CONCEPT PAPER

Microfinance Institutions in India

Piyush Tiwari and S.M. Fahad
Housing Development Finance Corporation
Ramon House, 169 Backbay Reclamation, Mumbai 400 020

Abstract

More than subsidies poor need access to credit. Absence of formal employment make them non `bankable'. This forces them to borrow from local moneylenders at exhorbitant interest rates. Many innovative institutional mechanisms have been developed across the world to enhance credit to poor even in the absence of formal mortgage. The present paper discusses conceptual framework of a microfinance institution in India. The successes and failures of various microfinance institutions around the world have been evaluated and lessons learnt have been incorporated in a model microfinance institutional mechanism for India.

1. Micro-finance and Poverty Alleviation

Most poor people manage to mobilize resources to develop their enterprises and their dwellings slowly over time. Financial services could enable the poor to leverage their initiative, accelarating the process of building incomes, assets and economic security. However, conventional finance institutions seldom lend down-market to serve the needs of low-income families and women-headed households. They are very often denied access to credit for any purpose, making the discussion of the level of interest rate and other terms of finance irrelevant. Therefore the fundamental problem is not so much of unaffordable terms of loan as the lack of access to credit itself (Kim 1995).

The lack of access to credit for the poor is attributable to practical difficulties arising from the discrepancy between the mode of operation followed by financial institutions and the economic characteristics and financing needs of low-income households. For example, commercial lending institutions require that borrowers have a stable source of income out of which principal and interest can be paid back according to the agreed terms. However, the income of many self employed households is not stable, regardless of its size. A large number of small loans are needed to serve the poor, but lenders prefer dealing with large loans in small numbers to minimize administration costs. They also look for collateral with a clear title - which many low-income households do not have. In addition bankers tend to consider low income households a bad risk imposing exceedingly high information monitoring costs on operation.

Over the last ten years, however, successful experiences in providing finance to small entrepreneur and producers demonstrate that poor people, when given access to responsive and timely financial services at market rates, repay their loans and use the proceeds to increase their income and assets. This is not surprising since the only realistic alternative for them is to borrow from informal market at an interest much higher than market rates. Community banks, NGOs and grassroot savings and credit groups around the world have shown that these microenterprise loans can be profitable for borrowers and for the lenders, making microfinance one of the most effective poverty reducing strategies.

To the extent that microfinance institutions become financially viable, self sustaining, and integral to the communities in which they operate, they have the potential to attract more resources and expand services to clients. Despite the success of microfinance institutions, only about 2% of world's roughly 500 million small entrepreneur is estimated to have access to financial services (Barry et al. 1996). Although there is demand for credit by poor and women at market interest rates, the volume of financial transaction of microfinance institution must reach a certain level before their financial operation becomes self sustaining. In other words, although microfinance offers a promising institutional structure to provide access to credit to the poor, the scale problem needs to be resolved so that it can reach the vast majority of potential customers who demand access to credit at market rates. The question then is how microenterprise lending geared to providing short term capital to small businesses in the informal sector can be sustained as an integral part of the financial sector and how their financial services can be further expanded using the principles, standards and modalities that have proven to be effective.

To be successful, financial intermediaries that provide services and generate domestic resources must have the capacity to meet high performance standards. They must achieve excellent repayments and provide access to clients. And they must build toward operating and financial self-sufficiency and expanding client reach. In order to do so, microfinance institutions need to find ways to cut down on their administrative costs and also to broaden their resource base. Cost reductions can be achieved through simplified and decentralized loan application, approval and collection processes, for instance, through group loans which give borrowers responsibilities for much of the loan application process, allow the loan officers to handle many more clients and hencee reduce costs (Otero et al. 1994).

Microfinance institutions can broaden their resource base by mobilizing savings, accessing capital markets, loan funds and effective institutional development support. A logical way to tap capital market is securitization through a corporation that purchases loans made by microenterprise institutions with the funds raised through the bonds issuance on the capital market. There is atleast one pilot attempt to securitize microfinance portfolio along these lines in Ecuador. As an alternative, BancoSol of Bolivia issued a certificate of deposit which are traded in Bolivian stock exchange. In 1994, it also issued certificates of deposit in the U.S. (Churchill 1996). The Foundation for Cooperation and Development of Paraguay issued bonds to raise capital for microenterprise lending (Grameen Trust 1995).

Savings facilities make large scale lending operations possible. On the other hand, studies also show that the poor operating in the informal sector do save, although not in financial assets, and hence value access to client-friendly savings service at least as much access to credit. Savings mobilization also makes financial instituttions accontable to local shareholders. Therefore, adequate savings facilities both serve the demand for financial services by the customers and fulfil an important requirement of financial sustainability to the lenders. Microfinance institutions can either provide savings services directly through deposit taking or make arrangements with other financial institutions to provide savings facilities to tap small savings in a flexible manner (Barry 1995).

Convenience of location, positive real rate of return, liquidity, and security of savings are essential ingradients of successful savings mobilization (Christen et al. 1994).

Once microfinance institutions are engaged in deposit taking in order to mobilize household savings, they become financial intermediaries. Consequently, prudential financial regulations become necessary to ensure the solvency and financial soundness of the institution and to protect the depositors. However, excessive regulations that do not consider the nature of microfinance institution and their operation can hamper their viability. In view of small loan size, microfinance institutions should be subjected to a minimum capital requirement which is lower than that applicable to commercial banks. On the other hand, a more stringent capital adequacy rate (the ratio between capital and risk assets) should be maintained because microfinance institutions provide uncollateralized loans.

