Institutional Framework of Microfinance Sector in India

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Abstract

The market structure of microfinance in India varies significantly across different states depending on their stage of financial development, level of economic development and policy environment. The present paper provides an overview of evolution, and institutional structure of the microfinance sector in India. It has evolved rapidly into a commercial and regulated institutional arrangement dedicated to providing access to a range of financial services to poor and near-poor households.

1. Evolution of Microfinance in India

In developing countries like India, financing to the poor through formal financial services failed to meet their credit requirements. The high risk and the high transaction costs of banks associated with small loans and savings deposits are the important factors that make them non-bankable. The lack of loans from formal institutions led to the dependence on the borrowings of money from local money-lenders on huge interest rates.

Since Independence Government of India has emphasized upon providing financial services to the poor and underprivileged. The commercial banks were nationalized in 1969 and were directed to lend 40% of their loan able funds, at a concessional rate, to the priority sector. The priority sector included agriculture and other rural activities and the weaker strata of society in general. The establishment of the Regional Rural banks in 1975 was another policy initiative of the government to broaden the outreach of formal credit systems to the rural population. However, these programmes have not worked well for the reasons such lack of political will to enforce loan repayment, access of wealthy and influential people rather than the poor to bank loans. Thus, the inability of formal credit institutions to deal with the credit requirements of poor effectively has led to emergence of microfinance as an alternative credit system for the poor. The development of Indian Microfinance sector can be chronologically classified into four distinct phases. The four phases are explained as follows:

1.1 Phase I: 1900s – 1969	**Cooperative Movement**
1.2 Phase II: 1969 - 1991	**State Driven Rural Finance through National Banks and emergence of NGOs**
1.3 Phase III: 1992 – 2000	**SHGs Bank Linkage program and Growth of NGO-MFIs**
1.4 Phase IV: 2000 – till date	**Commercialization of Microfinance**

1.1: Phase I: 1900s – 1969: Cooperative Movement:

This phase of Indian Microfinance can be described from early 20th century until 1969, and the credit cooperatives largely dominated as an institution in provision of microfinance services. During this phase Cooperative Societies Act 1904, was passed to extend credit in Indian villages under government sponsorship. In the post-independent period the government of India chose credit cooperatives as an institutional mechanism for delivering credit to the farm sector. However, rural cooperatives were riddled with plethora of problems. The 1945 Cooperative Planning Committee found that a large number of cooperatives were "saddled with the problem of frozen assets because of heavy over dues in repayment." It also revealed that the share of Institutional agencies, comprising the government, the cooperatives and the commercial banks, in financing the borrowings of rural household was only 7.3 per cent in 1951-52 corresponding to the share of private money lenders which was as high as 68.6 per cent. The large scale failure of credit Cooperatives sets the stage for fundamental changes in microfinance institutional delivery.

1.2 Phase II: 1969 – 1991: State Driven Rural Finance through National Banks and emergence of NGOs:

The nationalization of Banks in 1969 along with a strong political emphasis towards poverty eradication led to a new rural finance policy that was directed at reducing the lending imbalances in particular sectors. This new policy resulted in among other things to establishment of Regional Rural Banks (RRBs) and adoption of priority sector lending by Banks under direct specifications of the Reserve Bank of India (RBI). However, there existed negative perception about the creditability of micro borrowers that hindered the access of banking services for low-income people. Some civil society organizations successfully experimented with microfinance models that were more appropriate for the needs of poor households. Some prominent examples of this are SEWA Bank (Ahmadabad), Annapurna Mahila Mandal (Mumbai), and Working Women's Forum (Chennai). The first Self Help Groups (SHGs) started emerging in the country in 1980s as a result of NGO activities such as MYRADA. In 1984-85 MYRADA started linking SHGs to banks. SHGs idea was taken up on a large scale later by NABARD scaling up Indian Microfinance to new heights.

1.3 Phase III: 1992 – 2000: SHGs bank Linkage program and Growth of NGO- MFIs:

By 1990s the problems with both state promoted institutional forms viz. credit cooperative and RRBs in delivery of rural credit were quite evident. The credit cooperatives were crippled with poor governance, management and the poor financial health due to intrusive state patronage and politicization. RRBs financial position deteriorated due to the burden of directed credit and priority sector lending and a restrictive interest rate regime.

