

**India Country Scan for Financial Services Design/Delivery to Low Income People¹
Submitted to Hivos India For MicroNed**



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India Country Scan for Financial Services Design/Delivery to Low Income People

Commenting on the state of the microfinance scenario, a very senior industry observer remarked that “Less than ten percent of those who are in need of these services (about 425 million) are currently being served in India. For sure, more than ninety percent of those who are in need in India, are out of these services. An industry which exists, at least already 25 years, and reaches less than 10 percent of those who are in need of its services should reconsider some of its fundamental basics. I think that the key stakeholders of this industry should think about what they are doing once again and find ways to massify microfinance services in India”.

1 General Information

1.1 The Profile of India

The discovery of the ruins of the ancient Indian cities of Mohenjodaro and Harappa in the early part of the twentieth century has made it possible to date the development of the first Indian cities or the Indus Valley civilization back to the third millennium B.C. This was followed by the advent of the Aryans and the country's history is divided here into two phases, the pre-Vedic and the Vedic age. It was in the fourth century B.C. that large parts of the country were unified and brought under the rule of Emperor Ashoka. This was followed by the reign of various dynasties like the Mauryas, the Guptas, the Chalukyas, the Lodhis in the North and East and the Cholas, Pandyas and the Pallavas in the South. The first Mughal invasion of India can be traced back to Babur in 1526. The disintegration of the Mughal Empire occurred around the latter part of the seventeenth century. The British had in the meantime entered the country in the form of a trading concern by the name of East India Company in the early part of the seventeenth century. While the French and the Portugese also attempted to colonise parts of the country, India remained a predominantly British colony till the mid part of the eighteenth century. Though individual kings like the Maratha emperor Shivaji, Tipu Sultan, Rania Laxmi bai of Jhansi and others had rebelled against and fought the British, the Sepoy Mutiny of 1857 proved to be India's First War of Independence. It took the struggle and sacrifice of various great leaders Mahatma Gandhi, Sardar Patel, Netaji Subash Chandra Bose and Jawaharlal Nehru for India to achieve its independence in 1947, followed by it acquiring the status of a republic in 1950.

The three pillars of the Indian democracy have been the parliament, the judiciary and the executive. India for the most of part of its existence as a democracy has been a single party ruled state. The Congress, one of whose founders ironically was a Britisher, has been the single party to dominate the political firmament of the world's largest democracy. The political situation has slowly changed over time and the era of coalition politics has been slowly but firmly ushered in and the country is today ruled by a coalition government although the Congress remains the dominant partner.

The Indian republic is currently made up of twenty eight states and seven union territories, including the National Capital Region (NCR) of Delhi. India is currently the world's second most populated nation with a total population in excess of a billion. While it is officially a secular state, the majority of the country's population are Hindus (80.5%), the Muslims are next with 13.1%, the Christians and the Sikhs follow with 2.3 % and 2 % respectively, while the Buddhists, Jains and the others form the remaining 2 %. The average gender ratio stands at 944 women to a 1000 men. The literacy rate is 64.5 %. (all these data are as per 2001 census figures). While the women are disadvantaged in terms of the gender ratio, their life expectancy is marginally

better at 65.57 years as against 63.9 years for men. The TFR or total fertility ratio stands at 2.73 children per woman.

One disturbing aspect is that India also enjoys the dubious distinction of hosting the world's largest HIV + population (see Box 1). Of the population of more than one billion, it is estimated that 5 million people are afflicted with HIV. HIV emerged later in India than it did in many other countries, but this has not limited its impact. Infection rates soared throughout the 1990s, and have increased further in recent years. The crisis continues to deepen, as it becomes clearer that the epidemic is affecting *all* sectors of Indian society, not just the groups – such as sex workers and truck drivers – that it was originally associated with.

There are 22 official languages including Hindi, the official language and English, the co-official language. More than a 1000 languages and dialects are spoken across the country.

“The Indian economy² recorded a strong growth rate of 8.4 per cent during 2005-06 on top of 7.5 per cent growth in the previous year. Real GDP growth between 2003-04 and 2005-06 averaged at 8.1 per cent. The real GDP growth in 2005-06 was contributed by the recovery in agriculture and sustained expansion in industry and services. Real GDP originating from agriculture and allied activities registered a growth of 3.9 per cent, recovering from a low of 0.7 per cent in the previous year. The growth of real GDP originating from industry is estimated by Central Statistical Organisation (CSO) to have moved up to 7.6 per cent in 2005-06 from 7.4 per cent in the previous year. The industrial production, based on index of industrial production (IIP), recorded an impressive growth of 8.2 per cent during 2005-06 on top of 8.4 per cent growth a year ago. Sustained expansion in domestic as well as export demand and increased capacity utilisation underpinned the strength of the manufacturing sector. The services sector maintained a double-digit growth of 10.3 per cent during 2005-06, which was marginally higher than 10.2 per cent growth in the previous year. The services sector, with almost three-fifth of share in the GDP, led the Indian economic growth in 2005-06.”

1.2 Background of Indian Poverty

Despite significant progress made by India during the last decade or so, about 30 – 35% of the total population still lives below the poverty line. Poverty is now almost uniform, in terms of the proportion of population, in the rural and urban areas. Using the Indian definition based on income needed to acquire food to provide the minimum required calories (2100 for rural and 1800 for urban adults), roughly 260 million people or 26% of the population fall below the rather austere defined poverty line. The latest estimate for poverty line, based on National Sample Survey Organisation, for 2004-05 is 22%

Others (World Bank and other agencies) define the term poor to include those living on less than \$1 per day. Using that definition, the number of the poor would be much larger, around 400 million, accounting for over 36% of the population. Within that segment are the poorest who live on an income of less than \$0.50 per day. Then, there is the segmentation of the poor as rural and urban poor. Many of the poor have no regular job or income and little in the form of assets. A World Bank study found that of the rural poor, 50% are landless, 43% are from scheduled castes and tribes, 43% are wage earners, and in 66% of families, one or more of the adults is illiterate. Much less is known about the urban poor as there are very few studies available.

No doubt, reforms have benefited thousands of Indians, but equally surely, they have left a vast majority untouched. Education, healthcare and water remain just a dream for them. Lack of

² Source: “Report on Trend Progress of Banking in India 2005-06” from RBI Website

opportunities in villages is driving millions of Indians to a life in urban slums. The central government over the years has done a lot – a cursory glance of statistics on literacy rates, healthcare infrastructure, poverty levels, access to electricity and water reveal that more people in India today have access to these basic needs than they did 15 years ago. Literacy rates have gone up to more than 65% from 52% in the early 90s. The number of out-of-school children is down to 95 lakhs, up from 320 lakhs in 2001, and almost 85% of children in the age group 6-14 are enrolled in schools. However, does this mean that literacy is no longer a national issue? Not really, if you look beyond numbers to some qualitative aspects where some startling facts get thrown open Almost 85,500 schools, about 10% of all elementary schools, did not even have a black board in 2004. Barely a third of the schools in India had electricity and less than a fourth of the primary school teachers were graduates. The same is true of quality aspects in financial services as well.

1.3 Strategic Context of Low Income People and Their Livelihoods

A critical issue is that while India has recorded impressive growth rates, in excess of 7%, over the last few years, what has become more apparent with this growth is the dualistic nature of the Indian economy - where the gaps are indeed widening across various sections of the society. The classic manifestation of these gaps and the failure of the economy to re-adjust and ensure equitable distribution of wealth, especially in relation to the work and inputs, can hardly go unnoticed –one manifestation is suicides by small and marginal farmers. Several structural aspects appear to have caused this serious crisis in agriculture and related rural livelihoods as shown below.

Table 1: Situational Factors Affecting Low Income People In India

Failure of Agriculture Related Livelihoods	Farming is both a way of life and the principal means of livelihood for 65 per cent of India's population of 110 crore, The farm population is increasing annually by 1.84 per cent, the average farm size is becoming smaller each year and the cost-risk-return structure of farming is becoming adverse, with the result that farmers are getting increasingly indebted. Marketing infrastructure is generally poor, particularly in perishable commodities. The support systems needed by farmers, like research, extension, input supply and opportunities for assured and remunerative marketing are in various stages of disarray. Small farmers are forced to borrow money from money-lenders at high rates of interest, since less than 60 per cent of the credit requirements of farmers is met by institutional sources.” (Dr M S Swaminathan, Chairperson, National Commission on Farmers, 2006).
Rapid Urbanisation	The second important situational aspect is the rapid urbanisation taking place in India as outlined in the table given below. This burgeoning urbanization has several important consequences for low income people, who tend to migrate and live in slums. A recent NSSO survey revealed that nearly 40 per cent of farmers would like to quit farming, if they have the option to do so. Unfortunately, there is little option for them except moving into urban slums ³ . Urbanization, in turn, implies greater growth of urban slums, which hold a lower quality of life for the poor, many of whom have migrated from rural areas in search of livelihood. In fact, as the data suggest, almost 50% of country's population and a large majority of the poor are likely to reside in urban slums in India by 2020.

³ INDIA has always been considered a country that lives in its villages. But increasingly rural India is moving towards the town and the City. The 2001 Census established that almost one- third of India's population, an estimated 285 million people, lived in urban areas. By 2020, half the country's population is expected to be city-based.

Table 1: Situational Factors Affecting Low Income People In India

Regional and Geographic Disparity	<p>The other issue concerns regional and geographical disparity, as outlined below. There are several geographic areas, which have, over the years, consistently under performed on various social development parameters. The urban poor have been increasingly concentrated in Uttar Pradesh, Maharashtra, West Bengal, Madhya Pradesh, and Andhra Pradesh. Their share in all-India urban poverty rose from 56 per cent in 1993-4 to 60 percent in 1999-2000. The occupational composition of rural poor varied across the states. In general, in developed states, poverty was highly concentrated among agricultural labour households, while, in contrast, in backward states poverty extended to other occupational groups including the self-employed in agriculture. And there is significant consensus that North Eastern India is among the most neglected regions in the whole country.</p>
Disadvantaged Groups	<p>Likewise, there are large populations of naturally disadvantaged groups of people such as dalits, women, scheduled tribes and other such low income groups who continue to live in poverty and suffer harsh and oppressive living and working conditions – much of their suffering also stems from their being dalits or women or tribals. Among the social groups, Scheduled Castes (SCs), Scheduled Tribes (STs), and backward castes accounted for 81 per cent of the rural poor in 1999-2000, considerably more than their share in the rural population. The poor, among the SCs in rural areas, were concentrated in Uttar Pradesh, Madhya Pradesh, Bihar, and West Bengal. These states accounted for 58 per cent of the SC population living in poverty. In urban areas, Madhya Pradesh and Uttar Pradesh accounted for 41 per cent of the SC population living in poverty. The percentage of STs among the rural population living in poverty, has been increasing rapidly, from 14.8 in 1993-4 to 17.5 in 1999-2000. The increase was mainly on account of comparatively slower reduction in the incidence of poverty among STs. Bihar, Gujarat, Madhya Pradesh, and Maharashtra together accounted for 75.5 per cent of the rural STs living in poverty in 1999-2000. It is noteworthy that nearly 30 per cent of the poor ST population were located in Madhya Pradesh alone.</p>
Gender Dimension of Poverty	<p>The incidence of poverty among females has tended to be marginally higher in both rural and urban areas. The percentage of female persons living in poor households in rural areas was 37 per cent and 27 per cent in 1993-4 and 1999-2000 respectively, with the corresponding percentages for urban areas being 34 and 25 per cent. In contrast, the percentage of males living in poverty in rural areas was 36 per cent and 26 per cent in 1993-4 and 1999-2000 respectively, while those in urban areas was 32 and 23 per cent respectively. Females accounted for slightly less than half of the poor, about 49 per cent in both rural and urban areas in both the years⁴.</p>

⁴ The lower percentage of females among the poor despite higher female poverty ratio is attributed to the adverse sex ratio. It should be noted that the above measure of gender poverty ignores intra-household inequalities in consumption. There are other dimensions of poverty such as food insecurity, malnutrition, and health that are associated more with female members.

2 Financial Sector in General

2.1 General

The table below summarises changes in the Indian financial sector environment over the years.

Table 2: Comparative Analysis Of The Indian Financial System	
The Indian Financial System (until the early 1990s)	The Situation Today (2007)...
× Interest rate ceilings	✓ Deregulated interest rates by the RBI followed by imposition of ceilings through Usury Acts in some states (Tamilnadu). × However, state governments are not fully responding and some are not cooperating with the RBI de-regulation.
× Barriers to entry	✓ Barriers to entry significantly reduced
× Special directives on lending to various target groups	✓ Populist schemes still exist but not to that extent
× Nationalized of banks	✓ Private sector allowed into banking
× Protected insurance sector (no private players)	✓ Private sector insurers allowed ✓ Special micro-insurance regulation passed
× Not much restrictions on non-banking finance companies (NBFCs)	× Severe restrictions on NBFCs continue but to safeguard clients because of past problems with NBFCs
× Inappropriate Cooperative Laws	✓ Progressive Cooperative Legislation in several states and more cooperative reforms underway.
	× However, state governments are not fully responding and some are even anti-cooperatives.
	✓ Doorstep banking re-introduced
	✓ Banking Correspondents and Facilitators Allowed but with some restrictions
	✓ New Micro-Finance Bill introduced in parliament
	✓ Financial inclusion is being seriously promoted by RBI

2.2 Banking Sector

The banking sector comprises of Scheduled Commercial Banks, Co-operative Banks (urban and rural), Financial Institutions and NBFCs. According to the RBI, in its report on the progress in banking 2005-06, the following are salient aspects with regard to the banking sector: "The banking sector reflected a pick-up in the real economic activity during 2005-06. In the backdrop of robust macroeconomic environment, bank credit witnessed a strong expansion for the second year in succession. The demand for credit was also broad-based led by the housing and the retail sectors. The growth in deposits, though higher than the previous year, was insufficient to meet the high credit demand forcing the banks to liquidate their holdings of Government securities. It was the first time since the nationalisation of banks in 1969 that investment by commercial banks in Government securities declined in absolute terms (by Rs.19,514 crore) in any single year. Similarly, investments by the commercial banks in bonds/debentures/shares of the corporate sector also declined during the year. "

2.3 Rural Credit

In India, the history of rural credit, poverty alleviation and micro-finance are inextricably interwoven. In the development strategy adopted by independent India, institutional credit was perceived as a powerful instrument for enhancing production and productivity and for alleviating

poverty. And the policy on rural credit was to ensure that sufficient and timely credit was reached as expeditiously as possible to as large a segment of the rural population at reasonable rates of interest. The strategy devised for this purpose comprised:

1. Expansion of the institutional structure
2. Directed lending to disadvantaged borrowers and sectors
3. Interest rates supported by subsidies

The institutional vehicles chosen for this were Cooperatives, Commercial Banks and Regional Rural Banks. Regional Rural Banks were set up in 1976 as low cost institutions mandated to reach the poorest in the credit-deficient areas of the country. In hindsight it may not be wrong to say that RRBs are perhaps the only institutions in the Indian context, which were created with a specific poverty alleviation - microfinance – mandate. The financial sector reforms motivated policy planners to search for products and strategies for delivering financial services to the poor – microfinance - in a sustainable manner consistent with high repayment rates. The search for these alternatives started with internal introspection regarding the arrangements which the poor had been traditionally making to meet their financial services needs. It was found that the poor tended to – and could be induced to – come together in a variety of informal ways for pooling their savings and dispensing small and unsecured loans at varying costs to group members on the basis of need. For many years, the national budget and other policy documents have almost equated microfinance with promoting SHG links to the banks. The central bank notification that lending to MFIs would count towards meeting the priority sector lending targets for Banks offered the first signs of policy flexibility towards MFIs. The insurance sector was partially opened to private and foreign investments during 2000. Over 20 insurance companies are already active and experimenting with new products, delivery methodologies and strategic partnerships.

