

includes debate by practitioners and academicians on a contemporary topic

## *Rural Finance in Contemporary Times: Interface with Microfinance*

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### *Executive Summary*

In India, when we talk about rural finance, the stereotype offered is that of a banking system that fails to reach out to the poorer clients and, when it does, fails to recover the money so disbursed. The counter-point offered is usually the magic wand of microfinance. This Colloquium was an interface between leading bankers and microfinance practitioners in India to examine where these two worlds meet and how they could learn from each other. The discussions were organized around three themes: a) the legacy of the banking system, b) the limitations of microfinance, and c) an assessment of the potential.

On the issue of legacy, the message was clear that the intervention of the state in certain aspects has been undesirable. These areas were clearly identified as granting general pardon for loans, tinkering around with interest subsidies, and interfering with the commercial aspects of banking.

The limitations of the microfinance institutions were in terms of their sustainability and their inability to draw commercial capital and grow rapidly. However, these limitations were partly seen as a consequence of regulatory apathy and support from the state both in terms of formulating and articulating a regulatory framework and also in terms of the central bank being reluctant to supervise the efforts. These did not help in enhancing the legitimacy of microfinance institutions.

The participants saw a great potential in the rural markets which were beyond agriculture. The emerging sectors were identified as construction, non-farm enterprise, handloom, clusters that involve garment making and quarrying, etc. According to them, there was scope for both the banks and the microfinance institutions to intervene. The following points emerged from the discussion:

- Rural finance has suffered from interventions from the state in the past. While some interventions have been positive, they have harmed the sector when compromises such as write-offs have been made.
- Microfinance has emerged as an important mechanism to reach out financial services to the poor. There are interesting lessons from this for the banks to adopt.
- There are problems for the microfinance institutions in the form of regulatory and supervisory apathy. This leads to financial exclusion of large segments of the poor.
- There is a huge market for financial services — both loans and savings.
- Innovations across the world indicate important breakthroughs in delivery of financial services. These can be implemented provided the regulatory impediments are removed.
- The issue of risk management has to be systematically addressed.
- The role of the state, wherever positive, has been effective and, therefore, this should be sharply defined to see how the state could contribute to this sector.
- The issue of interest rates continues to be vexatious and needs to be addressed urgently. ❖

**Note :** This colloquium is based on the Workshop on Microfinance held on 4th September, 2004 at Indian Institute of Management, Ahmedabad.

#### KEY WORDS

Microfinance  
Financial Exclusion  
Regulation  
Financial Service  
Delivery Innovations  
Defaults  
Write-offs

## INTRODUCTION

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This colloquium was triggered by the fact that since the last few years, rural India has not been getting as much attention as warranted from the banking sector. The signs of apathy were clear from some of the statistics. The number of formal sector outlets that were catering to the rural people was reducing as indicated by Table 1. An interesting aside of this data is that a major chunk of the closure or relocation of the rural branches (around 370) originated from the regional rural banks (RRBs) which were mandated to work in these areas.

While the flow of credit from the banking system has grown with the banks playing a significant role in disbursing credit to agriculture, rapid growth has come about only in the recent years after a phase of stagnation. Rural credit has suffered from high levels of non-performing assets. While the policy of the state has been in the direction of trying to get more banking services to the poor, the performance of the banks has been somewhat skewed.

In an interesting work, Burgess and Pande (2003)<sup>1</sup> have argued that the policy of forcing banks to open more branches in the rural areas using the 1:3 rule (banks get a licence to open one branch in a location that already has a branch of another bank only if they open branches

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in three other unbanked locations) was instrumental in making significant impacts on poverty. This rule was abandoned in 1990 and, since then, we can see stagnation in the expansion of bank branches. While the population in the rural areas is on the increase, the number of bank branches in the rural areas has been slowly going down. This certainly has implications on the ability of the branches to reach out to the small customer.

The task force on revival of rural cooperative credit institutions identifies two trends that emerge from the overall flow of credit to agriculture from the commercial banking sector.<sup>2</sup> The number of rural branches has reduced and even though the commercial banks almost meet their targets for lending to the priority sector, they have moved more towards larger customers. The average size of direct loans to agriculture in the portfolio of the commercial banks was Rs. 13,500 in 1997 and is Rs. 31,585<sup>3</sup> now. The average size of loans of the cooperative sector, in comparison, is currently only Rs. 6,640<sup>4</sup> per borrower, according to the data tabulated in Table 2.

The phase in which the mainstream banking services have slowed down has also seen an aggressive growth of the microfinance sector. The microfinance

<sup>2</sup>Task Force on Revival of Cooperative Credit Institutions, Ministry of Finance, Government of India, 2005.

<sup>3</sup>*Trend and Progress of Banking in India*, Mumbai: Reserve Bank of India.

<sup>4</sup>Task Force on Revival of Cooperative Credit Institutions, Ministry of Finance, Government of India, 2005.

<sup>1</sup> Burgess, Robin and Pande, Rohini (2003). "Do Rural Banks Matter? Evidence from Indian Social Banking Experiment," BREAD Working Paper No.037.

**Table 1: Spread of Bank Branches across the Years**

Branch Location	1997	1998	1999	2000	2001	2002	2003	2004	Change
Rural	32,918	32,882	32,791	32,771	32,549	32,434	32,249	32,212	(706)
Semi-Urban	13,783	13,971	14,205	14,329	14,605	14,742	14,911	15,035	1,252
Urban	9,379	9,604	9,931	10,051	10,309	10,493	10,739	10,937	1,558
Metropolitan	7,573	7,782	8,069	8,189	8,472	8,590	8,744	8,934	1,361
Total	63,653	64,239	64,996	65,340	65,933	66,259	66,643	67,118	3,465

Source: *Trend and Progress of Banking in India* (various years), Mumbai: Reserve Bank of India.

**Table 2: Average Loan Size of Public Sector Banks vis-à-vis PACS (as on March 2003)**

Particulars	Amount in Rs.		
	No. of Accounts	Loan Amount Outstanding	Average Loan Size
Public Sector Banks (PSBs)	16.4 million	517.99 billion	31,585
Primary Agricultural Credit Society (PACS)	63.9 million	424.11 billion	6,637

Source: *Report of the Task Force on Revival of Rural Co-operative Credit Institutions* (2005). Ministry of Finance, Government of India, New Delhi.

sector comprises of two distinct strands:

- The self-help group (SHG) movement that has emerged from the mid-1980s and is actively promoted by the state and the banking system (Table 3 gives the growth of the SHG movement).
- The microfinance institutions (MFIs) that have emerged in the 1990s and are largely coming up at the initiative of the non-governmental organizations and supported by international donors.

The MFI movement has also been aggressively growing and is estimated to have an outstanding portfolio of around Rs.10 billion. Both these sub-strands of microfinance have achieved something that was difficult for the mainstream banking sector to achieve.

In brief, the performance highlights of the microfinance movement could be summarized as follows:

- The movement has penetrated into the client groups that a mainstream agency had not reached effectively in the past.
- It has added a new set of clients — not only the poor, but also, to a large extent, women.
- It has worked under a credit culture which bore a legacy of write-offs and political intervention and

has till now proved to be an insular system with very high repayment rates.

- It has worked under a paradigm of social collaterals, trust, and local systems thereby reducing significant amount of transaction costs.
- It has looked at activities other than agriculture helping people to diversify their livelihoods.

However, we must remember that the progress of the microfinance sector is in the segment termed as 'small, short, and unsecured' (Bouman, 1989)<sup>5</sup>. This means that the loans are really small amounts given for a short duration without any security.

This in itself could be the limitation of microfinance and, therefore, it was unlikely that microfinance would compete with the Indian

banking system. Instead, it can be safely assumed that these two segments are playing complementary roles. However, we need to examine some caveats in the mutual learning between these two segments of the rural financial market.

In microfinance, theory and practice do not quite meet. This gulf is important to appreciate both for the

<sup>5</sup>Bouman, F J A (1989). *Small, Short and Unsecured: Informal Rural Finance in India*, Delhi: Oxford University Press.

**In microfinance, theory and practice do not quite meet. This gulf is important to appreciate both for the growth of microfinance and for commercial banks that may wish to adopt microfinance practices.**

**Table 3: Agency-wise Distribution of SHGs that were Linked with External Credit**

(Amount in Rs. Million)

Year	Commercial Banks		Regional Rural Banks		Cooperative Banks		Total	
	No.	Loan Amount	No.	Loan Amount	No.	Loan Amount	No.	Loan Amount
1997	5,362		3,048		131		8,541	120#
% share	62.79		35.68		1.53			
1998	8,704	154.7	5,192	77.6	421	5.2	14,317	240
% share	60.79	651.4	36.26	326.7	2.94	21.9		
1999	20,115	386.8	11,610	166.6	1,270	17.3	32,995	570
% share	60.96	677.8	35.19	291.9	3.85	30.3		
2000	51,619	1,278.3	38,998	574.6	4,028	76.9	94,645	1,930
% share	54.54	662.4	41.20	297.8	4.26	39.8		
2001	124,246	2,958.6	97,824	1,599.6	12,773	250.5	234,843	4,810
% share	52.91	615.3	41.66	332.6	5.44	52.1		
2002	274,247	6,009.0	188,738	3,459.0	39,906	795.0	502,891	10,260
% share	54.53	585.5	37.53	337.0	7.94	77.5		
2003	361,061	1,150.0	277,340	7,272.0	78,959	172.0	717,360	20,490
% share	50.33	561.1	38.66	355.0	11.01	84.0		
2004	538,422	22,550.0	405,998	1,278.0	134,671	371.0	1,079,091	390,40
% share	49.90	577.6	37.62	327.4	12.48	95.0		

# Only total available for this year.

Source: Primary Data from Institutional Development Department, National Bank for Agriculture and Rural Development (Unpublished).

growth of microfinance and for commercial banks that may wish to adopt microfinance practices.

The theory on banking has two elements. One, that banks have specialized knowledge and monitor the borrowers' project. Two, recent literature argues that what keeps banks going is that they have depositors who can demand their money back. In other words, while many of us are concerned that demandable deposits may be vulnerable, theory argues that a run on the deposits is what makes the banks stable and also disciplines them. Interestingly, the depositor who first withdraws patronage is the one who has been monitoring the bank. There is no place for a free rider. If you are a depositor willing to monitor a bank, you will withdraw money at the earliest and the 'spectator' depositor loses.

Contrast this with microfinance in which the loan repayment is monitored, not the borrower's project. Monitoring projects and monitoring repayment cash flows are completely different issues. If we are monitoring only cash flows, we may find that the borrower might actually be borrowing from other sources to service a microfinance loan. In other words, we may be providing an additional market for a moneylender. This is because, for the moneylender, the safest customer is a member of an SHG or an MFI client where he knows that if that person repays to the group, he/she gets a higher loan in the next cycle. Things will be generally under control but for externalities like failure of agriculture or rainfall or something else that might have a contagious effect.

In this structure, we have not introduced demandable deposits. Therefore, there is no scope for monitoring by depositors. Contrast this with what happened a few months back in a cooperative: Many experts were admiring a district cooperative bank for its achievements in SHG movement while, on the same day, the depositors were withdrawing their deposits. The depositors understood that the microfinance might have been doing well in the cooperative but the other activities were not doing well. Therefore, by suppressing deposits, we are suppressing an important mech-

anism for the functioning of MFIs.

Portfolio quality may be extremely good when small sums of money are lent for a short-term with the assurance of a larger loan if the earlier loan is repaid. Extrapolating this experience to larger loans of longer tenure — that can make a meaningful difference in incomes from livelihood — should be done with caution. Any comparison of the loan portfolio quality of new microfinance institutions with that of commercial banks has to take loan size and tenure into account.

