

Triangular Perspectives in Microfinance

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Abstract

India lives in its villages, with majority of the population below the poverty line, microfinance companies have an important role to play in bring up the economic status of the country. Microfinance industry has evolved slowly but surely and is loaded with promises for the future. This paper takes a look at the micro finance industry in India, the opportunities and challenges, and innovative ways and means to utilise the power of microfinance for the economy. A review of related models in literature is included. From the study of all the existing models and innovations in the industry, a triangular perspective is suggested that summarises the interactions among the stake holders and process of micro financing. The three major participants in the microfinance market include the Lender, Borrower and Regulators. These are influenced by micro and macro variables in the immediate environment in which microfinance operates. These participants have specific roles to play and interact with one another to effectively complete the micro financing process but still have their own perspectives. The study concludes with synergy among the three players and indications to harness the power of microfinance to yield better living standards and provide a ray of hope to the bottom of the pyramid.

Keywords: Microfinance, Lender, Borrower, Regulatory Body.

Introduction

The evolution of microfinance has been steady ever since it was first used by Mohammed Yunus in Bangladesh. Other countries started to take note of the effect the model used by Grameen bank and saw it as a very effective way of dealing with poverty. But, have the results been very satisfactory?

The growth in the last 6years has been tremendous since the United Nations (UN) proclaimed 2005 the year of micro credit in an attempt to globally promote the benefits and potential of the microfinance industry. In doing so, the UN acknowledged that, unlike top-down development initiatives such as debt forgiveness or international aid, microfinance stands out for its bottom-up approach.

There has also been much criticism of the high interest rates charged to borrowers. The real average portfolio yield cited by a sample of 704 microfinance institutions that voluntarily submitted reports to the Microbanking Bulletin in 2006 was 22.3% annually. However, annual rates charged to clients are higher, as they also include local inflation and the bad debt expenses of the microfinance institution. Muhammad Yunus argued that microfinance institutions that charge more than 15% above their long-term operating costs should face penalties.

The role of donors has also been questioned. The Consultative Group to Assist the Poor (CGAP) recently commented that "a large proportion of the money they spend is not effective, either because it gets hung up in unsuccessful and often complicated funding

mechanisms (for example, a government apex facility), or it goes to partners that are not held accountable for performance. In some cases, poorly conceived programs have retarded the development of inclusive financial systems by distorting markets and displacing domestic commercial initiatives with cheap or free money."Deutsche Bank Research (December 2007) estimated the volume of total microfinance loans to be around USD 35bn in 2009 having risen sharply in recent years from an estimated USD 4bn in 2001. According to Dr Vikram Akula of SKS Microfinance (India), the total market for microfinance in India now stands at around USD 2bn. As per Deutsche Bank Research, there are 7 Indian MFIs in top 20 MFIs world wide with the half a million to a million borrowers each and a gross portfolio size of approx USD 25 million to USD 92 million. The average borrowing size is around USD 100 and a write off ratio of less than 1%.

The importance of microfinance lies in the fact that it provides a model of development that is Bottoms up. It promotes entrepreneurship and gives people the means to fight poverty. Currently, the steadily growing popularity of microfinance has reached a global audience. The United Nations (UN) proclaimed 2005 the year of microcredit in an attempt to globally promote the benefits and potential of the microfinance industry. In doing so, the UN acknowledged that, unlike top-down development initiatives such as debt forgiveness or international aid, microfinance stands out for its bottom-up approach. It emerges locally and enables micro-borrowers to improve their situation through their own efforts rather than relying on external development strategies. In their collectivity, micro-loans lead to large-scale economic improvements and foster growth in target countries. In 2006, Prof. Yunus and the Grameen Bank were awarded the Nobel Peace Prize for their "efforts to create economic and social development from below". The Nobel committee honoured the contribution microcredit has made

to the advance of democracy and human rights worldwide.