2.4 Financial Services for Low Income People in India Today

Micro finance, as an industry, appears to have arrived in India. The burgeoning growth experienced by the sector, over the last few years, is testimony to the fact that a large number of stakeholders are embracing micro-finance, as a sustainable approach to poverty reduction. This appears to be true, irrespective of whether you consider the NABARD SHG Bank-model, the SIDBI MFI approach, the ICICI partnership model and/or other innovative approaches⁵

2.4.1 The Financial Market Place for Micro-Finance

The Indian micro-finance system, as evident from [Figure 1](#), is a complex financial system with an increasing number of stakeholders⁶ involved in it - from NGOs, NGO-MFIs, Cooperatives, MFIs, NBFC(s), Commercial Banks (Public and Private Sector), RRBs, Cooperative Banks, DFIs and others. Explicit legitimacy to the sector is still lacking and as of today, micro-finance is delivered through a complex array of institutions governed by multiple laws⁷. Regulation⁸ of micro-finance is also complex, from very passive (for some types of entities) to very active (for others). In fact, some of these laws and hence regulatory/supervisory mechanisms, even have the potential to work at cross-purposes and the potential for conflict of interest also exists. The table in Annex 2 provides an analysis of the financial services industry for low income people – what it is now in terms of several industry parameters suggested Industry Analysis Expert Mike Porter.

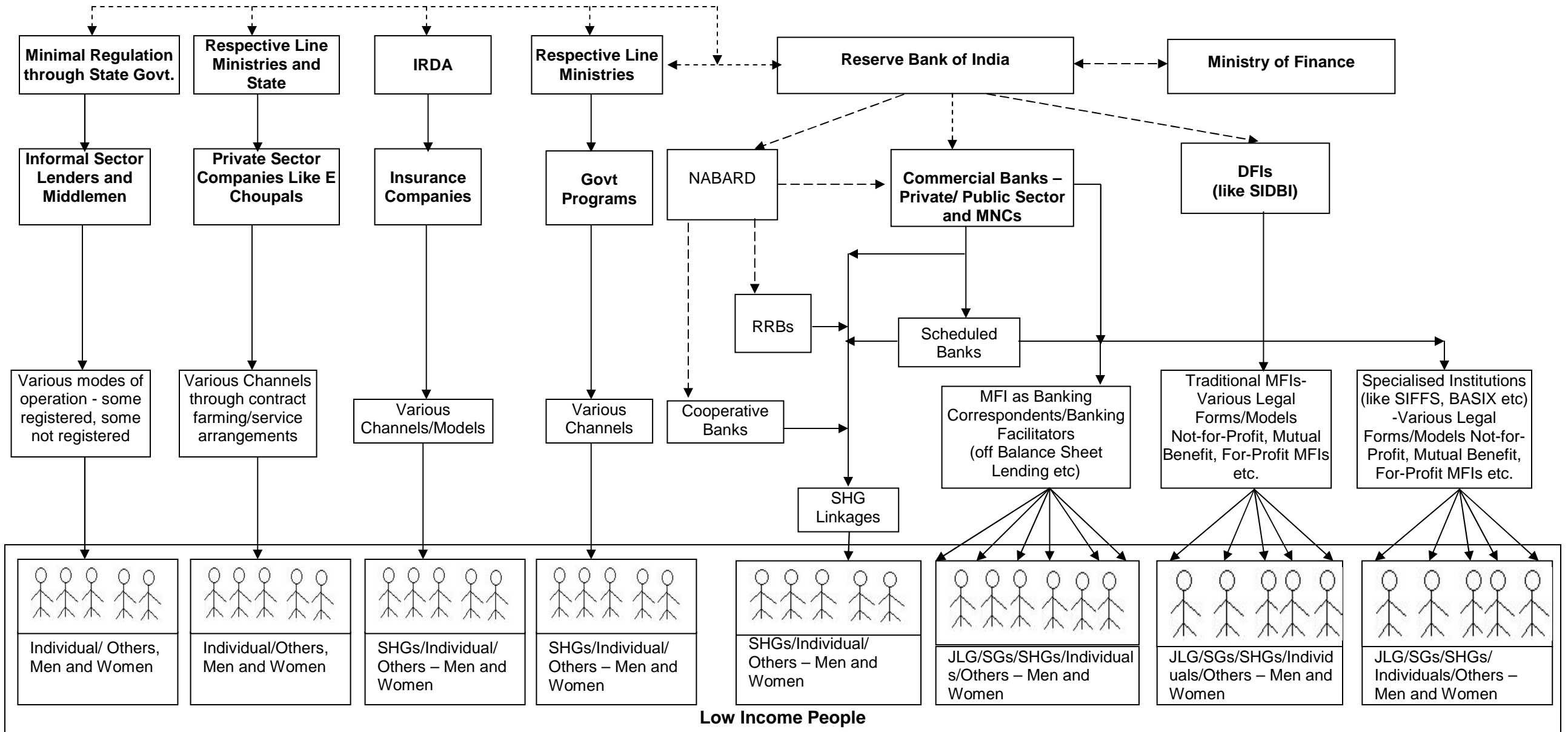
⁵ Summaries of 10 alternative micro-finance models in India, their growth, special characteristics, achievements, innovations and other aspects are available in **Annex 3**.

⁶ Please refer to **Annex 7** for a complete listing of various key stakeholders in the Indian microfinance sector.

⁷ Please refer to **Figures 2** and **3** for further details

⁸ Please refer to **Annex 10** for details.

Figure 1: The Financial Market Place for Low Income People in India



3 Models of Microfinance

As noted earlier, several models exist, but there are three key ones: The NABARD SHG Bank Linkage Model and its variants, The Institutional MFI Model supported by SIDBI, ICICI, FWWB, Commercial bankers and other stakeholders and The Partnership Securitization Model of ICICI and other commercial bankers. Subsequent to the draft version of this report, the partnership model has almost be stopped due to RBI guidelines on compensation of correspondents as well as that on outsourcing arrangements. Since, Jan 9th 2007, the original version of the partnership model has been stopped and the RBI BC/BF model has also not grown because of outsourcing and related issues. **According to News agencies, ICICI, the innovator of the partnership model, is likely to step up Microfinance term lending**⁹. "ICICI Bank, the largest lender to micro-finance institutions (MFIs), is stepping up its direct term lending to meet the funding needs of MFIs until it resumes the flow of funds under the partnership model of micro lending. A liquidity crunch had hit several MFIs after ICICI Bank had halted payments in early January following concerns raised by the Reserve Bank of India (RBI) about adherence to customer identification norms and record-keeping under the partnership model. "ICICI Bank has not resumed the flow of funds under the partnership model.

3.1 Performance of the Alternative Models

The quality of data in the sector is quite low. There are several issues here:

- 1 Data on performance in the sector is rather limited.
 - 2 The most useful data is available from Sa-dhan and NABARD reports but here too causative data is lacking and associational data is what is available.
 - 3 Most data is available is self-reported data – whether on MFIs/ SHGs and so, they lack credibility somewhat because there are no serious third party audits of the same
 - 4 In most MFIs/SHGs, the level of record keeping and quality of MIS is quite low. There are several issues with regard to the data that need to be clarified?
 - a) How are past due loans aged?
 - b) How is provisioning done?
 - c) What is the sequence of client repayment appropriation?
 - d) What are the rules for income recognition/reversal?
 - e) Plus several other aspects.
- So, given the above caveats on data, the analysis of performance, using the available data is provided in Annex 4

3.2 Major Supplier Stakeholders

The following table provides a summary of major supplier stakeholders in the delivery of financial services for low income people.

Table 3: Stakeholders in Delivery of Financial Services to Low Income People	
Stakeholder in Delivery Channel	Comments
<p>Private Sector Banks: Private sector banks such as ICICI Bank, UTI, HDFC, ABN Amro, ING-Vysya provide financial services to poor people.</p> <p>Number of Private Sector Banks: 18 plus 4/5 Foreign Banks are involved in micro-finance.</p> <p>Currently services are mainly provided through lending to MFIs for on-lending</p>	<ul style="list-style-type: none"> • A limited network of branches focused in rural areas • An inappropriate real cost structure for the low-income market • High perceived and real costs of direct lending • Over dependence on limited delivery capabilities of MFIs, especially on governance and MIS aspects • Inappropriate products for low income people

⁹ Shriya Bubna, April 11, 2007, Press release by **Business Standard, Mumbai**

Table 3: Stakeholders in Delivery of Financial Services to Low Income People

Stakeholder in Delivery Channel	Comments
<p>either through Grameen based programmes or through SHGs and/or through the banking facilitator/ correspondent model.</p>	
<p>Public Sector Banks: There are 27 public sector banks in India, the largest being the State Bank of India.</p> <p>Primary focus on SHGBLP and/or agriculture lending apart from DRI and other schemes.</p>	<ul style="list-style-type: none"> • A social obligation mentality • Government sponsored subsidized schemes are channelled through them • The Vigilance Commission and related aspects • Faith on SHGs as <u>the</u> key delivery mechanism for reaching the poor • Inappropriate products for low income people
<p>Regional Rural Banks: An Act of Parliament established regional Rural Banks in 1976 with the objective of developing the rural economy through the promotion of farm and non-farm sectors and to bridge the credit gap between the formal sector and rural communities.</p> <p>Number of RRBs: 196 but 133 after restructuring</p> <p>Primary focus on SHGBLP and/or agriculture lending.</p>	<ul style="list-style-type: none"> • Governance and control with parent bank • A social obligation mentality • Government sponsored subsidized schemes are channelled through them • Faith on SHGs as <u>the</u> key delivery mechanism for reaching the poor • Trade Unionism has increased costs of RRBs and made products like SHG loans unviable • Inappropriate products for low income people:
<p>Microfinance Programmes (Non SHG): Non SHG micro-finance programmers follow a variety of approaches, but the most common approach is to adapt and then rigidly apply the Grameen methodology. Under the Grameen methodology eight small solidarity groups of five are combined into a society, through which members access 50-week loans.</p> <p>Number of MFIs: about 800 Various groups/models and legal forms 15/20 are large MFIs</p>	<ul style="list-style-type: none"> • Legal form to accept deposits is rather limited • Governance, management systems and transparency continue to be issues, as espoused by the AP Crisis • Over-centralised management • Poor MIS systems and internal control • Limited technical capacity in terms of professional management • Portfolio quality is strictly not discernible because of the lack of good MIS • High costs of delivery because of inefficiencies • Assume a variety of legal forms
<p>Cooperative Banks: Urban and District Central Cooperative Banks</p> <p>Number of Cooperative Banks: 316</p> <p>Primary focus on SHG and Agri lending apart from DRI and other schemes.</p>	<ul style="list-style-type: none"> • Governance and systems are issues in many cases • A social obligation mentality • Government sponsored subsidized schemes are channelled through them • Faith on SHGs as <u>the</u> key delivery mechanism for reaching the poor • Inappropriate products for low income people:
<p>Self-Help Group Programmes: Self Help Groups typically consist of 15-20 women, who meet regularly to revolve members' own savings. External finances augment the groups' own revolving fund. SHG borrowings from external sources are often related to the volume of group savings. In</p>	<ul style="list-style-type: none"> • High level of subsidies which cannot be sustained • Over-centralised management • Poor MIS systems and internal control • Limited technical capacity in terms of professional management • Portfolio quality is strictly not discernible because of the

Table 3: Stakeholders in Delivery of Financial Services to Low Income People

Stakeholder in Delivery Channel	Comments
<p>many cases SHG's federate into Cooperatives at the Block level, which in turn are federated at a sub-state level.</p> <p>Number of SHGs: Figures vary at several million but 2.2 million have been linked to banks.</p> <p>a. <i>NABARD refinance based program – SHGBLP</i> b. World Bank financed SHG programmes like Velugu</p>	<p>lack of MIS</p> <ul style="list-style-type: none"> • Multi-purpose usage of delivery mechanism as a result of which credit discipline could be violated • Danger of Politicisation • Quality of Groups and their long term sustainability is at question
<p>Traditional Membership-Based Organizations (MBOs)</p> <p>Membership-based organizations can include financial cooperatives or credit unions, and savings and credit associations. These organizations usually have a common bond, such as community, geography or activity.</p> <p>Numbers of Cooperatives: Several Thousands including PACs</p>	<ul style="list-style-type: none"> • Membership-based organizations can include financial cooperatives or credit unions, and savings and credit associations. These organizations usually have a common bond, such as community, geography or activity. • Their major advantage is when well governed and managed, they enhance value of services to the members- who are owners, users and sometimes even managers. • High level of subsidies which cannot be sustained • Over-centralised management • Poor MIS systems and internal control • Limited technical capacity in terms of professional management • Portfolio quality is strictly not discernible because of the lack of MIS • Multi-purpose usage of delivery mechanism as a result of which credit discipline could be violated
<p>Land Development Banks</p> <p>Several</p>	<ul style="list-style-type: none"> • State-owned, these banks have a local network that provides financial services specifically for the low income sector. • LDBs tend to focus SHG BLP and agriculture financing.
<p>Traditional Non-Bank Finance Companies/Chit Funds</p> <p>Several which have potential but less than 10 at the moment</p>	<ul style="list-style-type: none"> • Traditional NBFCs/Chit Funds provide a range of financial services to the general population and some of them are going down market to serve low income people.
<p>Post Offices and Savings Banks</p> <p>Several which have potential but less than 20 at the moment</p>	<ul style="list-style-type: none"> • These often act as the principal source of deposit and money transfer services in rural areas. These are owned by the state and have tremendous outreach. • Experiments are now underway in Tamil Nadu between the post office and NABARD to lend to low income people
<p>Processors and Traders</p> <p>Several</p>	<ul style="list-style-type: none"> • A wide variety of businesses and entrepreneurs in the agricultural market system that are principally engaged in agricultural activities (such as processing, marketing, input provision, storage) also provide credit as part of transactions.
<p>Informal Financial Intermediaries</p>	<ul style="list-style-type: none"> • Rotating Savings and Credit Associations (ROSCAs),

Table 3: Stakeholders in Delivery of Financial Services to Low Income People

Stakeholder in Delivery Channel	Comments
Several Thousand of them All Over India	moneylenders, retail stores offering goods on credit, informal deposit collectors, and others.
Insurance Companies Life Insurers (16), Non-Life Insurers (15) and Re-Insurers (1)	<ul style="list-style-type: none"> Deliver a range of life and general insurance services through linkage, and other models to low income clients

3.3 Donors

While the specific support provided by donors is given in Annex 8, the table below highlights generic donor supporting strategies

Table 4: Types and Donors and Descriptions

Type of Donors	Descriptions
Bi-lateral Donors	<ul style="list-style-type: none"> Most have left India and DFID, SDC and USAID remain. Their preference is to work with Govt and/or large Microfinance programs. They are less inclined support individual MFIs
Multi-lateral Donor	<ul style="list-style-type: none"> World Bank (WB), Asian Development Bank (ADB), International Fund for Agriculture Development (IFAD), United Nations Organisations (UN bodies) and International Finance Corporation (IFC) are major donors. They work on very large scale projects and on policy aspects with regulators.
International NGO Donors	<ul style="list-style-type: none"> Ford Foundation, CARE, Action AID and other(s) who are active in supporting a range of MFIs. Increasing focus is on livelihoods as well. <i>The MicroNed group has been left out here as this report is done for them</i>
DFIs like SIDBI	<ul style="list-style-type: none"> Work with individual MFIs, providing them flexible grants to be used for various purposes. They also support sectoral players like Sa-Dhan as also individual MFIs for operational deficit support.
Institutions like NABARD (DFI and Regulator Supervisor)	<ul style="list-style-type: none"> The MFDEF is a good avenue for supporting innovative Microfinance projects. Besides, NABARD also has technology and innovation funds. NABARD also supports cooperatives, RRBs and several other types of institutions in several ways.
Institutions like FWWB	<ul style="list-style-type: none"> Supports capacity building in general and also Nascent/Emerging MFIs, providing them a package of support in several areas.
Private Commercial Banks – MNC	<ul style="list-style-type: none"> Support specialized MFIs and also some training/capacity building of their staff
Private Commercial Banks	<ul style="list-style-type: none"> Support specialized MFIs and also some training/capacity building of their staff
Public sector Commercial Banks	<ul style="list-style-type: none"> Support some capacity building but not much in general

Hence, MicroNed can intervene in the microfinance sector and work in several areas as mentioned in section 4. It can also devote resources to policy advocacy on a number of issues given in section 5.