The government has been talking about getting the focus back on rural India and putting a thrust on increasing access to agricultural credit in particular and providing greater access to financial services in the rural markets in general. Assuming that microfinance and banks operate in certain niche segments of the market

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and both of them are complementary, we thought that it would be a good idea to get both the microfinance and banking practitioners to examine what one could learn from the other sector.

This discussion brought in policy makers, practitioners (from commercial banks, credit cooperatives as well as the new microfinance sector), and academics to address rural finance through three inter-related themes. The first theme was the issue of legacy of several decades of state-directed lending that mainstream banks need to address when they attempt to reverse the declining share of rural lending in their loan portfolios. A logical corollary of this legacy is risk. The second, a recognition of the transformation that the rural economy has undergone in the last decade, was the financial needs of the rural sector beyond agriculture. These financial needs cannot be met by just pumping in more money but require new skill-sets in identifying market opportunities, loan appraisal and so on. While much success has been attributed to microfinance, the third theme focused on its limitations. Identifying and addressing these limitations is important both for the future growth of microfinance institutions and for adoption of good microfinance practices by mainstream banks. ♡

## SETTING THE AGENDA

**N S Sisodia**

Secretary (Financial Sector)

Government of India, New Delhi

Let us first look at the dynamics of the rural economy and how it has been changing so as to place rural finance and microfinance in their proper context. We have to recognize that services sector in the rural economy is growing rapidly. The requirement of finance for agriculture which contributes around 22 per cent to the GDP would continue to grow. There are a variety of services that are growing and this is coupled with the trend of greater mobility of labour, capital, products, and even finance in the rural, semi-urban, and urban areas. The commercialization of agriculture is leading to growth in buyers' and suppliers' credit. There is much greater focus on sub-sectors of agriculture that are not dependent on foodgrain. In traditional rural India, there was a landlord-based tenancy relationship. This is now getting switched to commercial-based tenancy systems. The rural people are resorting to multiple vocations like setting up cable networks, running STD booths, installing repair workshops, etc., leading to the need for more financial services. An improvement in the fields of literacy and education has its own impact on credit markets and the rural economy. The relationship of erstwhile creditors and borrowers is also undergoing some changes.

During the early plan periods, there was significant microcredit available through government and government-sponsored institutions. Although cooperatives have been functioning from the early 20th century, they have been unable to meet expectations and have suffered from a number of ailments. There was, therefore, a need to look at commercial banks as an additional source. When banks could not deliver, they were nationalized. In doing so, the primary objective was to ensure that the neglected sectors get credit. Then, there was some disillusionment in the mid-seventies with the functioning of the commercial banks in

so far as rural poor were concerned. The state promoted new RRBs. We are now at a stage when there is an acute realization that RRBs have not quite succeeded in achieving the objectives for which they were set up. However, these measures led to a vast growth of infrastructure. Now, we have around 150,000 outlets of credit including cooperatives which the state supported in some form. We also have a policy framework where 40 per cent of all net bank credit has to be directed towards identified sectors with sub-targets of 18 per cent to agriculture and 10 per cent to weaker sections.

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Overall, the contribution of the formal sector to making credit available has been less than satisfactory. According to the All India Debt and Investment Survey (AIDIS) of 1992, only 64 per cent of the borrowal accounts were serviced by the formal sector. Of course, some might differ with that figure and assess that it is much less, perhaps, only half of it. Nevertheless, the point is that, only a part of the rural populace is actually getting covered by formal institutional sources. According to official estimates, 36 per cent of the rural population still depends on non-formal sources.

The formal sector has problems in servicing this segment because of high transaction costs, small scattered accounts, and high transaction intensity. The formal institutions have inappropriate systems, procedures, products, rigidities, incapacity to innovate, and lack of initiative to service this segment. We have also seen a neglect of vital products like savings and insurance. In early nineties, when the state recognized this, the SHG movement was encouraged. It has been gaining strength and it is no exaggeration to say that the services purveyed through SHGs in India are now the world's largest. This, of course, does not say much because anything we do in India does not need much effort to be

the world's largest! As of March 2004, nearly 1.1 million SHGs have been credit-linked. They cover 16 million poor households. The total credit disbursed by these SHGs was around Rs.4 billion. However, the average loan size per SHG (the numbers differ widely but all numbers emphasize a general point) is modest. According to one set of figures, the average loan per SHG was Rs.36,000 and the loan per family was only Rs.2,412, which is quite low. I have seen other figures which indicate a larger average size of loan per family. Nevertheless, the size of loans continues to be rather modest.

Although there are differing numbers on repayment rates, all of them seem to support the view that the repayment of SHGs or MFIs is quite encouraging. Figures of recovery vary from 92-93 per cent to 98 per cent; in any case, recovery is over 90 per cent. The participation of women has been active. In addition, the private sector is now beginning to see that MFIs and SHGs offer a business opportunity. More importantly, the movement has promoted participative decision-making; savings; a diversity of loan products for consumption; production, and, in some cases, insurance and social security. The formal structures only look after the specific needs of consumption or production credit while the microfinance industry has shown the potential of addressing multiple needs. An important lesson from the SHG movement is that peer pressure can be used effectively for recovery. This needs to be considered in the context of extending the lessons of microfinance to the formal sector. For instance, joint liability groups can be promoted by the formal sector to advance agriculture credit to tenant farmers or share croppers.

While the achievements of microfinance programme in the country have been impressive, it is necessary to discuss some downsides. The performance of SHGs and MFIs in the south has been much better than the east, north-east, the central part of India or even some parts of western India. Some findings of a study by National Bank for Agriculture and Rural Development (NABARD) are worth a mention. Some major findings of the study were that the average value of assets per household increased from Rs.63,000 in pre-SHG period to

Rs.71,000 in the post-SHG period. About 62 per cent of the households reported increase in assets by 24.5 per cent from pre-to post-SHG situation. Almost all members were saving in the post-SHG situation as against only 23 per cent savers in pre-SHG situation. The average borrowings per household per year increased from Rs.4,282 to Rs.8,341. The average net income per household increased by 33 per cent from Rs.20,177 to Rs.26,889. These figures indicate that in terms of increase in assets or incomes, the impact of the programme has not been significant and it raises questions about its efficacy in its present form as an instrument of poverty alleviation. Therefore, if the instrument of microfinance is to make a visible impact, the content, quality, and the range of its products would need to be upgraded.

There are certain issues about the sustainability of MFIs and SHGs. A study indicates that although there are thousands of MFIs in the world, only 60 might be sustainable on a long-term basis as self-reliant and viable.

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This brings us to the issue of high interest rates of microfinance. I am aware of the argument that these reflect transaction costs. It is necessary, however, to communicate MFI's perspectives on interest rates effectively to policy-and law-makers. It is equally important to ensure better transparency on costs of dispensing credit. We also have to look for ways of moderating interest rates by cutting costs. When loans are for a short term, the problem does not seem unmanageable. The issue becomes problematic when microfinance gradu-

ates into investment financing, when the risks and tenors increase, and loans become unaffordable.

There is an emerging consensus that microfinance holds great promise particularly in the Indian situation. As everybody is paying attention and SHGs can be used to advance a political agenda, there is reason to worry. In this context, it is relevant to pose the question — To what extent should the movement be mainstreamed? Should it be mainstreamed at all? This is not something that we can easily take a view on. It is already gathering a momentum of its own because of its popularity; it also offers an opportunity for political mobilization. Every year, there is an announcement from the government

that it will support microfinance or SHGs in some way and, accordingly, targets are set. This trend should be watched with caution. The essence of microfinance is its voluntary character. It should not be over-regulated and be at the disbursing end of directed credit with excessive government involvement. Involvement of bureaucracy creates problems as we have seen in other such programmes. I am aware of at least one such programme which was initially an outstanding success. And, because of its success, there was excessive focus of the government on that programme and it became hugely popular. Its very popularity hastened its demise. As soon as a new government comes to power, it finds all kinds of issues and the first thing it wants to do is to bring about changes including changes in the name. Thus, there is invariably a problem with programmes of this nature. They get identified with specific political dispensations and that can hasten their demise if the dispensation changes. I suppose, microfinance movement is so far depoliticized but one has to be cautious. If somebody really espouses its cause for purposes which are political in nature, problems can arise in future. So, the questions are:

- To what extent should government instruments and

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agents and structures get involved in this programme?

- Can it be run only through NGOs? It is not really possible to mass produce NGOs. How does one find enough people who have a great deal of dedication, professional qualifications, and training?

There are suggestions that good NGOs must open branches in new areas and this will multiply their effort. But, to what extent can this be done? Some more branches can come. But can we have a mass movement? Should we even have a mass movement? How do we enlarge the role of microfinance? These are issues which need to be considered.

Another aspect that needs attention is capacity building. It is estimated that there is a need to train about 1,200 top management professionals, 4,000 middle management professionals, and 12,000 field management personnel for microfinance to realize its potential effectively.

There can be questions about the basis of arriving at these numbers; but, the point to be emphasized is that without attention to capacity building and upgradation of professional skills, perhaps it might not be possible to sustain the quality of this industry. ♡

## DEALING WITH LEGACY AND RISK

### M B N Rao

Chairman and Managing Director  
Indian Bank, Chennai

Let us unbundle some aspects that underpin the microfinance activities. The first pertains to banking — credit in particular — and the other is the developmental aspect. As a banker, most of the legacy and risk pertains to default. I wonder why we face the problem of default. Let us see if there is any agency providing credit and not facing default. If we think carefully, there are a number of other agencies that provide credit in various forms but possibly do not face as many problems as bankers. One such agency is the flower vendor near any temple. When we visit the temple, we collect a basket of offerings, get into the temple, and pay

the amount on return. The vendor is parting with the basket for a short period and the amount at risk is small. Considering the amount and period of loaning, this is like any microfinance activity. I asked the vendor if he has any bad debts. First, he thinks that I do not understand the business. But, if I explain default risk to him he then says that he has no default. The experience at an eating place will be similar. In these places, you do not have a credit report, you do not have to fill forms or follow other formalities. The vendor provides the material, the customers consume it, and at the end of the transaction, they pay. How is it that with no apprais-

al, no forms, and no credit report they are extending credit and are able to recover? This question begs an answer.

I have asked this to several people but one person gave me a very religious answer. He said as a banker you take forms and reports. In a temple, the issue is one of faith. Faith works in two ways — the person who borrows repays with the same faith. Bankers do not have faith in the borrower. Therefore, the borrower also takes chances. He does not pay when he is not able to pay. Perhaps, microfinance works on faith.

Having said this, I should not dismiss the Indian banking industry. Our banks carry many more responsibilities than any other bank elsewhere in the world. In 1969, when banks were nationalized, all banks put together had only Rs. 400 million by way of direct lending to agriculture. By 2003, this figure was Rs. 51.799 billion. In terms of composition of credit, it had moved from 1.3 per cent to 10.8 per cent. I think this is a substantial contribution by way of state intervention. But, even this has not been sufficient. There are 138.20 million rural households of which only 41.60 million households have access to any banking system. This comes to a mere 30 per cent. Even the national average on bank access at 35.50 per cent is not flattering. When we break up the access to all formal sources, the data indicate that about 66 per cent households access formal credit. But, these figures could not be revealing. We have to go to the individual slabs to understand this well. It is of significance to all of us who want to discuss microfinance or SHGs. At the lower end where borrowings are up to Rs.5,000, almost 60 per cent of the needs are met by informal sources. At the higher end at Rs. 0.2 million or more, only 18 per cent of the needs are met by informal sources. This means that the small borrower still does not get access to formal finance though sources are available. Our legacy has been in trying to bridge this mismatch. We are partially successful but we still need to address this mismatch.