Women make up the vast majority of borrowers, especially in Asia. Shares of female debtors are as high as 99%. The predominance of women reflects the fact that women are more reliable debtors because, due to stronger social and family ties, they often follow a more conservative investment strategy which in turn results in lower default rates for MFIs.

Literature Review

There has been lot written about microfinance over the years. Writes and thinkers have had varied opinions on whether microfinance is the solution to poverty or not. They have also argued on points ranging from applicability to a specific set of people to identifying various drivers for successful implementation of microfinance. In light of the above, I selected a few of such works which are relevant to my research on the topic.

Following is the summary of all article, papers and books that were read during the course of research:

1. Self-sustainability of self help groups in India-Two Analysis:

This paper reports on two separate studies of SHG programs conducted by CGAP staff and partners. Part 1 reviews SHGs developed by five different SHPIs, representing the main approaches to SHG promotion in India. The study looks primarily at the financial viability of these SHG programs. Part 2 proposes a methodology for designing SHG programs to ensure their sustainability.

2. Micro Finance and Poverty Reduction in Asia: What is the Evidence?

This paper aims to bring together some of the recent evidence that has been accumulating on the impact of microfinance activities on poverty reduction. In particular, the paper looks at evidence for (1) the extent to which microfinance initiatives have made a lasting

difference in pulling households out of poverty on a permanent basis, (2) the extent to which microfinance programs reach only the better-off amongst the poor, leaving the 'core poor' unaffected and (3) how far micro finance is a cost-effective means of transferring income to the poor.

3. Housing Microfinance Initiatives:

The report provides an assessment of current microfinance practices and the linkages between housing and microfinance. The tiered network that has developed among local lending institutions, governments, NGOs, and international organizations including multinational and bilateral development aid organizations is studied, and presents case studies that illustrate recent trends including diversification of services, financing mechanisms, and methods of capitalization, as well as promising avenues for adjusting program structures and improving outreach.

4. Impact of Microfinance on Poverty, Income Inequality and Entrepreneurship:

The purpose of this research proposal was to identify and explain if, in the past three decades wherein microfinance has taken place, there are any significant impacts on poverty and inequality in.

5. Micro Finance, Self Help Groups and Women Empowerment – current issues and concerns:

The paper links microfinance, SHGs, women empowerment and women entrepreneurship. The paper presents cases which highlight that how woman can pro-create their lives, given a conducive environment.

6. Self Help Groups in India- A study of the lights and shades:

The paper tries to take into consideration questions relating to self help groups like-

- How effective are the groups in managing their financial transactions?

- Are the groups sustainable?
- Do they help in mobilising women to take social action? How effective are such actions? -Who is really benefiting?
- Do the poorest benefit, do they not join at all or if they do join, are they more likely to drop out?

The research has been conducted on a sample of 214 SHGs in 108 villages across the country and provides insights on group mechanisms and long term viability.

Research Methodology

The research was basically aimed at building a model which would provide a suitable alternative to current microfinance models being used by MFIs. The problem with models in practice and their implementation is the fact that they are not solving the purpose they were aimed for i.e. eradication of poverty at the bottom of the pyramid and speeding up the process of economic growth and development. The methodology followed in this report was as follows:

1. Study the microfinance industry as a whole as to identify the overall patterns that exist and thereby have a overview as to what the industry has to present as a possible tool to eradicate poverty and speed up the process of economic growth and development.
2. Study the existing models in use currently like the Grameen model and the SHG model. The next step involved the study of the possible flaws in these models that prevented the achievement of the ultimate goals set for microfinance.
3. Study some of the latest innovations and developments in the field of microfinance and take out the best practices that were being followed in the industry.
4. From the study of all the existing models and innovations in the industry, a triangular perspective is suggested that summarises the

interactions among the stake holders and process of micro financing.

5. Suggest some measures that can be readily undertaken by the government to speed up the process of financial inclusion and economic growth.

The Business of Microfinance

Microfinance is the provision of financial services to low-income clients, including consumers and the self-employed, who traditionally lack access to banking and related services. Those who promote microfinance generally believe that such access will help poor people out of poverty.