3.4 Legal Forms for Micro-Finance Delivery – Key Intermediaries

Most of these models work through a complex array of institutional forms - including not-for-profit entities, mutual benefit organizations and for-profit institutions – that perform social and financial intermediation in different degrees, as per the requirements of the specific model. Please refer to **Figures 2 and 3** for the range of legal forms and associated laws/regulators. The key legal issues related to Microfinance in India are:

- 1) Individual lending below Rs.200,000 is restricted to Prime Lending Rate.
- 2) Competing products are heavily subsidised like the DRI Scheme and various avatars of IRDP (SHG-Bank Linkage, SJSY, PMRY etc).
- 3) Savings deposit norms for NBFCs are restrictive: NBFCs need to be in operation for at least 3 years and also attain minimum investment grade to be granted a license to accept public fixed deposits.
- 4) NBFCs cannot have savings accounts like banks and this affects their ability to undertake profitable savings transactions.
- 5) Obligation to pay undifferentiated interest rates on all account balances below Rs.1.5 million.
- 6) Restricted geographic areas of operation for RRBs could be a limiting factor in more efficient RRBs expanding
- 7) The legality of financial intermediation by Not-for-profit MFIs is shrouded by controversy.
- 8) The formal financial sector has no apex body like NABARD facilitating lending for low income urban clients.
- 9) Several states in India are in the process of enacting ordinances towards curbing usurious rates of interest (especially for low income clients) and this may prevent full cost recovery by the financial intermediaries rendering their services unviable.

Figure 2: Financial Services for Low Income People in India: Formal/Semi Formal Delivery Channels

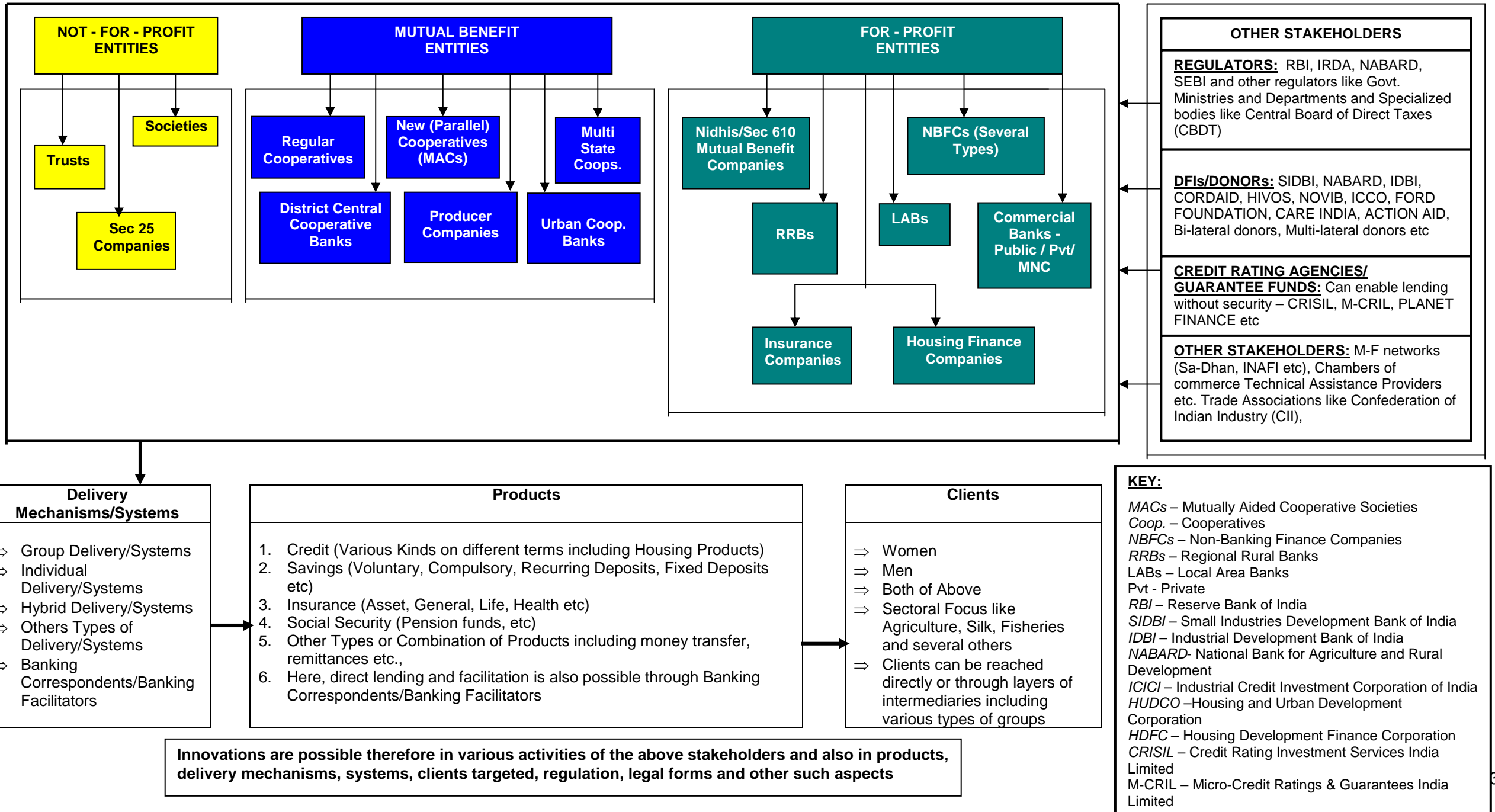
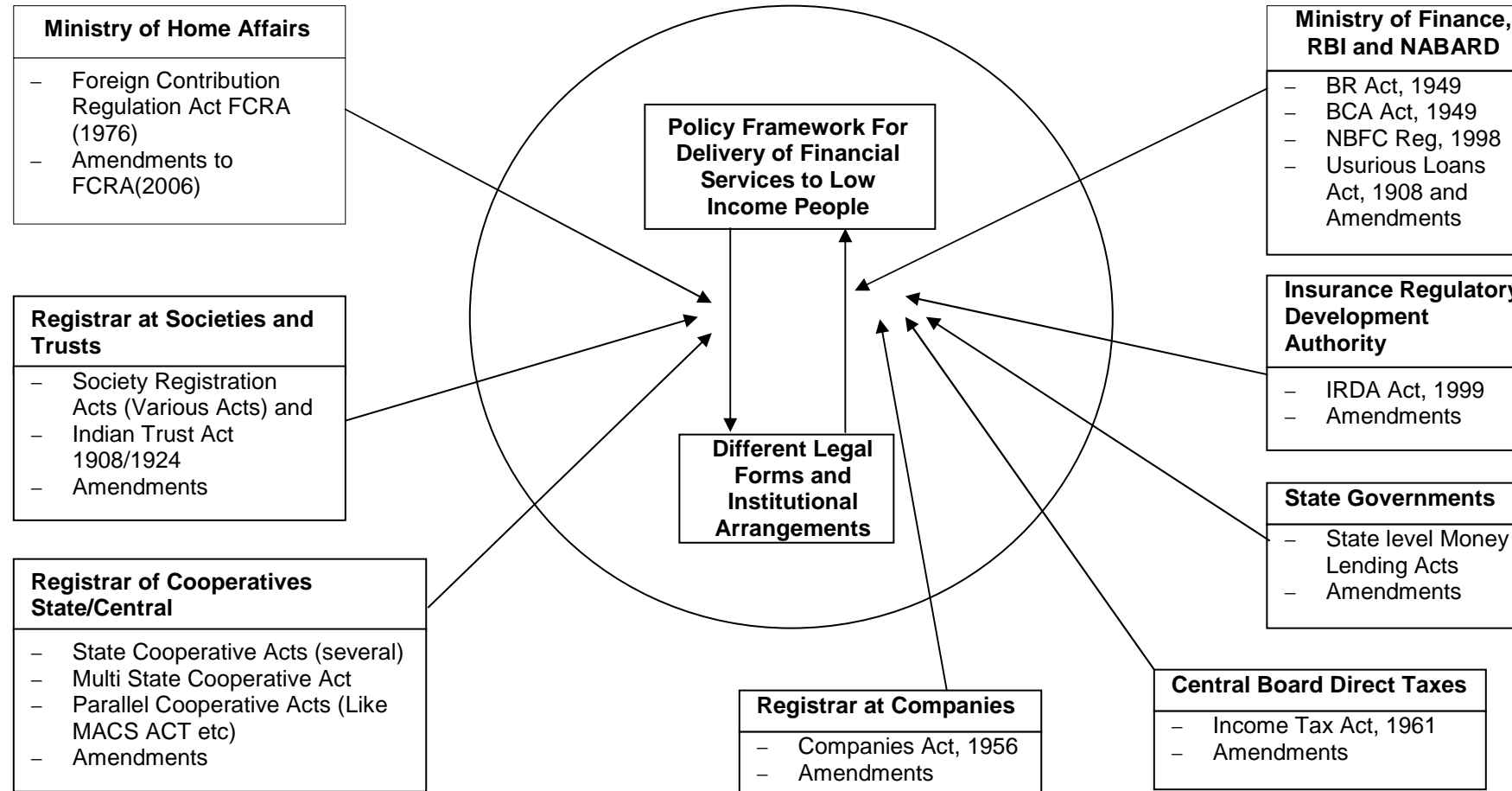


Figure 3: Policy Framework for Delivery of Financial Services to Low Income People



Key:

- BR Act – Banking Regulation Act, 1949
- BCA Act – Banking Companies Acquisition Act, 1970 and 1980
- NBFC Regulations – Non-Banking Finance Company (NBFC) Regulations till date
- RBI – The Reserve Bank of India (RBI) Act (1934) and amendments till date
- FCRA – Foreign Contribution Regulation Act (FCRA), 1976 and amendments
- MACS – Mutually Aided Cooperative Societies Act (MACs) and its amendments

The above Acts/Regulations and all amendments to date and several other Acts have to be consulted to get a comprehensive understanding of policy issues pertaining to delivery of financial services for low-income people in India. A new Microfinance bill is on the anvil as per efforts taken by Sa-Dhan as also newer regulations for Banking Correspondents/Facilitators, ECBs, NBFCs and the like, which are being announced by the RBI. Please refer to Annex 6 for recent circulars.

The Salient features and characteristics of the basic legal forms are summarized in Table below:

Table 5: Summary: Salient Features of Legal Forms for Microfinance in India

	Legal Sanction For Financial Intermediation	Credit Services	Client Savings Services	Insurance - In-House - Services	Insurance Linkage Services	Free to Establish Interest Rates	Individual Member Equity Investment	Institutional Equity Investment	Private Equity Investment	Public Deposit Services	Well Regulated	Well Supervised	Undue Government Interference	High Minimum Capitalisation	Difficulties in Registration	Special License Required	Location Restrictions	Mandatory Multi State Operations	All India Coverage Possible	Governance Safeguards in Regulation
Not-For-Profit																				
Trust	A qualified yes	Yes	No	No	Yes	No	No	No	No	No	No	No	Yes	No	No	No	No	No	Yes	No
Society	A qualified yes	Yes	No	No	Yes	No	No	No	No	No	No	No	Yes	No	No	No	No	No	Yes	No
Section 25 Company	Yes	Yes	No	No	Yes	No	No	No	No	No	No	No	Yes	No	No	No	No	No	Yes	A qualified yes
Mutual Benefit																				
Regular Cooperatives	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	A qualified yes	No	No	No	Yes	No	No	No	No	No	No	No
Parallel Cooperatives	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	A qualified yes	No	No	No	Yes	No	No	No	Yes	No	No	A qualified yes
Multi State Cooperatives	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	A qualified yes	No	Yes	Yes	No	No	No	No	Yes	Yes	Yes	A qualified yes
Urban Cooperative Banks	Yes	Yes	Yes	No	Yes	Yes	Yes	No	A qualified yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No	No	A qualified yes
For-Profit																				
NBFCs	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes	A qualified yes	Yes	Yes	A qualified yes	Yes	Yes	Yes	No	No	Yes	A qualified yes
LABs	Yes	Yes	Yes	No	Yes	A qualified yes	No	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No	No	Yes
Commercial Banks	Yes	Yes	Yes	No	Yes	A qualified yes	No	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	No	No	Yes	Yes

3.5 Clients and Products

Within institutions, financial and social intermediation is typically done by different types of groups – SHGs, Joint Liability Groups, Solidarity Groups and/or Neighborhood Groups. However, some of the institutional models also focus on individuals. Target clients tend to be primarily women, although programs are beginning to serve men as well. Likewise, urban areas are still very much underserved in comparison to rural areas.

Clients have demonstrated the need for a full range of financial services including savings, short- and long- term finance, insurance, money transfers for remittances, and leasing (see Table below). The sector has tried to meet these demands by designing financial products using client and market research, and adapting delivery mechanisms to provide low-cost and convenient access. These aspects are elaborated later.

Table 6: Generic Financial Products Demanded by the Poor

Savings	Savings mobilization contributes to an institution's sources of funds for on-lending, and is also a financial service that is equally, if not more, important to the poor than lending. In the absence of formal savings opportunities, the poor often pay depositors or store money in insecure places. The Indian microfinance sector is still at its infancy for savings because of regulation.
Short-Term Finance	This is finance for working capital, such as inventories or (agricultural) inputs short-term finance for (agricultural and other) activities including input supply and processing, tends to be linked to (crop business) cycles. The Indian microfinance sector is beginning to provide cash flow based financing now.
Term Finance	Term finance, defined as loan terms of around/over one year, may be used for machinery, equipment, improvements, livestock, tree crops and processing equipment. Term finance does not only imply loans, and may also include leasing of machinery and equipment. Term finance, is more costly and risky than short-term finance, since it ties up larger amounts of money for longer periods, and requires the mobilization of long-term funds (to balance assets with liabilities).
Leasing	In a lease agreement, the leaseholder pays a regular rent/lease for the use of equipment while the legal property remains in the hands of the institution. Due to the ready availability of collateral (the leased equipment), it may be an easier product to provide by financial intermediaries than other term finance, but its viability depends on appropriate tax, legal and other incentives. Micro-leasing is now a legitimate product in microfinance and used by some Indian MFIs.
Money Transfer for Remittances	Income from national or international remittances is important in most developing economies like India, and disproportionately so for many poor rural areas where it may be the principal income source. Remittance monies can make significant contributions to consumption smoothing, and efficient mechanisms for money transfers are widely demanded by the poor. However, care needs to be taken to ensure that access to remittance services will not be misused for money-laundering purposes. The Indian micro-finance sector is yet to respond to this product need. This need is also being felt because of need to transfer money from urban to rural areas. Also, remittances become important in sectors (like fishing) where migration is quite large
Insurance	Insurance products are in particularly high demand (and short supply) for the poor. Insurance products span credit life loan insurance, health, asset and other forms of general insurance, crop insurance, and life insurance, but experience with these is mixed. There is huge demand for good health, weather and crop insurance products and they need to be developed. Hedging instruments based on weather or price indices are also increasingly available. Recently micro-pensions were also launched in India. This sector is developing fairly rapidly

Several new financial products are also on the anvil, both at the intermediary and client level including warehouse receipt loans and the like. Deposit taking is restricted by legal form and voluntary savings, as a product, is used primarily by cooperatives although some societies and trusts are currently accepting recurring deposits. A micro-insurance legislation has been implemented and several insurance companies have come up with very innovative products in life and general insurance including some special micro-insurance products. A micro-pension scheme has also been recently launched.