The legacy also has some downsides — in the form of loan melas and write-offs. We at the bank have seen this recurring phenomenon: when the borrower per-

ceives that it is directed lending, the repayment is not very satisfactory. When the borrower takes the loan otherwise, the repayment is exceptionally good. In the same area, how do we justify that, at one end, the directed schemes get low repayments but, with SHGs, the repayment rate is more than 90 per cent? One of the reasons is that directed lending is seen as a one-time terminating affair. Other loans are seen as a part of an ongoing transaction. In addition, one of the SHG members once said: “Please do not use the word recovery; it is derogatory, forceful, and coercive; say repayment instead.” I think the way to deal with the legacy of write-off is really to have a culture of repayment. The borrowers should feel that it is for their development and repayment will enable them to borrow more for development. This will take care of the issue.

One more reason for default stems from the fact that we traditionally finance only for productive purposes. This gets diverted if there are other requirements. The act of building faith like the temple is to ensure that the relation with customers encompasses most of their needs. That involves appropriate design of financial products. In our bank, when we moved towards providing a part of the consumption needs, the defaults came down. We need to recognize the fungibility of money in designing products.

On the aspect of debt relief, we need to look at this issue constructively. If funds are lent for productive activities in the rural areas, then there is always a risk of failure. A study by Harvard indicates that only 20 per cent of the enterprises will be successful in the long run. Somebody has to bear the cost of failure of the other 80 per cent. This is the cost of building an enterprise. To that extent, you tax the people directly and then bear the cost of failure by way of subsidy or risk capital. It only needs to be appropriately packaged. This can be provided through the banking system as directed debt relief. These things are not inherently bad but are the requirements of any society. Intervention of the state by itself is not bad. It is the responsibility of the state to take stock of the welfare of the society on a more equitable distribution of wealth.

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The state could play a positive role in the area of microfinance and SHGs. Most SHGs now borrow for consumption requirements and this will grow for commercial requirements which would take borrowers face to face with the market. In case of small industries, we have experienced a delinquency of 20 per cent. This we believe is because of the marketing problems. The role of the state in infrastructure creation cannot be undermined. There are examples where state intervention has helped the farmers in Tamil Nadu and Andhra Pradesh where the state has set up markets that can be directly accessed by the producers. We need to focus on other livelihood clusters like weavers. With modernization in the textile industry, the weaving community is almost coming to extinction. What are we going to do?

## Vijay Mahajan

CEO

BASIX, Hyderabad

The issue of legacy and risks can be addressed in different ways. We first need to look at the policy environment and the legacy created therefrom. Let us dwell on this before we enter into specifics. The problem we have to address first is a review of the existing regulations and the consequent issue of inhibiting regulatory behaviour. At the top end is the Reserve Bank of India (RBI) which draws its mandate from an Act of 1934. This Act has not been substantially amended. We also have the Banking Regulation Act of 1949 which has been amended a few times substantially but only for events like bank nationalization or bringing the cooperative system into the purview of banking. Both these legislations are outdated. These laws represented perhaps the right thinking in 1934 or in 1949 but that wisdom is not so abiding that these need to continue significantly unchanged even now.

The problems of rural finance have to be traced right back to our Constitution which was a 100 years ahead of its time but also has flaws of its times. Schedule 7,

When we ask such questions, we think beyond defaults. When there are extraneous reasons for default, we have to consider it as a temporary shortfall in cash flows. We need to address this constructively and see how we can get them back on track. If we keep removing more and more people from our lists, even the measly 30 per cent who are covered by the banks will fall further. Therefore, we need to look at default in a positive spirit.

The other aspect to be addressed when we talk of risk is insurance. Insurance and safety nets are needed not only for individual risks but also for price and market risks. One way of addressing this is to have more information sharing through IT initiatives. The more conducive the environment, the more the banks would be able to penetrate and increase their share from the existing 30 per cent. ♡

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The role of the state in infrastructure creation cannot be undermined. There are examples where state intervention has helped the farmers in Tamil Nadu and Andhra Pradesh where the state has set up markets that can be directly accessed by the producers.

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legislations on insurance and pension funds.

While a point was made about the limited access to credit facilities from the formal banking sector, a far greater issue is going beyond credit — extending a full range of financial services. The RBI does not feel accountable for the fact that 80 per cent of the people in this country do not have a safe and reliable place to save. By refusing to regulate too many deposit taking entities, it denies the opportunity for a large number of the poor to access a place that is safe, regulated, and has reasonable transaction costs. The result is that a majority of deposits flow to local money guards, ‘fly-by-night finance companies,’ and chit funds. These are the outlets available for most people and they constantly lose money.

The RBI which is charged with the regulation of deposit-taking needs to be held accountable for this malaise. The RBI should not only be held accountable for what it chooses to regulate; it has a regulatory monopoly in the country and, therefore, has a responsibility. It needs to have a system starting with savings that provides every citizen a right and an avenue to save small amounts of money close by, with reasonable transaction cost and reasonable level of safety.

The other issue pertains to interest rates. Since we are talking about legacy, it might be good to get back our oldest legacy. I refer to Hardiman’s book, *Feeding the Bania* where he talks about *Manu Smrutu*. The *Manu Smrutu* set out different rates of interest which could be taken from each of the *varnas* — two per cent per month could be taken from a *Brahmin*, three per cent from a *Kshatriya*, four per cent from a *Vaishya* and five per cent from a *Shudra*. Even before *Manu Smrutu*, the *Arthashastra* advocates differentiation not by cost but by risk involved. We should remember that Kautilya had thought of risk-based pricing way back in the 4th century BC. The principle of interest rates being determined by one’s position in the social hierarchy proved to be a durable innovation lasting into modern times.

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There is an urgent need to have the entire gamut of financial legislation including new legislations on insurance and pension funds.

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The rural financial system is but one part of the overall system. The fact is that the urban poor are no better-off in terms of access. So, just being next to a bank in Delhi or Mumbai does not necessarily improve your access to credit.

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Hardiman’s book traces the deep nexus that existed between the state and the financial system. With this received wisdom, we have had successive politicians and ministers asserting their right to write-off loans or reduce interest to unsustainable levels. But, after all, whose money is it? The money in the banking system

is the citizens’ money and not the government’s. In addition, till recently, the government has been appropriating 25 per cent of deposits as SLR deposits. India had one of the world’s highest SLR — money going straight into the government treasury in feeding the deficit. Time is ripe for holding the policy makers and implementors accountable for the ills in the financial sector.

The rural financial system is but one part of the overall system. The fact is that the urban poor are no better-off in terms of access. So, just being next to a bank in Delhi or Mumbai does not necessarily improve your access to credit. We just finished doing a substantial study on access to microfinance and livelihood services in urban Delhi and the results are no different than they are for the rural Uttar Pradesh or Andhra Pradesh that came out from the World Bank study last year. Less than 17 per cent of the people have access to bank accounts.

Moving from criticism to action — we need to invest in solutions. We need to spend more effort on building the demand side. The year 2004 marks the 100th year of the Cooperative Act representing 100 years of state intervention in the credit system. In the second centennial, we need to break the nexus between state and finance. We need to take away the control of finance from

politicians to users, particularly depositors. Banks are highly leveraged institutions — on the liabilities side, most of the claimants are neither regulators nor equity holders but depositors.

We need to find mechanisms of providing an opportunity for the depositors and for protecting their interests. This can be done by having depositors involved in governance. For instance, out of 196 RRBs in the country, 60 have eroded their depo-

sits. Any regulatory regime should have shut these banks long ago. But, we have a regulatory regime which differentiates on the forms of incorporation. We need to have depositors on the governance because 80 per cent of the money comes from them and they are the unrepresented group in the financial sector architecture.

On the supply side, we need to make corrections on how we can offer composite financial services. Lower income households want a single place that provides access to all the financial services. They should be able to save small amounts, make withdrawals, take loans, remit, buy a mutual fund, buy insurance, pay premiums, lodge claims, and get compensation. All these transactions should be possible from one physical outlet. The technology for this has been in place. The physical locations are in place: we have 98,000 PACS, 155,000 post offices, 86,000 primary milk cooperatives, and if you want to count the private sector — 6,000 e-Choupals. We have no problem of satellite connectivity or large capacity servers. If we can provide the back-end through regulated institutions and the front-end through a local *bania* charging full cost for the transactions, we may have a working model. The local outlet will have no risk. If the outlet wraps up or the *bania* runs away, there will be no risk to the depositor or the insuree.

We have to learn the lessons from the reforms in the telecom sector. The simple idea of the STD PCO

enabled 100 times more people than the telephone owners to access the telecom infrastructure. This was because a privately owned friendly retail outlet was in place. We need the same in the financial sector. We need to nurture and promote innovations on these lines.

A final suggestion is that we should seize the opportunity of the avowed intent of a national pension fund. This can be done by having a 14 digit universal

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Lower income households want a single place that provides access to all the financial services. They should be able to save small amounts, make withdrawals, take loans, remit, buy a mutual fund, buy insurance, pay premiums, lodge claims, and get compensation. All these transactions should be possible from one physical outlet.

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card and making it available to citizens. India is an IT power; we can do it and enable every citizen to save a small amount electronically. This 'individual development account' would become the basis for all financial transactions. Each ID account should receive Rs. 100 per month per household where the poor save as per a pre-defined ability slab and the state tops up the amount as a social security measure. The accumulated money can be used for contingencies like saving withdrawals, as margin money for a loan, for insurance premium payments, etc. This becomes the basis for the credit history. In future, the credit history will become

the most important asset for households to participate in the financial sector.

In summary, while we can get into the ills of the existing rural financial institutions, we may be losing a major opportunity. Let us focus on the basic issue: majority of our people do not have access to financial services; indeed, they suffer from systematic financial exclusion while the nation has the financial resources and technological expertise to provide these. ▼

## BEYOND AGRICULTURE: IS THERE A BIG MARKET OUT THERE?

### V Leeladhar

Chairman and Managing Director  
Union Bank of India, Mumbai

**W**e are looking at beyond agriculture to find out if there is a big market out there. There is an anonymous quote which says: "Markets are made, not found. This is true of rural markets in India. It is a market for the creative marketer." The

rural market is fascinating and challenging at the same time. It offers scope on account of the sheer size of the country and is growing steadily. Even a modest growth pushes sales substantially because of the huge base. The experience of Coke in India is a typical example. Coke

doubled the number of outlets in rural areas from 80,000 in 2001 to 160,000 in 2003. This increased their market penetration from 13 per cent to 25 per cent. It brought down the price from Rs. 10 to Rs. 5 per bottle bridging the gap between soft drinks and other local options like tea, butter milk, and lemon water available in the villages. It doubled advertising expense on electronic media, increased price compliance from 30 per cent to 50 per cent in rural markets, and reduced overall costs. It tapped local forms of entertainment like annual *haats*, and made investments for distribution and marketing. Now, rural market accounts for nearly 80 per cent of the new Coke drinkers and 30 per cent of their volumes. Rural market of Coke grew at 37 per cent as against 24 per cent recorded in urban areas. The per capita consumption in rural areas has doubled in the last two years. The launch of Rs. 5 per bottle has yielded greater sales and is expected to account for nearly 50 per cent of Coke's sale in India.

The rural non-farm sector covers a wide spectrum of activities including handlooms, handicrafts, cottage and village industries, agro-processing units, and service and transport activities. The products manufactured by women belonging to SHGs include embroidered sarees, paintings, wooden handicrafts, jute products, sculptures, metal idols, leather bags, sea shells, cushion covers, etc.

The question, therefore, is: Are the commercial banks missing this great opportunity and a big market? In terms of impact on rural employment and income, the handloom industry is second only to agriculture in India. There are about 3.9 million handloom weavers with only 25 per cent of the weavers engaged on a full-time basis under the fold of cooperatives. In states like Andhra Pradesh, Kerala, Orissa, Tamil Nadu, and West Bengal, the cooperatives are strong and they have availed the assistance through cooperatives with refinance from NABARD. However, over the years, the credit flow to meet the requirements of weavers has not improved. This is only one example of the potential market that is available. It may be worthwhile to look at issues in supporting

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It may be worthwhile to look at issues in supporting the rural non-farm sector. Bankers are used to having a balance sheet and looking at capital to see whether the unit is bankable. The capital structure of most of the small units is fragile. There is a need to strengthen their capital base.