Governments should provide an enabling legal and regulatory framework which encourages the development of a range of institutions and allows them to operate as recognized financial intermediaries subject to simple supervisory and reporting requirements. Usury laws should be repelled or relaxed and microfinance institutions should be given freedom of setting interest rates and fees in order to cover operating and finance costs from interest revenues within a reasonable amount of time. Government could also facilitate the process of transition to a sustainable level of operation by providing support to the lending institutions in their early stage of development through credit enhancement mechanisms or subsidies.

One way of expanding the successful operation of microfinance institutions in the informal sector is through strengthened linkages with their formal sector counterparts. A mutually beneficial partnership should be based on comparative strengths of each sectors. Informal sector microfinance institutions have comparative advantage in terms of small transaction costs achieved through adaptability and flexibility of operations (Ghate et al. 1992). They are better equipped to deal with credit assessment of the urban poor and hence to absorb the transaction costs associated with loan processing. On the other hand, formal sector institutions have access to broader resource-base and high leverage through deposit mobilization (Christen et al. 1994).

Therefore, formal sector finance institutions could form a joint venture with informal sector institutions in which the former provide funds in the form of equity and the later extends savings and loan facilities to the urban poor. Another form of partenership can involve the formal sector institutions refinancing loans made by the informal sector lenders. Under these settings, the informal sector institutions are able to tap additional resources as well as having an incentive to exercise greater financial discipline in their management.

Microfinance institutions could also serve as intermediaries between borrowers and the formal financial sector and on-lend funds backed by a public sector guarantee (Phelps 1995). Business-like NGOs can offer commercial banks ways of funding microentrepreneurs at low cost and risk, for example, through leveraged bank-NGO-client credit lines. Under this arrangement, banks make one bulk loan to NGOs and the NGOs packages it into large number of small loans at market rates and rcover them (Women's World Banking 1994). There are many on-going research on this line but context specific research is needed to identify the most appropriate model. With this in mind we discuss various possible alternatives of formal-informal sector linkages in India.

In this context, following strategic, institutional and connectivity issues related to micro-finance arise.

Strategic Issues

- Is there a prevailing paradigm for micro-finance?
- Are there clearly visible pattern across the country?
- Is there a clearly defined foundation building blocks such as organizing principles, gender preferences and operational imperetives?
- What are methodological issues?

Institutional Issues

- Is there a need for a new institution?
- Should it operate all India or in a state?
- Where should it be located?
- Who can lead an institution of this sort?
- What will its contextual interconnections be?
- Who will be its beneficiaries?

Connectivity Issues

- How should the Corporate Financial Sector be involved?
- What is the role of donor agencies?
- How should communities be involved?
- Are there political issues that should be explicitly considered?
- Are there government policy issues?

2. The Formal Sector Institutions :

Traditionally, the formal sector Banking Institutions in India have been serving only the needs of the commercial sector and providing loans for middle and upper income groups. Similarly, for housing the HFIs have generally not evolved a lending product to serve the needs of the Very LIG primarily because of the perceived risks of lending to this sector. Following risks are generally perceived by the formal sector financial institutions:

- Credit Risk
- High transaction and service cost
- Absence of land tenure for financing housing
- Irregular flow of income due to seasonality
- Lack of tangible proof for assessment of income
- Unacceptable collaterals such as crops, utensils and jewellery

As far as the formal financial institutions are concerned, there are Commercial Banks, Housing Finance Institutions (HFIs), NABARD, Rural Development Banks (RDBs), Land Development Banks Land Development Banks and Co-operative Banks (CBs).

As regards the Co-operative Structures, the Urban Co.op Banks (UCB) or Urban Credit Co.op Societies (UCCS) are the two primary co-operative financial institutions operating in the urban areas. There are about 1400 UCBs with over 3400 branches in India having 14 million members, Their total lending outstanding in 1990-91 has been reported at over Rs 80 billion with deposits worth Rs 101 billion.

Similarly there exist about 32000 credit co.op societies with over 15 million members with their total outstanding lending in 1990-91 being Rs 20 billion with deposits of Rs 12 billion.

Few of the UCCS also have external borrowings from the District Central Co.op Banks (DCCBs) at 18-19%. The loans given by the UCBs or the UCCS are for short term and unsecured except for few which are secured by personal guarantees. The most effective security being the group or the peer pressure.

The Government has taken several initiatives to strengthen the institutional rural credit system. The rural branch network of commercial banks have been expanded and certain policy prescriptions imposed in order to ensure greater flow of credit to agriculture and other preferred sectors. The commercial banks are required to ensure that 40% of total credit is provided to the priority sectors out of which 18% in the form of direct finance to agriculture and 25% to priority sector in favour of weaker sections besides maintaining a credit deposit ratio of 60% in rural and semi-urban branches. Further the IRDP introduced in 1979 ensures supply of credit and subsidies to weaker section beneficiaries. Although these measures have helped in widening the access of rural households to institutional credit, vast majority of the rural poor have still not been covered. Also, such lending done under the poverty alleviation schemes suffered high repayment defaults and left little sustainable impact on the economic condition of the beneficiaries.