3.6 Rating Services

To overcome information asymmetry with regard to the micro-finance portfolio, credit rating is done by specialized agencies but these agencies also tend to be (indirectly) involved in capacity and systems building through group companies. Specialized credit rating agencies are available to rate MFIs as well as SHG federations. Very recently, M-CRIL, one of the leading rating agencies from India formed a strategic global alliance with MicroRate to offer standardized rating across the world. APMAS also offers a rating service for SHG federations. The table below compares the two major rating companies in terms of the services offered:

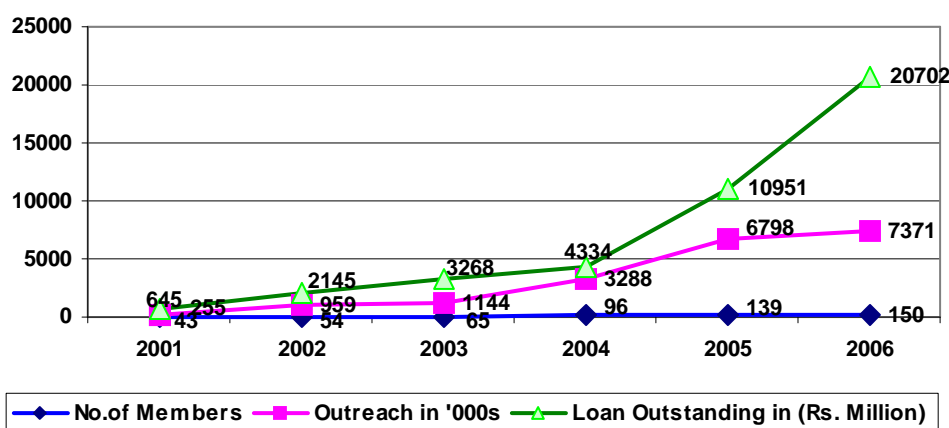
Name of Agency	CRISIL	M-CRIL
Primary Product	Credit Rating Risk Assessment	Credit Rating Risk Assessment
Legal Structure	Independent Business Entity	Independent Business Entity
Client Types	MFIs NGOs and projects Credit Unions and Cooperatives Banks and Non Bank Financial Institutions Non Bank Corporate Sector entities Public Sector entities	MFIs NGOs and projects Credit Unions and Cooperatives Banks and Non Bank Financial Institutions
Regions	South Asia	Europe and Central Asia South Asia East Asia & The Pacific
Number of Full-time Rating Staff	72	10
Number of associate rating staff	5	5
Methodology Weighting - Quantitative (%)	45	51
Methodology Weighting - Qualitative (%)	55	49
Source: CGAP Rating Web Site		

3.7 Industry Associations

Associations of micro-finance institutions have also become very active and they provide members with various services including access to information, policy advocacy, capacity building services and the like. One of them (Sa-Dhan) has been involved in preparing a Draft Micro-Finance Act along with specific provisions. The industry associations, both Sa-dhan and INAFI are working to help:

- Build a strong financial system in the form of Community Development Finance Institutions (CDFIs) with the help of MFIs, NGOs and others
- Encourage new and existing Microfinance Institutions (MFIs) to expand
- Create opportunities for existing and new MFIs and FIs to enter Microfinance by establishing a supportive legal and regulatory environment

Sa-Dhan Members Growth



3.8 Geographic Coverage

The state of Andhra Pradesh and Tamilnadu have the maximum coverage under various models. Despite a few setbacks (the crisis in AP with some MFIs) which the sector experienced during early 2006, the outlook continues to be very positive and the investments continue to flow, both in terms of finances as well as new and innovative products.

The geographic coverages of both models are highlighted below:

As Ghate 2006 notes, “although the SHG BLP is still heavily skewed in favour of the three southern states (AP, Tamil Nadu and Karnataka) the share of new loans for the four southern states came down from 49 percent in 2005 to 44 percent in 2006, and of cumulative loans from 58 to 54 percent. The number of new loans actually came down in AP, from 107,351 in 2005 to 94,311 in 2006. However, the number of repeat loans increased from 153,903 to 200,030¹⁰. In 2005, NABARD identified 13 priority states accounting for 70 percent of India's poor for special efforts and location-specific strategies. Table 2.2 shows that the number of groups linked in these states increased by 68 percent in 2005 and 51 percent in 2006 As against an increase of 49 percent in the number of new SHGs linked country-wide in 2005, the number went up by 54 percent in the Northeast, 45 percent in the West, and 44 percent in the East. Growth in the central, northern and southern regions ranged from 15 to 20 percent. Of these three regions, acceleration of growth in the central region deserves the highest priority¹¹.”

Table 7: Growth of SHGs linked in 13 Priority States

State	2002	2003	2004	2005	2006
Assam	1024	3,477	10,706	31,234	56,449
Bihar	3957	8,161	16,246	28,015	46,221
Chhattisgarh	3763	6,763	9,796	18,569	31,291
Gujarat	9496	13,875	15,974	24,712	34,160
Himachal Pradesh	5069	8,875	13,228	17,798	22,920
Jharkhand	4198	7,765	12,647	21,531	30,819
Maharashtra	19619	28,065	38,535	71,146	131,470
Madhya Pradesh	7981	15,271	27,095	45,105	57,125

¹⁰ The numbers stayed roughly steady in Tamil Nadu and Karnataka.

¹¹ Because coverage is at almost saturation levels in some districts of the South and poverty is relatively low in the North, with the exception of Rajasthan.

Orissa	20553	42,272	77,588	123,256	180,896
Rajasthan	12564	22,742	33,846	60,006	98,171
Uttar Pradesh	33114	53,696	79,210	119,648	161,911
Uttaranchal	3323	5,853	10,908	14,043	17,588
West Bengal	17143	32,647	51,685	92,698	136,251
Total	141804	249,462	397,464	667,761	1,005,272
Percent increase		76	59	68	51

Source: NABARD annual reports

Likewise, the region-wise growth in outreach of MFIs is given below and eastern zone has particularly grown well in the FY 2006

Table 8: Region-Wise Growth in Outreach of MFIs					
MFIs by regional distribution	No. of MFIs	Outreach - FY 2006	Annual Growth (%) in outreach FY 2006	Annual Growth (%) in outreach FY 2005	Annual Growth (%) in outreach FY 2004
East	56	695684	109	61.12	32.68
West	9	46,482	590	31.4	42.15
North	9	175478	92	11.34	19.5
South	55	1959693	15	67.5	51.73
Total	129	2877337	34	62.86	45.94

Source: Calculated and Compiled from Side-by-Side Reports (Sa-Dhan 2006).

3.9 General Systems, Operations and Other Aspects

Capacity building services are provided to the sector by a wide range of institutions and individuals. Specialized modules on delinquency, financial analysis, interest rate setting, accounting, MIS, operational risk management, business planning and other areas are also available.

MIS is at its infancy, both in terms of computerization as well as manual maintenance of key records and documents. While several vendors did make an attempt to service the sector, the lack of a standard off the shelf software and cost aspects have meant that MIS in the sector is still very nascent. As a result, most institutions are still experimenting with their own specially calibrated non-standard MIS¹²

Interest rates were de-regulated by The Central Bank (Reserve Bank of India) for micro-finance but State level ordinances continue to be an obstacle, although courts have provided some relief

There is a prominent viewpoint gaining ground that sustainability is not merely a function of charging appropriate interest rates. Rather, institutions and channels must be efficient and provide need based innovative products and services at affordable cost in a transparent manner – the case of micro-finance being market led

In several geographical pockets, micro-finance is witnessing severe competition but channels (in terms of individual intermediaries as well as generic options) are still very

¹² MIS is very nascent in India and needs to be attended to ensure greater transparency and accountability and also better management to keep up with the burgeoning growth. MIS is still at its infancy and there is a widespread recognition of the fact that a best practices MIS capable of handling large volumes of clients/records needs to be in place for reasons of accountability and transparency as well as effectively satisfy growth and regulatory requirements. Thus, MIS requires significant up gradation as portfolio is growing rather rapidly and computerisation to help keep pace with this growth is necessary

limited. However, new options like echoupals, Internet Kiosks, STD booths, post offices, and other such arrangements are being explored

E banking initiatives including low cost ATMs are also likely to be introduced in the future

Political interference with micro-finance because of its impact on money lenders and other factors, appears to be increasing at the local level

Religious groups are also active and pushing MFIs and other institutions towards micro-finance compatible with religious beliefs

Several expert committees appointed by The Reserve Bank (Vyas Committee, Ganguly Committee, Vaidyanathan Committee), amidst their regular mandate, have also dwelt on the role of micro-finance in promoting financial services for the poor and SMEs

Physical targets in terms of number of SHGs linked, loans disbursed to SHGs, loan outstanding of MFIs and clients reached by MFIs have become synonymous with the performance of the sector. Quality oriented indicators appear far less prominent while discussing the achievements of the sector

Large number of lenders and fewer donors, apart from DFIs, commercial banks (public and private sector) and others are lending to the sector with greater vigor. As a result, the sector currently has unlimited access to collateral free and almost condition less 'soft' interest loans including external commercial borrowings.

Private investors and equity funds are also on the rise for making appropriate investments in micro-finance. Microfinance institutions (MFIs) have finally begun looking beyond banks for their credit requirements. Hyderabad-based SKS Microfinance, on Thursday, announced an equity infusion of Rs 50 crore by private venture capital fund Sequoia Capital alongwith other investors such as Unitus Equity Fund, Vinod Khosla, Ravi Reddy and Odyssey Capital. The MFI, promoted by Vikram Akula, is also planning for another round of equity infusion in the next six months to raise another Rs 100 crore with a similar set of investors. This apart, SKS Microfinance is also looking at securitising assets to the tune of Rs 100 crore in the coming fiscal, while it may examine the possibility of hitting the markets with a bond issue in 2008.

3.10 Growth and Transformation

Intermediary institutions are transforming to become regulated entities but their capacity to comply with regulation is yet to be fully tested

Governance is at its infancy in the micro-finance and it requires considerable strengthening as strategic and fiduciary aspects are involved.

Decentralisation and building up of second line management is necessary as is enhancing staff accountability. Accordingly, professionalism is also required as part of the current growth and to address capacity constraints through induction of professionals

Enhancing staff accountability and job effectiveness/efficiency, especially in view of the burgeoning growth, is also very critical and hence, professionalising personnel administration is a must to attract quality staff and retain them. The Indian micro-finance sector is plagued by high turnovers today, which, by itself is not bad as long as people do not leave the sector.

Institutions are growing very fast and handling larger portfolios as well as larger volumes of cash. Cash management is therefore a critical aspect and given the nascency of internal control in micro-finance in India and the unique challenges of transferring money across rural areas, risk management becomes a very important issue. Growth also enhances several

risks such as political risk, fraud risk, operational risks and the like, which need to be immediately addressed.

With burgeoning growth, the systems are being severely tested and may have to be re-designed. Also, while general design of systems tend to be good on paper, consistent implementation is poor and needs to be enhanced

To summarise recent trends, what is beginning to happen in microfinance can be seen from the perspective of what has happened to phones in India. With the right enabling environment, and intense competition amongst private sector players, mobile phones in India expanded by 160% during just one year 2003-04 (from 13 to 33 million). Mobile tariffs fell by 74% during the same period. While this is heady progress, there is a less heralded but even more powerful nationwide success on access. In the late eighties, the phone infrastructure was the monopoly of public sector institutions. Phones were difficult to get and even more difficult to use for those lacking ownership. Realisation that users need not own a phone to access one led to privatisation of the last mile - where a phone user could interface with a private sector provider using the public sector telecom infrastructure. Even with this policy change, today there are 2.5 million entrepreneurs selling local, national and international phone services through the length and breadth of India. Many of these are now graduating to sell internet services and could potentially be banking agents - that is the evolving story.

3.11 Insurance: Models, Lessons, Regulatory Changes and Implications

3.15.1 Models

There are broadly four basic distribution models used for delivery of micro-insurance products to poor people. These are:

- Partner – Agent (MFI) model;
- Direct Sales model;
- Mutual Insurer model; and
- Independent Broker model.

The key features of each of these models are as follows:

- a) **Partner – Agent:** The Partner – Agent model is one where the insurer uses MFIs (as agents) to distribute insurance products to the MFI's captive low income clients. Typically, the insurer is responsible for product manufacturing whereas the agent (MFI) is responsible for sales and service. The best known example of the Partner – Agent model are the Insurance Company - MFI Linkages in India, for credit life group policies to clients.
- b) **Direct – Sales:** The direct sales model is for one where the insurer creates a direct sales force to sell/service the insurance products to BoP clients. The insurer is responsible, both for product manufacturing as well as sales/service. This model affords great control to the insurer over the sales force. The best known example of the direct sales model is Tata-AIG in India.
- c) **Mutual Insurer:** The mutual insurer model is a variation of the Partner- Agent model in that the agents have a stake in the ownership of the insurer. Here, there is significant participation and interaction between the insurers and intermediaries (who own the insurer in part or full) and this has afforded significant advantages in terms of shaping insurance product design, facilitating context specific servicing of clients apart. The best known example of a mutual insurance model are cooperatives/cooperative federations in India.
- d) **Broker:** The broker is a specialised intermediary who sells and services on behalf of many insurers. Also, in many environments, broking licenses have significant capital outlays and also special requirements in terms of staffing, training of their field staff and other such aspects. However, the greatest advantage of the broker model is the choice

of insurers and products offered to clients. The best known examples of the broker model is Megatop/ITC in India

3.15.2 Cost Reduction, Use of Technology and Other Trends

Apart from choice of models, there are other interesting trends in the micro-insurance market place with regard to use of technology and cost reduction strategies and these are discussed below.

Micro-insurance products have special characteristics, which makes distribution naturally difficult for any insurer/intermediary. Specifically, a high level of post sales service is required year after year, which means higher costs of servicing clients. Also, commission structures have not afforded sufficient incentive either due to inordinately high costs (because of remoteness and lack of easy access to customers) and/or regulatory barriers. So, the question is how have insurers, intermediaries and channels addressed this and enhanced distribution effectiveness, while at the same time being efficient. As ascertained by this review, insurers have used several specific strategies to optimize on performance and these are briefly enumerated below:

- **Insurers have integrated technology to enhance efficiency of front-end processes.**
- **Insurers have accessed some form of captive markets.**
- **Insurers have re-orientated their business strategy and decentralized processes.**
- **Insurers have employed local people as staff/agents.**

3.16 New Initiatives/Innovations

Critical to the growth of the sector is finding innovative products and delivery mechanisms to reach the consumers in the most cost effective manner. While there has been significant increase in the flow of credit, high delivery costs has been a stumbling block to further penetrate the market. In the last 12-18 months we have seen a few new initiatives that are being implemented / tested across the sector.