The Challenge for Microfinance

Traditionally, banks have not provided financial services, such as loans, to clients with little or no cash income. Banks incur substantial costs to manage a client account, regardless of how small the sums of money involved. There is a break-even point in providing loans or deposits below which banks lose money on each transaction they make. Poor people usually fall below that breakeven point. A similar equation resists efforts to deliver other financial services to poor people.

In addition, most poor people have few assets that can be secured by a bank as collateral. As documented extensively by Hernando de Soto and others, even if they happen to own land in the developing world, they may not have effective title to it. This means that the bank will have little recourse against defaulting borrowers.

Because of these difficulties, when poor people borrow they often rely on relatives or a local moneylender, whose interest rates can be very high. While the success of the Grameen Bank (which now serves over 7 million poor Bangladeshi women) has inspired the world, it has proved difficult to replicate this success. In nations with lower population densities, meeting the operating costs of a retail branch by serving

nearby customers has proven considerably more challenging. Hans Dieter Seibel, board member of the European Microfinance Platform, is in favour of the group model. This particular model (used by many Microfinance institutions) makes financial sense, he says, because it reduces transaction costs. Microfinance programmes also need to be based on local funds.

Although much progress has been made, the problem has not been solved yet, and the overwhelming majority of people who earn less than \$1 a day, especially in the rural areas, continue to have no practical access to formal sector finance. Microfinance has been growing rapidly with \$25 billion currently at work in microfinance loans. It is estimated that the industry needs \$250 billion to get capital to all the poor people who need it. The industry has been growing rapidly, and concerns have arisen that the rate of capital flowing into microfinance is a potential risk unless managed well.

Microfinance experts generally agree that women should be the primary focus of service delivery. Evidence shows that they are less likely to default on their loans than men. Industry data from 2009 for 704 MFIs reaching 52 million borrowers includes MFIs using the solidarity lending methodology (99.3% female clients) and MFIs using individual lending (51% female clients). The delinquency rate for solidarity lending was 0.9% after 30 days (individual lending—3.1%), while 0.3% of loans were written off (individual lending—0.9%). Because operating margins become tighter the smaller the loans delivered, many MFIs consider the risk of lending to men to be too high. This focus on women is questioned sometimes, however. A recent study of micro entrepreneurs from Sri Lanka published by the World Bank found that the return on capital for male-owned businesses (half of the sample) averaged 11%, whereas the return for women-owned businesses was 0% or slightly negative.

Microfinancial services are needed everywhere, including the developed world. However, in developed economies intense

competition within the financial sector, combined with a diverse mix of different types of financial institutions with different missions, ensures that most people have access to some financial services. Efforts to transfer microfinance innovations such as solidarity lending from developing countries to developed ones have met with little success.

In developing economies and particularly in the rural areas, many activities that would be classified in the developed world as financial are not monetized: that is, money is not used to carry them out. Almost by definition, poor people have very little money. But circumstances often arise in their lives in which they need money or the things money can buy.

The various types of financial needs of the poor are as follows:

1. *Lifecycle Needs*: such as weddings, funerals, childbirth, education, homebuilding, widowhood, old age.
2. *Personal Emergencies*: such as sickness, injury, unemployment, theft, harassment or death.
3. *Disasters*: such as fires, floods, cyclones and man-made events like war or bulldozing of dwellings.
4. *Investment Opportunities*: expanding a business, buying land or equipment, improving housing, securing a job (which often requires paying a large bribe), etc.

Poor people find creative and often collaborative ways to meet these needs, primarily through creating and exchanging different forms of non-cash value. Common substitutes for cash vary from country to country but typically include livestock, grains, jewellery and precious metals.

