ORIGINAL RESEARCH PAPER

Economics

EMERGENCE OF MICRO FINANCE INSTITUTIONS AND ROLE FOR CLUSTER DEVELOPMENT

KEY WORDS: Emergence – Mfi – Working Capacity – Cluster Approach.

Dr.V.Balamurugan. MA(Eco)., MA(Eng)., B.Ed., M.Phil., Ph.D., DCA, Parttime research Scholar, PG & Research Department, Urumu Dhanalakshmi College, Tiruchirappalli – 620019, Tamilnadu.

ABSTRACT

The microfinance sector in India, largely unfettered by tedious regulation and interference is young and dynamic. The biggest obstacle until recently was little access to commercial markets and the forbidding cost of capital funds. As private banks, spearheaded by ICICI in 2003, entered the microfinance market, this barrier has partly disappeared and microfinance is growing at a break-neck pace on all fronts viz. loan outstanding, client outreach, product and service diversification or geographic spread. Concerns have now shifted to growth management issues such as skilled human resources, flexible product design, reducing transaction costs, ensuring adequate management information systems, standard credit information, better use of advances in technology, accessing alternative financing, expanding into underserved areas, and dealing with regulatory hurdles and political risks. There is an urgent need for structured long term financing to the sector to fully address these important issues and smoothly transition into a well functioning mature industry.

INTRODUCTION

There are very few reliable aggregate data available for the Indian microfinance market and no comprehensive database or directory of microfinance institutions.

However, India presents an obvious scope for microfinance in general and housing finance in rural India. Urban sector has traditionally been less attractive to the microfinance institutions as compared to the rural areas:

- High migration in urban areas increases the default risk of microfinance portfolio, especially since loans are unsecured.
- MFIs operating in urban area suffer comparison with commercial banks on interest rates.
- Various methodologies of group formation and peer pressure are not as successful in urban areas as in rural areas.
- Urban population mostly have a tendency of service or organized employment as compared to self employment in rural areas thereby increasing the probability of loan being utilized for consumption purposes in urban areas.

In spite of various challenges, some MFIs are now accelerating their expansion in urban areas.

DEMAND

There are various opinions about the microcredit demand. M-CRIL, a leading micro-credit rating agency provides a conservative estimate for the annual demand at $9.6 Bn (Rs. 480 Bn) based on 60-70 million poor families with an average household credit demand of Rs. 8,000 (less than $160). Another estimate from the prominent microfinance practitioner, Vijay Mahajan at $30 Bn weights India with 10% of the estimated global aggregate demand of $300 Bn. In spite of the difficulty to classify the urban population on an occupation basis, one could broadly use self employed, service class or unemployed. There have been limited systematic analysis on credit demand/need in urban areas and more information needs to be collected. In a study conducted by Vijay Mahajan and Nagasri the demand for credit was evaluated at $180 (Rs. 9,000) per annum per household among the urban poor while the Paradigm Group survey estimates the same at $201 (Rs. 10,071) per annum. Considering these two estimates and the number of urban households around 20 Mn, we can infer an annual credit demand between $2.7 Bn (Rs. 137.4 Bn) to $3.1 Bn (Rs. 153.6 Bn)

The rural population is easier to classify according to primary occupation and income level and we can account for credit demand per household according to these segments. Given that population involved in agriculture have a higher credit demand due to high cost of agri-inputs. Considering the number of households per segment, the weighted average annual credit demand per household is $420 (Rs. 21 K) for non-agriculture population and $1,300 (Rs.65 K) for agriculture population. The overall annual credit demand for households with income below $2 per day (Rs.100) therefore amounts to $ 57 to 101 Bn (Rs. 2,833—5,064 Bn). Similarly, assuming $2 K (Rs. 100 K) as the average housing loan required and taking an average repayment period of five years, we can infer an annual housing credit demand of $12—15 Bn (Rs. 592—740 Bn). Therefore, the overall annual cumulated credit demand (micro-credit and housing) would be in the range of $71—119 Bn (Rs. 3,562—5,962 Bn).