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the rural non-farm sector. Bankers are used to having a balance sheet and looking at capital to see whether the unit is bankable. The capital structure of most of the small units is fragile. There is a need to strengthen their capital base. Venture capital will have to come in a big way to take care of such units. We have had such initiatives in the past. The National Equity Fund administered by the Small Industries Development Bank of India (SIDBI) is a wonderful scheme. The terms on which investments are made under this scheme are very attractive. But, in the rural bank branches or in the branches of SIDBI, there is hardly any worthwhile attempt to sell this scheme. There is a need to track the financial require-

ments on an ongoing basis. Ideally, the same agency should meet all the requirements of a unit. Unfortunately, we have multiplicity of institutions. The term loans are given by one agency, working capital is provided by another, and subsidy by a third agency. As a result, coordination is a problem and many schemes remain on paper. Banks have now introduced artisan credit cards and Kisan credit cards in large numbers. This has improved credit delivery significantly. The problem is not in credit delivery but for the borrowers to find marketing facilities. Institutions providing marketing support to these units need strengthening.

Recently, there was an exhibition of products manufactured by SHG members at NABARD headquarters. These were classified state-wise. The variety and quality of products manufactured by the groups were amazing. But, why are the markets for these products not taking off? The main problem was finding a marketing arrangement where they could deal with one agency and get a remunerative price. After the exhibition, there was also a seminar in which the Khadi and Village Industries Commission (KVIC) made a presentation on the system for selling products manufactured by these units. But, neither the artisans nor the bankers were aware of the schemes. All these schemes were funded but, ultimately, something that is not very visible has been funded. We may have to work on aspects like technology upgradation. Though we have institutions like the Small Indus-

tries Service Institute (SISI) and the District Industries Centre (DIC) which are expected to take care of these challenges, it does not naturally happen. An initiative worth replicating is the Rural Development and the Self Employment Training Institutes (RUDSETI) which have come up in several districts. These are small institutes with the land and building given by the state. We need to depute faculty to teach and some skilled artisans to train the people on how to run small enterprises. The replication of this model

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There is an urgent need for shifting from a minimalist approach of offering only financial intermediation to an integrated approach of providing enterprise development services like marketing support with direct linkage between borrowers and buyers.

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will trigger the need for credit as well. There is an urgent need for shifting from a minimalist approach of offering only financial intermediation to an integrated approach of providing enterprise development services like marketing support with direct linkage between borrowers and buyers. We have institutions for every extension work. The commercial banks have to collaborate with these institutions and work in a co-ordinated manner to tap the large

market out there. ♡

## M P Vasimalai

Executive Director

Dhan Foundation, Madurai

The market beyond agriculture should be looked at in terms of two objectives: examining the trends and thinking of the way forward. From the supply side, we need a policy for rural finance at each bank level. While corporate policies are in place, we do not have a strategy for rural finance. We should look at these issues from the perspective of the branch manager. How can he understand the local economy and how can this understanding be leveraged?

Let us examine the trends first. The rural market is opening in a big way, probably, more so in the south and not so much where the primary, agriculture-based sector has to pick up. This has implications for the opening up of the service sector. Our experience indicates that in many of our federations — covering about 0.2 million families — about 40 to 50 percent are in the service sector. The challenge is to understand and proactively respond to this trend.

The first noticeable trend is in the housing sector. People ask for loans not only for constructing new houses but also for house repairs. There are also many people who are landless and who do not have 'titles' wanting to take a loan. They are not even looking at subsidies. What are the issues involved in addressing this seg-

ment? Efforts to understand such issues and develop the market will have to be made.

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The second trend is reflected in the emergence of clusters. In Tamil Nadu and Andhra Pradesh, there are villages which are known for workers specializing in road laying and quarrying. They move to regions where there is work. How do we interact with them? There are large numbers of people migrating for this kind of work not only within India but also to places like Dubai, Singapore, and Malaysia. There is a large market for them. But, they are still unskilled. We have found instances where village councils loaned Rs. 50,000 to workers for getting visa and migrating to markets that extend employment. We need to spot such trends. Construction is a big sector that is opening up and is one of the escape routes for people in the drought-prone areas. If we are able to identify these trends, then we can work at the ground level — these people earn Rs. 30 to 40 a day and there is a scope to increase their skills for income augmentation. This trend spotting can be done by the local branch manager. These people also need support for organizing themselves and possibly for the sub-components of the projects on their own.

Another remarkable trend is the increasing mobility of the people due to better roads and improved local transport. There are three sub-trends here. The distance of a daily commuter for employment has stretched. A person can now actually travel up to 40 kms. for work using a town bus. The second is seasonal migration. Organizing savings, credit, and remittance is an issue that we need to look into. Seasonal migration is still a black box and we need to understand how to handle this positively and help migration. The third category is permanent migration but these people have a strong foot in their home. We are, therefore, looking at three slices of the market. How do we do labour market financing? This is a big opportunity for people to augment their income and they also have the capacity to pay back, but for financing agencies, mobility itself is a problem! There is a need, therefore, for NGOs to provide support systems to ensure that the work conditions at the destination are not miserable.

A big opportunity lies in taking on the growth of private finance. Most of the studies indicate that each family is indebted at least to the extent of Rs. 10,000 to Rs.15,000 in the informal market. A recent study indicates that total indebtedness could be three times the outstandings of our groups. We have a Rs. 1 billion loan outstanding. So, how do we handle this market? It is not that these groups start savings from zero. They could even be in the negative and servicing this could be a big market. How do we offer a debt consolidation loan? We are trying to make this a loan product so that they can buy out the debt from the private financiers. There are opportunities but, at the same time, it is a complex situation. While we might prefer to be a single provider of finance, people prefer to borrow from multiple sources. We also need to recognize that there is a new breed of informal moneylenders like teachers, government employees, and others who receive regular income and have surplus money. There are also chit funds. How do we regulate this sector? The best way is to effectively compete in this segment and ensure that we provide alternatives to the people.

The fifth trend is about private investment complementing the public investments. Water-sheds are an

example where large investments are being made. Certain components of watersheds are bankable. While the scheme could be grant-based, farm pond is a sub-segment that is bankable. We need to have processes that tie in a combination of grants, subsidies, and loans. This should be ideally dealt at the local level. The support of the state is needed for promotional and experimental projects.

Infrastructural development is another big need and the state has the responsibility to further this. For instance, we found that about 30 per cent of our members do not have electricity connections though there is a grid. If we want to encourage them to get electricity, this would trigger a demand of around Rs.1 billion. Water for daily consumption is a big market. In many areas,

people are buying water through tankers. Is there an opportunity here? We need a BOT (Build-Operate-Transfer) model. While it seems to exist for cities or for large projects, we need community projects also. Developing this market would be a challenge. This would also entail a change in the mindset of the government and the people.

If we need to look at markets beyond agriculture and tap the rural

markets, lazy banking cannot work. The only way is to reach out. This could be done by outsourcing through NGOs. Reaching out with a target should replace the 'waiting for customer' approach. This approach needs market research for business opportunities which the branches will have to do. Rural banking is driven more by considerations of image building than by considerations of business expansion. It should not be treated as a public relations exercise. There have to be targets on fund deployment, number of transactions, and exposure amounts. There could be targets like Community Reinvestment Act. The paradigm must shift from exclusive to an inclusive approach. This shift can happen by fostering partnerships. With several banks getting into this mode, it is expected to grow to a larger scale. The range of partnerships could include banks with NGOs and community federations.

The cost of promotion of community organizations that deliver the last mile service has to be borne by the

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state, philanthropic organizations, and banks. It was suggested in Swarnajayanti Gram Swarojgar Yojna (SGSY — a poverty alleviation programme) that bankers could seek compensation for promotional costs from the state. This process should be taken forward. Large scale expansion needs long-term institutional partnership. This will take time but it could be lasting.

The next challenge is to scale model projects. The state and the banks should allocate a part of their margins for experimentation which, in turn, will create business for them. If something works, it needs to be documented and shared. This is necessary for upscaling across different branch locations. Financial markets do not end with credit. As others indicated, we really need to look beyond credit. In fact, for an effective banking model to emerge, the other elements of the economy have to be in place.

The penetration into weekly markets or *shandies* is

a big market we might be missing. The business in a *shandy* could be Rs. 0.2 or 0.3 million. How do we monetize this? *Shandies* are places where producers are also consumers. They might be selling grain, but they also consume detergents and soaps. Where there is business, there is scope for financial intermediation.

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The state and the banks should allocate a part of their margins for experimentation which, in turn, will create business for them. If something works, it needs to be documented and shared. This is necessary for upscaling across different branch locations.

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All these have to be appropriately packaged as a project or a product in order to pull it through. If one needs the support of the banks, then it should be amenable to be broken into components. One way to start is to plough back a part of the profits of the banks as development investments. These investments are to be accompanied with

technical assistance. When international agencies give aid, they also package it with such technical assistance. When banks make such investments in customers, there should also be a similar technical assistance initiative from them. ✓

## LIMITATIONS OF MICROFINANCE

### Rama Reddy

President

Cooperative Development Foundation, Hyderabad

**M**icrofinance — savings, credit, and insurance — is about people. It is easy for us to deal with inanimate things but management of human relations is a difficult task.

The subject of microfinance is very old but we discuss it as if it is a new discovery. Formal microfinance activity in our country started in 1904, under the colonial rule, and has just completed 100 years of its existence. It is known as the three-tier rural cooperative thrift and credit system. Presently, it consists of about 100,000 primary agricultural credit cooperatives, 400 district co-

operative banks, and 25 state cooperative banks. The number of people covered by this system is mind-boggling.

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While discussing the issue of microfinance, it is important to realize that money alone is not the solution for all aspects relating to quality of life. Most of us assume that the quality of life will automatically change if only we have money... it is a fallacy.

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While discussing the issue of microfinance, it is important to realize that money alone is not the solution for all aspects relating to quality of life. Most of us assume that the quality of life will automatically change if only we have money. Therefore, we attribute most of the ills of rural areas to lack of access to credit. The argument being that, if access to credit was there, most of the problems would have been resolved by now. It is a fallacy.

Unless microfinance is tuned with livelihoods in production, manufacturing, and service sectors, it would not be able to deliver anything. It will make more and more people indebted because of an easy access to credit. It is important that the money is used productively. It has to produce something — goods or services — that could be marketed at a remunerative price. The delinking of credit from livelihood is a very vulnerable trend and credit — micro or any other — will not lead us anywhere.

Therefore, I go back to the example of the three-tier cooperative thrift and credit system. This system has been traditionally under the government patronage. The patronage helped growth but has also brought in several undesirable factors into the system. After 100 years, if we are not able to say that even 10 per cent of the primary agriculture cooperative credit societies are vibrant and if we repeatedly speak about institutional building, organizational building, and capacity building, something must have gone wrong with our effort to put the concept of cooperation into practice.

The central government, state governments, RBI, and NABARD are actively involved in this system. The system is living on a life-prolonging ventilator, and, as soon as the supply of oxygen is stopped, it will collapse. While the old system is allowed to continue on false hopes, several governmental and non-governmental agencies have moved on with other experiments. It makes one wonder when NABARD says that there will be one million SHGs, each one having on an average 15 members, and capacities of these SHGs will be built as if it has a magic wand. The history of rural cooperative thrift and credit system tells us about the capabilities of RBI and NABARD. Of the 100,000 primary agricultural cooperatives, one cannot claim even ten per cent to be vibrant and functional. How would one million SHGs become vibrant and functional in 2004? How would NABARD and others build their capacity? SHG seems to be just a buzzword.