The reorientation of policy framework towards Regional Rural Banks (RRBs) around the1990s took place. The external factor of macroeconomic crisis external factors crisis in early 1990s that led to introduction of Economic Reforms of 1991 also influenced Indian Microfinance. An important development in this phase was SHG Bank linkage program by NABARD which greatly increased banking system outreach to otherwise unreached people and initiated a change in the bank's outlook towards low-income families from beneficiaries to customers. During this phase, the new delivery channel viz. Microfinance Institutions (MFIs) entered the microfinance sector mainly on non-profit motive. Another remarkable achievement during this phase was the creation of a new generation of cooperatives viz. "Mutually Aided Cooperative Societies" (MACS), which lie outside the state control. This was done mainly in an attempt to reform the cooperative system.

1.4 Phase IV: 2000 – till date: Commercialization and Regulation of Microfinance:

The rural markets emerged as the new growth drivers for MFIs and banks. Commercial entities (such as banks, companies etc.) participated in the microfinance sector not only as part of their corporate social responsibility but also as a new business line. This phase emphasizes on "inclusive growth and financial inclusion". In 2004, RBI included MFI lending within the priority sector and recognized MFIs as a tool for financial inclusion. This period also saw many NGO-MFI transform into regulated legal formats such as Non-banking finance companies (NBFCs).Commercial banks adopted innovative ways of partnering with NGO-MFI and other rural organization to extend their reach into rural markets. During 2005–2010, the microfinance sector reported strong growth supported by strong demand for loans from borrowers neglected by the banking system and investors eager to invest funds in the high growth industry. However, microfinance sector was subject to little regulation.

The minimal regulation and rapid growth without discipline amongst lenders and borrowers led to the Andhra Pradesh crisis in the year 2010. Due to low repayment rates, microfinance institutions, with exposure to Andhra Pradesh, suffered significant losses which created liquidity crunch for Microfinance institutions in India. The Reserve Bank of India (RBI) responded by appointing an RBI sub-committee known as the Malegam Committee and issued final notifications with an aim to provide broad framework to regulate MFIs.The regulation ensures strong equity capital base, prudential norms in terms of classification of assets and provisioning, fair lending norms and improvement of operational efficiency. In the year 2014, RBI recognized MFIN as Self-regulatory Organization (SRO) whose primary function is to nurture member NBFC-MFIs towards compliance with RBI Directions & Fair Practice Code, Industry Code of Conduct. Recently, a majority of the large MFIs are being converted to differentiated banks, the Small Finance Banks (SFBs).

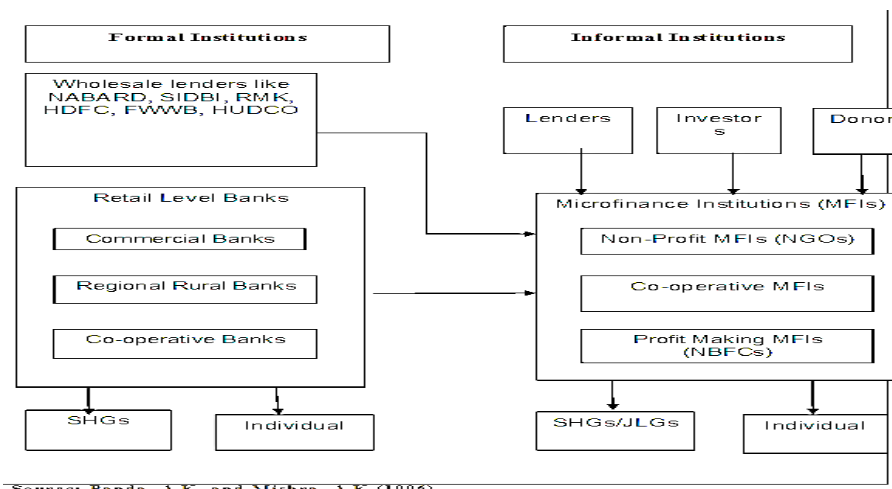
2. Institutional Arrangement and Disbursement of Microfinance in India:

