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The microfinance in India- An overview

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A B S T R A C T

Microfinance is a form of financial services for entrepreneurs and small businesses lacking access to banking and related services. The two main mechanisms for the delivery of financial services to such clients are: (1) relationship-based banking for individual entrepreneurs and small businesses; and (2) group-based models, where several entrepreneurs come together to apply for loans and other services as a group. In some regions, for example Southern Africa, microfinance is used to describe the supply of financial services to low-income employees, which is closer to the retail finance model prevalent in mainstream banking.Microfinance is a broad category of services, which includes microcredit. Microcredit is provision of credit services to poor clients.Microcredit is one of the aspects of microfinance and the two are often confused. Critics may attack microcredit while referring to it indiscriminately as either 'microcredit' or 'microfinance'.

Introduction

Microfinance is a form of financial services for entrepreneurs and small businesses lacking access to banking and related services. The two main mechanisms for the delivery of financial services to such clients are: (1) relationship-based banking for individual entrepreneurs and small businesses; and (2) group-based models, where several entrepreneurs come together to apply for loans and other services as a group.

For some, microfinance is a movement whose object is “a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers." Many of those who promote microfinance generally believe that such access will help poor people out of poverty. For others, microfinance is a way to promote economic development, employment and growth through the support of micro-entrepreneurs and small businesses.

Microfinance is a broad category of services, which includes microcredit. Microcredit is provision of credit services to poor clients. Microcredit is one of the aspects of microfinance and the two are often confused. Critics may attack microcredit while referring to it indiscriminately as either 'microcredit' or 'microfinance'. Due to the broad range of microfinance services, it is difficult to assess impact, and very few studies have tried to assess its full impact. Proponents often claim that microfinance lifts people out of poverty, but the evidence is mixed. What it does do, however, is to enhance financial inclusion.

History of Micro finance

Over the past centuries, practical visionaries, from the Franciscan monks who founded the community-oriented pawnshops of the 15th century to the founders of the European credit union movement in the 19th century (such as Friedrich Wilhelm Raiffeisen) and the founders of the microcredit movement in the 1970s (such as Muhammad Yunus and Al Whittaker), have tested practices and built institutions designed to bring the kinds of opportunities and risk-management tools that financial services can provide to the doorsteps of poor people. 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.

The history of microfinancing can be traced back as far as the middle of the 1800s, when the theorist Lysander Spooner was writing about the benefits of small credits to entrepreneurs and farmers as a way of getting the people out of poverty. Independently of Spooner, Friedrich Wilhelm Raiffeisen founded the first cooperative lending banks to support farmers in rural Germany. The modern use of the expression "microfinancing" has roots in the 1970s when organizations, such as Grameen Bank of Bangladeshwith the microfinance pioneer Muhammad Yunus, were starting and shaping the modern industry of microfinancing. Another pioneer in this sector is Akhtar Hameed Khan.

Micro Finance in India

Loans to poor people by banks have many limitations including lack of security and high operating cost and so Microfinance was developed as an alternative to provide loans to poor people with the goal of creating financial inclusion and equality.

Muhammad Yunus a Nobel Prize winner, introduced the concept of Microfinance in Bangladesh in the form of the "Grameen

Bank".NABARD took this idea and started concept of Micro Finance in India.

Micro Finance is defined as, financial services such as Saving A/c, Insurance Fund & credit provided to poor & low income clients so as to help them to rise their income & there by improve their standard of living.

From this definition it is clear that main features of Micro Financing:

1) Loan are given without security

2) Loans to those people who live BPL *(Below Poverty Line)*

3) Even members of SHG enjoy Micro Finance

4) Maximum limit of loan under micro finance Rp25,000/-

5) The terms and conditions given to poor people are decided by NGOs

6) Micro Finance is different from Micro Credit- under Micro Credit, small amount of loans given to the borrower but under Micro Finance besides loans many other financial services are provided such as Savings A/c, Insurance etc. Therefore Micro Finance has wider concept as compared to Micro Credit.

Inclusive financial systems

The microcredit era that began in the 1970s has lost its momentum, to be replaced by a 'financial systems' approach. While microcredit achieved a great deal, especially in urban and near-urban areas and with entrepreneurial families, its progress in delivering financial services in less densely populated rural areas has been slow.

The new financial systems approach pragmatically acknowledges the richness of centuries of microfinance history and the immense diversity of institutions serving poor people in developing world today. It is also rooted in an increasing awareness of diversity of the financial service needs of the world's poorest people, and the diverse settings in which they live and work.