SUPPLY

Currently, roughly 66% of the formal supply is disbursed through the Self Help Group-bank linkage route, largely financed by the National Bank for Agriculture and Rural Development (NABARD) while the rest comes from microfinance institutions (MFIs) increasingly backed by commercial banks.

Up to March 31st 2005, a grand total of 1.62 million SHGs, representing 24.3 million poor families or approximately 121.5 million people, have received cumulative loans of over $1.4 Bn (Rs. 68 Bn) from commercial banks. During the sole 2004-05 fiscal year, 573 banks participating in the SHG-bank linkage program financed 539,365 new and 258,092 existing SHGs, representing 11.2 million families or 56 million people over 31 States and Union Territories and 572 of the 602 districts of India. The amount of loans disbursed by banks to SHGs during this fiscal year amounts to $600 Mn (Rs. 29,900 Mn), i.e. an average of $751 (Rs. 37,546) per SHG. That figure displays a growth of 49% over the previous year's figure of 361,731 new SHGs linked to banks. The increase in credit flow to SHGs over the previous year is 61%, showing a growth in the average credit size disbursed to SHGs .

Sa-Dhan, an association of 139 community development finance institutions states that the total portfolio outstanding of its members has risen 2.5 times from $90 Mn (Rs. 4.3 Bn) in 2004 to $210 Mn (Rs. 10.6 Bn) by March 31st 2005. The client outreach during the same period rose by 96% from 3.3 million to 6.48 million.

Despite these efforts, the World Bank estimates that the Indian microfinance activity currently reaches only 4% of the poor. In a sample study of 40,000 households cited by Sa-Dhan, the "money-lender" is still supreme, holding average outstanding loans at $418 (Rs. 20,908). Similarly, a 2003 national government survey found that 22% of all cultivator households access credit from informal sources and only 27% from formal sources.

Whichever source used, it clearly appears that, in spite of the rapid growth in the past two years, the supply of credit is well below the demand. There was a total credit supply of $1.5 Bn (Rs. 75 Bn) in non-agriculture, of $25.1 Bn (Rs. 1,253 Bn) in agriculture and none in rural housing.

Therefore, the annual supply-demand gap of credit is in the range of $45 to 93 Bn (Rs.2,234—4,629 Bn).

CREDIT DELIVERY MODELS

The SHG-bank linkage model and the joint liability group model (widely called the Grameen model although Grameen with its particular features is actually a subset of joint liability) are the most prominent microfinance operational models in India. Although some MFIs use one model exclusively, most use both or hybrid models.

A self-help group (SHG) is a group of around fifteen to twenty poor individuals—usually women—who provide financial support to one another in the form of pooled savings and internal credit assistance. SHG members generally use the loan for both consumption and productive purposes. Given the fungible nature of money, most MFIs do not scrutinize loan utilization. The bank issues a loan to the group, after rating them based on their savings and internal credit behaviour. The loans are kept on the bank's balance sheet. The SHG can also lend internally both before and after the bank linkage takes place. The SHG may choose to keep only part of their savings in the bank account, partly in order to maintain internal financing capability for emergency loans.

A joint-liability group (JLG) is a small group of borrowers (typically 4-5) who are jointly liable to an external lender (MFI) for a loan that they receive. Unlike the SHG, the sole purpose of existence of a JLG is to receive a group loan from an MFI.

REGULATION AND LEGAL FORMS

At present, there is not one universal legal definition or form or parliamentary regulation or regulatory authority for what constitutes a MFI in India. We broadly apply the term to an organisation engaged in lending of very small amounts to low-income households previously disconnected from or underserved by the formal banking sector. The organisation may be for or not for profit. It may operate under a variety of legal forms governed by different pieces of legislation and different regulators.

There are nine broad legal forms. MFIs are registered as Societies as per Societies Registration Act 1860 or state legislation and as Trusts as per Public Trust Act 1920 or Indian Trust Act 1882. Section 25 companies are registered as per the Companies Act (1956) with permission from central Government. These three types of organizations are not directly governed by any regulatory authority.