Much progress has been made in developing a viable, commercial microfinance sector in the last few decades, several issues remain that need to be addressed before the industry will be able to satisfy massive worldwide demand. The

obstacles or challenges to building a sound commercial microfinance industry include:

1. Inappropriate donor subsidies
2. Poor regulation and supervision of deposit-taking MFIs
3. Few MFIs that meet the needs for savings, remittances or insurance
4. Limited management capacity in MFIs
5. Institutional inefficiencies
6. Need for more dissemination and adoption of rural, agricultural microfinance methodologies

Evidence for reducing Poverty

Some proponents of microfinance have asserted, without offering credible evidence, that microfinance has the power to single-handedly defeat poverty. This assertion has been the source of considerable criticism. In addition, research on the actual effectiveness of microfinance as a tool for economic development remains slim, in part owing to the difficulty in monitoring and measuring this impact. At the 2008 Innovations for Poverty Action/Financial Access Initiative Microfinance Research conference, economist Jonathan Murdoch noted there are only one or two methodologically sound studies of microfinance's impact.

The BBC *Business Weekly* program reported that much of the supposed benefits associated with microfinance, are perhaps not as compelling as once thought. In a radio interview with Professor Dean Karlan of Yale University, a point was raised concerning a comparison between two groups: one African, financed through microcredit and one control group in the Philippines. The results of this study suggest that many of the benefits from microcredit are in fact loaned to people with existing business, and not to those seeking to establish new businesses. Many of those receiving microcredit also used the loans to supplement the family income. The income that went up in business was true only for men, and not for women. This is striking because

one of the supposed major beneficiaries of microfinance is supposed to be targeted at women. Professor Karlan's conclusion was that whilst microcredit is not necessarily bad and can generate some positive benefits, despite some lenders charging interest rates between 40-60%, it isn't the panacea that it is purported to be. He advocates rather than focusing strictly on microcredit, also giving citizens in poor countries access to rudimentary and cheap savings accounts.

Existing Models in Practice

The Grameen Model

Grameen Bank concept was born in the village of Jobra, Bangladesh, in 1976. Professor Yunus, Nobel prize winner for peace in 2006, had a field visit with his students. Today Grameen Bank has 2,475 branches. It works in 80,511 villages and has 7.4 million borrowers and recently passed the \$US 6.6 Billion mark in loans to the poor.

The Grameen Lending Model

Grameen group lending and savings model has been developed and refined over thirty years by the Grameen Bank. The basis of the system is a peer group model in which borrowers encourage, support and learn from each other. The group model requires prospective borrowers to form or join 5 member "Groups". Groups are then organized into centres with up to 8 Groups to a Center. Center meetings take place on a weekly basis and are facilitated by Center Managers who are employed by Grameen. The Grameen model targets women because Grameen's experience around the world has shown that women are more comfortable with the group lending model, are more likely to repay their loans, and are more likely to direct their earnings to providing better clothing, housing, nutrition, health care and education to their families.

The SHG Model

The self-help group (SHG) model is the dominant form of microfinance in India. SHGs have grown explosively in recent years. It is reported that by March 2006, 2.23 million SHGs were reaching about 33 million members. Such outreach appears to represent a major breakthrough in a country where 50 million households live in poverty, with very limited access to financial services. Although the term *self-help group* is used in different countries to describe a variety of financial and non-financial associations, in India it refers to a group of 10–20 poor women who band together for financial services—beginning with periodic, compulsory savings and then mainly loans—and sometimes social services as well. SHGs are managed by their members, with varying degrees of external support. SHGs are formed with the assistance of self-help promotion institutions (SHPIs), which include nongovernmental organizations (NGOs), government agencies, banks, cooperatives, and microfinance institutions. In addition to helping with group formation, SHPIs provide training, monitoring, and other support services. Occasionally, promoters give SHGs initial seed capital to lend, but more typically, groups begin by saving and lending out their members' own resources. Most, but by no means all, SHGs eventually borrow from an external source, usually a bank. This bank linkage is the most distinctive characteristic of the Indian SHG model. The massive outreach of SHGs has generated interest in the model's sustainability and replicability in India and elsewhere.