3. The Existing Informal financial sources :

The informal financial sources generally include funds available from family sources or local money lenders. The local money lenders charge exhorbitant rates, generally ranging from 36% to 60% interest due to their monopoly in the absence of any other source of credit for non-conventional needs. Chit Funds and Bishis are other forms of credit system operated by groups of people for their mutual benefit which however have their own limitations.

Lately, few of the NGOs engaged in activities related to community mobilisation for their socio-economic development have initiated savings and credit programmes for their target groups. These Community based financial systems (CBFS) can broadly be categorised into two models: Group Based Financial Intermediary and the NGO Linked Financial Intermediary.

Most of the NGOs like SHARAN in Delhi, FEDERATION OF THRIFT AND CREDIT ASSOCIATION (FTCA) in Hyderabad or SPARC in Bombay have adopted the first model where they initiate the groups and provide the necessary management support. Others like SEWA in Ahmedabad or BARODA CITIZEN's COUNCIL in Baroda pertain to the second model.

The experience of these informal intermediaries shows that although the savings of group members, small in nature do not attract high returns, it is still practised due to security reasons and for getting loans at lower rates compared to that available from money lenders. These are short term loans meant for crisis, consumption and income generation needs of the members. The interest rates on such credit are not subsidised and generally range between 12 to 36%. Most of the loans are unsecured. In few cases personal or group guarantees or other collaterals like jewellery is offered as security.

While a census of NGOs in micro-finance is yet to be carried out, there are perhaps 250-300 NGOs, each with 50-100 Self Help Groups (SHG). Few of them, not more than 20-30 NGOs have started forming SHG Federations. There are also agencies which provide bulk funds to the system through NGOs. Thus organisations engaged in micro finance activities in India may be categorised as Wholesalers, NGOs supporting SHG Federations and NGOs directly retailing credit borrowers or groups of borrower.

The Wholesalers will include agencies like NABARD, Rashtriya Mahila Kosh-New Delhi and the Friends of Women's World Banking in Ahmedabad. Few of the NGOs supporting SHG Federations include MYRADA in Bangalore, SEWA in Ahmedabad, PRADAN in Tamilnadu and Bihar, ADITHI in Patna, SPARC in Mumbai, ASSEFA in Madras etc. While few of the NGOs directly retailing credit to Borrowers are SHARE in Hyderabad, ASA in Trichy, RDO Loyalam Bank in Manipur.

4. Mechanisms Adopted in Other South Asian Nations In Targeting Programmes for the Low Income Groups

The Grameen Bank in Bangladesh

The concept is the brainchild of Dr Muhammad Yunus of Chittagong University who felt concern at the pittance earned by landless women after a long arduous day's work labouring for other people. He reasoned that if these women could work for themselves instead of working for others they could retain much of the surplus generated by their labours, currently enjoyed by others.

Established in 1976, the Grameen Bank (GB) has over 1000 branches (a branch covers 25-30 villages, around 240 groups and 1200 borrowers) in every province of Bangladesh, borrowing groups in 28,000 villages, 12 lakh borrowers with over 90% being women. It has an annual growth rate of 20% in terms of its borrowers. The most important feature is the recovery rate of loans, which is as high as 98%. A still more interesting feature is the ingenious manner of advancing credit without any "collateral security".

The Grameen Bank lending system is simple but effective. To obtain loans, potential borrowers must form a group of five, gather once a week for loan repayment meetings, and to start with, learn the bond rules and "16 Decisions" which they chant at the start of their weekly session. These decisions incorporate a code of conduct that members are encouraged to follow in their daily life e.g. production of fruits and vegetables in kitchen gardens, investment for improvement of housing and education for children, use of latrines and safe drinking water for better health, rejection of dowry in marriages etc. Physical training and parades are held at weekly meetings for both men and women and the "16 Decisions" are chanted as slogans. Though according to the Grameen Bank management, observance of these decisions is not mandatory , in actual practice it has become a requirement for receiving a loan.

Number of groups in the same village are federated into a Centre. The organisation of members in groups and centres serves a number of purposes. It gives individuals a measure of personal security and confidence to take risks and launch new initiatives.

The formation of the groups - the key unit in the credit programme - is the first necessary step to receive credit. Loans are initially made to two individuals in the group, who are then under pressure from the rest of the members to repay in good time. If the borrowers default, the other members of the group may forfeit their chance of a loan. The loan repayment is in weekly instalments spread over a year and simple interest of 20% is charged once at the year end.

The groups perform as an institution to ensure mutual accountability. The individual borrowing member is kept in line by considerable pressure from other group members. Credibility of the entire group and future benefits in terms of new loans are in jeopardy if any one of the group members defaults on repayment.

There have been occasions when the group has decided to fine or expel a member who has failed to attend weekly meetings or wilfully defaulted on repayment of a loan. The members are free to leave the group before the loan is fully repaid, however, the responsibility to pay the balance falls on the remaining group members. In the event of default by the entire group, the responsibility for repayment falls on the centre.

The Grameen Bank has provided an inbuilt incentive for prompt and timely repayment by the borrower i.e. gradual increase in the borrowing eligibility of subsequent loans.

A survey has shown that about 42% of the members had no income earning occupation (though some may have been unpaid family workers in household enterprises) at the time of application of the first loan. Thus, the Grameen Bank has helped to generate new jobs for a large proportion of the members. Only insignificant portion of the loans (6 per cent) was diverted for consumption and other household needs.

About 50 per cent of the loans taken by male members were for the purpose of trading and shopkeeping. 75 per cent of loans given to female members were utilised for livestock, poultry raising, processing and manufacturing activity.