Other legal forms including NBFCs registered as Section 25 companies, for profit NBFCs, Cooperative Banks and Local Area Banks are regulated by the Reserve Bank of India (RBI). Cooperatives are registered as per the State, National and MACS Acts and governed by the State Registrar of Cooperatives. Union Finance Minister P. Chidambaram has promised to table a bill to provide a formal statutory framework for the promotion, development and regulations of the microfinance sector at the 2006 Parliament Budget session. The nine legal forms an MFI could take and the permissible microfinance services for each form are listed in Annex 2, Table 1.

FINANCING MODELS

Traditionally, civil society organisations financed all operational and capital costs incurred for small lending activity through donor funds. Now, MFIs take on commercial debt for on-lending and raise capital by securitization of assets and portfolio sales. Other avenues available are equity investment, quasi-equity through the partnership model, and loan guarantor funds.

1) On-lending involves the MFI borrowing from banks and then lending that money to clients. On-lending is the predominant model of financing.
2) Securitization: In India, in the absence of a secondary market for microfinance securities, people often use the term synonymously with portfolio sales. The first step of a securitization is the buy-out of a micro-finance loan portfolio against a purchase consideration calculated by computing the net present value of receivables at an agreed discount rate. The originator (MFI) or a third party (such as USAID or Grameen Foundation USA) provides partial credit protection i.e. credit enhancement to the investor (Bank) in the form of a guarantee or over collaterisation etc. amounting to a certain percentage of the receivables under the portfolio by way of a lien on fixed deposit.
3) The MFI continues to service the loan portfolio in exchange for service fees. Although ICICI has purchased several microfinance portfolios, there have been only two securitization deals. In 2004, the largest ever securitization deal in microfinance was signed between ICICI Bank and SHARE Microfin Ltd, a large MFI operating in rural areas of the state of Andhra Pradesh.
4) Technical assistance and the collateral deposit of $325 K (93% of the guarantee required by ICICI) were supplied by Grameen Foundation USA. Under this agreement, ICICI purchased a part of SHARE's microfinance portfolio against a consideration calculated by computing the Net Present Value of receivables amounting to $4.3 Mn (Rs.215 Mn) at an agreed discount rate.
5) The interest paid by SHARE is almost 4% less than the rate paid in commercial loans. The other deal was conducted by ICICI Bank and BASIX in 2004 for a part of their portfolio amounting to $842 K (Rs.42.1 Mn). After this deal, BASIX felt that the reporting requirements imposed by ICICI were too demanding and decided to raise funds henceforth by other means.

CONCLUDING OBSERVATIONS

Indian MFIs are going through a massive growth phase, sparked by increased international attention in 2005 (UN Year of Micro-Credit) but more pertinently, new and better access to relatively low cost capital from banks led by ICICI Bank. Below we highlight some interesting facts about the Indian microfinance market:

Market leaders: A Mix-Market survey found that large MFIs (seven institutions from their sample of 28) dominate the market. Large MFIs hold 81% of the overall loan portfolio and serve 67% of borrowers. The three largest institutions, which alone covered 54% of borrowers, are NBFCs based in south India.

Asset Quality: Institutions sometimes undertake aggressive write-offs to sanitize their portfolios and only write-off ratio will reveal the genuineness of PAR. With 4% of their portfolio at risk over 30 days and 0.5% of write-off ratio Indian MFIs maintain good portfolio quality.

References

1. Harper, M. (2002). Grameen bank groups and self help groups: What are the difference? ITDG Publishing , 1-20.
2. Ananth, B. (2005). Financing microfinance - the ICICI Bank Partnership model. Small Enterprise Development Vol.16 No.1 , 57-65.
3. Bedson, J. (2009). Microfinance in Asia: Trends, Challenges and Opportunities. Melbourne, Australia: The Foundation for Development Cooperation.
4. Bhole, B, & Ogden, S, (2010). "Group lending and individual lending with strategic default". Journal of development Economics, 91(2), 348-363.
5. Rupapara, B., & Patoliya, J. (2012). Problems faced by Microfinance Institutions and Measures to solve it. LAP LAMBERT Academic Publishing.
6. Sa-Dhan. (2012). Financial Inclusion: A study on the efficacy of banking correpondent model. Delhi: City Foundation.