In India, Self Help Groups or SHGs represent a unique approach to financial intermediation. The approach combines access to low-cost financial services with a process of self management and development for the women who are SHG members. SHGs are formed and supported usually by NGOs or (increasingly) by Government agencies. Linked not only to banks but also to wider development programmes, SHGs are seen to confer many benefits, both economic and social. SHGs enable women to grow their savings and to access the credit which

banks are increasingly willing to lend. SHGs can also be community platforms from which women become active in village affairs, stand for local election or take action to address social or community issues (the abuse of women, alcohol, the dowry system, schools, and water supply).

Kiva and ECCs Innovative Model

Kiva's field partner in Costa Rica, EDESA, provides credit services to a network of "Empresas de Crédito Comunal" (Community Credit Enterprises), or ECCs, established by FINCA Costa Rica. The ECCs is small, grassroots microfinance organizations formed by rural community members. The objective of each ECC is to provide financial services to individuals within the community for the development of economic activities that allow them to move out of poverty. FINCA Costa Rica works to establish ECCs to serve as the financial engines of the neediest communities across the country. To form the ECCs, FINCA provides comprehensive training to rural community members that includes financial and business elements and culminates in the formal establishment of the ECC as a legal autonomous business.

Not only do ECCs provide financial benefits, but many of them also work with other organizations in sectors such as health, education, and sports and often provide other programs such as investment education for children and youth. While each ECC governs its own policies, the average price for a share across the network of ECCs is 2,000 Costa Rica Colones (approximately US\$3.50) so becoming a partial owner of the business is fairly accessible, even in the poorest of communities.

Over the years, as the ECCs grew and their members' businesses expanded, some members began requesting loans that exceeded the ECCs' lending capacity. EDESA serves as the ECCs' national financing institution, with the mission of bringing credit services to the ECCs. EDESA is a firm operated just like an ECC, but on a national level. The ECCs are the shareholders

and receive profits (dividends) if positive financial results are achieved.

This model of community members becoming partial owners of the ECCs and the ECCs being partial owners of EDESA has proven remarkably effective.

The Financial Access at Birth (FAB) Model

Bhagwan Chowdhry, a Professor of Finance at UCLA's Anderson School, has outlined his organization's mission to give every newborn in the world access to financial legitimacy. The most stunning part of the Financial Access at Birth (FAB) campaign isn't the remarkable impact that participants would get from a mere \$100 starting balance or even the GNP metrics envisioned to fund this campaign, it's the idea that this could help erase poverty.

The emergence of the microcredit industry, with innovators such as Grameen Bank in Bangladesh, ACCION in Latin America and more recently Kiva in cyberspace, has begun to address the issue of financial services for the poor. But microcredit is only one piece of the puzzle of financial inclusion, and while these early leaders provide inspiring examples, they help only a small fraction of the world's poor. The poor also suffer because they are inadequately insured against unanticipated shocks and contingencies caused by events such as illness or death of a family member, and natural calamities such as floods, droughts or earthquakes. Any security provided by savings and assets is grossly compromised for the poor who are excluded from the formal economy, as emphasized by Hernando DeSoto and former U.S. Secretary of State Madeline Albright in a recent U.N. report. Even during catastrophic events, such as tsunamis, earthquakes, floods and droughts, attempts to provide social insurance in the form of aid and charity are often inadequate and inconsistent.

The **three perspectives** depicted are

- i. Lender perspective

- ii. Borrowers perspective
- iii. Regulators perspective

The three major participants in the microfinance market include the Lender, Borrower and Regulators. These are influenced by micro and macro variables in the immediate environment in which microfinance operates. These participants, namely, lender, borrower and regulatory body have specific roles to play and interact with one another to effectively complete the micro financing process but still have their own perspectives. The significance is that these three players have an equally strong role to play and the effectiveness and smooth functioning of

the microfinance system depends on equal participation of the lender borrower and regulatory bodies.