Savings Programme

It is compulsory for every member to save one Taka per week which is accumulated in the Group Fund. This account is managed by the group on a consensual basis, thus providing the members with an essential experience in the collective management of finances. Amounts collected from fines imposed on members for breach of discipline is also put into this account. The amount in the Fund is deposited with Grameen Bank and earns interest. A member can borrow from this fund for consumption, sickness, social ceremony or even for investment (if allowed by all group members). Terms and conditions of such loans, which are normally granted interest free, are decided by the group.

Factors behind success of the Grameen Bank are : participatory process in every aspect of lending mechanism, peer pressure of group members on each other, lending for activities which generate regular income, weekly collection of loans in small amount, intense interaction with borrowers through weekly meetings, strong central management, dedicated field staff, extensive staff training willingness to innovate, committed pragmatic leadership and decentralised as well as participatory style of working.

The Grameen Bank experience indicates the vital importance of credit as an entry point for upliftment programme for rural poor. If a programme is to have an appeal for people living in abject poverty, it must offer them clear and immediate prospects for economic improvement. Thereafter, it is easier to sell other interventions of social development, however unconventional they may appear, once improvements in standard of living are demonstrated.

The Grameen Bank clearly shows that lack of collateral secuirty should not stand in the way of providing credit to the poor. The poor can utilise loans and pay them if effective procedures for bank transactions with them can be established. In case of the Grameen Bank, formation of groups with a small group of like minded rural poor has worked well, and group solidarity and peer pressure have substituted for collateral security.

Linking Banks with Self-Help Groups : A Pilot Project from Indonesia

In Indonesia, financial liberalization since 1988, disenchantment with traditional subsidised credit programs and an openness to innovative approaches led the Central Bank to support a pilot project in which 13 participating banks, with the assistance of 12 NGOs, have lent to about 420 self-help groups (SHGs) in the first phase, to be onlent to their members.

Some of the principles underlying the project and the guidelines that were issued to the implementing groups are listed below :

- The SHGs are to use part of their funds (almost 60%) for lending to their members and the rest for depositing in a bank to serve as the basis for refinancing from the bank.
- Savings are to come first: no credit will be granted by the SHG without savings by the individual members of the SHG. These savings are to serve as partial collateral for their loans.
- The joint and several liability of the members is to serve as a substitute for

physical collateral for that part of loans to members in excess of their savings deposits.

- Credit decisions for onlending to members are to be taken by the group collectively.
- Central Bank refinance is to be at an interest rate equal to the interest rate at which the savings are mobilised.
- All the intermediaries (the Central Bank, banks, NGOs and SHGs) will charge an interest margin to cover their costs.
- Interest rates on savings and credit for members are to be market rates to be determined locally by the participating institutions.
- Instead of penalties for arrears, the banks may impose an extra incentive charge to be refunded in the case of timely repayments.
- The ratio of credit to savings will be contingent upon the creditworthiness of the group and the viability of the projects to be implemented, and is to increase over time with repayment performance.
- SHGs may levy an extra charge on the interest rate for internal fund generation (which would be self-imposed forced savings).

Within the first ten months of the implementation period, by March 1990, 7 private banks and 11 branches of government banks had made 229 group loans to SHGs, which had retailed them to about 3500 members. Loans totalling about $0.4 million had been disbursed , on an average of about $2000 per group and $118 per member. SHG savings deposits with the bank amounted to about $400 per group, giving a credit to savings ratio of about 5. NGOs have received loans from the banks at 22 to 24 per cent which is only slightly higher than the refinancing rate of large to small banks. Rates to end users have been between 30 to 44 per cent after the NGOs and SHGs have added their margins to cover costs and build funds to cover joint and several liability. Only one of the participating banks had sought a guarantee under the scheme from the Central Bank.

Pag IBIG Fund - Philippines

Pag IBIG Fund, is one of the most financially stable Government owned -and-controlled Corporations in Philippines today. Pag - IBIG, is an acronym for Pagtulungan sa Kinabukasan (Partnership for the Future), Ikaw (You), Banko (Bank) Industriya (Industry) Gobyerno (Government). To date, it has a total of 1.2 million members with a fund base of US $ 800 million. The fund is a provident savings fund and a housing credit system for the wage earners.

To make the fund a better instrument for the National Shelter Program (NSP) a Presidential Decree was signed in December 1980 establishing the Home Development Mutual Fund (HDMF) as a separate entity to administer the provident fund for housing.

The main objectives of the HDMF are :

- To promote self-reliance and self-determination among workers through membership in an integrated nationwide savings system
- To invest the provident savings of its members taking into consideration the profitability and safety of the funds as a means of providing them provident benefits upon termination of their membership in the Fund.
- To promote home ownership through the establishment of an affordable and adequate housing credit system for its members
- To provide small and short loans and other benefits to its members.

For the effective working and success of the Fund it was decided to make membership to the Fund mandatory and it was also based on the conviction that people deserve higher incomes and in the process they themselves must be savers and as savers they themselves be the capital base of the nation. Waivers were granted to employers who prior to the creation of the Fund already had superior retirement and provident plans for their employees or employers whose plans are similar to those of the fund or who are incapable of paying counterpart contribution due to financial losses.

Savings and Housing are closely intertwined and the first step was to take care of the members basic need for housing. The Fund instituted a systematic, regular and easy savings system and tapped new groups of savers who could not be reached by commercial banks and became a major source of funds for developing the economy.

