



FINANCIAL SYSTEMS OF MICRO FINANCE IN INDIA

Arts

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ABSTRACT

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.

In Stuart Rutherford's recent book *The Poor and Their Money*, he cites several types of needs:

- Lifecycle Needs: such as weddings, funerals, childbirth, education, homebuilding, widowhood, old age.
- Personal Emergencies: such as sickness, injury, unemployment, theft, harassment or death.
- Disasters: such as fires, floods, cyclones and man-made events like war or bulldozing of dwellings.
- 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, jewelry, and precious metals.

KEYWORDS

INTRODUCTION

As Marguerite Robinson describes in *The Microfinance Revolution*, the 1980s demonstrated that "microfinance could provide large-scale outreach profitably," and in the 1990s, "microfinance began to develop as an industry" (2001, p. 54). In the 2000s, the microfinance industry's objective is to satisfy the unmet demand on a much larger scale, and to play a role in reducing poverty. While 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:

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

Ways in which poor people manage their money

Rutherford argues that the basic problem poor people as money managers face is to gather a 'usefully large' amount of money. Building a new home may involve saving and protecting diverse building materials for years until enough are available to proceed with construction. Children's schooling may be funded by buying chickens and raising them for sale as needed for expenses, uniforms, bribes, etc. Because all the value is accumulated before it is needed, this money management strategy is referred to as 'saving up'.

Often people don't have enough money when they face a need, so they borrow. A poor family might borrow from relatives to buy land, from a moneylender to buy rice, or from a microfinance institution to buy a sewing machine. Since these loans must be repaid by saving after the cost is incurred, Rutherford calls this 'saving down'.

Rutherford's point is that micro credit is addressing only half the problem, and arguably the less important half: poor people borrow to help them save and accumulate assets. Micro credit institutions should fund their loans through savings accounts that help poor people manage their myriad risks

Most needs are met through mix of saving and credit. A benchmark impact assessment of Grameen Bank and two other large microfinance institutions in Bangladesh found that for every \$1 they were lending to clients to finance rural non-farm micro-enterprise, about \$2.50 came from other sources, mostly their clients' savings. This parallels the experience in the West, in which family businesses are funded mostly from savings, especially during start-up.

Recent studies have also shown that informal methods of saving are unsafe. For example a study by Wright and Mutesasira in Uganda concluded that "those with no option but to save in the informal sector are almost bound to lose some money – probably around one quarter of what they save there."

The work of Rutherford, Wright and others has caused practitioners to reconsider a key aspect of the micro credit paradigm: that poor people get out of poverty by borrowing, building micro enterprises and increasing their income. The new paradigm places more attention on the efforts of poor people to reduce their much vulnerability by keeping more of what they earn and building up their assets. While they need loans, they may find it as useful to borrow for consumption as for micro enterprise. A safe, flexible place to save money and withdraw it when needed is also essential for managing household and family risk. Current scale of microfinance operation

No systematic effort to map the distribution of microfinance has yet been undertaken. A useful recent benchmark was established by an analysis of 'alternative financial institutions' in the developing world in 2004. The authors counted approximately 665 million client accounts at over 3,000 institutions that are serving people who are poorer than those served by the commercial banks. Of these accounts, 120 million were with institutions normally understood to practice microfinance. Reflecting the diverse historical roots of the movement, however, they also included postal savings banks (318 million accounts), state agricultural and development banks (172 million accounts), financial cooperatives and credit unions (35 million accounts) and specialized rural banks (19 million accounts).

Regionally the highest concentration of these accounts was in India (188 million accounts representing 18% of the total national population). The lowest concentrations were in Latin American and the Caribbean (14 million accounts representing 3% of the total population) and Africa (27 million accounts representing 4% of the total population, with the highest rate of penetration in West Africa, and the highest growth rate in Eastern and Southern Africa). Considering that most bank clients in the developed world need several active accounts to keep their affairs in order, these figures indicate that the task the microfinance movement has set for itself is still very far from finished.

By type of service "savings accounts in alternative finance institutions outnumber loans by about four to one. This is a worldwide pattern that does not vary much by region."

An important source of detailed data on selected microfinance institutions is the *Micro Banking Bulletin*, which is published by Microfinance Information Exchange. At the end of 2009 it was tracking 1,084 MFIs that were serving 74 million borrowers (\$38

billion in outstanding loans) and 67 million savers (\$23 billion in deposits)

As yet there are no studies that indicate the scale or distribution of 'informal' microfinance organizations like ROSCA's and informal associations that help people manage costs like weddings, funerals and sickness. Numerous case studies have been published however, indicating that these organizations, which are generally designed and managed by poor people themselves with little outside help, operate in most countries in the developing world.

Help can come in the form of more and better qualified staff, thus higher education is needed for microfinance institutions. This has begun in some universities, as Oliver Schmidt describes. Mind the management gap

The micro credit era that began in the 1970s has lost its momentum, to be replaced by a 'financial systems' approach. While micro credit 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 others' financial circumstances and can offer convenience and flexibility. 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.^[25] Led by Grameen Bank and BRAC in Bangladesh, Prodem in Bolivia, 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.

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