The Central Government has drafted a 'Micro Finance Institutions (Development and Regulation) Bill 2012' will apply to all microfinance organizations other than

(a) banks

(b) Co-operative societies engaged primarily in agricultural operations or industrial activity or purchase or sale of any goods and such other activities

(c) NBFCs other than licensed under section 25 of the Companies Act, 1956

(d) Co-operative societies not accepting deposits from anybody except from its members having voting rights or from those members who will acquire voting rights after a stipulated period of their making deposits as per the law applicable to such co-operative societies.
The Bill is being debated, off the parliament for a long time now. The Bill refined and it was tabled in the Parliament in 2012 as the Micro Finance Institutions (Development and Regulation) Bill, 2012. It is hoped that the Act will provide for all entities covered by the Act to be registered with the regulator. Possibly entities where aggregate loan portfolio does not exceed Rs.10 crore may be exempted from registration. Further as RBI regulates NBFC it has been suggested that if NABARD is designed as the regulator under the proposed Act, there must be close co-ordination between NABARD and RBI in the formulation of the regulations applicable to the regulated entities. Another important suggestion is that the micro finance entities governed by the proposed Act should not be allowed to do the business of providing thrift services.

Microfinance is not a single tool but a combination of tools.MFIs around the world serve different types of clients, operate in diverse environments and offer different combination of services.

There have been many surveys, both in India and abroad as to the impact of microfinance on the lives of the poor people it is intended to reach. The results have been both conflicting and confusing. These surveys report many success stories but they also voice many apprehensions that microfinance has in some cases created credit dependency and cyclical debt. Doubts have also been expressed as to whether lending agencies have in all cases remained committed to the goal of fighting poverty or whether they are solely motivated by financial gain. Mere extension of micro credit unaccompanied by other social measures will not be an adequate anti poverty tool.

While the lender has the responsibility to provide timely and adequate credit at a fair price in a transparent manner, the borrower also has the responsibility to honour his/her commitments for payment of interest and repayment of principal. A financial system ultimately depends on the circulation of funds within the system. If the recovery culture is adversely affected and free flow of funds is interrupted the system will break down. This will affect the borrowers themselves as the slowdown of recovery will inevitably reduce the flow of fresh funds into the system.

**5.2.1 Comparison between Malegam Committee recommendations and RBI guidelines**

The comparison between Malegam Committee recommendations and RBI guidelines is presented in Table 9.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Malegam Committee Recommendations</th>
<th>RBI Guidelines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualifying assets</td>
<td>The loan given to a borrower who is a member of a household whose annual income does not exceed Rs.50,000/-</td>
<td>Loan disbursed by an MFI to a borrower with a rural household annual income not exceeding Rs.60,000 or urban and semi urban household income not exceeding Rs.1,20,000/-</td>
</tr>
<tr>
<td>Loan amount</td>
<td>The amount of loan does not exceed Rs.25,000/ and the total outstanding indebtedness of the</td>
<td>Loan amount not to exceed Rs.35,000/- in the first cycle and Rs.50,000/- in subsequent cycles. Total</td>
</tr>
<tr>
<td><strong>Pricing of interest</strong></td>
<td>There should be a 'margin cap' of 10% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of Rs.100 crore and a 'margin cap' of 12 per cent in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding Rs.100 cr. There should also be a cap 24% on individual loans.</td>
<td>Banks should ensure a margin cap of 12 per cent and an interest rate cap of 26 per cent for their lending to be eligible to be classified as priority sector loans.</td>
</tr>
<tr>
<td><strong>Tenure of loan</strong></td>
<td>The tenure of the loan is not less than 12 months where the loan amount does not exceed Rs.15000 and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases.</td>
<td>Tenure of loan not to be less than 24 months for loan amount in excess of Rs.15000 without prepayment penalty. Loan extended without collateral.</td>
</tr>
<tr>
<td><strong>Loan from Income Generating activities</strong></td>
<td>The aggregate amount of loans given for income generating purposes is not less than 75 per cent of the total loans given by the MFIs.</td>
<td>Aggregate amount of loan given for income generation not to be less than 75 per cent of the total loans given by the MFIs.</td>
</tr>
<tr>
<td><strong>Repayment</strong></td>
<td>The loan repayable by weekly, fortnightly or monthly installments at the choice of the borrower.</td>
<td>Loan to be repayable by weekly, fortnightly, or monthly installments at the choice of the borrower.</td>
</tr>
<tr>
<td><strong>Loan issued by MFI to individuals outside the SHGs</strong></td>
<td>Loans by MFIs can be extended MFI to individuals outside the SHG/JLG outside the SHGs mechanism. Bank loans to other NBFCs would not be reckoned as priority sector loan with effect from April 1, 2011.</td>
<td></td>
</tr>
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</table>
5.2.2 Other recent initiatives"

Consequent to Malegam Committee recommendations, the RBI has issued a series of guidelines, notifications and directives, starting with the creation of a separate category of NBFC-MFIs. The regulatory guidance extends to capital requirement, qualifying asset category, asset classification and provisioning norms, pricing of credit, fair lending practices, transparency and disclosure in interest rate, avoidance of multiple lending excessive debt, recovery practices, corporate governance and improvement in efficiency through information technology.

Priority sector lending is a policy initiative, which requires banks to allocate a percentage of their portfolios to investment in specified priority sectors at a reduced interest rate. Currently, the loans from microfinance institutions registered as NBFC-MFIs are designated as a priority sector. In order to register as an NBFC-MFI, an institution must meet requirements specified by the RBI. In December 2011, the RBI opened up the external commercial borrowings (ECBs) channel to NBFC-MFIs, something that was previously open only to non-profit MFIs.

The network organizations, support institutions, research and policy advocacy groups have been working to bring microfinance back to track and prepare it for orderly and responsible growth. The lead initiative taken by SIDBI towards carrying out the Code of Conduct Assessments of MFIs has helped pave the way for ensuring effective client protection principles in the operations.

Recognizing the importance of systematic compilation of credit information of clients for effective monitoring and follow-up, RBI has made it mandatory for NBFC-MFIs to register with at least one credit information company. The need of a Microfinance Credit Bureau Infrastructure in India was triggered mainly by two factors.

1. Regulatory changes brought in by RBI allowing MFIs to register as NBFC-MFIs, and making it mandatory for NBFC-MFIs to register with at least one credit information company (CIC) and
2. The strong need in the industry to know about the other liabilities of its borrowers and their performance on those.

In this backdrop, High Mark Credit Information Services (High Mark) launched the country's first Microfinance Credit Bureau in March 2011. The data captured in High Mark's database is of individuals who have been given credit through--MG, SHG or direct lending. (Microfinance credit bureaus have been operational, and are successfully helping the MFIs in screening multiple borrowing by customers from MFIs).

5.3 CODE OF CONDUCT FOR MICROFINANCE INSTITUTIONS IN INDIA

Microfinance Institutions irrespective of legal forms, seek to create social benefits and promote financial inclusion by providing financial services to clients of financially un-served and underserved households. Over time, the Microfinance sector has become an integral part of the financial infrastructure for the vulnerable sections of society in India. Hence it is important to define core values and fair practices for the microfinance sector so as to ensure that microfinance services through MFIs are provided in a manner that benefits clients and is ethical and dignified.

The core values of Microfinance are stated as follows:

**A. Integrity**
- To provide low income clients women and men and their families, with access to financial services that are client focused and designed to enhance their wellbeing and are delivered in a manner that is ethical, dignified, transparent, equitable and cost effective

**B. Quality of Service**
- To ensure quality services to clients, appropriate to their needs and delivered efficiently in a convenient and timely manner
- To maintain high standards of professionalism based on honesty, non discrimination and customer centricity

**C. Transparency:**
- To provide complete and accurate information to clients regarding all products and services offered.
- To create awareness and enable clients and all other stakeholders to understand the information provided with respect to financial services offered and availed

**D. Fair Practices:**
- To ensure that clients are protected against fraud and misrepresentation deception or unethical practices
- To ensure that all practices related to lending and recovery of loans are fair and maintain respect for client's dignity and with an understanding of client's vulnerable situation

**E. Privacy of client information**
- To safeguard personal information of clients, allowing disclosures and exchange of relevant information with authorized personnel only, and with the knowledge and consent of clients

**F. Integrating social values into operations:**
- To ensure high standards of governance and management
- To monitor and report social as well as financial data

**G. Feedback and grievance redressal mechanism**
- To provide clients formal and informal channels for feedback and suggestions To consistently assess the impact of services in order to enhance competencies and serve clients better
- To provide a formal grievance redressal mechanism for clients

**Code of Conduct for Micro finance Institutions**
All MFIs are required to follow all regulatory norms as well as consumer protection practices (specifically, RBI's Guidelines on Fair practices for NBFCs) laid down by the government and the regulators in both letter and spirit. The Code of Conduct lays down additional requirements to enhance and improve sector practices. The Code of Conduct is to be followed by all MFIs regardless of their form.