- The Institute for Development and Research in Banking Technology (IDRBT), along with banks, is rolling out a pilot project at Warangal in Andhra Pradesh to offer Biometric cards to people in rural areas. Union Bank of India, SBI, Andhra Bank and UTI Bank, among others, are participating in this project. Under the pilot project, each bank will appoint a village business facilitator to identify account holders before offering biometric cards to villagers for use at the terminals deployed in the area. Both ICICI and Citibank have also launched biometric cards/ATMs for their customers in partnership with their MFI partners.
- NABARD has initiated and supported several pilots described in Table below. As the NABARD annual report notes, "The micro-finance sector is making rapid strides and has had a positive impact on the lives of the rural poor. In order to improve the sustainability of the SHG-Bank linkage programme and also to simplify some of the procedures related to it, NABARD has been experimenting with innovative ideas"

Grain Banks and SHGs	<ul style="list-style-type: none"> • The project aims at ensuring food security to village poor through establishment of grain banks by SHGs and provision of bank loan against the stock of foodgrains. • Three grain banks have been established in Silet, Sikerguda and Maltipadar tribal villages in two blocks of Kalahandi district, Orissa. • The project enabled the poor to save in kind, raise resources against such savings and gain access to self-managed, participative food security systems.
Rural Volunteers as Book-Writers	<ul style="list-style-type: none"> • The pilot project being implemented through five RRBs in three districts of Uttar Pradesh and two districts of Bihar since 2004-05 for associating local rural volunteers as book-writers for SHGs to improve regularity/accuracy in the maintenance of books of accounts and to explore the possible evolution of MIS between banks and SHGs continued during 2005-06. • As on 31 March 2006, 41 volunteers were trained, who have been maintaining books of accounts of 502 SHGs linked to Poorvanchal, gomti and Pratapgarh RRBs

	in Uttar Pradesh.
Project on Processor Cards	<ul style="list-style-type: none"> The project aims to introduce processor cards for active clients like KCC holders and SHGs as also automation of book-keeping of groups with a view to project is expected to test the acceptability and adaptability of IT in rural areas, as also address MIS needs in rural branches of banks. It is being implemented in five branches of Sri Visakha Grameena Bank in Andhra Pradesh and has gone on-line in two branches. The technology provider is customizing processor cards for SHGs. The field staff of the concerned branches and DRDA functionaries were trained in the operation of simputer for recording transactions of SHGs.
Project on 'e-Grama'	<ul style="list-style-type: none"> With the aim of equipping and enabling villagers/SHGs members to access information, NABARD during 2005-06 has part funded establishment of 13 Village Information Centres (e-grama) through an NGO in Davangare district of Karnataka. The technology integrated information network covers various areas like weather conditions, crop inputs, product prices, land records and other useful information for the rural folk. Besides this, many add-on services like book-keeping of SHGs, DTP, scanning, etc., are also envisaged to be provided.
Joint Liability Groups	<ul style="list-style-type: none"> The project on Joint Liability Groups (JLGs), initiated during 2004-05 is being implemented through 10 RRBs and 1 PCARDB located in diverse agro-climatic regions covering eight States (Assam, Bihar, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Tamil Nadu, West Bengal) by adopting a flexible approach and giving the partner banks enough freedom to implement the project, keeping the ground realities and context in perspective. During the year, the participating banks provided credit support of Rs.7.93 crore to 565 groups. As on 31 March 2006, 850 JLGs have been provided credit support of Rs.12.40 crore.
Financing Rythu Mitra Groups	<ul style="list-style-type: none"> Since 2003-04, Rythu Mitra Groups(RMGs) are being promoted by the Government of Andhra Pradesh to bring about a marked improvement in the lives of small, marginal and landless farmers through collective action. RMGs are expected to serve as a conduit for its members for technology transfer, access to market information/markets, and in carrying out activities like soil testing, assessing input requirements, training, organizing health camps, etc. A pilot project for financing RMGs by banks was launched in 13 districts during 2004-05. Encouraged by the success, the project was extended to all districts of Andhra Pradesh. During the year 12,468 RMGs were extended loan amount of Rs.131.77 crore by 20 commercial banks, 16 RRBs and 9 DCCBs participating in the project. A study of 67 groups from three districts, viz., East Godavari, Mahbubnagar and Nizamabad was conducted to assess the functioning of RMGs
Setting-up of Computer Munshi	<ul style="list-style-type: none"> PRADAN, an NGO has been sanctioned a grant assistance of Rs.6.10 lakh for setting-up of computer munshi. The project is being implemented in four districts (9 units) in Jharkhand and one district (1 unit) in Orissa. Ten youths have been trained under the project and their services are being availed of by 1,220 SHGs in these States.

- ING Group and PlaNNet Finance India have come together to institute the Microinsurance Awards (MI Awards) 2007, which aims to build a comprehensive inventory and identify existing best practices in product design and distribution channels implemented by the existing micro insurance schemes in the country. The initiative would also promote the development of new products and delivery models targeted at the rural market.
- The UTI Asset Management Company is in discussions with the self-help groups in Kerala such as Kudumbasree to bring them under the newly- launched micro pension

scheme of UTI AMC. Feb 9th 2007 saw the launch of the micro-pension scheme through Shepherd, an NGO-MFI in Trichy

Box 1: Micro-pensions

- A micro-pension scheme is typically designed as a defined contribution scheme. The scheme essentially operates on the principle of voluntary savings accumulated over a long period. These savings are intermediated through financial and capital markets by a professional fund manager. At an agreed upon withdrawal age (usually 58 or 60 years) the accumulated balances can be withdrawn in a lump-sum, a phased withdrawal, annuity or some combination of these methods.
- In India, the insurance companies and two mutual funds have been offering pension plans for individuals for a considerable period. However only one mutual fund, UTI AMC (Asset Management Company) which is in the public sector began offering plans in 2006 which can be loosely termed as micro-pensions.
- The key characteristic of the UTI AMC micro-pension plans are small sum's (ranging from Rs.50 to Rs.200 per month); flexibility in payments (monthly or yearly contributions are not mandatory), and presence of a third party, such as cooperative, self help group (SHG) or an NGO.¹³ The non-mandatory nature is an important departure from the traditional pension plans.

Source: Compiled and Sourced from "Time to Mainstream Micro-Pensions in India" by Mukul G Asher

- The Indian bank, had taken up a national pilot project of financial inclusion and launched a "no frills account" in the Union Territory of Pondicherry, Taking the services of the nationalised banks to the lowest strata of the society is the biggest challenge and the introduction of the 'no frills account' scheme in banks is a step in the direction of financial inclusion of all sections, said the Union Finance Minister, Mr P. Chidambaram at the launch function.
- State Bank of India is teaming up with NGOs in an innovative scheme to reach housing finance to the rural poor in Kerala. The Agricultural Development Branch of the bank at Palakkad is extending required finance to Shalom Trust, an NGO, who will on-lend to self-help groups to reach funds to the rural poor
- Tata Consultancy Services Ltd has developed a Web-enabled information and communication technology solution for Andhra Pradesh Rural Employment Guarantee System, a scheme under the National Rural Employment Guarantee Act (NREGA). The solution has gone live in 658 mandals across 13 districts in the State. Such technological solutions will be the key to reduce the delivery costs and thereby make the sector more accessible for financial players.
- After low-cost housing for the urban low-income groups, the focus is now likely to shift towards 'housing micro finance'¹⁴—a project targeted at consumers in semi-rural and rural markets to solve problems relating to housing. Micro finance institutions (MFIs), apart from banks, would be roped in for the project for the first time. Besides, the apex housing body—National Housing Bank—is exploring the possibility of getting into direct financing for the same. Until now NHB has been refinancing banks and housing finance companies. "For the first time, we are planning to rope in the MFIs for financing of micro loans in the rural and semi rural markets. The MFIs can become an important tool for providing finances in these areas," S Sridhar, chairman and managing director, NHB said. There is a sizeable population in these areas with repayment capacity and cannot be overlooked, he pointed out.

¹³ If the third party uses traditional agent model to obtain members, costs will be higher, impacting the viability of micro-pensions.

¹⁴ "Bankers may use micro-finance to turn rural home dreams into a reality" - Mahua Venkatesh, April 04, 2007 **The Financial Express**

3.17 Overall Size of the Indian Microfinance Market

A World Bank study assessing access to financial institutions found that amongst rural households in Andhra Pradesh and Uttar Pradesh, 59% lack access to deposit accounts and 78% lack access to credit. Considering that the majority of the 360 million poor households (urban and rural) lack access to formal financial services, the numbers of customers to be reached, and the variety and quantum of services to be provided are really large. Vijay Mahajan, Managing Director of BASICS, estimated that 90 million farm holdings, 30 million non-agricultural enterprises and 50 million landless households in India collectively need approx US\$30 billion credit annually. This is about 5% of India's GDP.

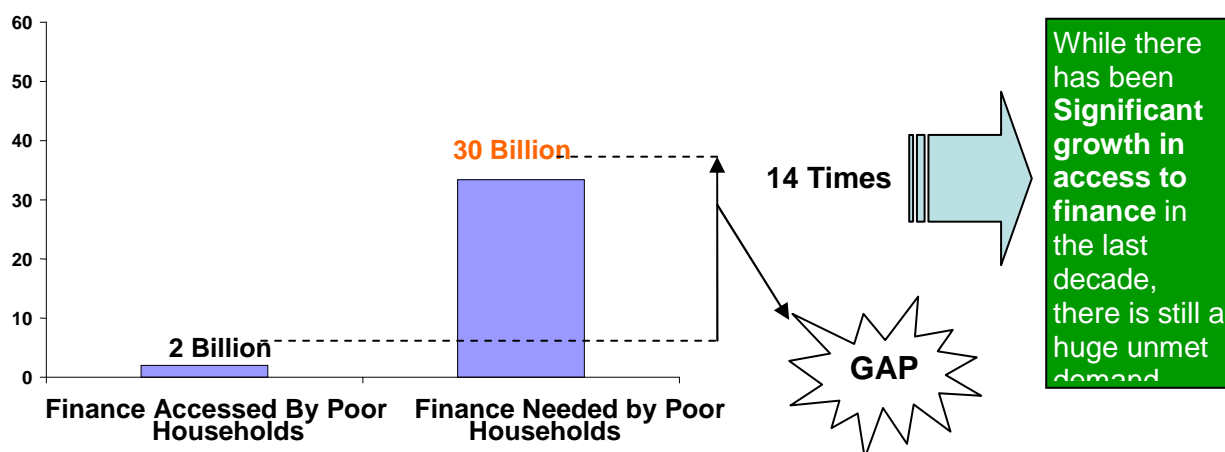
Currently there are about 800 MFIs and about 2.2 million government backed SHGs that are operating in this sector. And they cumulatively serve about 41 million women (about 33 million under the SHGBLP and another 8.4 million through MFI lending) across ten states in India. While these figures are best effort estimates by NABARD and some other leading MFIs, it does reflect the extent of reach and growth required. Titus (2006) concurs that, access to financial services for low income people has tremendous potential in India for the following reasons:

- 75 million families rely predominantly on informal sources to access Rs. 750 million (US \$15 billion) of credit
- Penetration of life insurance services in rural India is <10%. Asset, health, weather and other general insurance services are still nascent
- Securities, commodity derivatives and pensions are much less used as are money transfers, remittances etc.

Box 2: Current Outreach in India

- Govt. supported SHG-Bank Linkage programme
 - Involvement of 35,294 branches of 560 Banks (Commercial banks - 48; Regional Rural Banks - 196; and Cooperative Banks - 316) in 563 districts and 30 states
- Another channel of delivery are: 700 – 800 MFIs, mostly small and registered as NGOs. Since 2000, banks have only targeted 15 - 20 larger MFIs as part of priority sector lending
- **SHG – Bank Linkage Program**
 - 23 million households gained access to formal credit (90% women)
 - Cumulative loan outstanding as on 31st March 2006 – Rs.4000 crores
 - Highly skewed (75% of the funds flowing to 4 states in Southern India)
- **MFIs, many of whom are Sa-Dhan Members**
 - Cumulative loan outstanding of Rs.2000 Crores
 - Reaching over 8.4 million clients

Figure 4: Finance Needed and Accessed by Poor Households



In fact, as the figure above indicates, taking the broad annual potential to be US \$ 30 Billion, the gap can be addressed by a factor of growth of 14 times. A herculean task undoubtedly.

3.18 Andhra Pradesh Crisis

After prolonged deliberations, except Basix and SKF in Andhra Pradesh agreed to slash down lending rates to 15 per cent. Interestingly, Government Finance Department officials also seem to have worked out the sustainable interest rate at not more than 15 per cent for MFIs. The Andhra Pradesh crisis has raised several key questions given below:

1. In objective terms, what are the comparative costs and benefits of alternative channels – MFIs, Banks, Governments and other channels like the private sector – in delivering financial services to the poor? This question is best looked at by civil society with eminent people from various sectors participating
2. What is the real role for the Central Bank in ensuring delivery of inclusive financial services, especially when state governments are known to bring in other norms that overrule those established by this commonly agreed authority (Central Bank)? The question is the Central Bank deregulated interest rates, under specific conditions of lending in April 1999, vide circular in India. What should it do when state governments overrule this aspect and try to bring in money lending acts, usurious loans acts etc?
3. What is coercion in repayment? A clear definition of what is coercion and what is not coercion is required
4. What is usury in interest rates? When people do not have access to formal channels, which lend at highly subsidized rates, what is the basis for comparison? What is affordable interest for low income people?

One solution to the above situation is a public audit where civil society looks at these and other aspects to resolve these issues plaguing the micro-finance sector in AP and India. That alone will guarantee access to financial services for the poor on equitable terms and help them survive in their struggle to build sustainable livelihoods.

3.18.1 Why did the Andhra Pradesh crisis occur – some thoughts...

While the above discussion highlights the consequences of the Andhra Pradesh crisis and two alternative view points on the cases and learnings, the discussion below highlights a long list of causes, which in the opinion of one of the author¹⁵, were all responsible for the Andhra Pradesh crisis. The figure at the end of this section tries to map causality in a tree diagram.

There are several reasons for the Andhra Pradesh crisis and there are given below:

1. The unparalleled growth of the MFI model – burgeoning growth where MFIs grew at a scorching pace and MFIs system/governance were not commensurate to manage that growth
2. Poor governance practices in most MFIs coupled with a perceived lack of transparency in some MFIs
3. Personal life style of certain MFI promoters, who were said to lead an extravagant lifestyle
4. Lack of certain systems in MFIs like risk management, internal control, internal audit, MIS – which, even if available, were not to the required standard to manage the burgeoning growth in a transparent/effective manner.
5. Lack of sensitivity on the part of the government to take an enabling rather than an ideological/restrictive view.
6. Lack of any serious consideration by MFIs to the loan absorption capacity of borrowers – indiscriminate loaning to borrowers, concurrent loans, repeat loans without sufficient gaps between loan cycles etc

¹⁵ Ramesh S Arunachalam

7. The govt's rigid ideological stance on SHG's being the best way to promote micro-finance.
8. The govt's lack of sensitivity and appreciation for the actual costs in delivering doorstep financial services to low income people under different models.
9. The inability of MFIs to present credible (cost) data with regard to interest rates and cost structures
10. The lack of consumer education on the part of the MFIs in terms of making clients understand actual and effective costs of borrowing
11. The many hidden charges in case of some MFIs, which made the Effective Interest Rates, as high as 45-80% in special cases.
12. The lethargy and low inertia in the Govt Velugu model, which resulted in SHG member(s) naturally moving to MFIs to get services
13. The MFIs piggyback riding on the promotional work done by Govt in many places and cannibalising the clients in SHGs
14. The genuine desire of mature SHG clients to get larger loans and the lack of tolerance on the part of Govt (Velugu) programs with regard to the fact that clients can indeed graduate and may have differing needs
15. The general impact of large scale delivery of financial services for low income people (MFIs/SHG) on the larger political economy which is closely networked with money lenders, middlemen and politicians
16. The unhealthy competition between MFIs themselves on the one hand and the resultant antagonistic competitive practices on the ground by them against one another, which got undue media attention.
17. The very structure of the subsidised Govt program, which distorted the competitive dynamics in the Microfinance market place – lending at 3% per annum is the issue here
18. The irresponsible and hype style reporting of the media, without serious consideration of facts and figures
19. The over emphasis by some MFIs/Banks on consumption based financing
20. The highhandedness and authoritarian behavior of some MFI promoters, senior bureaucrats and politicians – beyond a point, it become a question of one's own ego for all concerned
21. The lack of timely intervention by the Central Bank at the early stages of the crisis both to reign in the Govt as well as ensure transparent practices by MFIs
22. The inability of commercial banks to do serious and proper due diligence on MFIs
23. The desire of commercial banks to seek growth at all costs, especially with little consideration for the loan absorption capacity of MFIs, prevalence of systems, governance practices etc.
24. The inability of banks to influence MFI boards (in some cases) in terms of practicing good governance and transparent practices
25. The desire of banks to meet priority sector obligations through growth come what may and with little concern for the quality of the growth
26. The repayment recovery excesses committed in some cases by MFIs and the open call by Govt (in some cases) to the clients to not repay the loans

4 Future Challenges and Potential Areas for MicroNed Intervention

4.1 Governance Aspects of Intermediaries, Business Correspondents and Business Facilitators

4.1.1 Specific Description of the Problem

- As MFIs and other intermediaries grow and attempt to reach larger number of poor people, the institutional form and associated governance mechanisms become very important.
- These intermediaries must focus on governance related issues and evolve appropriate strategies to transform their governance structure from an informal type of governance to

a more formal, transparent and accountable governance structure, so that perceived and real risk of investing in and supporting them is low.