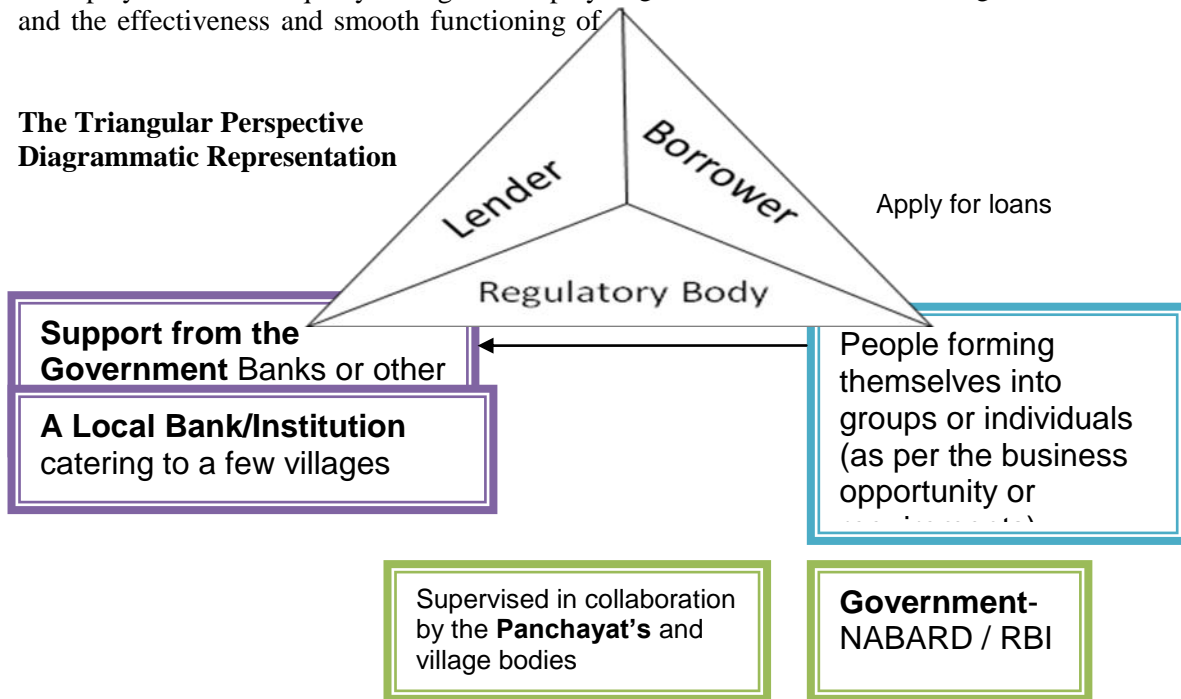
Even if one of the parties is weak, non-synergised with the other or is not able to adhere to the basic principles the entire system would fail to deliver.

Comparative Analysis

i. Lender perspective

Lender – Regulatory Body - Lender does not follow the reporting system as per stipulated guidelines then it would bring in non-

The Triangular Perspective Diagrammatic Representation



transparency, may be window dressing in the financial statements, lack of corporate governance and much more. Their prime idea is profit maximisation rather than helping the poor.

Lender – Borrower - If the lender does not adhere to the basic principles of microfinance of helping the bottom of the pyramid by charging a interest rate which falls in red zone i.e. above

25% (as mentioned by Mohammad Yunus, 2005)

This can be seen in situations where lenders are strong, the bargaining power is more and regulatory bodies are side lined and unable to help achieve objectives of microfinance of helping the needy and bottom of the pyramid.

ii. Borrowers perspective

Borrower – Lender – If the borrower is charged interest rate in the red zone (above 25%)

then being a borrower in the microfinance category he is prone to make a default as his earnings would not be sufficient enough to do the repayment fully and timely.

This might also give another rise to a debt vicious circle which might bring in more problems of raising second loan from repaying the first one and so on.

Again if he/she is a wilful defaulter then he might already have wrong intention of non-repayment at the very onset of transaction where in recovery process is not only difficult but might be more problematic.