When we come to micro livelihoods, a widespread and well-known area in this country is that of dairying. This sector is 60 years old having 80,000 village-level milk producers' cooperatives, 175 district unions, and

20 state federations — a three-tier cooperative milk marketing system, similar to the three-tier cooperative credit system. It is known as the 'Anand pattern of dairy development.' This well-designed pattern has made micro dairy farming a viable proposition for rural people with meagre means. The 60 years of experience in this pattern has shown that small people with meagre means can get benefited through cooperative enterprises. The member interacts with his/her dairy cooperative twice a day not once in six months. The system is vibrant and functional though it has some weaknesses. In comparison with the rural cooperative credit system, the cooperative milk marketing system is a real success in this country. But, still, some people at the helm of the affairs think of tinkering with the system. Why?

Innovators and innovations do find a place in history. If you copy the existing ones, you are at best a replicator. But, each one of us seems to have an urge to be an innovator and ensure for oneself a place in history.

When it comes to SHGs, the situation is going to be worse. We took 100 years to put rural cooperative credit system on life-prolonging ventilator. The life span of the SHGs will not be more than 20 years. The design itself is faulty. In 2010, we will not be speaking about SHGs. We

will have some other buzzword. I think as long as we keep coining buzzwords and have a feeling of being an innovator, we do not achieve anything. We are unwilling to put our efforts and take a concept to a logical conclusion. For instance, I can conceptually demonstrate that the three-tier cooperative credit system and the three-tier cooperative milk marketing system in this country have a future; they will succeed if you stick to the concept. Then, I put a caveat saying that there are 50 per cent chances of success because everything that is successful as a concept will not necessarily be converted into a success in practice. But, in case of SHGs, I have yet to meet a single person who can convince me that it is a concept that can succeed and that it will lead us to a destination to which we want to reach. Every second sentence of the concept would have 'with,' 'but,' 'if,' 'when.' We do not have answers for several questions on the SHG movement.

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Unless microfinance is tuned with livelihoods in production, manufacturing, and service sectors, it would not be able to deliver anything. It will make more and more people indebted because of an easy access to credit.

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Decision-makers and policy-makers should be able to demonstrate that programmes could theoretically and conceptually be successful. There are several studies that tell us what is wrong with our rural development programmes. But, we do not have the urge to take remedial steps. Thus, we move from one platform to another and one slogan to another instead of trying to resolve the issues that we are facing. As far as micro-finance is concerned, if it has to spread, and if 80 per cent of the people who are denied the facilities of saving, credit, and insurance have to get services, there is no other system which is better than the three-tier cooperative thrift and credit system with all its faults relating to practice, not to concept. The existing system has reached a stage from which there is no redemption. We have to start afresh.

In the case of micro livelihoods, backward and forward linkages have to be based on group activity. Our producers are so small that to expect them to do something individually and succeed is unfair. They have to work as a group and know a lot about group activity and dynamics. They have to know how to run a cooperative enterprise. It takes time and effort. We should be willing to invest and

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## Brij Mohan

Development Consultant  
New Delhi

**B**efore discussing the limitations of microfinance, I would like to take stock of what it has delivered. Limitations should not lead us to believe that things are weak and nothing is going to happen.

There have been several studies providing various numbers. However, all studies indicate that the reach of microfinance is large. Whether it is more than or less than 20 million may be debatable, but, in a short period, through this new mechanism, the number of people accessing financial services has increased significantly. The outstanding amount has increased and, in the SIDBI portfolio, we see that the momentum is picking up. Even

not expect results in the next five years. It has to be a long-term objective. Amul's success story has 60 years of history. People with knowledge of commodities and marketing have to come together to assist the small producers with meagre means. We have a large number of success stories in milk, sugarcane, cotton, etc. Even if we have 10,000 agricultural credit cooperatives as successful examples spread throughout the country, with some history, we have something to showcase.

If someone tells me that, in ten years, one million SHGs will be built into viable, sustainable, and replicable organizations, there is something wrong with the thought process. Our task is of organizational building and for that, we need particular skills, resources, and time. We have to accept that we may not be able to see the results of our efforts because group dynamics or running a group economic activity is not a simple thing. It is a highly complex operation. Thus, microfinance by itself is no solution to the problems faced by rural India. The answer lies in production and successful marketing of goods and services that will fetch the small producer a reasonable return. We have to look beyond microfinance. ♡

where the start was slow, things are now moving fast. In the last two years vis-à-vis the earlier two-year period, the growth has been 183 per cent for SIDBI's top ten clients. This indicates that both in terms of reach and the quality of service, as we go along on the learning curve, the growth will be on an exponential scale.

All aspects of social development are being attended to by this sector, whether it is coverage of women, attention to rural areas or poverty targeting. These conclusions are as per the annual assessment study commissioned by SIDBI and done on a large sample. This evaluation study shows that not only the business part

but even the social impact component of microfinance is gaining momentum. There may be a regional imbalance but, on the whole, the movement has had an impact on investment decisions, reach, and social impact. I say this on the basis of an annual verifiable study.

The limitations are many. First, let us see if the money is properly utilized. We know that the money is going to the family and the repayment is coming from the family. As per the assessment, about two-thirds of the borrowers are using full or part of the loan amount for productive purposes. However, investment in a new enterprise is very low. Most of the loans are facilitating expansion of the existing enterprises. Money is going for working capital to existing businesses. But, here, the impact is strong. Money is going to the un-reached — 69 per cent of the customers were without any formal credit and 81 per cent without access to formal saving services.

There are issues in cost recovery and integration into the financial system. Even in SHG-bank linkage programme, only a part of the cost is taken up by the formal systems and a lot is left out from the cost to the formal systems. These are managed by some invisible inputs from the NGO sector.

I see a major limitation in terms of regulation. The microfinance sector is still unregulated and not supervised by any dedicated body and this may prove to be a serious handicap. MFIs are growing fast — people who started with Rs. 10 million need Rs. 400 million, MFIs which needed Rs. 2 million are asking for Rs. 200 million. With rating mechanisms and other arrangements like quarterly monitoring meetings, SIDBI and other lenders are managing the risk. But, when MFIs grow and ask for Rs. one billion, what do the bankers do? There are risks in dealing with informal institutions and non-collateralized loans. In cases of loan default, what will be the response of the bank management? We need to have a supervisory system in place. This mechanism need not be for every MFI. We may have a cut-off point.

Moreover, compliance issues need to be highlighted. Every institution accepts that even if savings as an

important service violates the banking regulation, we have to rethink on whether the policy is right or the violation should be punished. If savings are important, we need to ask what safety mechanisms do we build into these institutions? Neither denying the service nor allowing an unregulated, unlawful act by default is advisable.

Another limitation is that of regional imbalances. We need strategies to have a much wider coverage if we want that microfinance be accepted as a national answer to some of our major problems such as the problems of universal financial service and poverty alleviation.

The next limitation is that of low level of professionalism. The movement has its roots in the NGOs. When the NGOs transform themselves into financial entities, the governance culture and management structures

do not appropriately change and are generally weak. On the supply side, there is a dearth of trained manpower and good outside consultants. We do not have commonality in accounting system including a standard chart of accounts. It is difficult to assess the institutions' health from the published documents.

The high costs of transactions lead to high interest rates. MFIs are providing door step services and

helping confidence building and empowerment through various measures including participation in the group meetings. These add efficiency to the money spent. Therefore, one has to look at transaction costs in this perspective. These costs substantially come down when the organization picks up scale. The average transaction costs used to be above 30 per cent. Now, they are in the range of 20 per cent. Soon, for large players, the transaction cost would be much below 10 per cent and the interest rates would be in the proximity of 20 per cent. The technology could also help in cost reduction. Further, a part of the interest paid stays within the group as future equity. The efforts to peg down the interest rates right in the beginning will make the operations unsustainable. The programmes will continue till somebody is meeting the deficit and this would mean limit on growth. Let us accept that institutions have to cover

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their costs and there is no short-cut to sustainability. We have to be patient on interest rates which are coming down in scale. Large players are, in fact, bringing down interest rates while their efficiency parameters are improving.

There was a point on sustainability where it was said that world over only 60 or 70 MFIs are sustainable. We have to remember that other countries did not have large markets as we have in India. Here, the market size will make these institutions sustainable. We just need to understand that the gestation period in MFIs is longer than normal business. While this is an issue, we see that several institutions are crossing over the sustainability hump with volumes and IT inputs. This will not remain an issue over a period of time.

The next issue is about capital. Except for three or four institutions, the capital adequacy is very low. Bankers will definitely look at this aspect once the demand for funds grows and microfinance is fully accepted as a normal business activity. Adequate own funds could also prove helpful in better management of liquidity and temporary defaults.

We also need to ask this oft-repeated question: Is microfinance an answer to poverty alleviation? No. It is, in fact, an intermediate step. It builds the base and in this respect it has done well. But, for addressing the issues of poverty, we need to have a different strategy including business counselling and hand-holding. It may be risky for MFIs to get involved in enterprise services. But, MFI clients do need business services if we want them to move from microfinance to micro enterprise. There is a need for a mounting micro enterprise or micro livelihoods programmes on the base of microfinance. The clients of microfinance have stood the test of time. They have borrowed and repaid several times. If we address this market, then microfinance should be a good intermediary tool to alleviate poverty. Effective enterprise support intervention should also address the needs of hard core poor who are perhaps 10 to 12 per cent of the population. These people are looking for job opportunities. We need tiny and micro enterprises that create jobs to help these people, who are risk averse, to make a beginning.

I propose to focus on the following five major issues for putting microfinance on a stronger footing:

- Savings are important. Not only do they bring down the cost of capital for the institution and build credit discipline but, more importantly, build self confidence in the poor. As per the experience, the pass-book beside the group assurance is the most important empowerment instrument. Even otherwise, we know that for every five savers, there are only two borrowers and so the saving service is more in demand. We are possibly worried that with microfinance type of informal arrangement, savings of poor may be at risk. But, our response should be to build safety. If an MFI has good ratings and RBI

can independently inspect, what is the harm in permitting savings with this set of institutions? Is it fair to have a blanket no to this facility that the poor so desperately need? Banks can never be as flexible as MFIs and, therefore, it is important to encourage and nurture the latter.

- For mainstreaming microfinance, we need regulation. This cannot be denied in the name of safety for depositors or in the name of freedom of operations. If MFIs are dealing with 20 million people, regulation is something which has to be put

in place. They need regular supervision. Financing institutions are doing their due diligence but that is not sufficient. I agree that it may be difficult to regulate all but regulation is needed much more for the larger ones. Even otherwise, the country does not need thousands of MFIs. We need possibly around a hundred large institutions. This number can surely be regulated. All other issues of survival and growth are linked to this crucial aspect. There are three or four models of MFIs in India. We need to have an MFI Act which can accommodate the various models with client-friendly check and supervision. It looks odd that these institutions, having shown a good record for years and being well rated, are not under any regulation. I do not know which RRB was well rated but they had an entire policy for themselves. If we have had a bad experience elsewhere, that cannot be cited as a reason

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Is microfinance an answer to poverty alleviation?

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for restricting the integration of microfinance entities into the financial mainstream. We need an act so that stipulations are followed. The time has come when all our concerns as stakeholders — the financial institutions, government, support agencies, RBI — are addressed through a formal structure.