**Application of the Code**
- The Code applies to the following activities undertaken by Microfinance Institutions
- Providing credit services to clients, individually or in groups
- Recovery of credit provided to clients
- Collection of thrift from clients, wherever applicable
- Providing insurance and pension services, remittance services or any other related products and services
- Formation of any type of community collectives including Self Help groups, Joint Liability groups and their federations
- Business development services including marketing of products or services made or extended by the eligible clients or for any other purpose for the welfare and benefit of clients.

**Micro Finance Institutions must agree to:**
- Promote and strengthen the Microfinance movement in the country by bringing low-income clients to the mainstream financial sector
- Build progressive, sustainable and client-centric systems and practices to provide a range of financial document services (consistent with regulation) to clients
- Promote cooperation and coordination among themselves and other agencies in order to achieve higher operating standards and avoid unethical competition in order to serve clients better

In order to adhere to the core values of Microfinance, the Code of Conduct as mentioned below must be abided by all institutions providing microfinance services.

**Code of Conduct**

**Integrity and ethical behaviour**
- MFIs must design appropriate policies and operating guidelines to treat the clients and employees the client with dignity
- MFIs must incorporate transparent and professional governance system to ensure that staff and shall not persons acting on their behalf are oriented and trained to put this Code into practice
- MFIs must educate clients on the code of Conduct and its implication

**Transparency**
- MFIs must disclose all terms and conditions to the clients for all services offered. Disclosure must be made prior to disbursement in accordance with the Reserve Bank of India’s fair practices code, in any one of the following ways.
  a) individual sanction letter
  b) Loan card
  c) Loan schedule
  d) Passbook
  e) Through group/centre meetings (details can be printed in a paper and all borrowers can sign on the same as acknowledgement of their acceptance)
  f) MFIs must communicate all the terms and conditions for all products/services offered to clients in the official regional language or a language understood by them
  g) At the minimum, the MFI must disclose the following terms
    a) Rate of interest on a reducing balance method
    b) Processing fee
    c) Any other charges or fees howsoever described
    d) Total charges recovered for insurance coverage and risks covered.
MFIs must communicate in writing charges levied for all financial services rendered. Fee on non-credit products/services will be collected only with prior declaration to the client.

h) MFIs must declare all interest and fees payable as an all-inclusive Annual Percentage Rate (APR) and equivalent monthly rate.

i) MFIs must follow RBI's guidelines with respect to interest charges and security deposit.

j) Formal records of all transactions must be maintained in accordance with all regulatory and statutory norms and borrowers' acknowledgement/acceptance of terms and conditions must form a part of these records.

Client protection

Fair Practices:
- MFIs must ensure that the provision of microfinance services to eligible clients is as per RBI guidelines.
- MFIs must obtain copies of relevant documents from clients, as per standard KYC norms. Additional documents sought must be reasonable and necessary for completing the transaction.
- Product should not be bundled. The only exception to bundling may be made with respect to credit life, life insurance and life-stock insurance products, which are typically offered bundled with loans. The terms of insurance should be transparently conveyed to the client and must comply with RBI and Insurance Regulatory and development authority (IRDA) norms. Consent of the client must be taken in all cases.

Avoiding over indebtedness
- MFIs must conduct proper due diligence as per their internal credit policy to access the need and repayment capacity of client before making a loan and must only make loans, commensurate with the client's ability to repay.
- If a client has loans from two separate lenders, then irrespective of the source of the loans, a MFI shall not be the third lender to that client.
- MFIs must not, under any circumstances, breach the total debt limit for any client as prescribed by RBI or Central/State government.

Appropriate interaction and collection practices
- MFIs must have clearly defined guidelines for employee interaction with clients.
  - MFIs must ensure that all staff and persons acting on behalf of the MFI
    1. use courteous language maintain decorum, and respectful of cultural sensitivity during all interaction with clients
    2. Do not indulge in any behaviour that in any manner would suggest any kind of threat or violence
    3. Do not contact clients at odd hours as per the RBI guidelines for loan recovery agents.
    4. Do not visit clients at inappropriate occasions such as bereavement, sickness etc to collect dues
  - MFIs must provide a valid receipt (in whatever form decided by the MFI) for each and every payment received from the borrower
  - MFIs must have a detailed board approved process for dealing with clients, at each stage of default.
MFIs must not collect shortfalls in collections from employees and their HR policies must categorically denounce this practice. An exception can however be made in proven cases of frauds by employees.

Privacy of client information: MFIs must keep personal client information strictly confidential. Client information may be disclosed to a third party subject to the following conditions

(a) Client has been informed about such disclosure and permission has been obtained in writing
(b) The party in question has been authorized by the clients to obtain client information from the MFI
(c) It is legally required to do so
(d) This practice is customary amongst financial institution and available for a close group on reciprocal basis (such as a credit bureau).

Governance: MFIs must incorporate a formal governance system, that is transparent and professional, and adopt the following best practices of corporate governance

- MFIs must observe high standard of governance by inducting persons with good and sound reputation as members of Board of Directors/ Governing Body.
- MFIs must endeavour to induct independent person to constitute at least one third of the governing board, and the Board must be actively involved in all policy formulation and other important decisions.
- MFIs must have a Board approved debt restructuring product / programme for providing relief to borrowers facing repayment stress.
- MFIs will appoint an audit committee of the Board with an independent director as Chairperson
- MFIs must ensure transparency in the maintenance of books of accounts and reporting / presentation and disclosure of financial statements by qualified auditor/s
- MFIs must put in best efforts to follow the Audit and Assurance Standard issued by the Institute of Chartered Accountants of India (ICAI)
- MFIs must place before the Board of Directors a compliance report indicating the extent of compliance with this Code of Conduct, specifically indicating any deviation and reasons therefore, at the end of every financial year.

Recruitment: The Code covers all MFI staff

- As a matter of free and fair requirement practice, there will be no restriction on hiring of staff from other MFIs by legitimate means in the public domain like general requirement advertisement in local newspapers, web advertisements, walk-in interviews etc
- Whenever an MFI recruits staff from another MFI, it will be mandatory to seek a reference check from the previous employer. The reference check will be sought from current employer only after an offer is made and an offer letter is issued to the prospective employee
- MFIs should respond to the reference check request another MFI within two weeks
- MFIs must honour a one month notice period from an outgoing employee.
- No MFI shall recruit an employee of another MFI irrespective of the grade/ level of the employee, without the relieving letter from the previous MFI employer. An exception can however be made in instance where the previous employer (MFI) fails to respond to the reference check request within 30 days. All MFIs must provide such relieving letter to the outgoing employee in case she or he has given proper notice, handed over the charge and
settled all the dues towards the MFI, except in proven cases of fraud or gross misconduct by the employee.

- Whenever an MFI recruits from another MFI, at a level up to the branch manager position, the said employee shall not be assigned to the same area he/she was serving at the previous employer, for the period of one year.

**Client Education**

- MFIs must have a dedicated process to raise clients' awareness of the options, choices and responsibilities vis-à-vis financial products and services available.
- New clients must be informed about the organization's policies and procedures to help them understand their rights as borrowers.
- MFIs must ensure regular checks on client awareness and understanding of the key terms and conditions of the products/services offered/availed (As part of the internal audit systems or through some other regular monitoring).

**Data sharing**

MFIs will agree to share complete client data with all RBI approved Client Bureaus, as per the frequency of data submission prescribed by the Credit Bureaus.

**Feedback / Grievance Redressal Mechanism**

- MFIs must establish dedicated feedback and grievance redressal mechanisms to correct any error and handle/receive complaints speedily and efficiently.
- MFIs must inform clients about the existence and purpose of these mechanisms and how to access them.
- MFIs must designate at least one grievance redressal official to handle complaints and/or note any suggestion from the clients and make his/her contact numbers easily accessible to clients.
- Each MFI will have an appropriate mechanism for ensuring compliance with the Code of Conduct.
- Where complainants are not satisfied with the outcome of the investigation conducted by the concerned MFI into their complaint, they shall be notified of their right to refer the matter to the grievance redressal mechanism established by the industry Association.