- Aspects of governance in business correspondents/business facilitators/MFIs/Intermediaries that require consideration include the following:
 - a. Board of directors' roles, functioning and composition: with attention to independent directors, terms of office, rotation of board of directors, status of chairperson, segregating CEO and chairperson, capacity building of directors
 - b. Board independence with attention to composition and remuneration of board members and measurement of board performance
 - c. Use of sub committees on the board with the focus on their composition, number of members, independence in functioning, expertise of members, frequency of meetings and whistle blower procedures.
 - d. Code of conduct of board: whether it exists, whether it is complied with and whether action is possible against members who are non compliant.
 - e. Auditors: with attention to method of appointment, rotation mechanisms, relationship to company in terms of granting of other work etc,
 - f. Risk management procedures available and adopted by the board.
 - g. Disclosure of group companies and relationship with these entities in a manner that facilitates transparent understanding of relationships. Information regarding the composition of the board of group companies, including subsidiaries, extent of inter board interaction, and extent of audit committees interaction, also have to be clarified in a transparent manner.
 - h. Information disclosure on performance of the institution as evident from the MIS includes reporting of off balance sheet, and other aspects.
 - i. CEO/CFO appointment and succession, and
 - j. Recognition of right of various stakeholders and measures to protect rights these.

4.1.2 What MicroNed Can Do?

1. MicroNed can support training, research and implementation mechanisms that will help to improve governance across the board, in all types of intermediaries/institutions.
2. MicroNed should also support policy advocacy to incentivise/disincentivise good/bad governance practices (respectively) with regulatory and industry association support.
3. A comparative study on the Governance norms for MFIs across the world and key elements of this would also enable regulators in India to frame appropriate regulations. MicroNed could provide a truly global perspective drawing on the resources of its member donors on governance, enabling regulations and best practices, with regard to low income finance

4.2 Policy and Regulatory Aspects

4.2.1 Specific Description of the Problem

- For a long time, there has been considerable effort to ensure that there is recognition for the low income finance sector by the regulatory authorities
- The primary regulatory challenge is the lack of an appropriate legal form, specific to micro-finance. MFIs can critically incorporate themselves as either not-for-profits or mutual benefit organisations or for-profit entities.
- While the Government of India's efforts are underway to have a mF bill, there is much more work required than already done.
- Recently, The Hon Union Finance Minister, Shri P Chidambaram, introduced the "*Micro Financial Sector Development and Regulation Bill 2007*" in Lok Sabha on 20th March 2007.

- While the need for a Micro-Finance bill is well understood and documented, it must be remembered that there is a cost to regulation – both in the process of drafting and creating it as well as during its implementation.
- From this perspective, it is important that the above bill, which is due for discussion in the Hon Lok Sabha is analysed and critiqued with regard to its content and structure. The same is attempted here using seven criteria listed below:
 - € Is the Act/Bill Inclusive?
 - € Is it Discriminatory?
 - € Is there any Additionality to it being enacted?
 - € Does it seek to interfere with the functioning of other existing regulatory mechanisms?
 - € Is it clear in its definitions, roles and functions?
 - € Does it have any potential for conflict of interest?
 - € Does it create an enabling environment?
- The proposed bill, in ITS PRESENT FORM (the 20th March 2007 version as introduced in the Lok Sabha by the Hon Finance Minister), is:
 - a) **Non-Inclusive and Discriminatory** – because it excludes certain prominent legal forms of Microfinance organizations - i.e., specifically, MFIs incorporated as Section 25 Companies and NBFCs, which are several in number and increasingly the preferred form for Microfinance service delivery. The rationale for exclusion of MFIs incorporated as NBFCs/Sec 25 Companies and inclusion of Multi-State/Mutual Cooperatives in the proposed Act is really puzzling.
 - b) **Somewhat Redundant** – as it seeks to regulate hundreds of cooperatives (mutually aided or multi-state cooperatives or others), which are already subject to regulation/supervision as per prevailing laws. Infact, many of these cooperatives are already collecting member (not public) deposits and so, where is the need to bring them under a new Act to enable them to accept deposits? Put differently, the additionality of the proposed Bill is questionable, at least as far as the cooperatives are concerned.
 - c) **Not Enabling in Nature** – because it aspires to take over a State (Govt) subject and interfere with the autonomous functioning of Cooperatives. The level of administrative control proposed is certainly not going to create an enabling environment – rather, it will stifle growth and it is against the very spirit of cooperative democracy/functioning and also the recommendations of the erstwhile Brahamaprakash, Mirdha and Vaidyanathan Committees, the model cooperative acts and the like and
 - d) **Somewhat Ambiguous** – in its definitions of terms and roles for the proposed Micro-Finance Development council (MFDC). Specifically, given the limited (advisory) scope of activities for the MFDC under the act, one wonders whether it is needed at all?
- Given these challenges and also the prevailing situation on the bill, it is clear that enacting the above bill in its current form is not at all appropriate.
- The bill needs to be further discussed with all concerned stakeholders and then carried forward in a manner that will serve to strengthen the Micro-Finance Industry in India and help better integrate it into the mainstream financial system.
- So, while the need for a Microfinance bill (to facilitate the building of an inclusive financial system) is clear and compelling, such a bill will have to be broad based and revised to serve its purposes.
- In terms of operational feasibility, just as has been successfully done in other countries such as South Africa and other sectors like insurance in India, it appears that the best way forward is to create a specialized INDEPENDENT body for Micro-Finance Regulation (Micro-Finance Regulatory and Development Authority) with representation of the Central Bank and various stakeholders including DFIs, Industry Associations, Different Types of MFIs, Commercial banks and others.

- Such a body could function like the IRDA (Insurance Regulatory Development Authority) and serve to develop and regulate the nascent Microfinance sector.
- Any entity desirous of pursuing Micro-finance would have to register with this specialized body and abide with the extant regulations. Only such a strategy will give a clear focus and thrust to Micro-finance while ensuring its independence, orderly growth and development.
- Thus, it is time the Government and the RBI think of constituting a central regulatory agency, which will have under its ambit the various intermediaries including unincorporated bodies now regulated by State governments.
- The authority can be under the Finance Ministry or under the RBI as long as the learning curve is being traversed. Outlines for suggestive roles for such an agency are given below.

4.2.2 What MicroNed Can Do?

1. MicroNed could support Sa-Dhan and other stakeholders in their efforts, with regard to MF bill.
2. MicroNed could also support regulatory bodies with regard to action research, research, pilot testing, capacity building and exposure visits to other countries with specific focus on building/creating enabling regulation for micro-finance in India
3. Specifically, workshops, experience sharing, field visits etc to other countries that have enabling regulation could also be sponsored and arranged by MicroNed.
4. MicroNed could also sponsor participation of central bankers from various member donor countries to the annual bankers conference in India. This will facilitate sharing of views and experiences.
5. Lastly, MicroNed could interact with the Basel Committee for Banking Regulation to evolve suitable enabling norms and guidelines for regulation and supervision of micro-finance

4.3 Credit Bureau, MIS, Automation and Disclosures

4.3.1 Specific Description of the Problem

- Credit history is the only immediate collateral that a low income finance client builds through his/her prompt repayments of small loans over the loan cycles.
- Capturing this credit history and making it available to the client/financier is increasingly becoming important with a number of institutions operating in multiple geographies and at times overlapping geographies.
- Also, availability of credit history helps segments of population like migrant labourers to access credit from different places they migrate to.
- Technology enables all these and much more and needs to be properly harnessed to this effect.
- A related issue here is that there is a need to standardize accounting norms and ensure accuracy of book-keeping. For so long as the Financial Institutions are operating on low scale the current methods of managing the borrowers will keep the business going. However, to reach scale, financial institutions need to invest in automation as well as technology trained staff to manage the operations.

4.3.2 What MicroNed Can Do?

- MicroNed can help India devise a credit Bureau strategy, drawing on global experiences and best practices in credit bureau design and implementation, scoring models and the like.
- MicroNed, could invest in equity of a sectoral venture for design and implementation of an MIS/Credit Bureau. **Worldwide, MIS is still at its infancy and MicroNed may well want to partner with mainstream IT companies to produce a flexible, affordable and effective microfinance MIS that could later be integrated with a credit bureau.**

- MicroNed could also provide policy advocacy support to influence various stakeholders in creating micro-finance specific standards for MIS, portfolio management, accounting and related issues. The MoF, The Central Bank, Microfinance Regulatory Body (if created), Industry Associations and several others would need to be involved in this regard.

4.4 Reducing Transaction Costs

4.4.1 Specific Description of the Problem

- The search for a low cost retail model for delivering financial services to the poor is another aspect that is worthy of attention.
- With or without use of technology, it is time that the sector provides a low cost alternative to massify retailing of financial services to the poor.
- This search for a low cost retailing mechanism should be seen in the context of the fact that only so much of upscaling of MFIs is possible and alternative mechanisms that facilitate downscaling of banks and other such Financial Institution's must be seriously explored.
- A second aspect related to transaction's cost is that the issue that blew up in Andhra Pradesh in early 2006 was about investigations into certain intermediaries/ financial institutions by the authorities for charging "high" rates of interest. Per unit transaction costs of small loans are high but many opinion leaders still persist with the notion that poor people cannot be charged rates that are higher than commercial bank rates.

The reality of the high transaction costs of serving small customers is a reason for most bankers to shy away from retailing to this market as a business opportunity. This also results in the poor quality of services provided. This in turn makes the poor turn to informal sector for finances.

- There is one major issue here: pilots for technology testing/use in the Indian context.
- The use of mobile phones and other such mechanisms need to be explored in a manner, in which they can be scaled up through pilots. Too often, pilots are so conducted that they succeed during a pilot test due to several factors which cannot be replicated/controlled during a large scale rollout.
- Investing in public/private partnerships that use a variety of stakeholders to provide efficient scaleable pilots that are effective and adaptive from the perspective of low income people is perhaps required.
- While the central bank has deregulated most interest rates, interest rate restrictions on commercial bank for retail loans below Rs.2,00,000/- remain and caps on deposit rates also discourage sharing transaction costs with customers.
- So, in the event of caps remaining, a key issue would be to use Technology like Vodafone's M-PESA to reduce transaction costs and facilitate outreach to remote areas.
- MicroNed can support pilot-testing, adaptation and rollout of innovative technologies in India as well as facilitate exchange of experiences on this aspect globally.
- A range of technologies are already being tested and they would need to be refined and adapted for use in the Indian context in this regard. MicroNed could again work with various stakeholders in refining and adapting these technologies

4.5 Growth and Systems

4.5.1 Specific Description of the Problem

- **Issues for intermediaries:** the burgeoning growth of the low income financial sector means that financial intermediaries may not have the administrative and managerial capacity (systems and human resources required) to handle increasingly larger and rapidly growing portfolios.

- This in turn has implications for risk management and portfolio quality management. There are several specific issues in this regard and they are highlighted below:
- Intermediaries/Institutions (Banking Correspondents/Business Facilitators) are growing and are handling larger portfolios – be it clients, groups or loans.
- This in turn means that they are handling larger volumes of cash and larger number of people, both as organisations and as individuals working within such organisations.
- Cash management is therefore a critical aspect and given its nascency in India and the unique challenges of transferring money across rural areas, risk management becomes a very important issue.
- Growth also enhances several risks such as political risk, fraud risk, operational risks and the like, which need to be immediately addressed.
- The increasing profit orientation of the micro-finance industry has even attracted private investors and overall, the suppliers of finance to the industry have grown significantly, both in terms of volume of money available as well as the diverse stakeholders doing it (NABARD and SIDBI, Private and Public Sector Commercial Banks, Private Investors, Semi Wholesalers and many others).
- Now, with increasing flow of funds to the sector and with all of them targeting¹⁶ the available 20-30 larger/medium MFIs, there is a serious risk of rapid/burgeoning growth fuelled by the supply (wholesaler) side and not backed by appropriate growth in MFI systems and administrative capacity to manage that growth – this could result in portfolio quality problems within the sector.

With burgeoning growth, the systems are being severely tested and may have to be re-designed. Also, while general design of systems tend to be good on paper, implementation in terms of consistency need to be enhanced.

- Hence, risk management within intermediaries is a critical aspect that needs to be focussed on. *This can be addressed through the requirement of design/implementation of standardised and appropriate risk management and internal control systems in all institutions.*
- As noted earlier, Burgeoning growth also requires good corporate governance and especially, with transparency and accountability. However, governance is at its infancy and it requires considerable strengthening.
- *Here again, it would be useful to help institutions practice better governance by incentivising the process and having regulatory guidelines and enabling enforcement.*

4.5.2 What MicroNed Can Do?

1. MicroNed could take the lead and facilitate design/delivery of specialized courses with regard to the above systems – risk management and governance – such courses would have to include a practical component apart from best practices, especially those relevant to the Indian context. The objective would be ensure that such courses bring about adaptive change in participating institutions

¹⁶ There are several reasons for this limited targeting: (1) The nature of suppliers have changed as compared to the past and donors have given way to a pool of suppliers including DFIs, commercial banks, private investors and others with a for profit orientation for whom equity investments (and returns) are likely to be more important; (2) Also, because of seemingly high entry barriers (minimum capitalisation requirements and other aspects) associated with regard to registering as a for profit NBFC MFI, smaller MFIs registered as trusts and societies are not able to access funds and as a result, most of the suppliers are concentrating on the few available larger for profit MFIs and facilitating them to grow, albeit at a pace that is not accompanied by commensurate development of systems, policies and procedures; and (3) Another reason is essentially regulatory for the inability of promising NGO MFIs to become for profit NBFC. This pertains to the aspect of investing the accumulated surplus of NGO MFIs in the new for profit ventures. All of these have resulted in limited number of for profit players available to service the micro-finance industry

2. *MicroNed can also support research and pilot-testing in this regard – like the implications of adoption of basel II by banks and financial intermediaries on systems such as the above – especially risk management.*

4.6 Sensitizing the Regulator

4.6.1 Specific Description of the Problem

There is a need to invest in sensitizing the regulators especially, with regard to building regulatory/supervisory mechanisms tailored to the financial and livelihood needs of the strategic context – i.e; of low income people.

- This could include technical assistance to the regulators/supervisors as in the case of IRDA (supported by USAID consultants), sponsoring of field/exposure visits of regulators/supervisors to other countries with progressive regulation (like South Africa or Brazil or Philippines), specialized mentoring of regulators/supervisors by their peers (with relevant exposure to the low income market) and the like.
- Sponsoring of specialized workshops for regulators/supervisors in areas like loan portfolio audit, technology could also be very useful as it will help them better understand the volatile low income finance portfolios; how transaction cost is affected by technology etc
- **Specialized Technology Training for Regulators is Needed:** With the technology options that are now becoming available (see Annex 12), the delivery models are likely to undergo drastic changes and this again, could have an impact on supervision and regulation, especially in relation to E Banking.
- Security aspects with regard to physical movement of cash and internet/mobile banking require good understanding of the subject and appropriate regulations.
- This fact gets compounded by the fact that communication technology is at a stage where by newer technology leap frogs older technology (by passes at least one generation of technology) and any regulation to deal with such rapidly changing technology must also keep in mind the likely future direction in the structure and application of the technology.
- Without question, internet kiosk banking, e choupals, Mobile/SMS banking, various types of electronic cards and other such applications of technology to reduce transaction and operational costs will undoubtedly require special regulatory expertise not only in the finance domain but also technology domain.
- Hence, there is a need to invest in specialized training like in technology, loan portfolio audit, etc for regulators and supervisors.