In India, there is a wide variety of institutions in public as well as private sector which provide microfinance to the poor. These institutions can be broadly divided into two types. First type is the traditional formal financial institutions, while the second type is Microfinance Institutions (MFIs) and Self Help Groups (SHGs). There is a hierarchical network of institutions starting from the apex wholesale level to the retail level financial institutes. The retail level banks and MFIs borrow funds from apex financial institutions and use their branch network to provide microfinance at the doorstep of poor people. Some of the important apex and retail level financial institutions have been discussed below:

2.1 Apex Financial Institutions:

The number of apex financial institutions. Some of them are like National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), Housing Development Finance Corporation (HDFC), Housing and Urban Development Corporation Limited (HUDCO), and Rashtriya Gramin Vikas Nidhi (RGVN). They provide bulk amount of funds to retail level banks and MFIs for on-lending to the poor.

Figure 1: Institutional Arrangement for Microfinance Disbursement in India



Source: Panda, A.K. and Mishra, A.K (1996)

2.2 Retail Level Banks:

At the retail level Commercial Banks, Regional Rural Banks, Co-operative Banks, and different types of MFIs provide microfinance services. These banks provide loans directly to individuals, SHGs and MFIs

2.3 Microfinance Institutions (MFIs) and Self Help Groups (SHGs):

Microfinance institutions (MFIs) and SHGs are the organizations or associations of individuals that provide financial services to the poor. In India, there is a wide range of such organizations with diverse legal forms, varying significantly in size, outreach, mission and credit delivery methodologies. Figure 1 represents the hierarchy of financial institutions for the microfinance disbursement.

3. Microfinance Delivery Models in India

In India, microfinance is provided through the SHG-Bank Linkage Model (SHGBLM) and Microfinance Institution (MFI) Model. The SHG-BLM developed by NABARD is widely prevalent throughout the country. In this model, the informal SHGs are credit linked with the formal banking system. On the other hand, MFI model is used by the various MFIs which emerge to reach the rural poor people in the areas not served by the formal banking sector. These are discussed as follows:

3.1 Self-Help Groups (SHGs)

3.2 Microfinance Institutions (MFIs)

3.1 Self-Help Groups (SHGs):

SHGs are small, informal and homogeneous groups of 10 to 20 members each. Members of almost equal economic and social status are chosen to minimise any mutual conflict. The members are encouraged to make a voluntary thrift on regular basis. The group members mutually decide about the amount and frequency for individual savings to be deposited in the group account. They use this pooled resource to make small interest bearing loans to their members within the group. This process, known as inter-loaning, gradually builds financial discipline among the group members and they learn to handle resources of a size that is much beyond their individual capacities. The bank loans are given without any collateral and at specified interest rates. Banks find it convenient to lend money to the groups rather than providing small funds to individual members. Generally, the banks charge between 9-10 per cent rate of interest per annum from the SHGs. SHG-Bank Linkage Model (SHG-BLM) is developed in India to provide microfinance with the help of vast rural network of the formal financial sector. In this model, the informal SHGs are credit linked with the formal financial institutions. The programme uses SHGs as an intermediation between the banks and the rural poor to help in reducing transaction costs for both the banks and the rural clients. Banks provide the resources and bank officials/NGOs/ government agencies organize the poor in the form of SHGs. Under this programme, loans are provided to the SHGs with three different methodologies:

Model I: SHGs Formed and Financed by Banks:

In this model, banks themselves take up the work of forming and nurturing the groups, opening their savings accounts and providing them bank loans.

Model II: SHGs Formed by Agencies Other than Banks, but directly Financed by Banks:

In this model, NGOs and other formal agencies in the field of microfinance facilitate organising, forming and nurturing of SHGs and train them in thrift and credit management. The banks directly give loans to these SHGs.