**Client Protection guidelines for Microfinance Institutions (CPG)**

The CPG states that all MFIs, regardless of their form,

- Shall display the client protection code in all branches and offices, in plain view.
- Shall endeavour to provide microfinance services to all eligible clients, as per RBI guidelines.
- Shall educate clients, staff, and any person acting on their behalf on the code of conduct and its implementation.
- Shall disclose all terms and conditions to the client for all products, services offered, prior to disbursement in any of the following ways.
  - (a) individual sanction letter
  - (b) loan card
  - (c) loan schedule
  - (d) pass book
  - (e) through group/centre meetings (details can be printed on a paper and all borrowers can sign on the same as acknowledgment of their acceptance).
Shall communicate all the terms and conditions for all products / services in the official regional language or a language understood by clients

(g) Shall disclose the following terms
   (a) rate of interest on a reducing balance method
   (b) processing fee
   (c) any other charges or fees howsoever described
   (d) total charges recovered for insurance coverage and risk covered

- Shall communicate in writing, charges levied for all financial services rendered.
- Shall not collect fee on non credit product / services without prior declaration to the client
- Shall declare all interest and fees payable as an all inclusive APR and equivalent monthly rate
- Shall follow RBI's guidelines with respect to interest charges and security deposits
- Shall obtain copies of relevant documents from clients as per standard KYC norms. Additional documents sought must be reasonable and necessary for completing the transaction
- Shall not bundle products, except for credit life, life insurance and Livestock insurance products. The terms of insurance should be transparently conveyed to the customer and must comply with RBI and IRDA norms. Consent of the client must be taken in all cases.
- Shall conduct proper due diligence to assess the need and the repayment capacity of clients before making a loan and must only make loans commensurate with the client’s ability to repay.
- Shall not be the 3rd lender to a client if the client has loans from two other lenders (irrespective of the source of loan)
- Shall not breach the total debt limit for any client as prescribed by the RBI or Central / State Government.

- Shall ensure that all employees follow company guidelines for interaction with clients
- Shall ensure that all staff and persons acting for the MFI or on behalf of the MFI
   (a) use courteous language, maintain decorum, and /or respectful of cultural sensitivities during all interactions with clients
   (b) do not indulge in any behaviour that in any manner that would suggest any kind of threat or violence to clients
   (c) do not contact clients at odd hours as per the RBI guidelines for loan recovery agents
   (d) do not visit clients at inappropriate occasions such as bereavement, sickness etc to collect dues
- Shall provide a valid receipt (in whatever form decided by the MFI) for each and every payment received from the borrower
- Shall follow approved company procedure to deal with clients default sensitively
- Shall follow the debt restructuring mechanism adopted by the MFI for borrowers under liquidity stress.
- Shall keep personal client information strictly confidential
- Shall disclose client information to a third party only under the following conditions
   (a) Client has been informed about such disclosure and permission has been obtained in writing.
   (b) The party in question has been authorized by the client to obtain client information from the MFI
   (c) It is legally required to do so.
   (d) This practice is customary amongst financial institution and available for a close group on reciprocal basis (such as a credit bureau)
• Shall follow company approved process to raise client awareness of the options, choices and responsibilities vis-à-vis financial products and services available.
• Shall inform all new clients about the organization's policies and procedures
• Shall inform clients about the existence and purpose of feedback mechanism and how to access them

**Institutional conduct guidelines for Micro Finance Institutions (ICG)**

The ICG states that all MFIs regardless of their form

• Shall have an appropriate mechanism for ensuring compliance with the code of conduct
• Shall have appropriate policies and operating guidelines to treat clients and employees with dignity.
• Shall maintain formal records of all transactions in accordance with all regulatory and statutory norms and borrowers acknowledgement/acceptance of terms/conditions must form a part of these records
• Shall have detailed board approved process for dealing with clients at each stage of default
• Shall not collect shortfalls in collection from employees except in proven cases of frauds by employees
• Shall have a Board approved debt restructuring product/program for providing relief to borrowers facing repayment stress
• Shall seek a reference check from previous employer for any new hire.
• Shall provide within two week the replies to the reference check correspondence for another MFI
• Shall honour a one month notice period from an outgoing employee.
• Shall not recruit an employee of another MFI without the relieving letter from the previous MFI employer except where the previous employer (MFI) fails to respond to the reference check request within 30 days
• Shall not assign a new employee recruited from another MFI, to the same area he/she was serving at the previous employer for a period of one year. This restriction applies to positions up to the branch manager level
• Shall have a dedicated process to raise clients awareness of options, choices, rights and responsibilities as a borrower and shall conduct regular checks on client awareness and understanding of the key terms and conditions of the products/service offered/availed
• Shall agree to share complete client data with all RBI approved credit bureaus, as per the frequency of data submission prescribed by the Credit Bureaus
• Shall establish dedicated feedback and grievance redressal mechanism to correct any error and handle/receive complaints speedily and efficiently
• Shall designate an official to handle complaints and/or note any suggestions from the clients and make his/her contact numbers easily accessible to clients

5.4 LET US SUM UP

In the existing regulatory environment, MFIs can set up under different legal forms viz., NBFCs or Section 25 Company, Trusts, Co-operatives, Societies. The AP crisis 2010 led to setting of Malegam Committee and various other developments such as regulatory initiatives by RBI, tabling of The Microfinance Institutions (Development and Regulation) Bill, 2012 in Parliament, initiatives on Code of Conduct for microfinance sector etc. The Bill is referred to the Parliamentary Standing Committee on Finance. The mission of Micro-finance is to service low-income clients—women and men and their
families. Micro-finance aims at providing them short term and/or long-term access to financial services. These services must be client focused, designed to enhance their well-being, and delivered in a manner that is ethical, dignified, transparent, equitable and cost effective. Code of conduct for Microfinance Institutions includes the core values of Microfinance, code of conduct for Microfinance Institutions (The Code), client Protection Guidelines for MFIs and Institutional Conduct guidelines.

5.5 KEY WORDS
Core values; code of conduct; client protection; institutional conduct guidelines.

5.6 CHECK YOUR PROGRESS
1. According to the recommendation of the Malegam Committee, the amount of loan given to a member of a household by the NBFC-MFI does not exceed_________
   (a) Rs.20000/
   (b) Rs.25000/
   (c) Rs.30000/
   (d) Rs.35000/

2. Ghost borrowing as a device leads to the following
   (a). For multiple lending
   (b) Over borrowing.
   (c) It would create fictitious repayments and thus hide the actual level of delinquencies
   (d) All the above

3. According to RBI guidelines, aggregate amount of loan to the total loans given by the MFI for income generation not to be less than
   (a) 75%    (b) 70%    (c) 72%    (d) 80%

5.7 KEY TO CHECK YOUR PROGRESS
1-{b}, 2- {d}, 3-{a}
CHAPTER 6
EVOLUTION AND CHARACTERISTICS OF MICROFINANCE IN INDIA

6.0 Objectives
6.1 Introduction
6.2 SHG-Bank Linkage Programme
   6.2.1 Policy Support for Micro Finance in India
   6.2.2 Objectives of SHGs Bank Linkage Programme
   6.2.3 Criteria for Selection of SHGs for Bank Linkage Programme
   6.2.4 Uniqueness of SHG — Bank Linkage Programme
   6.2.5 Advantages of SHG-Bank linkage Programme
   6.2.6 Purpose of Loan Under SHG Bank Linkage Programme
   6.2.7 Ten — Pillars of SHG-Bank Linkage Programme
   6.2.8 Models under SHG-Bank Linkage Programme
   6.2.9 SHG — Bank linkage Model — Advantages and Limitations
   6.2.10 Micro Enterprise Development Programme
   6.2.11 Initiatives by NABARD
   6.2.12 Role of NABARD for Other Microfinance Initiatives

6.3 Joint Liability Groups (JLGs)
6.4 Micro Finance Institutional Approach
6.5 Bank Partnership Model
6.6 Banking Correspondent Model
6.7 Penetration of Microfinance — MPI and MPPI
6.8 Micro-finance Institutional Structure: Types of MFIs
6.9 Constraints in Mainstreaming of MFIs and Challenges Faced by the Sector
6.10 Let Us Sum Up
6.11 Keywords
6.12 Check Your Progress
6.13 Key to Check Your Progress
6.0 OBJECTIVES
After reading this chapter you will understand:

- evolution of microfinance in India
- objectives, policy support and models of SHG-Bank Linkage programme
- characteristics of Microfinance institutional channel

6.1 INTRODUCTION
Microfinance in India can trace its origins back to the early 1970s when the Self Employed Women’s Association (“SEWA”) of the state of Gujarat formed an urban cooperative bank, called the Shri Mahila SEWA Sahakari Bank, with the objective of providing banking services to poor women employed in the unorganized sector in Ahmedabad City, Gujarat. The microfinance sector went on to evolve in the 1980s around the concept of SHGs, informal groups of people that would provide their members with much-needed savings and credit services. From humble beginnings, the sector has grown significantly over the years to become a multi-billion dollar industry, with bodies such as the Small Industries Development Bank of India and the National Bank for Agriculture and Rural Development devoting significant financial resources to microfinance. Today, the top five private MFIs in the sector reach more than 20 million clients in nearly every state in India and many Indian MFIs have been recognized as global leaders in the industry.