4.6.2 What MicroNed Can Do?

1. MicroNed could facilitate/sponsor this training by enabling regulators to attend such a training, either by sponsoring a certain number of seats or by facilitating specialized courses for them or both
2. MicroNed could commission case studies on these new technologies with a focus on what works and why, What does not and why not, what are the key challenges for commercialization etc?

4.7 Sensitizing Politicians/Bureaucracy

4.7.1 Specific Description of the Problem

- Much of the Andhra Pradesh crisis that occurred last year can be attributed towards lack of sensitisation of various stakeholders including local level politicians and bureaucrats
The key question is how can one continuously keep influencing policy and keep working towards building a competitive, transparent and vibrant low income financial services sector, as it evolves in a dynamic fashion.

Traditional attempts to influence policy has perhaps mainly focused on a project or bureaucratic level - the State or Central Govt officers or similar professionals, who have by and large been sympathetic to the cause of low income finance. This should continue with greater vigor.

- However, given the field realities, in India, a strategic change is also required.
- This is because, in a country like India, the elected representatives (at local, state and national levels) have become more aware of the development of finance low income people.
- While many are positive about it, some of them see this development, especially at the local level, as (perhaps) a competitive threat to their local domain.
- Take for example, a small town like Vijaywada or Guntur in Andhra Pradesh. When Financial Institutions expand and extend their outreach, a lot of people are impacted and this includes local business people, money lenders, middlemen and others.
- They are also perhaps part of local political networks as anyone can have a political affiliation. Therefore, it is only expected that there is some reaction, as has happened.
- The key therefore would be for bi-lateral and multi-lateral donors to try and set in motion, sensitization processes at various levels, with a focus on elected representatives as well. And this can happen in so many ways - Govt to Govt at national, state or provincial levels; officers to officers, people to people and through the media.
- Unless this happens, political insulation, would not be a reality and by IGNORING elected representatives at all levels (especially, local level) and not engaging/sensitizing them, the sector would perhaps not be addressing one of the important causes of problems (like what we are seeing in Andhra Pradesh).

4.7.2 What MicroNed Can Do?

1. MicroNed could talk to Industry Associations and others to build a strong program for such sensitization at all levels
2. MicroNed could also sponsor political stakeholder(s), bureaucracy and others to enable them to better understand micro-finance and its impact on low income people – this could be done by sending them to courses in India or elsewhere

4.8 Human Resource Challenges

4.8.1 Specific Description of the Problem

- The microfinance sector is experiencing exponential growth. For the pace of the growth to continue, quality staff are required at all levels of the organizations.
- While qualified staff may be available, it has been hard to find trained and experienced staff.
- Building capacity of the staff of Self Help Group (SHG) promoters and also of the Micro Finance Institutions (MFIs) is a major issue.

If the staff are not well trained and lack the required capacity, the quality of the program cannot be ensured and also it will undermine sustainability, in the long run.

- Manpower at the Senior Management as well as at the ground level would be critical for both start-ups as well as emerging MFIs.
- MFIs are trying to transform from being NGOs and, hence, there is a need to look at attracting mainstream professionals to play the roles of Chief Executive Officers (CEOs), Chief Technology Officers (CTOs), Chief Operating Officers (COOs) etc. so that they can guide the MFIs to imbibe the best practices of the corporate sector.
- MFIs also need to look at tapping local talent from the lesser known Business schools for their supervisory roles.

4.8.2 What MicroNed Can Do?

1. MicroNed could sponsor specialised programs to support induction of mainstream business school students and professionals into micro-finance through direct/indirect support to a range of institutions
2. MicroNed could facilitate the establishment of a nation wide internship program for such students so that the best and most interested are picked up even during their course work

4.9 Code of Conduct Challenge

4.9.1 Specific Description of the Problem

- Over the past few years, the sector has experienced several major problems.
- There has not been enough effort among the practitioners to follow an ethical code of conduct to ensure that the operations are sustainable and the growth is manageable.
- There is a need to evolve codes of conduct and to ensure that these are implemented through a self regulation mechanism.
- There has been unhealthy competition among the practitioners which has created certain problems in ensuring orderly growth of the sector.
- Sa-dhan has taken a lead in this regard and is to introduce an ETHICAL CODE of CONDUCT for its member MFIs. While the draft CODE of CONDUCT guidelines prepared by Sa-dhan are quite appropriate, the key test will lie in its implementation, enforcement and possible penal action.
- How Sa-dhan and the sector deal with these aspects is something to be watched very carefully in the future.

4.9.2 What MicroNed Can Do?

1. A major issue here is that the proposed code of conduct will not apply to institutions that are not members of Sa-dhan. Hence, the key is to promote some consensus on these aspects among the two major associations – Sa-dhan and Inafi – and MicroNed could play an important role as its member donors support both associations.
2. MicroNed could also try to support pilot testing of “observing the proposed code of conduct by a voluntary sample of MFIs. This should help in clearly determining what is practically possible to implement, what changes are necessary in the proposed code of conduct and the like.
3. MicroNed could also support research on aspects like what is coercive repayment, what are the effective interest rates of borrowing from other sources, what are the real costs of delivering micro-finance through various models and the like?

4.10 Coordination and Collaboration Challenges

4.10.1 Specific Description of the Problem

- Collaboration and coordination among the different players in the sector also requires proper attention.
- When there is exponential growth, there is need for institutionalised mechanisms for sharing, learning and conflict resolution.
- While certain workshops and conferences are serving the purpose, there is a need to explore institutionalised processes for this to happen.
- Of course, the MF (micro-finance) UNDP community is a step in that direction.
- There is also a need for honest documentation and dissemination of lessons and attention must be paid to issues that might become future problems. With the rapid growth in the sector, there are increasing conflicts among various stakeholders and appropriate mechanisms need to be evolved in this regard.

4.10.2 What MicroNed Can Do?

1. MicroNed can support the development of such a platform that can serve as a neutral body and facilitate this exchange of experience and ideas. Various stakeholders can be involved including the regulators, MoF, DFIs, Industry Associations, MFIs, Bankers and others.
2. MicroNed can work with industry associations to establish norms for staff turnover – which is a source of conflict among the MFIs
3. MicroNed can also work at the state level to create local forums for MFIs – that can feed into national level associations as well. There could be state chapters too

4.11 Capital Challenge

4.11.1 Specific Description of the Problem

- The importance of capital need not be over-emphasised.
- While, investors exist, absence of an exit route had prevented venture capitalists from making investments into start-up microfinance ventures.
- There has been some good news of late though with the interest being shown in this space by social venture capital funds like Aavishkar, Lok Capital and Bellwether.
- Hopefully, the future should see more vibrant activity in this space thereby facilitating a new breed of MFIs.
- This aspect has become very crucial, as MFIs are now cash strapped because of the RBI's outsourcing guidelines, which has constrained commercial banks from using the partnership/Banking Correspondent model.

4.11.2 What MicroNed Can Do?

1. MicroNed could intervene by providing the much needed exit routes to private investors by offering options for buying of their stake in MFIs.
2. MicroNed could also invest in MFIs, CDFIs by building their capacity to get listed in the open market.
3. MicroNed can work with industry associations to facilitate fair valuation of MFIs

4.12 Debt Challenge

4.12.1 Specific Description of the Problem

- Thankfully there is no dearth of supply of funds into the sector, given the vibrancy that the sector has generated over the past few years. With the proliferation of more MFIs in newer geographies, the sector would see more customised products in this space in coming years.
- Until now, most banks have reached out to MFIs with traditional financial instruments like – bulk loans, equity participation, securitisation, portfolio buy-outs etc.
- However, the need now is for the banks to work with the MFIs in identifying their needs and providing them with tailor made solutions.

4.12.2 What MicroNed Can Do?

1. MicroNed could support innovations by bankers, MFIs and others with regard to post harvest and other agriculture loans – examples, include Warehousing Receipt, Contract Farming etc. This will be a key determinant for consolidation of the players as well as for MFI to attain scale.
2. Banks and financial institutions need to study the need for products like structured debt, hedge options, leveraged buy out etc for the bigger MFIs and thereby enable them to move to the next level of operations, including for buy-outs/takeovers and consolidation of players. MicroNed could facilitate the above

4.13 Geographical Expansion (and Reaching the Unreached) Challenge

4.13.1 Specific Description of the Problem

- While there has been exponential growth of the sector in the South, the growth in other parts of the country has not been as expected.
- Additional resources will have to be invested in ensuring that there are appropriate strategies to reach the unreached.
- The gaps include firstly geographical unevenness and inadequate spread in these northern states (e.g. Madhya Pradesh, Haryana, Uttar Pradesh) and North East.
- Thus, a tiny segment of this US\$30 billion potential market has been reached so far and this is unlikely to be addressed by MFIs and NGOs alone.
- Reaching this market requires serious capital, technology and human resources. However, 80% of the financial sector is still controlled by public sector institutions.
- Competition, consolidation and convergence are all being looked at to improve efficiency and outreach. There is a significant and growing gap between the surging growth in South India, which contrasts with the stagnation in Eastern, Central Northern and North Eastern India.
- Microfinance on its own is unlikely to be able to address formidable challenges of underdevelopment, poor infrastructure and governance.
- Growth of Microfinance in the two Southern States of Andhra Pradesh and Tamil Nadu occurred, atleast partially, through growth in consumption financing for Low Income People.
- There is no doubt that money is fungible and credit needs are multiple but can growth of Microfinance through consumption financing be a viable approach to scaling up Microfinance in North East and other Under served Areas in the North? Perhaps **Not!**
- As lessons from the Andhra Pradesh Crisis suggest, at the most fundamental level, Microfinance (or any form of financing) has to be tempered with realistic estimates on the 'loan absorption/repayment capacity' of the borrowers – which of course would depend on the Livelihoods pursued.
- This aspect is more relevant for the North East and under served areas of North as here, a large number of livelihoods (of Low Income People) are related to agriculture/allied areas.
- Thus, fragile and vulnerable livelihoods for Low Income People, (especially, in the context of the North/North Eastern states where market imperfections in agriculture product/process markets abound), suggest that growth of Microfinance in these areas through consumption financing is less likely and may **not** even be a viable/desirable strategy.
- There is however a great window of opportunity for MFIs to get into “Livelihoods Financing”, in partnership with Bankers/Corporates and other(s) through Public Private Partnerships.
- MFIs could certainly play a important role in several sectors including **Jatropha/Bio-Diesel, Floriculture, Medicinal and Aromatic Plants etc**, through livelihoods financing with one or a mixture of several products:
 - € Warehouse Receipt Financing
 - € Contract Farming (various types)
 - € Cash Flow Based Financing and
 - € Other Innovative Products including Leasing.

4.13.2 What MicroNed can do?

- 1 MicroNed can support research and best practices with regard to livelihood finance
- 2 MicroNed can support basic feasibility studies in various sub-sectors, that can add value to lives of the low income people and help various stakeholders to operationalise and implement projects quickly

4.14 Quality of SHGs Challenge

4.14.1 Specific Description of the Problem

- The Self Help Group movement is beginning to focus on issues of quality.
- Rush by NGOs/Banks to link SHGs to banks for financing has resulted in diluting the focus on savings and credit discipline established during the formation of the SHGs.
- This coupled with illiteracy among the poor has resulted in poor book-keeping.
- This affects the sustainability of the group.
- The success of lending to the SHGs by the banks has been largely due to the efficient functioning of the group as a borrower and if this base is not nurtured, growth cannot be sustained.

The need now is to focus on:

- Ensuring formation of the group is an **inclusive process** –
Study on SHG models reveal that only a little over 50% of the “**poor**” enroll as members.
Also there is a tendency amongst borrowers for **caste affinity** while forming groups. NGOs and other developmental agencies need to ensure that other backward classes do not get excluded owing to caste preferences etc.
There are barriers inherent in the conditions of membership to a group formed to mediate financial transactions – **regular meetings, savings and loan repayments**. Such conditions effectively exclude women who migrate for seasonal wage employment, households with variable or uncertain incomes. Both these are economic characteristics of the poor and very poor. They lead to self-exclusion by group members. There is need to include the poor and poorest and this might require more effort and more intensive follow-up by the SHPA and also work a way to accommodate their needs in terms of varying cash flows etc.

As we write this report, not much work has been done to address this gap.

- Ensuring that the group learns the fundamentals of accurate **book keeping and management of accounts**. Over 50% of the members in SHGs have never had any access to schooling and hence are illiterate. And in 30% of the groups, no member has ever been to a school or has had any form of education. This has implications for record keeping and accountability. Even post training and developmental efforts, less than 50% have been made functionally literate.
- Sudden rush by banks and financial institutions to lend to the SHGs resulting in diluting the **credit and savings discipline** among the borrowers. Need to ensure that the SHGBLP linkage is established in a progressive manner and while competition is good in any sector, easy availability of finance could result in overheating of the market which can then lead to a meltdown situation.
- There is also a need to map the **economic growth** of the SHG members – while studies by various agencies have shown that there is an upward movement in the wealth rank from poorest/very poor to poor, the movement from poor to non-poor is not that significant. The need here is to be able to understand the constraints of further growth from poor to non-poor categories and then work on removing those roadblocks.

4.14.2 What MicroNed can do?

1. MicroNed could work with NABARD and APMAS to help build capacity with regard to the above in the SHG/Federations model.
2. MicroNed could sponsor special courses and module development in this regard.

4.15 Training and Capacity Building Challenges

4.15.1 Specific Description of the Problem

- With the relaxation of constraints on the availability of on-lending and investment funds in the last couple of years, **human resources** development has become perhaps the most important challenge facing the sector.
- There has been an increase in the number of and variety of institutions offering training courses and other capacity building activities and the number and variety of courses themselves have multiplied but still in comparison with the needs, there exist huge gaps.
- But for the training courses to be more effective, there is a need to educate the MFI management to understand and appreciate the need and importance of training. This will make them willing to pay for such services.
- With the various institutions offering several courses to address the training requirements of SHG federations and MFIs, the need now is to be able to integrate class room based training not only with on-site mentoring and hand-holding over a period of time but also to have a formal and structured **pre-training needs assessment**. Microsave has begun work on this but the issue remains that of the ability and willingness of the MFIs and SHGs to pay for all three stages as well as availability of quality trainers.
- A second aspect is that, of late, people from mainstream professions are looking at venturing into microfinance. These people, not being from the sector, have to go through the entire grind of starting from ground zero, learn from trial and error method by applying available models "as it is". Existence of a manual/blue book which can capture the genetic code of microfinance business coupled with on-field handholding by an existing MFI would enable the "new generation" MFIs find their feet sooner than if they were on their own.
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4.15.2 What MicroNed Can Do?

1. MicroNed can facilitate the above with regard to design of the blue book and also the delivery of specialized package courses – which would need to provide an integrated overview of various aspects rather than focus on individual modules
2. MicroNed could also sponsor standalone consultants/mentors to specialised courses so that they can handhold/mentor various nascent and emerging MFIs and especially, in the Under Served Northern Areas and also North East

4.16 'Feminisation of Poverty' Challenge

4.16.1 Specific Description of the Problem

Poverty also has a great gender dimension. Hence, any serious attempt to tackle poverty must be holistic and address the gender aspects. Mere provision of credit cannot tackle poverty in the absence of ensuring that women really hold custody of the income that they earn. There are too many instances of women earning the money and men using the same for alcohol etc.