Borrowers – Regulatory Body – The borrowers are going through a painful recovery process which includes mental harassment. They have reported to the village level authorities or RBI/NABARD or even consumer forum and many other platforms. As result the regulatory body for microfinance has been very recently decided as NABARD because of the inability of MFIs to help the poor rather making this as a profit making opportunity.

iii. Regulators perspective

Regulatory – Borrower – Regulatory bodies includes the law of land like Income tax requisites, RBI / NABARD have stringent norms for the KYC and verification process. This is enforced with the intention of establishing the creditworthiness but end up with formalities difficult for the borrower to comprehend and fulfil.

Regulatory – Lender – The regulatory body expects that the law of land is abided for which includes a lot of documentary and other compliances including the high tax rate which even motivates the MFIs for tax evasion. The lender operating in the microfinance market bears the risk of recovery and also now a days of pre-set targets to be achieved which also brings in reckless lending in the market.

Key Features of the T.Perspectives :-

1. The (regulator) government will provide interest free funds to the banks in its bid to strive for economic growth and development specially focussing on the people at the bottom of the pyramid.
2. The borrower perspective includes the people at the bottom of pyramid and includes the OBC/ST/SC and any other minority groups in need of funds.
3. The banks should be ready to bear set-up costs for setting up branches in villages and expect to recover costs over an extended period of time.
4. The Panchayat's can the share power in their domain with the banks and guide them on loan disbursements.
5. Loans applied for by the groups or individuals should be for commercial purposes so that promotes the entrepreneur.
6. The loan applications need not be supported by any collateral or difficult KYC or documentary requirements.

The process will start from the very fact that the primary objective of any government is to eradicate the problem of poverty, ensure health and education for all. In pursuit of these objectives, it sets out some amount from the annual budget for these activities. The Banks will also play a very important role in this process. The government will be working in tandem and collaboration with the banks. The next step will involve village panchayat's to chalk out the strategy for each region and ensure support from them. The banks and the panchayat's will together form a body which would be in charge of a region and would cover a few villages. This body would be controlled by the banks and panchayat's representatives and would appoint local bodies for each village which would be responsible for administering the process of sanctioning loans to the people who apply for them. The local body would assess the application and advice from the panchayat representatives on the applicants' status. The body would then decide whether to grant the loan or not. The local body set would be entrusted

with the following tasks as part of the government policy to ensure basic facilities for everybody. They are as follows:

1. **Loans at minimal rates of interest.**
2. **Health insurance for all**
3. **Setting up education facilities**

The microfinance lending will be accompanied by low rates of interest and thus, will ensure low default rates, better recovery and timely recovery.

Conclusion- 'A Ray of Hope'!

Comprehensive impact studies have demonstrated that:

1. Microfinance helps very poor households meet basic needs and protect against risks;
2. The use of financial services by low-income households is associated with improvements in household economic welfare and enterprise stability or growth;
3. By supporting women's economic participation, microfinance helps to empower women, thus promoting gender-equity and improving household well-being;
4. For almost all significant impacts, the magnitude of impact is positively related to the length of time that clients have been in the programme.

Poor people, with access to savings, credit, insurance, and other financial services, are more resilient and better able to cope with the everyday crises they face. Even the most rigorous econometric studies have proven that microfinance can smooth consumption levels and significantly reduce the need to sell assets to meet basic needs. With access to micro insurance, poor people can cope with sudden increased expenses associated with death, serious illness, and loss of assets.

By reducing vulnerability and increasing earnings and savings, financial services allow poor households to make the transformation from "every-day survival" to "planning for the future." Households are able to send more children to school for longer periods and to make greater

investments in their children's education. Increased earnings from financial services lead to better nutrition and better living conditions, which translates into a lower incidence of illness. Increased earnings also mean that clients may seek out and pay for health care services when needed, rather than go without or wait until their health seriously deteriorates.

We can expect the same effect to happen in India if proper policies are implemented and with the right kind of conceptual framework. Indeed, it presents everybody at the bottom of the pyramid with a 'Ray of Hope'.

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