The beginning of state led Microfinance movement in India could be traced to the SHG-Bank Linkage programme started as a pilot programme in 1992 by NABARD with the RBI’s recognition of Informal groups in July 1991. Launched in 1992 in India, early results achieved by SHGs promoted by NGOs such as MYRADA, led NABARD to offer refinance to banks for collateral-free loans to groups. The programme has since then come a long way from the pilot project of financing 500 SHGs across the country. It has proved its efficacy as a mainstream programme for banking with the poor who mainly comprise the marginal farmers, landless labourers, artisans and craftsmen and others engaged in small business. The programme not only proved to be successful but has also emerged as the most popular model of microfinance in India. Other approaches like MFIs also emerged subsequently in the country. Recognizing the potential of microfinance in influencing the development of the poor, RBI, NABARD and SIDBI have taken a range of initiatives over the years to give a fillip to the microfinance movement in India. This chapter traces the evolution of Microfinance movement in India, the supporting policies and current status in this regard.

6.2 SHG-BANK LINKAGE PROGRAMME
NABARD has spearheaded the microfinance programme through partnership with various stakeholders (including NGOs, co-operatives and banks) in formal and informal sector with the support from both Government of India and RBI since the early 1990s. The SHG-Bank linkage Programme was launched by NABARD as a pilot project in 1992. Encouraged by the positive results of the pilot project, RBI advised the banks to mainstream the SHG-Bank Linkage programme. Under SHG-Bank Linkage programme, RBI/ NABARD stipulated that no collateral security should be insisted from SHGs. The bank cannot hold the savings bank account balance of the SHGs, as a security to the bank loan as it will prevent the SHG to lend from its internal savings.

6.2.1 Policy Support for Micro Finance in India
The various policy supports from RBI/NABARD for microfinance in India is given in Table 10.

<p>| Table 10: Various Policy Support for Micro Finance in India |</p>
<table>
<thead>
<tr>
<th>Year</th>
<th>Policy Support</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991 —</td>
<td>RBI (Circular to Commercial Banks) Pilot Project on SHG Bank Linkage — 500 SHGs — MYRADA</td>
</tr>
<tr>
<td>1992 —</td>
<td>NABARD (Circular) Operational Guidelines to Banks for implementation of SHG Bank Linkage Programme</td>
</tr>
<tr>
<td>1993 —</td>
<td>NABARD (Circular) Registrars of Cooperatives) Linkage Programme extended to Co-operatives banks</td>
</tr>
<tr>
<td>1994 —</td>
<td>NABARD (Circular) Clarified the legal position 'Sec 11 (2) of the Companies Act' — only 20 members</td>
</tr>
<tr>
<td>1996 —</td>
<td>KALIA Committee. NABARD SHG under priority sector SHG lending under service area plan Lead Bank to include SHG under service area credit plan, Service area norms for SHGs relaxed Training to branch managers on SHG SHG linkage to be added in corporate plan and training curriculum Assistance to SHGs with default members.</td>
</tr>
<tr>
<td>1997 —</td>
<td>NABARD Prohibits blocking of groups savings in groups SB accounts by banks as collateral</td>
</tr>
<tr>
<td>2000 —</td>
<td>NABARD Refinance support at the rate of 80% to banks for financing MFIs</td>
</tr>
<tr>
<td>2002 —</td>
<td>RBI Set up 4 informal groups to look into the issues relating to (a)structure and sustainability (b) funding(c) regulations (d) capacity building of MFIs.</td>
</tr>
<tr>
<td>2004 —</td>
<td>Advisory committee on Flow of credit to agriculture and related activities from the banking system- chairman-V.S.Vyas To protect the interest of the depositors, RBI announced in the Annual Policy Statement for the year 2004-05, MFI would not be permitted to accept public deposits unless they complied with the extant regulatory framework of the RBI.</td>
</tr>
<tr>
<td>2005 —</td>
<td>RBI —Internal group under the chairmanship of H.R.Khan With the objective of ensuring financial inclusion and increasing the outreach of the banking sector, banks were permitted in Jan 2006 to use the services of NGO/SHG/MFIs (other than NBFCs) and other civil society organizations as intermediaries in providing financial and banking services through BC/BF models.</td>
</tr>
</tbody>
</table>

The SHGs were mainly promoted by many NGOs. The formation of SHGs involves cost. It requires intensive efforts in identifying groups of people with common interests. Subsequently, these groups have to be trained. The cost of group formation has been met by the NGOs through grant funds. In case of non-availability of grant fund, this cost has to be built into the overall transaction cost.

Over the years the collateral-free loans increased progressively up to four times the level of the group's savings deposits. SHGs thus 'linked' almost became micro-banks able to access funds from the formal banking system. The linkage permitted the reduction of transaction costs of banks in two fold: firstly through the externalisation (to the SHG) of costs of servicing individual loans, secondly by ensuring their repayments with the peer pressure mechanism (among SHG-members).
6.2.2 Objectives of SHGs- Bank linkage Programme

- To evolve supplementary credit strategy for meeting the credit needs of the poor by combining flexibility, sensitivity and responsiveness of the informal credit system with the strength of technical and administrative capabilities and financial recourses of the formal credit institutions.
- To build mutual trust and confidence between the bankers and rural poor.
- To encourage banking activity both on the thrift as wells credit side.

6.2.3 Criteria for selection of SHGs for Bank Linkage Programme

- The group should be in active existence for at least a period of six months.
- The group should have successfully undertaken savings and credit operations from its own resources.
- The group must have demonstrated democratic functioning wherein all members feel that they have a say.
- The group should maintain proper accounts/records.
- The group should be convinced that the group has not come into existence only for availing loan.
- Members preferably have a homogeneous background and interest.

6.2.4 Uniqueness of SHG — Bank Linkage Programme

The Indian experience of SHG Bank linkage programme is unique and different from other models in various aspects. RBI and NABARD have tried to promote "relationship banking" i.e. improving the existing relationship between the poor and the bankers with the social intermediation by NGOs. The Indian model is predominantly a linkage model which draws upon the strength of various partners — NGOs who are involved in mobilizing and capacity building of the poor and the bankers involved in financing. Thus as compared to other countries where parallel model of lending to the poor is predominant, the Indian model tries to use the existing formal financial network to increase the outreach to the poor while ensuring necessary flexibility of operations for both the bankers and the poor. The uniqueness of the SHG — Bank linkage programme is presented in figure 4 and Table 11.
Figure 4: Uniqueness of the SHG–Bank linkage programme
<table>
<thead>
<tr>
<th><strong>Table 11: Uniqueness of the SHG —Bank linkage programme</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Decision making</strong></td>
</tr>
<tr>
<td><strong>Convergent Financial services</strong></td>
</tr>
<tr>
<td><strong>Supplementary to formal banking</strong></td>
</tr>
<tr>
<td><strong>Cutting costs</strong></td>
</tr>
<tr>
<td><strong>NPA savvy</strong></td>
</tr>
<tr>
<td><strong>Peer pressure as collateral</strong></td>
</tr>
<tr>
<td><strong>Quality clients</strong></td>
</tr>
<tr>
<td><strong>Client preparation</strong></td>
</tr>
<tr>
<td><strong>Social agenda</strong></td>
</tr>
<tr>
<td><strong>Exclusive poor focus</strong></td>
</tr>
<tr>
<td><strong>No subsidy dependence syndrome</strong></td>
</tr>
</tbody>
</table>
6.2.5 Advantages of SHG-Bank linkage Programme

The linkage between banks and SHGs, with the NGOs, as facilitator and financial intermediaries, serves as a mechanism for channelling credit to the poor on a sustainable basis. It offers a number of potential advantages. Banks:

- Reduction in transaction cost by way of externalization of a part of the credit cycle (appraisal, disbursement, supervision and repayment).
- Mobilization of small savings.
- Assured and timely repayment leading to faster recycling of funds.
- An opportunity for expansion of business and coverage of poor clientele.