Membership to the fund was made voluntary in 1987. A member could withdraw his accumulated savings upon maturity of his membership after 20 years, permanent departure from the country, total disability, retirement or separation from service due to health.

Housing loans were the Fund's greatest attraction, for which reason, a Trust Fund Agreement with the National Housing Mortgage and Finance Corporation (NHMFC) was entered into . The agreement allows the Fund to direct its lending through the NHMFC Secondary Mortgage Market System, where mortgage instruments are traded by NHMFC. The Fund was guaranteed a fixed return making it possible for the Fund to lend to its members at 9% p.a. and declare dividends.

The Government also established the Housing and Urban Development Coordinating Council (HUDCC) as the sole authority and policy making body on housing, to take charge of identifying and redefining the mandates of housing agencies. The HUDCC was to act as the lead funding agency and extend funding commitments to financial institutions who could act as loan originators for the home buyers'.

To meet its major objective of assisting low and middle income families in meeting their housing requirements through the provision of appropriate and affordable housing loan packages, the HUDCC offers loan packages with interest rates ranging from 9% to 16% per annum depending upon the loan amount. Maximum loan amount per borrower is 46 times his monthly income, consisting of his monthly basic salary plus cost of living allowance plus the monthly equivalent of the weighted average of other income during the last three years. Maximum loan repayment period is 25 years but shall not go beyond the age of 70 for the principal borrower.

There was also an Appliance and Furniture Loan Programme (AFLP) that granted short term loans . The loan amount was computed based on the length of the membership and the applicant's salary. The 2 year loan carries an interest of 10.75% p.a. Later the AFLP was expanded into the Multi Purpose Loan Program (MPL) which covers various needs: educational, medical & hospitalisation, livelihood, minor home improvement, purchase of appliances and furniture etc. To qualify for a Multi Purpose Loan, a member must have made atleast 24 monthly contributions, must be an active Fund member and there must be a commitment from both employer and employee to continuously remit contributions at least for the term of the loan. The loan bears an interest of 10.75% p.a., paid in advance for the first year of the loan period. The second year interest is spread and paid equally over the 24 month term of the loan. The MPL continues to lend to members on a regular basis, it enables a member to borrow again after 50% of the outstanding loan has been repaid.

Thus Pag-IBIG helps every Filipino to have his own house by pooling the savings of its members and channeling them for the long term financing requirement of housing.
Urban Community Development Office of Thailand: The People's Bank

Urban Community Development Office (UCDO) was established in 1992 as a government sponsored organization with the mandate of enhancing the capacity of slum dwellers and urban poor, through credit provision process, to generate income on a stable basis and to obtain adequate housing with secure rights and improved living environment. UCDO facilitates the formation and strengthening of savings and credit organizations in urban poor communities through technical assistance and training on organization and management of the savings groups.

The office provides wholesale loans to these member organizations to on-lend to individuals to support community development. Therefore, it serves as a bank for urban poor. To be eligible for UCDO loan, the saving group must have been engaged in savings activities for at least three months and demonstrate a clear management structure. Credit is provided as a tool to unleash communities' potential for self improvement.

The credit from UCDO consists of general purpose revolving loans to meet immediate household or community needs with a maximum three year, income enhancement loans for up to five years to support equipment purchase and working capital, and housing loans of a maximum 15 year maturity to finance group housing projects including land purchase and non-project housing loans for up to 5 years. As of Mach 1996, $ 17.8 million of credit was disbursed to the benefit of about 3000 families in 62 communities. Housing loans accounted for $12.6 million, followed by income enhancement loans ($3.8 million) and general purpose loans ($1.4 million).

All committee members of a community group must sign their names as guarantors for a loan. In the case of housing projects, land titles or the housing may have to be put as collateral as well. The lending rate is set based on cost of funds and provision for bad debts and a markup for community organizations. Current rates are kept below commercial rates thanks to UCDO's access to low cost funds. The community can decide upon the loan amount and the repayment period within the precribed maximum terms. The community or savings group may repay daily, weekly, fortnightly or monthly. The method of repayment is flexible and arragned according to the needs and process decided by the community. The repayment rate stands at 98.7%.

5. Credit Mechanisms Adopted by HDFC (India) for Funding the Low Income Group Beneficiaries

HDFC has been making continuous and sustained efforts to reach the lower income groups of society, especially the economically weaker sections, thus enabling them to realise their dreams of possessing a house of their own.

HDFCs' response to the need for better housing and living environment for the poor, both, in the urban and rural sectors materialised in its collaboration with Kreditanstalt fur Wiederaufbau (KfW), a German Development bank. KfW sanctioned DM 55 million to HDFC for low cost housing projects in India. HDFCs' approach to low-income lending has been extremely professional and developmental in nature. Negating the concept of dependence, HDFCs' low cost housing schemes are marked by the emphasis on peoples participation and usage of self-help approach wherein the beneficiaries contribute both in terms of cash and labour for construction of their houses. HDFC also ensures that the newly constructed houses are within the affordability of the beneficiaries, and thus promotes the usage of innovative low cost technologies and locally available materials for construction of the houses.

For the purpose of actual implementation of the low cost housing projects, HDFC collaborates with organisations, both, Governmental and Non-Governmental. Such organisations act as co-ordinating agencies for the projects involving a collective of individuals belonging to the Economically Weaker Sections. The projects could be either in urban or rural areas.