Model III: SHGs Financed by Banks Using Other Agencies as Financial Intermediaries:

This is the model where the NGOs take on the additional role of financial intermediation along with the formation of group. In areas where the formal banking system faces constraints, the NGOs are encouraged to form groups and to approach a suitable bank for bulk loan assistance. This method is generally used by most of the NGOs having small financial base.

3.2 Microfinance Institutions (MFIs):

MFI model of credit delivery is found worldwide whereas the SHG-BLM model is an Indian model. In MFI model, MFIs borrow large amount of funds from the apex financial institutions, donors and banks for on-lending to the individuals or groups. These MFIs provide financial services to the individuals or to the groups like SHGs, Grameen groups etc. MFIs typically receive external funding for their lending operations from donor organizations, apex institutions (including, among others, the Small Industries Development Bank of India (SIDBI), which has for many years promoted and funded MFIs, NABARD and Friends of Women's World Banking), as well as from public and private banks.

he MFIs are an extremely heterogeneous group registered as Non-Banking Financial Companies (NBFCs), societies, trusts and co-operatives. On the basis of their legal forms, the MFIs in India can be broadly subdivided into four categories:

3.2.1: Non-profit Making MFIs.

3.2.2 Mutual Benefit MFIs.

3.2.3 For Profit MFIs.

3.2.4 Local Area Banks (LABs).

3.2.1: Non-profit Making MFIs:

The non-profit making MFIs include NGOs and non-profit making companies. Majority of these are registered as trusts or societies. The society is registered under the Societies Registration Act, 1860, and a trust is created under the Indian Trust Act, 1880 or public trust registered under any State enactment governing trust or public, religious or charitable purposes.

The companies registered under Section 8 of the Companies Act, 2013 are also non-profit companies. The activities of these companies are restricted to charity or other social purposes. Section 8 companies are formally recognized and regulated by the RBI. These companies, being non-profit in character, cannot take group savings of their clients.

3.3.2.2 Mutual Benefit MFIs:

The mutual benefit MFIs are the Mutually Aided Co-operative Societies (MACS). These societies are registered under the State Co-operative Societies Act or any multistate cooperative society registered under the Multi State Cooperative Societies Act, 2002 and does not include:

- Acooperative bank as defined in clause (cci) of section 5 of the Banking Regulation Act, 1949
- A cooperative society engaged in agricultural operations or industrial activity or purchase or sale of any goods and services‟.

3.3.2.3 For Profit MFIs:

For profit MFIs include Non-Banking Financial Companies (NBFCs) and Local Area Banks (LAB). The NBFC- MFIs in India which are larger in size. These companies are registered under the Companies Act, 2013; and are regulated by RBI. These companies can deposit the savings of their clients with them.

3.2.4 Local Area Banks (LABs):

LABs are private banks permitted to operate in few districts of the country. They are able to deliver credit and provide savings and insurance. As of 2017, only two LABs provide microfinance on a significant scale. The distribution of MFIs operating in India based on different legal forms is given below:

Table 1: Distribution of MFIs in India across Legal Forms

Type of MFI	Estimated Number	Legal Acts under Which Registered
1. *Non-Profit MFIs*		
(a) NGO-MFIs	**62**	Societies Registration Act, 1860 or Indian Trust Act, 1882
(b) Non-profit Companies	**24**	Sec. 8, Companies Act,2013
2. Mutual Benefit MFIs		
Mutually Aided Co-operative Societies (MACS)	**7**	Mutually Aided Co-operative Societies Act enacted by State Governments
3. For Profit MFIs		
NON-Banking Financial Companies (NBFCs)	**71**	Companies Act, 2013 and Reserve Bank of India Act, 1934
Local Area Bank	**02**	Companies Act, 2013 and Banking Regulation Act,1949
Total	**166**	

Source: Compiled from NABARD Report on Microfinance, 2017

4. Conclusions:

The Indian microfinance sector constitutes diverse microcredit delivery models of SHGs and MFIs. These delivery models are working simultaneously with the same objectives and target group. However, they diverge in their framework, approach and execution and outreach also, as well in performance. In all the models, the performance and sustainability depends on its loan repayment status and discipline amongst the borrowers and lenders.

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