NGOs:

- Facilitate deepening of their developmental efforts.
- Synergy in operating social Programmes with economic Programmes.
- Increase the outreach to the poor through credit plus approach.
- Emergence as a bridge between banks and the poor.
- Avenue for performing financial intermediation in unbanked and backward areas.

6.2.6 Purpose of Loan under SHG Bank Linkage Programme

Loan may be granted by the SHGs both for consumption purpose and production purpose. The group will discuss and decide about the purpose for which loans are to be given to the individual members by the SHG. The bank does not decide the purpose for which the SHG gives loans to its members.

6.2.7 Ten — Pillars of SHG-Bank Linkage Programme

- Participative financial services management is more efficient and responsive
- Poor can save and are bankable
- The capacities of the banking system can match the expectations of the poor.
- Poor need credit support as well as savings and other services
- Small cohesive group of poor with/without support can effectively manage and supervise micro credit.
- Collective wisdom of the group and peer pressure are more effective securities than the collaterals
- SHG is a pre micro enterprise stage for majority of the rural poor.
- SHG as client facilitates wider outreach
- Lower transaction cost including risk costs.
- Empowerment of poor especially women could be one of the major outcomes

6.2.8 Models under SHG-Bank Linkage Programme

Under the SBLP the following three different models have emerged.

Model I — (Direct Model) SHGs Formed and financed by Banks
Model II — (Indirect Model, NGO Acting as Social Intermediary) SHGs formed by NGOs or other agencies but financed by Banks
Model III — (Indirect Model, NGO acting as Financial Intermediary)

These three models have certain advantages and limitations on account of parameters such as i) Transaction cost of lending for the banks ii) Transaction cost of borrowing for the SHGs iii) Risk of funds and guarantee of repayments iv) Ease of adoption by the stakeholders v) Reliability vi) Social and economic impact of SHG movement vii) Extent of social investment required. The advantages and limitations of the above three SHG-Bank linkage models are presented in Table 12.

<table>
<thead>
<tr>
<th>Models</th>
<th>Advantages</th>
<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model I</td>
<td>Exposes bankers to social realities first hand Possible solution where NGOs are not present</td>
<td>Wide scale application may not be feasible because of other priorities of bankers.</td>
</tr>
<tr>
<td>Model II</td>
<td>Each partner institution plays a role best suited to it. NGOs organize the poor into SHGs and SHGs manage small group finance in their own interest. Banks lend. The whole system is localized. SHGs and local NGOs learn to deal with an accessible bank branch and vice versa.</td>
<td>Despite the wider acceptability of the model, all the bankers are not yet sensitized and do not view it as banking mandate. In many places, it is still difficult for a SHG to open a savings account.. Absence of NGOs in many areas.</td>
</tr>
<tr>
<td>Model III</td>
<td>It further reduces the transaction cost and risk cost of the bank as the banks lend a larger sums to an NGO which guarantees. Easier for the poor to deal with an institution which they know and trust. Easy to be adopted by stakeholders.</td>
<td>NGOs are not traditionally equipped to work as financial intermediaries. Calls for substantial investment in capacity building of NGOs. Wide scale adoption not possible.</td>
</tr>
</tbody>
</table>

6.2.9 Micro Enterprise Development Programme
NABARD launched the MEDP for skill development in March 2006 with the basic objective of enhancing the capacities of matured SHGs to take up micro enterprises through appropriate skill upgradation. The programme envisaged development of enterprise management skills in existing or new livelihood activities both in farm and non-farm sectors. More than 60000 SHG members have so far been benefited under this programme and many of them have turned micro entrepreneurs.

6.2.10 Performance under SHG-Bank Linkage Programme(SBLP)
The coverage of the SHG-bank linkage programme (SLBP) is given in Table 13. At present it is claimed that it is the largest micro-finance programme worldwide. The SHG Bank linkage programme has passed through various stages like Pilot Testing (1992-96), mainstreaming (1996-98) and expansion
(1998 onwards) and has transformed into a microfinance movement in the country. The SLBP was accelerated growth path till recently and it has slowed down during the last two years. The growth performance of SBLP during the last two years has reached a stage of a plateau, and it is time for giving it new direction for future expansion.

### Table 13: Growth Trends in SBLP

<table>
<thead>
<tr>
<th>Particulars Indicators</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of SHGs with bank loans</td>
<td>2,238,565</td>
<td>2,924,973</td>
<td>3,625,941</td>
<td>4,224,338</td>
<td>4,587,178</td>
<td>4,813,684</td>
<td>4,354,567</td>
<td>4,451,434</td>
</tr>
<tr>
<td>Of which in southern region</td>
<td>1,214,431</td>
<td>1,522,144</td>
<td>1,861,393</td>
<td>2,283,992</td>
<td>2,421,440</td>
<td>2,663,569</td>
<td>2,355,732</td>
<td>2,415,191</td>
</tr>
<tr>
<td>Average disbursed loan per group (Rs.)</td>
<td>37,574</td>
<td>44,343</td>
<td>46,800</td>
<td>74,000</td>
<td>115,820</td>
<td>122,744</td>
<td>144,086</td>
<td>168,757</td>
</tr>
<tr>
<td>Outstanding loans (Rs. billion)</td>
<td>123.66</td>
<td>169.99</td>
<td>226.76</td>
<td>272.66</td>
<td>306.19</td>
<td>363.41</td>
<td>393.75</td>
<td></td>
</tr>
<tr>
<td>Incremental groups (million)</td>
<td>0.69</td>
<td>0.70</td>
<td>0.60</td>
<td>0.36</td>
<td>0.22</td>
<td>0.45</td>
<td>0.10</td>
<td></td>
</tr>
<tr>
<td>Incremental loans O/S (Rs. billion)</td>
<td>123.66</td>
<td>46.33</td>
<td>56.77</td>
<td>45.90</td>
<td>33.53</td>
<td>57.22</td>
<td>30.34</td>
<td></td>
</tr>
</tbody>
</table>

Source: Microfinance India SOS Report, 2012 and status of Microfinance in India (NABARD) 2012-2013

The commercial banks had a share of 59 per cent of all groups with outstanding loans followed by Regional Rural Banks with a 30 per cent share and the co-operative banks with a share of 1 per cent. Commercial banks had 67.66 per cent of all loans outstanding with SHGs, followed by regional rural banks with a 26.72 per cent share. The share of cooperative banks in loans was at a measly 5.62 per cent. The average outstanding loan per group was the highest in the case of commercial banks Rs 1 lakh followed by RRBs at Rs 0.79 lakh. In the case of cooperative banks, the average outstanding loan was only Rs 0.46 lakh, which is less than 50 per cent of that of commercial banks (Table 14).

### Table 14. Bank loans outstanding against SHGs as on 31st March 2013

<table>
<thead>
<tr>
<th>Type of Bank</th>
<th>No. of SHGs</th>
<th>Loan Outstanding (Rs. lakh)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Bank</td>
<td>2643971</td>
<td>2663944.38</td>
</tr>
<tr>
<td>Cooperative Bank</td>
<td>480096</td>
<td>221462.43</td>
</tr>
<tr>
<td>Regional Rural Bank</td>
<td>1327367</td>
<td>1052122.91</td>
</tr>
<tr>
<td>Total</td>
<td>4451434</td>
<td>39337529.72</td>
</tr>
</tbody>
</table>
During the financial year ending March 2013, the percentage share of groups linked with loans in the southern region had a share of 69 per cent followed by eastern region with 15 per cent. The region-wise SHG loans outstanding is given in Table 15.

**Table 15. Region wise SHG loans outstanding as on 31st March 2013**

<table>
<thead>
<tr>
<th>Region</th>
<th>Loans 0/S Amount (Rs. In lakh)</th>
<th>% share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northern</td>
<td>116068</td>
<td>2.95</td>
</tr>
<tr>
<td>Northeastern</td>
<td>79676</td>
<td>2.02</td>
</tr>
<tr>
<td>Eastern</td>
<td>553813</td>
<td>14.06</td>
</tr>
<tr>
<td>Central</td>
<td>277685</td>
<td>7.06</td>
</tr>
<tr>
<td>Western</td>
<td>146752</td>
<td>3.73</td>
</tr>
<tr>
<td>Southern</td>
<td>2763536</td>
<td>70.18</td>
</tr>
<tr>
<td>All</td>
<td>3937530</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: NABARD, 2013, ‘Status of Microfinance in India 2012-13

**Qualitative aspects of SHG Lending**

With fast all-round spread of the SHG —bank linkage programme having credit linkages with a huge number of SHGs the quality of the SHGs has come under stress and is reportedly getting impaired.