The security for the loan is generally the mortgage of the property being financed.

The construction work is regularly monitored by the co-ordinating agencies and HDFC. The loans from HDFC are disbursed depending upon the stages of construction. To date, HDFC has experienced 100% recovery for the loans disbursed to various projects.

6. Strengths of Informal Sector

A synthesis that can be evolved out of the success of NGOs/CBOs engaged in microfinance is based on certain preconditions, institutional and facilitating factors.

Preconditions to Success:

Those NGOs/ CBOs have been successful that have istilled financial value/ discipline through savings and have demonstrated a matching value themselves before lending. A recovery system based on social intermediation and various options including non-financial mechanisms has proved to be effective. Another important feature has been the community governance. The communities in which households are direct stake holders have successfully demonstrated the success of programs. A precondition for success is to involve community directly in the program. Experience indicates that savings and credit are both critical for success and savings should precede credit. Chances of success more with women: Programs designed with women are more successful.

Operating Indicators :

The operating indicators show that programs which are designed taking into account the localized and geographical differences have been successful. Effective and responsive accounting and monitoring mechanisms have been an important and critical ingradient for the success of programs. The operational success has been more when interest rates are at or near market rates: The experience of NGOs/CBOs indicates that low income households are willing to pay market rates. The crucial problem is not the interest rates but access to finance. Eventually in absence of such programs households end up paying much higher rates when borrowing from informal markets. Some NGOs have experimented where members of community decide on interest rates. This is slightly different from Thailand experience where community decides on repayment terms and loan amount. A combination of the three i.e. interest rates, amount and repayment period if decided by community, the program is most likely to succeed. A program which is able to leverage maximum funds from formal market has been successful. Experience indicates that it is possible to leverage higher funds against deposits.

The spreads should be available to meet operational costs of NGOs. Most of the directed credit program in India like Kfw have a ceiling on the maximum interest rate and the spread available to NGOs. A flexible rate of interest scheme would indicate a wider spread for NGOs. Selected non-financial services, viz. business, marketing support services enhance success. Appropriate incentives for borrowing and proper graduation of credit has been essential component of success. A successful program can not be generalized for all needs and geographical spread. The programs which are simple and replicable in similar contexts have contributed to success.

Betterment in quality of life through better housing or better economic opportunities is a tangible indicator of success. The programs which have been able to demonstrate on some measurable scale that the quality of life has improved have been successful. To be successful the program productivity with outreach should match. The credit mechanism should be flexible meeting multiple credit needs: The programs which have taken care of other needs such as consumption, marriage etc. besides the main shelter, infrastructure or economic needs are successful.

Facilitating Factor

Another factor that has contribiuted to the success is the broad environment. A facilitative environment and enabling regulatory regime contributes to the success. The NGOs/CBOs which have been able to leverage funds from formal programs have been successful. An essential factor for success is that all development programs should converge across sectors.

7. Weaknesses of Existing Microfinance Models

One of the most successful models discussed around the world is the Grameen type. The bank has successfully served the rural poor in Bangladesh with no physical collateral relying on group responsibility to replace the collateral requirements. This model, however, has some weaknessed. It involves too much of external subsidy which is not replicable Grameen bank has not oriented itself towards mobilising peoples' resources. The repayment system of 50 weekly equal instalments is not practical because poor do not have a stable job and have to migrate to other places for jobs. If the communities are agrarian during lean seasons it becomes impossible for them to repay the loan. Pressure for high repayment drives members to money lenders. Credit alone cannot alleviate poverty and the Grameen model is based only on credit. Micro-finance is time taking process. Haste can lead to wrong selection of activities and beneficiaries.

Another model is Kerala model (Shreyas). The rules make it difficult to give adequate credit {only 40-50 percent of amount available for lending). In Nari Nidhi/Pradan system perhaps not reaching the very poor.

Most of the existing microfinance institutions are facing problems regarding skilled labour which is not available for local level accounting. Drop out of trained staff is very high. One alternative is automation which is not looked at as yet. Most of the models do not lend for agriculture. Agriculture lending has not been experimented.

- Risk Management : yield risk and price risk
- Insurance & Commodity Future Exchange could be explored

All the models lack in appropriate legal and financial structure. There is a need to have a sub-group to brainstorm on statutory structure/ ownership control/

management/ taxation aspects/ financial sector prudential norms. A forum/ network of micro-financier (self regulating organization) is desired.

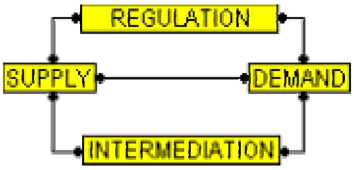
8. A New Paradigm

A new paradigm that emerges is that it is very critical to link poor to formal financial system, whatever the mechanism may be, if the goal of poverty allieviation has to be achieved. NGOs and CBOs have been involved in community development for long and the experience shows that they have been able to improve the quality of life of poor, if this is an indicator of development. The strengths and weaknesses of existing NGOs/CBOs and microfinance institutions in India indicate that despite their best of efforts they have not been able to link themselves with formal systems. It is desired that an intermediary institution is required between formal financial markets and grassroot. The intermediary should encompass the strengths of both formal financial systems and NGOs and CBOs and should be flexible to the needs of end users. There are, however, certain unresolved dilemmas regarding the nature of the intermediary institutions. There are arguments both for and against each structure. These dilemmas are very contextual and only strengthen the argument that no unique model is applicable for all situations. They have to be context specific.