- We have been discussing about the need for an equity fund for MFIs. Many international agencies are keen to invest. Microfinance is being seen as a good business. We should encourage that. We need to make some efforts in establishing an equity fund. Under the current dispensation, the promoters of MFIs are not in a position to bring in equity and we cannot take it from poor clients because this cannot be well-serviced for some time. We need patient investors as there would be a long gestation period. It is a profitable business and equity investors will get their return in due course.
- We also need money for capacity enhancement whether it is groups, intermediaries or MFIs. With

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There is an urgent need to identify and nurture new institutions in underserved regions to ensure that the financial services reach a very large number of poor left out by the voluntary grassroot initiative.

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SIDBI partners, we have made some provisions. But, we are talking of large numbers. We need this support to make sure that these institutions are promoted on a solid base and their clients get all the services they need to move up the prosperity ladder. Investment in capacity building is a public good and must be met by public institutions.

- We need to have regional strategies. We have only a few good institutions in eastern region, central belt, and, of course, the north-east. Wider inclusion is an important un-attended agenda. There is, therefore, an urgent need to identify and nurture new institutions in these underserved regions to ensure that the financial services reach a very large number of poor left out by the voluntary grassroot initiative. This is indeed a serious limitation and calls for a focused effort.

The last point I would like to make is: With all the thinking we have of today, can it lead us to think of converting a good MFI into a private sector RRB? ♡

## DISCUSSION

### Regulatory Issues

M P Vasimalai

The issue of accountability of RBI and the government is important. Are they really not accountable? The individuals in these institutions appear very reasonable. However, as institutions, they are not able to flag the issues because of the forces of different kinds. The issues need to be prioritized and addressed. We also need anchors who will take the new ideas and reforms forward. Most of the time, follow-up from the organizations is seen as a favour to the person/organization piloting the cause and the idea gets killed. But, there are a number of people who could think beyond. We can ask some prominent people to sit together and come out with a coherent way forward.

Ravinder Yadav

The regulators, particularly RBI, indulge in micro man-

agement while not controlling for systemic failures. For instance, in the case of Global Trust Bank, the RBI knew the problems since the past four years but took drastic steps a bit too late. Their interim steps were half-hearted. The stakes and the role of depositors are something we have to consider. On the other hand, those who have the legitimate right to govern — the shareholders—were totally ignored. On the regulatory issues, I would like to make the point that public sector banks do not have a level playing field with the private banks. The private banks can appoint selling agents but we cannot. Our microfinance branch collects a rupee a day as savings. We have a weekly meeting where each member pools the weekly savings. If a person has to individually come to the branch for this transaction, it is neither viable for the person nor for the bank. Therefore, having selling

agents working on a small fee from the SHGs would be helpful.

### **Priya Basu**

There are a couple of points on the regulatory and legal environment that we need to raise. Issues like loan recovery contract enforcement, the question of land titling, etc., have to be made more effective.

### **Gautam Ivatury**

Regulation is an issue that needs to be addressed. If agents can collect savings, that itself may have a significant impact. This initiative is even more important for the northern regions of India where we do not find intense microfinance activity.

### **Samar Datta**

In any civil society, the concerns of borrowers and depositors have to be taken care of. The solution to this lies in having depositors as a part of a participatory management practice.

### **Ajit Kanitkar**

An issue that we need to understand is the policy-making process. In the last four years, many changes have taken place in the insurance sector. Similar is the case with telecom. However, in the rural finance sector involving Rs. 500 billion and 70 per cent of the population, no major changes are taking place. The problems are diagnosed but where can we make a small breakthrough? We have heard about post office linkage for the last two years but what prevents 100 post offices to have a pilot? Someone says "the regulations do not permit them to take deposits." But, in telecom, several things change on an on-going basis. How do we achieve this in rural finance?

### **M N Gopinath**

Mr Brij Mohan talked about the need for an MFI Act which I think is desirable in the long term. That will take a long time as there are so many models. Every model is a different

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On the regulatory issues, the public sector banks do not have a level playing field with the private banks.

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religion; all are good and the goal is the same. Since the partnership model can take us to scale and MFIs could be trusted partners, we could allow the bank that partners with the MFIs to regulate them. This is like the depositors regulating the banks.

If the banks are staking money with agents, they will regulate and supervise them closely. Therefore, we can possibly trust the banks to do this work initially.

### **Moumita Sen Sarma**

On the regulatory front, we also need to look at the norms for external commercial borrowings for MFIs. Besides that, instead of asking for regulations from the government, banks as a consortium could possibly get together to put in place a standard set of accepted operating procedures for dealing with MFIs and standard compliance requirements from MFIs. This could be done quickly and if we could get SEBI also into the picture, a great deal of credibility would be added.

### **Vijay Mahajan**

While we have been talking about the market paradigm, we need to worry about where our benchmarks are. Tanzania did not have the word microfinance till about the year 2000. Today, it has a national microfinance bank. We, therefore, need to worry about who is going to bring in a major change in the system. The Ministry of Finance has to address policies but, at the same time, the day-to-day changes are to be brought in by the regulator. We need to have a paradigm shift in the self-concept of the regulator. Otherwise, all these ideas will die here and now. In my opinion, the top three regulatory changes required are as follows:

- RBI needs to be made responsible for the equivalent of the universal services obligation for saving services in the country. The regulator in a developing country is also responsible for the development of the market. We need to have annual reports from the RBI to the Parliament about what is done by it to enable savings services to happen.

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- The RBI, jointly with the IRDA, should agree on a formal definition of a microfinance institution defined by function and not by form of incorporation. It should not be defined by the form of incorporation but by its function and by an upper level, for instance, savings, not more than Rs.10,000 per person, loans up to Rs.50,000, and insurance of Rs.100,000 sum assured and so on. Once an MFI is recognized, the RBI should enable these institutions to work as partners of stronger regulatory institutions, namely, the banks and insurance companies. MFIs need not have the right to take deposits but should have the right to offer saving services. If a bank is willing to hire MFIs as agents and if they can be made reasonably safe, we should go ahead and experiment.
- The RBI should have a department of innovation. In 1992, the same RBI allowed 500 SHGs to be linked with banks for a period of three years. By 1995, actually, 2,000 had been linked; this paved the way for a large scale SHG linkage movement in India. The fact is that if innovations were allowed on a tightly supervised basis and then allowed to permeate the larger system, we will have a more responsive financial system. As of now, we have several people in the RBI who will say 'no' for any innovation. We need to have someone who would say 'let us try that out.'

### **N S Sisodia**

There have been suggestions on changes in regulation including a change in the entire legal framework. The regulators might have some legitimate and genuine concerns. There is a difference between giving advice and taking the responsibility. Only the party that has to take a decision and is responsible for implementation knows what it entails. Therefore, it would be good to have specific suggestions, sometimes repeatedly. It may be useful to draw some international experiences to convince the state. There is concern in the government that there should be changes in the regulations for institutions focusing on the rural areas. It is a window of opportunity and we should take full advantage.

### **Write-offs/Defaults**

#### **M N Gopinath**

There would be failures in enterprise. But, should everybody who fails be taken care of by the government? Is write-off to be treated as the social cost of entrepreneurial development? That would open up undesirable practices. The system has the capacity to cope with risks without any external interference. The community from which the enterprise emerges has to take a call. In a village or an SHG, if one member fails, the rest bear the burden. They know the reasons well. It is desirable to institutionalize the process at a government level. Let the communities take care of the problem.

#### **M B N Rao**

On the issue of write-offs, we have several international examples. In the US savings and loan associations, three hundred billion dollars were bailed out. When the West and the East Germany integrated, ten years of their future were written off. The West German economy is still paying for the integration. The entire banking system in Japan — a highly capitalistic country — was bailed out for 500 billion dollars. There is no example anywhere for the entire loss of the system being solely borne by the banks. In India, as small people are not articulate and cannot access media, only the criticism from the intelligentsia gets highlighted without a counter-opinion.

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If innovations were allowed on a tightly supervised basis and then allowed to permeate the larger system, we will have a more responsive financial system.

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#### **Samar Datta**

The question is whether a country like India can afford to spend the type of resources that bailed out the savings and loan associations in the US.

#### **Ravinder Yadav**

It may be all right to accept legitimate defaults but there is no provision in banking to postpone the repayment and say that a default is a 'good default' because of natural calamities. Even then, banks cannot postpone repayment unless annavari is declared. Even in rescheduled loans case, we cannot expect repayment of the whole account in one shot. Therefore, there is a problem.

## Directed Credit/Role of Government

### V Leeladhar

Doubling the exposure to agriculture over three years is not very difficult. In the case of the Union Bank of India, we have been able to increase our agriculture deployment by 120 per cent in the last three years. The recovery has increased from 52 per cent to 80 per cent. We have examined the books and are confident that these are correctly computed. Rural credit is a viable proposition. But, the growth will depend on the extent to which the managers get enthusiastic. The question one would like to ask is whether we would prefer giving a loan to Levers — money which they do not need — at an interest of five per cent or give to a person who is poor, indebted to the moneylender, and willing to pay 12 per cent.

We should now create awareness that rural credit is viable. This has to be at all levels. We have shareholders from abroad who keep asking us about directed lending. This is something we have been doing for long and our experiences are good. But, this becomes very difficult for them to understand because the media as well as the intelligentsia does not acknowledge the positive aspects of this.

### Ravinder Yadav

While there is a lot for us to learn from SHGs and microfinance, we need to see if it is universally applicable. We talk about everything being done by SHGs — how can we have SHGs in lift irrigation which requires the participation of the whole village? In a village, there might be ten SHGs with divergent interests. Therefore, it might not be advisable for the state to have SHGs in all kinds of partnerships like ration cards, public distribution system, etc. The state should assume two roles: focus on infrastructure and take care of the land reforms. These are important aspects that have been neglected.

On doubling of credit to agriculture in the next three years, we have no issues. It is a herculean task but the banks are geared up. The good thing about this direction is that it has come with an action plan. There are 12 points of action plan which give what banks can do and how they can achieve this. In addition, there is no other sop like a write-off or a waiver. It has been specifically

mentioned there. Wherever there is a problem, re-phasing will be available and the repayment will be amortized in the next five years which is a common banking practice. In addition, the directive says that every rural branch has to add 100 fresh accounts, which I think is conservative, but this document should motivate bankers to get into rural banking in full steam.

### Trilochan Sastry

We also need to worry about the institutional mechanisms that can help in achieving 'doubling of credit' to agriculture. The institutional mechanisms cannot be MFIs and they are not going to be the formal banks. They have to be people's institutions — cooperatives. They have to be institutions of the people and intermediaries for doubling that credit. In the absence of that, no matter whatever brilliant schemes we develop, they are likely to be hijacked in the long run.

### Samar Datta

We have been highlighting the supply side of credit. Credit is a derived demand and, therefore, it would be inappropriate for the government to say that within three years the supply of credit will be doubled. If there is no demand for the products and services, no access to markets, and no technical inputs, how would people make themselves creditworthy? Therefore, supply side pronouncements are an extension of the *loan mela* culture.

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While there is a lot for us to learn from SHGs and microfinance, we need to see if it is universally applicable.

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### Rajeev Gowda

In Karnataka, the government is now offering incentives and subsidies for well-functioning groups. I do not know how much voluntary spirit is required for these groups to function well and how many of these groups are going to continue. In the last election, persons involved in SHGs wanted to trade votes with the candidates. This is happening rapidly. The real world stuff may spell doom in a manner predicted by Mr Reddy but for a different reason. Not because of jargons but because of the fabric of the groups and how quickly that dynamics might deteriorate.

The other issue is that everyone seems to have an underlying knowledge of what can go wrong. How come

we are not putting these implications together? There is a scope for sharing insights on where we are going wrong or just being aware of extraneous players and their imperatives. Let us take this *loan mela*. Was it actually a failure? No one really seems to have a sense of that. For a political player, it is a way of projecting a rapport with the poorer classes. If we know the political imperatives and pay attention, we can design programmes that are much more sustainable and less vulnerable to collapse even when there is political interference.