- The instances of client drop outs from SHGs is increasing.
- As the target for group coverage increases , the gap between the number of saving group and borrowing groups is on the rise.
- Perceived reluctance on the part of the banks to deal with numerous small SHGs. o Pressure from government sponsored programmes for linking groups promoted by them.
- Falling repayment rates.
- The southern markets which seemed to have unlimited potential have now hit road block. Retaining existing customers in the southern is probably a greater challenge for banks than penetrating new market.
- The low average loan prevents the members of the SHGs taking up enterprise activities.
- The original sets of discipline adopted by the SHGs have become increasingly difficult to maintain. Regularity in attendance, timely repayment and prioritization of member needs do not seem as important as they were a few years back. The study commissioned by NABARD in Karnataka and Tamilnadu has revealed that (a) loans are being equally being divided among the members as they do not want to take a credit risk on others (b) default rates show an increasing trend after farm loan waiver and (c) meeting attendance is not regular as members perceive the opportunity cost of time spent in meeting to be high.
- Individual banks (both commercial banks and RRBs) in many cases had perceived a higher risk perception and gave smaller size loans. Inadequate loans tend to encourage multiple borrowing by members and force them access informal sources of funds. This increases the risk of default which the banks want to avoid. Under-financing has been a major reason for multiple loans and multiple borrowing.
- The continuing pressure of government sponsored programmes for formation of groups tended to split the existing groups and reduce the average number of members in groups. Smaller groups push cost of intermediation as also costs of group maintenance. Going forward, the current emphasis on number of groups should give way to number of members as an indicator of outreach. Efficiency and productivity of SHPIs should be measured on number of members per group and costs incurred per member rather costs per group.
• The impact of SGSY on SHG — bank linkage programme is adverse. There is no subsidy element in SHG-Bank linkage programme, whereas the government is giving some amount of subsidy to the SHOs promoted by SGSY. Various reports and studies point out that many members of existing SHGs are inclined to join SGSY groups in view of the subsidies being offered and as a result quite a few quality groups disintegrate. It is also pointed out that SGSY groups lack quality and the poor do not get long term benefits under the programme.
• The failure to make use of the groups to secure their livelihoods represents an economic loss.

**Box 6: Findings of NABARD study (2010) conducted in seven states in India**

The study findings of NABARD (2010) conducted in seven states in India revealed the following:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>SHGs have helped to reduce the dependence on local moneylenders (upto 66% of the members are now free — either fully or partially from the clutches of local moneylenders in TamilNadu and as high as 92 % in Karnataka).</td>
<td></td>
</tr>
<tr>
<td>Bankers continue to take long time to provide the first loan to SHGs and only a few groups were able to get bank loans after six months.</td>
<td></td>
</tr>
<tr>
<td>While NGOs and Government departments provided skill training to the SHG members, bankers as SHPIs were not very pro active in providing vocational training to members.</td>
<td></td>
</tr>
<tr>
<td>The training given by the SHPIs did not meet the skill requirements of the members for taking up suitable income generating activities.</td>
<td></td>
</tr>
<tr>
<td>There is laxity in enforcing group discipline like regular attendance and regular savings in the meetings.</td>
<td></td>
</tr>
<tr>
<td>Asset creation out of the SHG loan is seen in about 28 per cent cases while in other cases loans are used for consumption / purchase of utility items of household goods.</td>
<td></td>
</tr>
<tr>
<td>Competition among various SHPIs and emphasis on achieving targets also resulted in multiple memberships by SHG members.</td>
<td></td>
</tr>
</tbody>
</table>

**6.2.11 Initiatives by NABARD**

NABARD has been playing a crucial developmental role for the micro finance sector in India. NABARD has been organizing / sponsoring training programmes and exposure visits for the benefit of bank officials, NGOs, SHGs and Government agencies to enhance their effectiveness in the field of micro finance.

**6.2.12 Role of NABARD for other Microfinance initiatives**

A number of innovative projects in microfinance have been funded by NABARD. Important among them are as follows:

• SHG-Post office Linkage Programme
• Social Security system for SHG members
• Financial assistance for developing software — MYRADA
• Pilot project on processor cards and branch automation
• Piloting alternative mechanisms for book-keeping and accounting in SHGs: Setting up of Computer Munshi
• Grain Banks and SHGs

The role of NABARD in microfinance area is presented in the figure 5
6.3 JOINT LIABILITY GROUPS (JLGs)
JLGs are informal groups of 4-10 members who are engaged in similar economic activities like crop production and who are willing to jointly undertake to repay the loans taken by the groups from the banks. Unlike in the case of SHGs, JLGs are intended basically credit groups for tenant farmers and small farmers who do not have proper title of their farmland and such regular savings by the groups is purely voluntary and their credit needs are to be met through loans through financial institutions and such loans could be individual loans or group loans. Financing of JLGs was introduced as a pilot project in 2004-05 by NABARD in eight states with the support of 13 RRBs. Apart from extending refinance support of 1 per cent of such finance to banks, NABARD also extends financial support for awareness creation and capacity building of all stakeholders of the programme. NABARD also extends grant support for formation and nurturing of JLGs to banks and other JLG promoting agencies.

6.4 MICRO FINANCE INSTITUTIONAL APPROACH
While the SHG Bank Linkage Programme remains the most widely used model of microfinance in India, other MFI models have also gained momentum in the recent past. The MFI landscape in India is characterized by a diversity of institutional and legal forms. MFIs in India exist in a variety of forms like Trusts registered under the Indian Trust Act, 1882 / Public Trust Act 1920, Societies registered under the Societies Registration Act 1860, Cooperatives registered under the Mutually Aided Cooperatives Societies Acts of the States and non-banking financial companies (NBFC)-MFIs which are registered under Section 25 of the Companies Act, 1956 or NBFCs registered with the Reserve Bank of India. These MFIs are scattered across the country and due to the multiplicity of registering authorities there is no reliable estimate of the number of MFIs.

The overall industry outreach under MFI Approach is presented in Table 16. As against 264 MFIs that reported information during the year 2010, only 167 MFIs (two thirds of the 264 that reported in 2010)
shared information with Sa-Dhan in 2012 which at best indicated the lack of motivation among MFIs and at worst the closure/dormancy of the rest. Though the regulatory environment is becoming clear, the lack of funding to the MFIs has resulted in a negative growth of the MFIs\(^\text{19}\).

<table>
<thead>
<tr>
<th>Table 16: Progress of MFIs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Particulars</strong></td>
</tr>
<tr>
<td>No. of MFIs Reporting</td>
</tr>
<tr>
<td>Customer outreach (Million)</td>
</tr>
<tr>
<td>Outstanding loans (Rs billion)</td>
</tr>
</tbody>
</table>

*Source: Data from Sa-Dhan's Bharat Microfinance Quick Report-2012*

The regional distribution of outreach and loan portfolio estimates based on the Sa-Dhan Bharat Microfinance Quick Report-2012 revealed that the dominance of the southern region still continues. The Southern region accounts for almost 50 per cent in both outreach and portfolio followed by the Eastern region (25 per cent). The outreach share of the Northern region remains below 5 per cent. When compared to the previous year, the Southern region registered an increased share both in terms of client outreach as well as loan portfolio. The share of the North East and Eastern regions has registered impressive growth while the Western region lost its share significantly.

### 6.5 BANK PARTNERSHIP MODEL

Banks can use MFIs as their agent for handling credit, monitoring, supervision and recovery. The MFI acts as an agent—it takes care of all relationships with the client, from first contact through final repayment. Another variation of this model is where the MFI, an NBFC holds the individual loans on its books for a while before securitizing them and selling them to the bank. Such refinancing through securitization enables the MFIs a greater funding access.

### 6.6 BANKING CORRESPONDENT MODEL

In January 2006, the RBI permitted banks to utilize the services of NGOs/MFIs other than NBFC and other civil society organizations as intermediaries in providing financial services through the use of BC/BFs. The BC model allows banks to do banking transactions at a location much closer to the rural population thus addressing the last mile problem. The BC model uses the MFI's ability to get closer to the poor clients—a necessity for savings mobilization from the poor—while relying on the financial strength of the bank to safeguard the deposits.

### 6.7 PENETRATION OF MICROFINANCE — MPI AND MPPI

The penetration of Microfinance is measured by computing two indices — Microfinance Penetration Index and Microfinance Poverty Penetration Index. These two indices are computed and reported ever since 2007 in the Microfinance India State of the Sector Report. The methodology adopted by the author of SOS report to calculate these indices is given below:

The number of credit clients of MFIs and members of SHGs with outstanding loans to banks were computed and each state's share to the country's total microfinance clients was worked out. The
intensity of penetration of microfinance (MPI) was computed by dividing the share of the state in microfinance clients with its share of population. The Intensity of Penetration of Microfinance among Poor (MPPI) was derived by dividing the share of the state in microfinance clients by share of the state in population of the poor. Since the microfinance clients are in the numerator, a value of more than one indicates that clients acquired were more than proportional to the population. The higher the score is above one, the better the performance. The lower the score from one, which is the par value, the poorer is the performance in the state. The values of MPI and MPPI as reported in SOS 2012 are given in Table 17.