Dilemmas

Community Based	Investor Owned
• Community Managed • Community (self) financed • Integrated (social & finance) • Non profit / mutual benefit • Only for poor • 'Self regulated'	• Professionally managed • Accepting outside funds for on-lending • Minimalist (finance only) • For profit • For all under served clients • Externally regulated

The four pillars of microfinance credit system (Fig. 1) are supply, demand for finance, intermediation and regulation. Whatever may the model of the intermediary institution, the end situation is accessibility of finance to poor. The following tables indicate the existing and desired situation for each component.



DEMAND

Existing Situation	Desired Situation
• fragmented • Undifferentiated • Addicted, corrupted by capital & subsidies • Communities not aware of rights and responsibilities	• Organized • Differentiated (for consumption, housing) • Deaddicted from capital & subsidies • Aware of rights and responsibilities

SUPPLY

Existing Situation	Desired Situation
• Grant based (Foreign/GOI) • Directed Credit - unwilling and corrupt • Not linked with mainstream • Mainly focussed for credit • Dominated	• Regular fund sources (borrowings/deposits) • Demand responsive • Part of mainstream (banks/FIs) • Add savings and insurance • Reduce dominance of informal, unregulated suppliers

INTERMEDIATION

Existing Situation	Desired Situation
• Non specialized • Not oriented to financial analysis	• Specialized in financial services • Thorough in financial analysis

• Non profit capital • Not linked to mainstream FIs • Not organized	• For profit • Link up to FIs • Self regulating

REGULATION

Existing Situation	Desired Situation
• Focussed on formal service providers (informal not regulated) • regulating the wrong things e.g. interest rates • Multiple and conflicting (FCRA, RBI, IT, ROC, MOF/FIPB, ROS/Commerce) • Negatively oriented	• include/informal recognise e.g. SHGs • Regulate rules of game • Coherence and coordination across regulators • Enabling environment

9. Possible Alternatives/Options

The three options that emerge out of above discussion regarding structure of intermediary institution is discussed below.

Option-I

- One possible option is to increase the flow of funds to informal lenders to supplement their own funds. The formal sector will take advantage of the lower transaction costs and risk premia of the informal sector so as to reach the low income group borrowers beyond the profitable reach of the formal sector. As for the beneficiaries, inspite of the transaction cost of the formal and the informal sector being transferred on to them, the cost of borrowing will remain low as compared to what exists through money lenders.

  In addition, access to the formal sector funds could promote competition within the informal sector and check the exhorbitant profits being made in this sector. It also promotes allocative efficiency by offering a broader choice for the productive use of savings by beneficiaries, irrespective of which sector they are mobilised by.

Thus this approach of promoting linkages combines the strengths of both sectors to supplement the resources of the informal sector. Here it is imperative to avoid the pitfall of discouraging informal savings by substituting cheaper formal funds for informal lenders.

The existing modes of borrowing for the low income group through the Co-operative Societies like Thrift and Credit Co.op Societies are already gaining momentum. The Formal Financial Institutions can establish linkages with these co-operative bodies. Funds could be channelised from the formal financial institutions at market rates to the low income group beneficiaries through the intermediaries like the co-operative bodies stated above. The credit worthiness of the intermediaries would be the basic security for the loans advanced by the formal financial institutions. However, the savings mobilised by the intermediaries from the informal sector could also be accepted as collaterals.

The intermediaries could then lend to groups of beneficiaries. The transaction cost of the formal sector would be transferred on to the intermediaries who would pass on the same to the beneficiaries.

In the process, the intermediaries would also charge additional fees to borrowers to cover their costs. It would also aid them in strengthening themselves. However, it would be aimed to make the funds reach the beneficiaries at applicable rates of the two institutions.

The intermediaries would accept the savings from groups as collaterals and would transfer the same to the formal sector for getting the deposits serviced better. Thus the two way flow of funds would benefit both the formal and informal sector.

The beneficiaries would benefit as the cost of borrowing would be low for them and their savings would be safe and would be serviced better.

An analysis of community-based finance systems highlights the high establishment costs of NGOs. They suggest that loan service costs are lower amongst co-operative societies, as compared to NGO-linked CBFIs, because of decentralized loan administration and availability of voluntary staff. The NGO-linked CBFI operations are generally supported by grants from national and international donor agencies.

NGO-linked CBFIs must aim at an adequate scale of operation and while it may be supported by grants to meet establishment costs in the initial period, dependency on such grants should be reduced over time. An adequate interest rate spread must be available to meet the transactions costs. CBFIs should be able to recover all costs through its financial operations, by building up their capacity for financial management, through training and interaction with the Formal sector institutions.

Option-II

- Since it is now being felt that the existing structures are inadequate to meet the housing and economic credit needs of the participating community, an Institution that would combine the strengths of an NGO and the expertise of a financial institution, with participation from the community will be appropriate.

  Thus, the concept of Development Association for Savings and Credit (DASC) could be utilised to address the issue of providing better access to housing finance and economic loans for the participating community in the project area. The DASC is built on the strength of the informal groups to create and improve access to skills, resources and markets. These Groups mobilize savings from their constituent members and other formal/informal sources. The funds mobilized are thus used for meeting the credit needs of the members. The DASC is proposed to be a registered company which will affiliate the Groups based on affiliation criteria and have community representation on its decision making body.