### Rama Reddy

There is something wrong with regimentation, uniformity, centralization, top-down approach, and government policy. These are not instruments of members' need. The 1904 law had a preamble that said that the object of the law was to promote the habit of thrift among rural people. Subsequently there have been directives by the Government of India, RBI, and NABARD in 1970 saying that the thrift collected from 1904 should be refunded. There was also a directive not to mobilize savings on the argument that it is the poor who are coming to borrow and it is not fair to ask them to save. So, cooperatives throughout the country were compelled to pay back whatever thrift and savings they had mobilized and prevented from mobilizing their own funds any more.

### M N Gopinath

We need to review the way government schemes work at the district level. The government's presence, however much we would like to contain, will continue. However, if we could redefine the role of the government and take it out from 'beneficiary identification' function, that would solve a lot of problems. If the bankers are free to route the schemes as long as the beneficiaries satisfy the eligibility criteria, there need not be any role for the government in forming groups. For instance, if 'Dhan' is forming a group of all those below poverty line, there is no reason why it should be denied the SGSY benefit. So, taking away the monopoly, whether it is mandated by the system or self acquired power, is important. The NGOs and the banks have the ability and the interest to do group formation and identification in

a proper manner because they have the responsibility for recovery. Alternatively, those who recommend should also be evaluated on how they help in the recovery process. If the people who recommend loans bear no responsibility for recovery, the system will come to grief.

### N S Sisodia

We had discussed vast possibilities of collaboration between people's collectives, corporate houses, NGOs, governments, and banks. If there is such a demand, why does this not happen naturally? This issue seems to be perennial. Ultimately, it all boils down to who will take the initiative. Some answers will come from creative thinking, environment, policy or law. But, if we expect the government to take the initiative, is there a way of avoiding bureaucracy and politics?

There seems to be a notion that the government has directed the banks on agricultural credit. There is no direction from the government about any kind of credit. Doubling of credit is a part of the government's agenda. Therefore, there has been a signalling that agricultural credit should grow at 30 per cent. This was decided after fairly extensive and broad-based consultations with the bankers. It was found that they were unable to meet the target of 18 per cent to agriculture. The disbursement to agriculture would perhaps have

increased by 20 to 24 per cent in a normal year. It was felt that increasing to 30 per cent would not be all that difficult, although it was challenging. It was also felt that there was lazy banking — funds were parked in government securities. This is no effort at directed credit.

## Delivery Mechanisms

### V Leeladhar

From the perspective of the commercial banks, one issue that would need some attention is the manning of rural branches. The managers of rural branches are outsiders and not familiar with the rural conditions. Even managers from the rural areas would have become urbanites over a period of time. Nobody wants to work in a rural branch for more than three years. Given the current

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structure, most of the applications received in a rural branch can be approved only by the Branch Manager. If the manager does not use his power diligently, the outlet could be almost non-existent. On the externalities, the provisioning norms are getting stringent. In case of a crop loan, till recently, the norm was that if the loan remains unpaid for one season, it becomes a non-performing asset (NPA). The RBI has liberalized this to two crop seasons. What happens when an account sanctioned by the manager becomes NPA? As per the manuals, we fix the responsibility and the accountability and only later go into why the account was NPA and how the borrower could be rehabilitated. In hindsight, one could always say that the loan decision was incorrect. Therefore, chances are that for many of these non-performing accounts, the accountability is fixed on the manager.

Till recently, these managers were coming under the purview of the Central Vigilance Commissioner (CVC). The bank may know that the manager has taken all care but still the loan has gone bad. But, the manager's fate depends on the paper work and the defence that is placed in front of the disciplinary authority. Fortunately, the level of managers that come under the purview of the CVC has been modified. This fear of accountability for bad loans is being used by the non-performing managers as a reason.

### **T Vijayakumar**

The comment about the motivated branch managers is right. It makes a big difference and, in our project, because of the manager, we have been able to meet the credit and investment needs of all the families with a good credit plan. We were also able to provide technical assistance by contacting experts in collaboration with the branch manager. A good manager can negate a lot of ills including bad policies. It is, therefore, important to keep the delivery channel in mind.

### **M S Sriram**

The arguments of how to get the Branch Manager to be more proactive are interesting. But, enthusiastic and

proactive Branch Managers are exceptions. They are personality-driven. How do we everyone that this enthusiasm permeates into average Branch Manager? The bank branch system is devised to guard cash and not do extension banking. There is a large amount of cash and there are layers of people guarding cash while doing counter banking. The branch is devised with several barriers before one can go to the strong room. Therefore, the obvious choice seems to be pointing towards partnerships where agencies specialize in extension, cash handling, and other functions. The challenge is to bring them together.

### **Vijay Mahajan**

The US is a nation of small banks. It has 10,000 federally regulated community banks of which 4,500 are one-branch banks serving small communities. We, therefore, have to re-look at the policies leading to a minimum equity investment of Rs. 10 billion for opening new banks and also the issue of having only six or seven mega banks. Even the US has a legislation called CRA where the banks are obliged to invest money in specified areas, equivalent of the blocks

from where they raise deposits. If they cannot give loans directly, they are mandated to invest in institutions that can do this on their behalf. If we look at a large number of community banks and CRA type imposition, a financial architecture plan emerges for India. We need to address the issue of people not having access to savings services.

### **Priya Basu**

From the discussion, it is clear that that there is a market and banks are not reaching there. This may be because the formal sector perceives the rural clients as risky. This could be justified because the rural poor have irregular volatile incomes and no credit information heightened by heavy transaction costs, particularly where the population is dispersed and often illiterate. This is a trade-off between the transaction costs of the bank and the risks. Microfinance has shown that risks can be dealt with through mechanisms like door-step banking, group collaterals, flexible and innovative products, repayments

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How do we convert these into structural solutions? The bank branch system is devised to guard cash and not do extension banking. Enthusiastic and proactive Branch Managers are exceptions. They are personality-driven.

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in small amounts, and greater frequency. Microfinance has demonstrated the possibility of reduced risks, cost recovery, and even profitability. The question is: Are the lessons from microfinance good enough for the banks to reach to the poorest of the clients in a big way?

### Vartika Jaini

While there are issues pertaining to regulation, we also need to worry about some softer aspects of perceptions. The image of a bank, manager, interest, and loan in the eyes of a customer is in itself a barrier for a manager to reach out. Some of the aspects have evolved connotations; for instance, 'loan' is something not to be paid, while the same amount when referred to in the local vernacular is treated as something that needs to be repaid. The challenge for the banks is also to go beyond these set images. In addition, we need to reorient the training of bankers, particularly the public sector bankers. In addition to issues of motivation and drive, there is a great need for them to have refresher courses in understanding costs as well as larger economic issues. Banks could also take initiatives to open up dialogue with the microfinance sector by having such discussions outside the usual NGO setting.

### Satish Deodhar

While the surpluses generated locally should be used, we should also take stock of the existing infrastructural facilities in the rural areas and see how they could be leveraged. Like PCOs which are everywhere, we also have opportunities in microfinance. Using post offices is one possibility.

### Ravinder Yadav

We have our experiments and islands of excellence. We started our own microfinance project in 1995 and we have two models which are doing very well. We charge 8.5 per cent interest at our microfinance branch. This branch does nothing else other than microfinance. It

does not open at 10 a.m. It is a 100 per cent door-step bank with a portfolio of Rs. 35 million of advances and a little less than Rs. 30 million deposit in seven years. It is making profit without any cross-subsidy. If we think that low interest rates are a drag on rural banking, we are wrong. Banks do not have problems with the rural branches. In fact, 14 per cent of the total deposits of the banks are garnered by rural branches and these branches disburse just above nine per cent of the total loans. The rural areas are not only taking care of themselves as far as the fund requirement is concerned but also feeding the urban and the metro centres in this regard.

### N S Sisodia

What are the learnings from microfinance? From the viewpoint of enlarging rural finance, flexible timings are suggested. Is it possible for rural branches to function at a time suitable for cultivators so that easy access can be provided? Microfinance has shown that peer pressure is working well for recovery of dues. We have to have a greater penetration—possibly also cover tenant farmers through joint liability groups. This will increase the scope of rural credit. We should also give diversified financial services in days to come. In that context, the banker should consider giving other services like insurance in particular. Crop insurance becomes very important. In addition, work is being done by

informal sectors in areas of buyers' and sellers' credit. This is something which banks and microfinance institutions could consider by providing loans against warehouse receipts which we have not been able to do so far. Lastly, if we could make credit cards applicable to rural finance, I think we can get rid of the entire controversy on interest rates. Life will be easier for bankers and farmers if there is no distinction between consumption credit and agricultural credit. In any case, this should help them in tiding over any emergency fund requirements.

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Microfinance has shown that risks can be dealt with through mechanisms like door-step banking, group collaterals, flexible and innovative products, repayments in small amounts, and greater frequency. Microfinance has demonstrated the possibility of reduced risks, cost recovery, and even profitability. The question is: Are the lessons from microfinance good enough for the banks to reach to the poorest of the clients in a big way?

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## Partnerships

### T Vijaya Kumar

In Andhra Pradesh, there has been some brainstorming and 12 livelihood sectors were identified to take care of 1.1 million rural poor in a substantial manner. This involves partnerships between the women's collectives, buyers, technology providers, financial institutions, and insurance agencies. Women's collectives will take care of food security aspects and we extend this to three million families. All this would be based on SHG networks and partnerships.

### M N Gopinath

While the banking sector has reach, it is woefully inadequate unless other partners are brought into the system. We need to understand the reservations in banks working through agents. For credit, the credit card and the retail loan sector have increased the reach of banks but it has not done so for deposits. There is no reason why we should not have deposit agents. If PCOs have succeeded because of the entrepreneurial spirit, it is time we leveraged this in financial services, particularly, if the banks are willing to bear the risk.

We also have a large number of primary cooperatives across the country. These cooperatives need to be freed from the limitations of seeking permission. Making the primary cooperatives available to the banking system can greatly transform the rural scenario. Banks can leverage their reach to the rural poor by providing them credit and management inputs.

About infrastructure, apart from what there is on the ground is also a state of mind. It possibly is not a big constraint in India today. If we take the initiative, we can go forward—we have to start somewhere. Use of technology is the key if it is to scale up substantially. There is a regulatory hurdle and this needs to be addressed urgently. There is one regulatory factor involved here. Use of plastics for delivering cash, accepting cash, and accounting reduces costs. It also removes the ills of pigmy deposit agents. The pigmy system failed on the burden of corruption because there was no way of cap-

turing the credit and debit immediately. On-line connectivity is now available in several places. We can start where we already have connectivity. This needs to be facilitated and accelerated. Merchants should be allowed to dispense cash. If we can remove this constraint with due regulatory checks, then the ATM will become irrelevant. We need to push that.

### Gautam Ivatury

A large proportion of the poor do not have a safe place to save — this issue needs to be addressed. The solution may be in a partnership model between banks and retail infrastructure such as gas stations, merchants, savings, and credit cooperatives. In Africa, a microfinance bank is using merchants to open accounts, collect savings, and provide smart cards. There are also partnerships between MFIs, banks, and gas stations so that people in the vicinity have electronic access to money. These examples give us some direction but involve costs and require collaboration across MFIs and banks. It has to work for the poor and serve the other segments of the population too. We need not look at exclusive or parallel systems. Innovation on the part of formal institutions has not been significant compared to other countries. This needs to be addressed by the banks.

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Making the primary cooperatives available to the banking system can greatly transform the rural scenario. Banks can leverage their reach to the rural poor by providing them credit and management inputs.

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### N S Sisodia

On issues of placing ATMs and forging new partnership, we have to factor in the infrastructural facilities for implementing some of the innovations. Regular power supply may not be available in rural areas, the IT connectivity might not be good, and there could be factors such as illiteracy and capacity to adjust to modern innovations in ICT. All this might take time. But, sometimes, policy makers are unable to wait and may have to look at some immediate solutions.