While 'women' have been extremely good to micro-finance and MFIs as clients, borrowers and members, it is Unclear on whether micro-finance has been good for women in terms of financial, social and personal empowerment and other impact.

"But the evidence on microcredit and women's empowerment is ambiguous. Access to credit is not the sole determinant of women's power and autonomy. Credit may, for example, increase women's dual burden of market and household labor. It may also increase conflict

within the household if men, rather than women, control how loan moneys are used. Moreover, the group pressure over repayment in Grameen's loan circles can just as easily create conflict among women as build solidarity¹⁷”.

Several key issues require attention here in the Indian context and they are listed below:

- What is the small/medium/long term impact of micro-finance on women in terms of various aspects like burden of poverty reduction, debt burden, economic stress, working roles/hours, (within family/outside), decision making authority, custody of earnings/income, status within the family/society, asset ownership/creation, enterprise management, piece rate work, working conditions etc?
- To what extent are, financial products/services needed by women, met by the Microfinance Sector?
- What are the unmet needs for women (e.g., health insurance, maternity etc)? Are their special products that meet the risks and vulnerability of women?
- Another question here is whether the delivery mechanisms are convenient to the special needs of women?
- A related issue here is the aspect of how men field officers/loan officers/others actually treat women (as clients/members) and how do women perceive the way they are treated?
- Are Microfinance institutions concerned about women's empowerment? How many of them actually include gender aspects, women's empowerment and related issues as part of their mission? How many include these in their mission statements and actually translate these into action?
- What critical lessons can be learned from the Microfinance sector and elsewhere, on using women as entry points for various development /economic services? What are the pros and cons of using women as entry points for delivery of various financial services? Are we imposing the burden of poverty reduction primarily on women?
- One needs to understand the impact of targeting women as primary builders of household livelihood and food security. Specifically, this aspect has to be explored in the context of how their own food and nutrition security is affected even while ensuring the same for the household?
- What is the impact of enhanced work, by women in enterprises, on other women in the household? (e.g., Girl children help with domestic chores or older women do the same)
- Assuming that Microfinance enhances income, what is the net observable impact on women's food and nutrition security, women's autonomy and decision making capacity, Women's access to intra-household resources, Women's ability to acquire/retain assets etc.?
- How do MFIs that perform well on indicators such as return on Assets, Financial self sufficiency, SDI perform in respect of above aspects?
- Given a specific context, is there a trade-off between (a) pursuing enhanced Financial sustainability and expanded outreach and (b) Positive Impact on Women's Empowerment in a social and personal sense
- Are there certain legal forms (e.g., like Cooperatives, Credit Unions) which perform better on social and gender indicators?
- What are the key gender indicators to evaluate impact of micro-finance? Which of these would be acceptable to both financial and gender experts?

¹⁷ Source: “Microcredit and Women's Poverty” - **Submitted by dru on Wed, 2007-01-17 13:54.**
 “Granting this year's Nobel Peace Prize to microcredit guru Muhammad Yunus affirms neoliberalism”.
 by **Susan FeinerDrucilla Barker**

4.16.2 What MicroNed can do?

1. All of these are relevant areas/aspects that require attention of MicroNed and need to be explored in a programmatic fashion through action research, field research, workshops and the like – with a balanced development perspective.
2. MicroNed could involve the larger civil society, gender experts, microfinance experts in this so that there is objectivity to examining these issues in the wider context
3. MicroNed could also compare/contrast MFIs, govt programs and other types of Microfinance programs and examine the question of whether a focus on expanding outreach and enhancing sustainability has a trade off in terms of having a positive impact on economic, social and personal empowerment of women? In other words, we need to classify MFIs in terms of performance (outreach and sustainability) and examine whether good or poor financial performance is associated with high or low women's empowerment?
4. MicroNed can also examine and document products/innovations that can specially serve to address the risks and vulnerability that women face in their daily struggle for survival
5. Although micro-finance has strong roots in the gender movement and 99% of clients tend to be women, gender related inputs have been minimal by comparison. There are several aspects that donors (like MicroNed) can do to incentivise and enhance gender inputs in microfinance:
 - a) Set up a fund to provide scholarships to enhance the skills/capacities of women field workers/loan officers.
 - b) Help provide minimal infrastructure support to MFIs that use 'women' loan officers. Much of the field level interaction problems cited (during the AP crisis) between male loan officers and female clients would be mitigated by this
 - c) Create an accredited gender certification program for loan officers of all MFIs, who have >70% women as clients

4.17 Inclusion of Urban Poor Challenge

4.17.1 Specific Description of the Problem

- Historically, microfinance has been the focus of rural poor, which is understandable given the scale of rural poverty in India.
- Even today, close to 30% of Indians in rural areas live below the poverty line.
- While 70% of India may still be "found in its villages", India, like the rest of the world, is increasingly urbanizing.
- Depending on measurement criteria, two to three of the ten largest cities in the world can be found in India, and it is estimated that the country will be more than 40% urban by the year 2020.
- While the number of rural poor decreased from 25.7 crores (257 million) to 19.3 crores (193 million) between 1991 and 2001, the number of urban poor actually increased from 5.2 crores (52 million) to 6.7 crores (67 million).
- *Despite the large number of urban poor, most of whom have little or no access to formal financial services*, there is relatively little outreach of microfinance in major urban areas today.
- Indian microfinance practitioners have expressed reluctance in the past to target urban markets due to perceived high levels of client mobility and weaker social ties.
- Though much of the energy of the Indian microfinance sector to date has been directed towards the rural poor, some of the pioneers of the sector have always had a strong focus on urban poverty.
- SEWA Bank, for example, was founded in 1974 and has over 1.5 lakhs (150,000) clients, most of them in urban Ahmedabad.
- Similarly, Working Women's Forum has been providing microfinance and other livelihood services to over half a million poor women in the 3 southern states of India since 1978. Interestingly, both these institutions have been guided by a holistic approach to

combating poverty, steeped in a deep understanding of the myriad challenges faced by the urban poor.

- In recent times, there have been a few other MFIs (Swadhar, Nirman Bharathi, Aarohan and Ujjivan) who are experimenting with models on urban finance.
- However, efforts need to be put on large scale for it to have an impact, given the size of the population of urban poor.

4.17.2 What MicroNed Can Do?

1. The solution to some of the above points requires developmental funds, as against credit, regulatory framework and resources to take this growth story forward on a much larger scale in urban areas. MicroNed could contribute to this, both through resources as well as by policy advocacy.
2. Specific focus could be on creating a NABARD like institution for dealing with urban poverty and the Ministries of Finance, Urban Development, Women and Child Affairs and other related line ministries could be involved
3. MicroNed can talk to some of the older institutions like SEWA and WWF which have been operating in urban areas for almost 3 decades to compile key lessons and challenges to scaling up urban micro-finance. While there have been recent studies on these aspects, these studies have tended to focus on a large number of institutions rather than closely research the older ones. This is strongly recommended and could provide very valuable insights

4.18 Creation of Practice Focused Mentoring

4.18.1 Specific Description of the Problem

- Capacity enhancement is a very critical issue as microfinance scales up in India. A very important gap in India is the lack of qualified mentor(s)/consultants who can handhold nascent/emerging MFIs for fairly significant, long periods of time.

4.18.2 What MicroNed can do?

1. MicroNed can assist with this by investing in a “mentor creation, capacitation and work program”, whereby scholarships are available to potential/existing consultants to enhance their skills/capacity as well as work on the ground with 3-5 MFIs on an annual basis. The elements of the scholarship could be as follows;
 - a. Support to potential mentors to attend a minimum number of training/skill enhancement programs, and
 - b. Basic retainer support to high performing mentors to work with 3-5 MFIs/Microfinance programs each, especially in under served regions.

Please refer to Annex 17 for MCG’s ranking of importance of focus areas across nascent, emerging, expanding and mature MFIs. The table at end of section provides remarks across the specific sub-areas with regard to gaps and their importance for scaling-up micro-finance

4.19 SHGs as Delivery Mechanisms

4.19.1 Specific Description of the Problem

- Groups as a mechanism, induce efficiency and enhance solidarity. Microfinance must use groups in ways that are convenient to poor people, especially women. Good group methodology should not enhance transaction costs unduly for the poor like in some SHG settings. As an industry observer notes, would we sit in an SHG for several hours every week to get a loan and maintain several records? We would not as it would affect our livelihood.
- The need of the hour is to find ways for groups to be low cost in terms of transaction costs as well as initial establishment. The group leaders must play a pivotal role in the

whole process and leadership must be multiplied at the grass-roots, with more ordinary group members becoming leaders and forming their own groups, thereby enhancing outreach as well.

- Without question, as the SHG BLP and SHG models expand, it is clear that record keeping is becoming burdensome to clients and institutions.

4.23.2 What MicroNed can do?

1. MicroNed could also work towards simplifying the SHG model of working, whereby the burden on the poor women is reduced and their record keeping functions are minimized
2. Therefore, MicroNed could invest in re-engineering SHG working including rationalization of records so that overall transactions costs are minimized and basic/simple records are accurately maintained on-time and in a transparent and up-to-date manner.

4.20 Dissemination

4.20.1 Specific Description of the Problem

There is so much happening across the globe in micro-finance and especially with regard to technology, front-end processes, transformation, products etc. Thus, there is no need to reinvent the wheel and it is crucial that available lessons are built on in an incremental and add on type of fashion.

4.20.2 What MicroNed can do?

1. A global network like MicroNed can play a very important role in reviewing the extensive innovations that have/are going on worldwide around e-banking and other aspects and help in dissemination with a view to looking at:
 - (a) what it means for massifying microfinance in India;
 - (b) what it means for the rest of the world;
 - (c) examining where experiences from elsewhere in the world might be usefully incorporated/drawn-upon; and
 - (d) examining where the common pitfalls lie and how to overcome them.

4.21 Other Challenges

4.21.1 Specific Description of the Problem

Other challenge include:

- A number of NGOs are reluctant to move to microfinance with various apprehension. Views of NGOs on income tax and other taxes for the activities of Microfinance also need to be looked at.
- Another obstacle is compensating cost for providing microfinance at the doorstep vs. other loan products in the organized sector without appreciation of all costs.
- Reaching the ultimate needy in the context of both the SHGs and the MFIs: There is a strategic gap in identifying the needy clients in both rural and urban areas having huge microfinance potential.
- Information system is a major area of concern in the sector. Information technology has been in its advanced stage in India. Still it is very difficult to develop proper software to track the data from client level to the organization level. Big players can develop their own software whereas there are small MFIs, which cannot meet the cost and the same is true in the case of SHG federations.
- How to convert microfinance into livelihood finance is also an issue, which needs to be highlighted. As we know, there is a huge demand of livelihood finance.

4.21.2 What MicroNed Can Do?

1. MicroNed could sponsor specific studies to unearth needs/problems of stakeholders in these given areas as also identify potential solutions to the same.
2. Clearly, there are several challenges such as those given earlier that require the attention of the micro-finance sector in India – all are areas where MicroNed can intervene.
3. Annexes 16 and 17 highlight key areas for scaling-up microfinance in India. While Annex 16 is a summary of responses provided by 36 experts for scaling-up microfinance, Annex 17 is MCG's own perspective on the same. A comparative analysis of external stakeholder ranking and MCG ranking with explanations is given in Annex 16

5 Policy Advocacy Issues for MicroNed

Several critical issues in the low income finance sector will have to be addressed, if it is to become a full fledged industry. As shown earlier in Figures 1, 2 and 3, the Indian financial system for low income people is a complex one with different types of suppliers, intermediaries (channels) and end users. These different types of routes/channels notwithstanding, the fact of the matter is that more and more commercial banks are getting to serve low income clients, using a variety of intermediaries and products to reach different types of low income end users. This has implications for regulation/supervision of financial services including innovative offerings that come from the market. The following discussion outlines the key regulatory bottlenecks as per experiences of Commercial Banks, MFIs, Other Intermediaries, Insurance Companies and other stakeholders. ***Taken together, they represent a set of critical issues that require policy advocacy - that MicroNed can do on its own as well as in partnership with other stakeholders in India like Industry Associations (Sa-Dhan, INAFI etc)***

Table 9: Issues To Be Addressed By Regulation In India	
Banking/Insurance Related Issues	Whom to target for Policy Advocacy:
1. Opening of Branch Extension Counters/Branches	Reserve Bank of India (RBI), Department of Banking Operations and Development (DBOD) and Ministry of Finance (MoF) and Government of India (Gol)
2. Interest Rate Caps on Small Loans	RBI (DBOD), MoF
3. Business Correspondent/Business Facilitator Aspects	RBI, (DBOD) and MoF
4. Outsourcing Guidelines and Problem Areas	RBI, (DBOD) and MoF
5. Level Playing Field for All Commercial Banks	RBI, (DBOD) and MoF
6. Issues with Intermediaries Used by Commercial Banks	MoF, RBI and NABARD
7. Client and Product Issues	RBI, IRDA, SEBI, MoF and PFRDA (after it comes)
8. Growth, Systems, MIS and Reporting Aspects	RBI, MoF and NABARD
9. Technology Options for Serving Low Income Clients and Regulatory Aspects	RBI, MoF and NABARD
10. Political Interference and Related Aspects	MoF, RBI, MLA and MHA
11. Poorly Performing RRBs and Options	RBI, NABARD and MoF
12. Priority Sector Lending Definitions	MoF and RBI
13. Trusts as Micro-Insurance Agents	IRDA and MoF
14. Policy Refunds in Cash (Dispensation)	IRDA and MoF

Table 9: Issues To Be Addressed By Regulation In India	
Banking/Insurance Related Issues	Whom to target for Policy Advocacy:
15. TDS Exemption for Agents	IRDA and MoF
16. Two-Tier Structure for Micro-Insurance Compensation	IRDA and MoF
17. Orphaned Policies and Agents	IRDA and MoF
18. Training Issues and Agents	IRDA and MoF

To summarise, the following lesson are critical in dealing with policy:

1. Enablers are necessary to ensure that banking and formal finance institutions become more visible and accessible to the poor. As it is, the poor are very diffident about approaching formal institutions. So visibility and convenience are extremely important.
2. Alternative channels in under reached areas are certainly required and a development focus is necessary in regulation to ensure inclusive access to a range of financial services. The poor are creditworthy even by standards of informal money lenders and this is a fact that has to be acknowledged and regulated finance made available to them on easy and affordable but non-subsidized terms.
3. The potential of such finance to enhance the discretionary income of the poor is immense – from paying just interest on high cost debts they would be able to save money and build assets. The timing of intervention is most critical – when that critical time is passed, any intervention can have just minimal effect.
4. The poor need a range of financial services and apart from the typically talked of credit and savings; access to risk and vulnerability reducing mechanisms like insurance can prove really useful
5. The state has to ensure that the basic infrastructure and facilities like ration shops, PDS centres, primary health centres etc are maintained to at least a minimum standard, so that the poor are not forced to spend all their income on survival.
6. State sponsored formal employment programs never reach targeted audience and it is time that we introspect with integrity on whether or not these are effective.
7. Policy also needs to take note that health related issues can virtually debilitate many poor families and disposes them of their primary assets and security – physical labour. Hence it is imperative that, among the first interventions, policy should focus on ensuring access to basic risk mitigation and social protection mechanisms. Given this country and its huge outreach potential, these services need not be subsidized as low income women view protection against health related aspects as very critical and are willing to pay to gain access affordable preventive and health insurance and healthcare services.
8. The key is to find easily accessible and affordable mechanisms to reach low income people. Here in lies the challenge because the poor are unlikely to walk in to an insurance company and/or a bank to deposit their monthly premium or repayment for several reasons - the most important being the fact that they could loose almost an equivalent amount through loss of livelihood in attempting to remit the small amount of Rs 50 per month. That is too high a cost for them to negotiate and handle