The low value of MPPI in states like Bihar and UP coincides with a large proportion of households under poverty line in these states. This indicates the need for considerable work to be done in these states by the microfinance sector.

### Table 17: Ranking of select states based on MPI and MPPI

<table>
<thead>
<tr>
<th>Name of State</th>
<th>MPI</th>
<th>Name of State</th>
<th>MPPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manipur</td>
<td>4.13</td>
<td>Manipur</td>
<td>7.06</td>
</tr>
<tr>
<td>Pondicherry</td>
<td>3.46</td>
<td>Andhra Pradesh</td>
<td>6.24</td>
</tr>
<tr>
<td>Andhra Pradesh</td>
<td>3.34</td>
<td>Pondicherry</td>
<td>4.67</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>2.32</td>
<td>Tamil Nadu</td>
<td>2.76</td>
</tr>
<tr>
<td>Odisha</td>
<td>2.19</td>
<td>Sikkim</td>
<td>3.28</td>
</tr>
</tbody>
</table>

**LAST 5**

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Jammu and Kashmir</td>
<td>0.07</td>
<td>Mizoram</td>
<td>0.23</td>
</tr>
<tr>
<td>Mizoram</td>
<td>0.32</td>
<td>Jammu and Kashmir</td>
<td>0.46</td>
</tr>
<tr>
<td>New Delhi</td>
<td>0.24</td>
<td>New Delhi</td>
<td>0.45</td>
</tr>
<tr>
<td>Punjab</td>
<td>0.27</td>
<td>Bihar</td>
<td>0.42</td>
</tr>
<tr>
<td>Meghalaya</td>
<td>0.21</td>
<td>Uttar Pradesh</td>
<td>0.38</td>
</tr>
</tbody>
</table>

Source: Microfinance India SOS Report 2012

The Manipur state has taken the top position both in MPI (with a ratio of 4.13) and MPPI (with a ratio of 7.06). Puducherry (Pondicherry) has occupied second position in MPI and third position in MPPI. The last five ranks occupied by Jammu and Kashmir, Mizoram, New Delhi, Punjab and Meghalaya in case of MPI ratio and Mizoram, Jammu and Kashmir, New Delhi, Bihar and Uttar Pradesh in case of MPPI ratio.

### 6.8 MICRO-FINANCE INSTITUTIONAL STRUCTURE: TYPES OF MFIs

The organizations in the field of mF can be classified as 'mainstream' and 'alternative' Micro-finance Institutions (MFIs). All India Financial Institutions are involved in mainstreaming Micro-finance. These are National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), Housing Development Finance Corporation (HDFC), HUDCO, etc.

The Commercial Banks, the Regional Rural Banks (RRBs), and the credit cooperative societies, also play a substantive role in the micro-finance. These banks extend financial support and participate in the SHG linkage programme as also financing the MFIs directly or financing the clients in partnership with MFIs. These financial services to the poor are provided mainly by the rural and semi urban branches of commercial banks and branches of RRBs (The RRBs were established in 1975 to serve the credit requirements of the poor). RRBs could now emerge as major sources of micro-finance. and by
cooperative outlets — either bank branches or village level societies. State-owned cooperatives, moribund and politicized have proved that they may not be able to provide sustainable financial services to the poor.

The Commercial banks have been varying actively in the field of micro-finance. Funds have flowed to MFIs through advances from banks (either on their own accord or through directed credit programmes), linkage programmes between self-help groups and banks and wholesaling by apex agencies, notably SIDBI and Friends of Women’s World Banking/Ananya Finance for Inclusive Growth. Because of the role of the RBI, NABARD and the directed credit programmes, the banking system overall has a great role in micro-finance.

A more detailed generic list of stakeholders along with the constrictive features of their role with possible issues that they face in the development of the micro-finance sector is given in the Table 18.
Table 18: The Role of Stakeholders in Developing the Micro-Finance Sector

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Action</th>
<th>Constructive</th>
<th>Issues/Constraints</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Government</strong></td>
<td>1. Policy formulation</td>
<td>Allocating appropriate resources</td>
<td>Only working with government owned agencies. Governments expect diverse competencies from single agencies rather than seeing the need for a wider range of diverse organisations within the sector.</td>
</tr>
<tr>
<td></td>
<td>A. Identifying areas in line with political preferences</td>
<td>Defining priorities and increasing allocations</td>
<td></td>
</tr>
<tr>
<td></td>
<td>B. Monitoring Efficiencies</td>
<td>Sharing knowledge and information with other stakeholders</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. Policy Instruments:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>A. Policy measure</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>B. Resources Allocation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>C. Incentives such as tax break</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Regulatory</strong></td>
<td>Regulation and supervision including defining financial and legal</td>
<td>Removing distortions (interest rates, etc.) in</td>
<td>Primary reliance on main stream idea and primary attention to formal intermediaries to micro finance organisations.</td>
</tr>
<tr>
<td>agencies</td>
<td>forms</td>
<td>markets. Increasing acceptance diversity of</td>
<td>Lack of investment in internal capacity among regulators and supervisors.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>financial intermediaries that is neutral to the</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>model adopted and also allows products diversity</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Investments in understanding entities and their</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>asset and liabilities.</td>
<td></td>
</tr>
<tr>
<td><strong>Apex bodies</strong></td>
<td>Resources flows for public goods, debt, equity.</td>
<td>Sharpening organizational competences. Develop</td>
<td>Conflict of interest between different resources functions, such as lending capacity and supervisory functions.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>skill sets to match objective of instruments and</td>
<td>Many of the same constraints that apply to government also apply to the publicly owned apex bodies.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>resources (e.g. through bank linkage programmes)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Monitoring and improving asset quality.</td>
<td></td>
</tr>
<tr>
<td><strong>Banks</strong></td>
<td>Providing debt and equity</td>
<td>Improving services quality and costs</td>
<td>Only understand collateral based debt appraisal. May view lending to mE a an obligation rather than</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Potentially taking up equity positions.</td>
<td></td>
</tr>
<tr>
<td>Access to large volume of funds.</td>
<td>Donors</td>
<td>Resources flows for public goods, debt, equity.</td>
<td>Increasing flows to appropriate bodies and intermediaries. Resources for specialisation.</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>--------</td>
<td>-----------------------------------------------</td>
<td>-----------------------------------------------------------------</td>
</tr>
<tr>
<td>Limited instruments for interventions. Concentrating both loan and development funding in the same organizations. Limited allocation of resources for learning by doing.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MFOs, community based service providers</td>
<td>Service provision</td>
<td>Innovative and risk taking. Focus on expansion, targeting, experimentation, etc, with client group. Building of skills and products to suit client group.</td>
<td></td>
</tr>
<tr>
<td>Weak MIS and monitoring. Limited learning from operations and peers. Inadequate attention to micro enterprises demand and to demand constraints.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Support (third party) organizations</td>
<td>Bridging different experiences; Audit, rating, data verification; Organization and human resource dev, evaluation, impact, assessment.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Verifying information and data. Establishing quality benchmarks. Investing in research and refinement.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Limited specialization. Inappropriate application of tool and methods.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 6.9 CONSTRAINTS IN MAINSTREAMING OF MFIs AND CHALLENGES FACED BY THE SECTOR

To increase the outreach of micro-finance services to the needy, the issues/problems associated with the legal, regulatory and organizational systems should be addressed. Also attitude related issues need to be addressed.

The formal financial institutions are having large volume of funds and have access to equally large amounts of low-cost savings deposits. Credit Deposit Ratio (the ratio of credit outstanding to deposits outstanding) is an indicator of banks involvement in a given area. This ratio gets discussed in Lead Bank forums. Herein, it is observed that, the poorer the region, the lower the credit-deposit ratio. This can be inferred to mean that poor regions save more compared to what they borrow than richer regions. Most of eastern Uttar Pradesh (UP), Bihar, Orissa and the North-east have credit-deposit ratios of 20-30 per cent. Thus while banks are physically present in rural areas and offer concessional interest rates, rural producers are not able to access loans, with the result that the rest of the deposits are finding their way as credit into other regions. Some of the main reasons for the above are as follows:

* **Borrower-unfriendly Products and Procedures:** Most bank products are standardized/straight jacket type loans. The branches do not have the right to modify the projects. For example a majority of the rural/poor customers are illiterate and in need of consumption loans. As per banks' policy,
consumption loans require more documentation and collateral security. Other products have similar constraints. Hence, the products do not reach the rural poor.