On the partnership model, there are some regulatory concerns. It, therefore, might be a good idea to take an initiative on what regulations should be put in place which may in effect become self-regulation. A charter could be put out to enhance the level of credibility of good MFIs. For this, a formal recognition by the RBI or

the government in some form would be required.

## Marketing Support

### M N Gopinath

Whether the state should provide access to the market and eliminate middlemen is a moot point. This is to be done by the community through cooperatives. The involvement of the state may be counter-productive because of negative political externalities. It would be better that the involvement of the government in such initiatives is contained in favour of the community.

### Samar Datta

It is important to consider market inter-linkages that support the demand side of banking. In case of operation flood, it not merely handled the supply side in the villages but also had many development activities to boost the demand side. The smaller farmers need linkages. They might get some micro credit, but the question is: Would these people be able to run the show after paying the interest costs? It is argued that interest income remains with the SHG. But, to start with, the borrower has to survive and the product sold in the market has to be competitive. Even if we increase credit by 15 times, the borrower can possibly absorb provided we empower him to sell his product and services. Therefore, we need to have the system of linkages in place before we venture into more directions from the state.

## Retaining Resources Locally

### Trilochan Sastry

We are talking about increasing credit flow to the poor but our experience shows that while they may not be getting credit from formal sources, they somehow manage to get credit. Otherwise, they would have starved to death long ago. The issue to be addressed is whether surpluses are accumulating with the poor. Surpluses are indeed being generated in the rural areas but they are not in the

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control of the poor. The CRA type of regulation might address this. This ensures that deposits generated locally could be reinvested. There is a net leakage of surplus from the rural to the urban areas. Unfortunately, the concept of local area banks has been shelved. The alternative left is of cooperatives. We should look at a paradigm where the surplus generated by the poor is retained by their own management under their control. I do not think there is a better solution than this.

### Samar Datta

One way of retaining the surpluses locally is to ensure that they are channelized into a formal structure. The example of Warana illustrates this point. When the sugar cooperative was set up, its founder, Tatyasaheb Kore, found that people had become more affluent and were purchasing things from outside and, therefore, the profit was going to the outsiders. Since it was necessary to retain profits locally, the idea of a consumer's cooperative came about. People were common — they were sugar producers as well as consumers of other commodities. Warana also brought in a sense of quality with its foray into the grocery business. We need to learn from such experiments.

### Interest Rates

### V Leeladhar

We are charging low rates for corporates because of excessive liquidity in the banking system. The banking industry has nearly Rs. 500 million of liquidity with no avenues for lending. So, we cut losses of not deploying this amount by giving it to corporates who are least risky and thereby earn whatever is possible. For the rural poor, interest rates may not be the prime consideration; what matters would be timely access. They would be willing to pay a premium for this. From the point of view of risk, charging this category of borrowers is more essential and in line with the international norms.

## Vijay Mahajan

We should not infer the political class by what they say but what they actually do. There are two behaviours. The political class is getting the message that bribing the voter does not work and it wants to find

a new formula. In 1996, the interest rate for all RRBs and LABs was deregulated. That formal policy stands. However, for nationalized banks, loans below Rs. 0.2 million are to be lent at PLR. One can say that the largest part of the pool is not deregulated. But, if we look at the parliamentary proceedings of that time, we find that there was no opposition whatsoever on the deregulation. Therefore, we have to realize that there are two sides to our politicians. One is the practical business side — it is not possible to give loan endlessly at nine per cent to a large number of farmers. The other is the fact that they have to garner as many votes as they can. We should not confuse electoral politics which is a six-month phenomena with the political intent. The same political class has put some incredible legislations in place. Nearly 70 ministers in different state governments had to step down after the parliament voluntarily imposed the limit on the size of the state cabinets to 15 per cent of the state legislative assembly. What is missing is a concerted attempt by the group of stakeholders to get the acts in place. We need to get together and address the fact that our goal is to enhance the financial services to the rural sector.

## M N Gopinath

I would only add that personal loans do not attract interest rate limitations. Classifying as agricultural loan is purely a statistical exercise which banks do. If you are willing to take loan for a poor farmer as a personal loan, it is not a constraint. Otherwise, I think, competition takes care of interest rates. We started lending at 15 per cent and now we lend at eight per cent purely out of competition. But, at the same time, we cannot close our eyes to the political realities. In the long run, no bank can survive without taking care of the cost of transactions and the creditworthiness.

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## Ravinder Yadav

I agree that the rate of interest will motivate banks to lend more. The interest rates are directly linked to the cost of funds. A good bank in India would have an average cost of fund of five per cent. If we add

another 1.5 percent for establishment costs, 6.5 percent is the ultimate cost. Therefore, banks still make some buffer on loans to microfinance. In this category, most of the banks are charging below their PLR but may not be losing money. In the agricultural sector, the directions are that loans up to Rs. 50,000 should carry an interest of 8.5 per cent if it is a production loan. So, banks really have the comfort level.

## Samar Datta

We need to have a good idea of the costs in the banking system. Similar to the manufacturing sector, the banking sector also would have transformation costs and transaction costs. If the players do not have monopoly power, they would be constrained by the conditions of competition to minimize the transaction cost and the transformation cost. This will translate into lower interest rates.

## T Vijaya Kumar

We cannot ignore costs. Forming an SHG is a cost in itself. The question is who bears this cost. Even if the bank does wholesale lending, there is a management cost. In most cases, the members are picking up the costs. Typically, SHGs lend at 18 per cent or even at 24 per cent to their members. The margins go into their own corpus and do not go out of the system. We have to find mechanisms of cross-subsidizing these costs by either the bank or the government. This is a cost to be borne by the system because formal credit has not reached them. At 18 or 24 per cent interest, we have to see what contribution the poor person gets. Is it really that high

to push him out of the market? This would vary from situation to situation.

## Brij Mohan

On the issue of interest rates, the bankers seem to feel that this is not

a subject for debate. We have to realize that with all the high cost of transactions, we may be cross-subsidizing these loans. We possibly need to re-look at this aspect. In the discussions, there was a call made for certain support services to be provided through intermediaries. It might be good for the bankers to provide certain critical support services and the costs may be recovered either by way of service charge or higher interest rate. There is always a question on why the poor should be made to pay more. If we look at the range of products the poor produce and deliver, the cost of raw material and labour will be significant but the additional cost of interest will only be marginal. Therefore, it might be worthwhile to provide services and charge marginally more.

### N S Sisodia

Both the government and the RBI are sensitive to the issue that interest rates must remain deregulated; otherwise, it will have an impact on the credit flow. The political class probably does not have sufficient appreciation of this matter. It is constantly comparing the interest rate for agriculture with that of housing, vehicles and so on and thinks that it is an equity issue where poor farmers are getting loans at 11 per cent and a rich man gets his Mercedes car for seven per cent interest. This is an irrational and exaggerated view but this perspective prevails. The number of educated and sensible people holding this view is amazing. They feel that the entire system is iniquitous.

If you want to sustain and allow the government to function in this fashion, we will have to take up some effort at our level. The suggestion that there should be an informal forum including bankers is an excellent idea. There has to be a conscious effort at better communication of these issues where analysis can be done. There has to be appreciation among opinion leaders and amongst the policy-makers in the parliament and elsewhere and the environment has to be protected against any kind

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The Indian rural context has altered significantly in the last decade or so. The term 'rural' is no longer synonymous with agriculture. While traditional non-farm activities such as the handloom continue to be important, there are a number of new activities especially in the service sector.

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of interference from these popular myths.

Even though the interest rates are deregulated, we must realize that ultimately we are living in an environment which is democratic and there are all kinds of pulls and pressures. So, while a certain amount of flexibility can be allowed to reflect

true costs, we have to avoid being unreasonable.

### SUMMARY

The Indian rural context has altered significantly in the last decade or so. The term 'rural' is no longer synonymous with agriculture. While traditional non-farm activities such as the handloom continue to be important, there are a number of new activities especially in the service sector. There is increasing mobility. Rising rural incomes have a number of implications; rural markets are often the dominant market for consumer goods. The rural housing sector is another booming activity. All these imply that in addition to the traditional farm investment loans and seasonal operational loans, significant credit is required for the non-farm sector. Apart from credit, significant untapped opportunities exist in other financial services such as savings, insurance, and remittance facilities.

While one can be rightly proud of the banking sector's achievements over the last few decades, one is also left with a deep sense of failure. To its credit, the formal banking sector has created a reach unmatched in the world (with the caution that anything done in India should be unmatched in the world). However, the failure of the regulator in not emphasizing the development role while focusing on the regulatory role has led to unacceptably low levels of penetration of banking accounts. Regional disparities are striking with some areas performing poorly on both lending and savings.

The microfinance sector can be defined in two ways. One as comprising of the SHG movement and the new specialized microfinance institutions. The second recognizing

that the century-old cooperative movement as well as the commercial banking sector have also provided significant microfinance (defined as providing financial sources to the poor).

Microfinance, as defined above, has had relative success with small loans of short maturity if success is to be measured by high repayment rates. It certainly has met the needs of small investments and of consumption credit. The challenge now is to meet the needs of significantly larger sums for areas identified at the start of this summary. This requires lending organizations to have both much larger capital and much greater loan appraisal and portfolio management capacity than they now possess.

It is important to recognize that the state has a role to play in regulation and development (at policy level) and in support infrastructure but it should not be a 'player' especially in loans. The regulatory framework has constrained the development of full financial services microfinance institutions. However, within this regulatory framework, mainstream banks and microfinance institutions can work as partners and this perhaps is the way to the future. A useful analogy was provided in terms of the telecom sector and cable TV where partnerships between large formal regulated entities and small (often single individual) entrepreneurial firms have led to rapid growth. Second, loan portfolio qualities have been impaired in the past whenever the state has involved itself through directed lending or loan *melas*. Third, state intervention

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Microfinance has had relative success with small loans of short maturity if success is to be measured by high repayment rates. It certainly has met the needs of small investments and of consumption credit. The challenge now is to meet the needs of significantly larger sums for the non-farm sector.

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Mainstream banks and microfinance institutions will meet the challenging demand for financial services from rural India over the next decade. This will not be an easy task but is achievable especially if we provide an enabling policy framework.

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in interest rates has also had undesirable consequences. There may be less pressure on the state to intervene if financial institutions can transparently show the true cost of lending and signal that these costs are at efficient operating levels.

Commercial banks need to recognize the value of providing consumption credit; a single-minded focus on production credit may be self-defeating since incorporating consumption needs appears to reduce loan default. Microfinance institutions need to emphasize savings, both equity and capacity-building funding, and regional strategies to address the regional disparities identified earlier. Depositors need to have a larger role in governance of financial institutions.

Finally, on a sobering note — it is important that institutional support for micro-livelihoods be in place for financial services to have value. Institutional support for livelihoods similar to that existing in milk or sugarcane ensures that money is used productively. The century-old rural cooperative credit system is in poor shape and carries a warning for those who do not wish to learn from history. We wish to end by paraphrasing a playwright who commented that he was a pessimist by experience but an optimist by nature. In our opinion, mainstream banks and microfinance institutions will meet the challenging demand for financial services from rural India over the next decade. This will not be an easy task but is achievable especially if we provide an enabling policy framework. ✓

## List of Participants

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10. Mr. V Leeladhar, CMD, Union Bank of India, Mumbai
11. Mr. Vijay Mahajan, CEO, BASIX, Hyderabad
12. Mr. Brij Mohan, Development Consultant, New Delhi
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20. Prof. M S Sriram, Faculty, IIM Ahmedabad
21. Mr. M P Vasimalai, Executive Director, Dhan Foundation, Madurai
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