Brigit Helms in her book 'Access for All: Building Inclusive Financial Systems', distinguishes between four general categories of microfinance providers, and argues for a pro-active strategy of engagement with all of them to help them achieve the goals of the microfinance movement.

Informal financial service providers

These include moneylenders, pawnbrokers, savings collectors, money-guards, ROSCAs, ASCAs and input supply shops. Because they know each other well and live in the same community, they understand each other's financial circumstances and can offer very flexible, convenient and fast services. These services can also be costly and the choice of financial products limited and very short-term. Informal services that involve savings are also risky; many people lose their money.

Member-owned organizations

These include self-help groups, credit unions, and a variety of hybrid organizations like 'financial service associations' and CVECAs. Like their informal cousins, they are generally small and local, which means they have access to good knowledge about each other's financial circumstances and can offer convenience and flexibility. Grameen Bank is a member-owned organization. Since they are managed by poor people, their costs of operation are low. However, these providers may have little financial skill and can run into trouble when the economy turns down or their operations become too complex. Unless they are effectively regulated and supervised, they can be 'captured' by one or two influential leaders and the members can lose their money.

NGOs

The Microcredit Summit Campaign counted 3,316 of these MFIs and NGOs lending to about 133 million clients by the end of 2006. Led by Grameen Bank and BRAC in Bangladesh, Prodem in Bolivia, Opportunity International, and FINCA International, headquartered in Washington, DC, these NGOs have spread around the developing world in the past three decades; others, like the Gamelan Council, address larger regions. They have proven very innovative, pioneering banking techniques like solidarity lending, village banking and mobile banking that have overcome barriers to serving poor populations. However, with boards that don't necessarily represent either their capital or their customers, their governance structures can be fragile, and they can become overly dependent on external donors.

Formal financial institutions

In addition to commercial banks, these include state banks, agricultural development banks, savings banks, rural banks and non-bank financial institutions. They are regulated and supervised, offer a wider range of financial services, and control a branch network that can extend across the country and internationally. However, they have proved reluctant to adopt social missions, and due to their high costs of operation, often can't deliver services to poor or remote populations. The increasing use of alternative data in credit scoring, such as trade credit is increasing commercial banks' interest in microfinance.With appropriate regulation and supervision, each of these institutional types can bring leverage to solving the microfinance problem. For example, efforts are being made to link self-help groups to commercial banks, to network member-owned organizations together to achieve economies of scale and scope, and to support efforts by commercial banks to 'down-scale' by integrating mobile banking and e-payment technologies into their extensive branch networks.

Problems Associated with Micro Credits in Developing Countries

Credit is one of the many infrastructural needs of a micro entrepreneur. To respond to a potential demand for a good or service, a rural micro entrepreneur requires one or more of the Published in J.K. Gogoi (eds.) Rural Indebtedness in North East India, Dibrugarh University, Assam, 2004, pp.185-2004 following: transport, communications, power, irrigation, storage facilities etc. Infrastructural needs may be less important for some non-agricultural rural entrepreneurial activities such as cycle repairing, tailoring, etc but they are very important for agriculture which being one of the most significant rural micro enterprises in developing economies. No amount of accessible credit could induce an Indian subsistence farmer to cultivate land for cash crops, if for instance, there is no place to store crops or there is no marketing authority to market the crops or there is no way of getting the crops to the market place. Besides, market in developing countries is highly imperfect and unstable. Small farmers may not want to change from subsistence crop to cash crop and become entrepreneurs, even if cash crops could provide a significantly higher income in the absence a good transportation system and potential consumers.

Literacy, numeracy and formal education levels in most of the developing countries are extremely low. Non-numerate people find difficulties to start enterprises by themselves as it is extremely difficult for them to keep track of the flow of income in their enterprises. Those entrepreneurs who are numerate but not literate can often go some way in developing their enterprises, but their enterprises are severely limited. For example, they do not have access to information from the print media and can not enter into written contracts. They often have to act on trust and can not easily engage with the State and formal private sector who normally work with written documents.

Despite adverse effects of microfinance growing too fast in some regions, the popularity of microfinance among socially responsible investors has meant that millions of extra poor have access to financial services today. Without investors such growth would not have been possible. To some extent, firms in developed countries are Concerned with socially responsible investment because the extra demand for their shares lowers their cost of capital. Microfinance investment looks like a more appealing instrument to push for social change. Overall, microfinance appears to be attractive for investors, but there are several caveats. First, only the most profitable MFIs are attractive investments. Second, investors face a trade-off between financial returns and outreach to the poor. If they want MFIs to target poorer people, they have to give up financial returns. Third, MFIs are subject to many risks, on most of which there is little research.

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