  The DASC will be initiated with the objective to create an alternate, self-sustainable, community based financial organization appropriate to meet the shelter development and livelihood needs of the weaker section belonging to the rural community.

  The long term perspective of DASC will include :

  Establishment of a resource centre for shelter and livelihood development for the weaker sections of the society.

  Demonstration of a viable community based credit system in operation where the communities have access to and control over financial resources based on their own strength.

  Developing group based approach as a sustainable development paradigm for community development.

Option-III

- As mentioned before, a review of the cooperatives and NGOs illustrates a wide variety of arrangements as well as different stages of development of community-based financial institutions. In all cases, the strength of the community based systems is their close rapport and linkages with the community and its members. The broad arrangement involves a bulk loan from the Formal Financial Institution to the Community Based Financial Institution (CBFI) with specified terms and conditions for lending to households. The CBFI will have the responsibility for loan origination and servicing and therefore would also bear the credit risk.

In terms of specific arrangements, two forms of intermediation are envisaged by the strategy. The multi-tiered structure is one in which the bulk loans from the Formal Sector are routed through a Federation or Apex Agency or an NGO, which in turn lends to a primary CBFI. In the single-tiered structure, the Formal Sector Institution deals directly with the CBFI. It is felt that the administrative costs incurred with lending through the multi-tiered model are much higher than under the single-tier model.

In promoting these linkages between the Formal Institutions and CBFIs, directly or through the NGO, it is important that basic financial principles are developed for giving bulk credit to community-based financial institutions. The purpose of the loan, credit terms and underwriting criteria should be clearly defined for the bulk credit that is provided to the CBFI.

It is essential that a delinquency risk fund (DRF) be placed as a deposit with the Formal Institution to cover delinquency risk which may draw against the DRF if the CBFI fails to make a regularly scheduled loan payment. In order to meet the the DRF requirment, CBFIs should be encouraged to start a savings scheme. An appropriate legal status for the CBFI to be able to receive the bulk credit is essential. This may involve a simple registration under the Societies Act. The legal form should permit the receipt of bulk credit for onlending to the individual members.

10. Conclusion

Some valuable lessons can be drawn from the experience of successful Microfinance operation. First of all, the poor repay their loans and are willing to pay for higher interest rates than commercial banks provided that access to credit is provided. The solidarity group pressure and sequential lending provide strong repayment motivation and produce extremely low default rates. Secondly, the poor save and hence microfinance should provide both savings and loan facilities. These two findings imply that banking on the poor can be a profitable business. However, attaining financial viability and sustainability is the major institutional challenge. Deposit mobilization is the major means for microfinance institutions to expand outreach by leveraging equity (Sacay et al 1996). In order to be sustainable, microfinance lending should be grounded on market principles because large scale lending cannot be accomplished through subsidies.

A main conclusion of this paper is that microfinance can contribute to solving the problem of inadequate housing and urban services as an integral part of poverty alleviation programmes. The challenge lies in finding the level of flexibility in the credit instrument that could make it match the multiple credit requirements of the low income borrowers without imposing unbearably high cost of monitoring its end-use upon the lenders. A promising solution is to provide multi-purpose loans or composite credit for income generation, housing improvement and consumption support. Consumption loan is found to be especially important during the gestation period between commencing a new economic activity and deriving positive income. Careful research on demand for financing and savings behaviour of the potential borrowers and their participation in determining the mix of multi-purpose loans are essential in making the concept work (tall 1996).

Eventually it would be ideal to enhance the creditworthiness of the poor and to make them more "bankable" to financial institutions and enable them to qualify for long-term credit from the formal sector. Microfinance institutions have a lot to contribute to this by building financial discipline and educating borrowers about repayment requirements.

REFERENCES

Barry, N.(1995), "The Missing Links: Financial System that Works for the Majority," Women's World Banking, New York.

Barry, Nancy, Armacost, Nicola and Kawas Celina (1996) "Putting Poor people's Economics at the Center of Urban Strategies," Women's World Banking, New York.

Chriseten, R.Peck Rhyne, Elisabeth and Vogel, Robert C (1994) "Maximizing the Outreach of Microenterprise Finance: The Emerging Lessons of Successful Programs," September IMCC, Arlington, Virginia.

Churchill, C.F. (1996)," An Introduction to Key Issues in Microfinance: Supervision and Regulation, Financing Sources, Expansion of Microfinance Institutions," Microfinance Network, Washington, D.C. February.

Ghate, P. et.al.(1992) Informal Finance: Some Findings from Asia, Oxford University Press, Hong Kong.

Grameen Trust (1995) Grameen Dialogue No.24, Dhaka, October.

Kim Kyung-Hwan (1995) "Access to Credit, Term of Housing Finance and Affordability of Housing," Housing Finance International 9(4), June 22-27.

Otero, M. and Rhyne, E.(1994) The New World of Micro-enterprise Finance -Building Healthy Financial Institutions for the Poor, Kumarian Press, West Harford, Connecticut.

Phelps, P.(1995) "Building Linkages Between the Microenterprise and Shelter Sectors: An Issues Paper," GEMINI, Betuesda, Maryland.

UNCHS and ILO (1995) Shelter Provision and Employment Generation, Geneva.

Women's World Banking (1994) "United Nations Expert Group on Women and Finance," New York.

Source: http://www.gdrc.org/icm/conceptpaper-india.html
Accessed on 11/11/2004