Inflexibility and Delay: Banks follow rigid systems and procedures which result in a lot of delays. Borrowers are demotivated from taking further loans. Particularly in the case of small and micro loans, banks are not able to offer flexibility in the product. Thus the amount of loan and terms of loan are pre-fixed for a given set of clients which is often inadequate.

*High Transaction Costs*: The interest rate offered to the borrowers is regulated. However, the transaction costs are high. The borrowers have to make a large number of trips to provide the documents. The disbursements are not convenient. The different constituents of transaction cost of borrowing are as follows:

- transport cost,
- incidental cost,
- opportunity cost and
- intermediary cost.

This makes loans less attractive for borrowers particularly as the loans are very small and the repayment period is very short.

*Social Obligation and not a Business Opportunity*: Micro-finance has historically been seen by the formal institutions as a social obligation rather than a potential business opportunity.

*Financing to Alternative MFIs*: The NABARD Act does not permit NABARD to refinance a private sector financial institution and undertake direct financing. The direct lending to NGOs that NABARD has done so far has come out of donor funds. Similarly the SIDBI Act restricts it from extending loans to the agricultural and allied sectors, whereas many of the SHGs are engaged in such activities.

*Legal and Regulatory Framework*: The policymakers feel that farmers and poor people need low interest and subsidized credit. They believe that the poor cannot save, they are unwilling to repay the loans, and the administrative costs of servicing them are high.

Also small loans have been used as a tool for disbursing political patronage, undermining the norm that loans must be repaid. Thus the mainstream institutions feel that these loans are risky, difficult to serve and have a low or negative net spread.

The RRBs Act does not permit private shareholding in any RRBs, and the Cooperative Acts of all states do not permit district level cooperative 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.

*Up scaling of the programme*: The SBLP is facing problems of up scaling as there is lack of credible NGOs and other agencies/individuals that could do social intermediation. The absence of quality agencies for social intermediation is limiting the spread of the programme.

*Capacity building*: The capacity building of various partners in the programme namely bank officials, NGO officials, animators, SHG group leaders and SHG members is a gigantic task. NABARD has been paying attention to the capacity building of all partners. However the enormity of the programme
warrants other agencies which could also include donor agencies to collaborate in capacity building of the partners in the programme.

Sustainability of SIIGs: Sustainability of the SHOs depends to a great extent on the quality of the SHGs which in turn is dependent on the care and attention given by the SHPIs in the formation stage. It has been observed that there has been a tendency at the field level to hasten the process of formation of SHGs to achieve the targets which affects the sustainability of the groups on the long run.

Graduation of Microfinance to Micro enterprise: There are a vast number of SIIGs which have come of age and are struggling to graduate from the stage of microfinance to the stage of micro enterprises. Lack of adequate skills as also marketing linkages comes in the way of graduation of SHGs to micro enterprise stage. Not many NGOs / agencies are in a position to provide SHGs the requisite backward and forward linkages as also market survey reports. This affects setting up of micro enterprises on a sustainable basis.

Sustainability with outreach: The cost of outreach to the poor is high and the MFIs have a major issue before them. They need to address the issues of minimizing costs for the poor by having operating efficiency, administrative effectiveness, maintaining portfolio quality, tracking future risks in portfolio, covering expenses and fixing appropriate interest rates. Self regulation: The MFIs are handling savings of the poor people. Savings being an inherent part of microfinance, MFIs need to operate in a self-regulatory framework.

Constraints Faced by Micro-finance Institutions.
The main aim with which the alternative MFIs have come up is to bridge the increasing gap between demand and supply of financial services. A vast majority of them function as NGOs to get access to funds. The existing practice of SIDBI and NABARD is to fund only NGOs or NGO-promoted SHGs. As a result, most institutions enter such services through the non-profit route. The micro-finance finance institutions also have not been fully successful in reaching the needy. There are many reasons for this:

- Financial problems leading to setting up of inappropriate legal structures
- Lack of commercial orientation
- Lack of proper governance and accountability
- Isolated and scattered institutions

Inappropriate forms of organization (legal constraints)
NGOs invented micro-finance but NGOs are not the best type of agencies to carry out micro-finance on a long-term sustainable basis. If an NGO opts to become an MFI, it could face the following problems:

- The major sources of funds of NGOs are grants, which are very limited.
- If the NGOs earn a substantial part of their income from lending activity, they violate section 11(4) of the Income Tax Act and can lose their charitable status under Section 12.
- Moreover, NGOs do not have the appropriate financial structure for carrying out micro-finance activities. NGOs, being registered as societies or trusts, do not have any equity capital and can never have adequate capital.

It is a well recognized fact that capital adequacy is an important parameter to ensure risk bearing capacity. The other alternative for an MFI is to become a cooperative or a company. As in the long run, the primary source of lending funds for MFIs is deposits, till that stage, the MFI has to rely on
borrowings. 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.

In most states, with the exception of Andhra Pradesh, Maharashtra and Gujarat, cooperatives are politicized and state controlled and thus not an appropriate form of incorporation for an MFI. That leaves an MFI with the choice with the choice of being incorporated as a company and then becoming a Non Banking Finance Company (NBFC) or a Local Area Bank (LAB). The latter requires a licence and minimum start-up equity of Rs 100 crore. The minimum start-up equity is very difficult for an MFI to mobilize.

If an MFI opts to become an NBFC, it has the following problems:

- The minimum entry-level capital requirement is Rs 5 crore by 30 March 2014 (in case Rs 2 crore in case of North-eastern region).21
- It is difficult to mobilize any borrowings from Indian financial institutions due to the negative image of NBFCs in general. Further, deposit mobilization is not possible at least for the first three years, till a satisfactory credit rating is obtained.
- This leaves the portion of borrowing from foreign institutions. Borrowing from such institutions however is difficult in the first place, due to RBI's requirement of at least two credit ratings. Further, very few foreign institutions are willing to give rupee-denominated loans. Thus the MFI taking foreign currency loans are subject to exchange risks, which they cannot handle.

**Lack of Commercial Orientation**
In the initial period, most of the MFIs are highly successful in making credit to customers available at low cost on account of subsidies and grants that the MFIs are able to attract. However, they failed to maintain the same record in the long run because of the lack of commercial orientation, thus making it unsustainable.

**Isolated and Scattered**
The MFIs are isolated and scattered. There is no proper coordination among them and also there is the lack of information dissemination.

**Lack of Proper Governance and Accountability**
Governance and accountability are limited in case of not for profit organizations which need to be improved. Their boards must be made aware of their financial liabilities in case of failure. The lenders should be more stringent and insist on nominating a few directors.

**6.10 LET US SUM UP**
The state led microfinance movement started in India with the introduction of SHG Bank Linkage Programme in the early 1990s. At present there are two models of microfinance delivery in India—the Self Help Group Bank Linkage Model and MFI model. The chapter describes the evolution of microfinance in India and the policy measures extended by NABARD. The SHG Bank Linkage Model has emerged as dominant model in terms of number of borrowers and loan outstanding. In terms of coverage the model is considered to be the largest microfinance programme in the world. Reserve Bank of India, NABARD and SIDBI have taken a range of initiatives to provide a momentum to the Microfinance Movement in India. The objectives, uniqueness of SBLP, advantages, credit linkage models have been presented. The developments relating to evolution of various SHG bank linkage
models of the Microfinance movement arc detailed. The chapter also discussed the institutional channel of Microfinance and the challenges faced by the Microfinance sector.

6.12 CHECK YOUR PROGRESS

The intensity of penetration of microfinance (MPI) is computed by dividing the share of state
(a) In microfinance clients by its share of population
(b) Income by the share of population
(c) In microfinance clients by share of the state in population of poor
(d) GDP by BPL population

2. The micro-finance institutions have not been fully successful in reaching the needy due to the
(a) Financial problems leading to setting up of inappropriate legal structures
(b) Lack of commercial orientation
(c) Lack of proper governance and accountability
(d) All the above

3. Opportunity cost of the transaction cost arises on account of
(a) The borrowers have to make a large number of trips to provide the documents.
(b) Inconvenient disbursements of loans.
(c) Intermediary cost
(d) Wages that are foregone by the borrowers

6.13 KEY TO CHECK YOUR PROGRESS
1-a, 2-a, 3-a