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The historical and current climate of microfinance in India

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In the developing world, India presents a unique opportunity and need for poverty alleviation. India's stable political environment and strong economic growth over the last 10 years have put the country in a position to become the third-largest economy in the world by 2050.[1] At the same time, India accounts for the largest share of the world's poor with over 860 million people in 2006 living on less than US$2 a day[2] and economic development characterised by a widening income gap between the rich and poor parts of the country.[3]

The vast numbers of poor people, combined with an increasingly favourable economic climate in India, presents a great opportunity to expand microfinance and alleviate poverty on a large scale.

Development of the microfinance environment

Since Indian independence in 1947, successive governments have emphasised the link between improving access to finance and reducing poverty.

The creation of a nationwide network of rural cooperative banks in the 1950s was an attempt to improve financial access for India's poor, 75% of whom are concentrated in rural areas.[4] This was followed by further measures aimed at increasing financial access - the nationalisation of commercial banks in the late 1960s, and an aggressive drive through the 1970s and 1980s to expand rural banking.

In 1991, government reforms allowed for an increase in commercial banking in India. The country now has a wide-spread and efficient banking set-up with around 100,000 bank branches nationwide.[5] The expansion of commercial banking has also led to a more favourable financial environment for the poor in India. It was following these reforms that the "Self-Help Groups (SHGs)–Bank Linkage" model grew to become a key part of finance for India's poor.

Self Help Groups (SHGs) are informal associations of up to 20 women. The groups provide an opportunity for individuals to pool money, and then use these funds to lend small amounts to each other with interest. Through the SHG Bank Linkage Program, established groups can apply for loans through their local bank branch, limited in size to a ratio of the group's own funds. This limit may be increased over time as previous loans are successfully repaid. This model of finance – an Indian innovation – has been very successful, increasing from just 500 SHGs linked to banks in the early 1990s, to over one million at present.[6]

However, outreach of the SHG Bank Linkage Program remains limited. The program has provided savings account facilities to about 12 million women, and credit accounts to an estimated two to four million women.[7] The program remains concentrated in south India, with nearly 75% of funds flowing to SHGs in the four southern states.[8] The SHG-Bank model has also had mixed success in targeting the poorest. For example, in Andhra Pradesh – one of India's poorest states – less than half of SHG members are from the poorest groups (as defined by size of land-holding).[9]

There are also limitations in the way the model operates. SHGs are required to demonstrate an ability to save, learn bookkeeping skills and act as a cohesive group before they are permitted to borrow and because of this it can often take a year before groups are allowed to receive their first loans.

In recent years, other institutional structures for microfinance have emerged: notably, independent specialised microfinance institutions (MFIs). The success of MFIs in India has also attracted several new private sector banks, notably ICICI Bank, UTI Bank and HDFC Bank. Some of these newer banks are pursuing innovative approaches to microfinance. They view microfinance as a potential business rather than simply a social objective or priority sector lending obligation.

While the SHG Bank model is defined by the links between SHGs and the rural branches of commercial or cooperative banks, MFIs are typically independent of the existing rural banking network. This allows MFIs to take a more flexible approach to lending. However, as with the SHG model, most MFIs provide financial services to groups of individuals and therefore face many of the same issues around the cost and time required to promote and manage these groups.

The vast majority of India's rural poor still do not have access to formal finance.

Currently, 75% of the total supply of microfinance credit is via the Self Help Group-Bank linkage route, largely financed by the National Bank for Agriculture and Rural Development (NABARD). The rest comes from MFIs, increasingly backed by commercial banks.[10]

The need for a new microfinance initiative

In spite of the success of the SHG model in the 1990s and continued growth of MFIs, the vast majority of India's rural poor still do not have access to formal finance.[11]

The rural poor face severe difficulties accessing savings and credit from the formal sector. Even where finance is available, it takes, on average, 33 weeks for a loan to be approved by a commercial bank.[12] This makes formal credit an unrealistic option for poor people, particularly for the purpose of meeting unforeseen expenses or emergencies. Difficulty in accessing formal finance has resulted in a heavy reliance on informal finance.

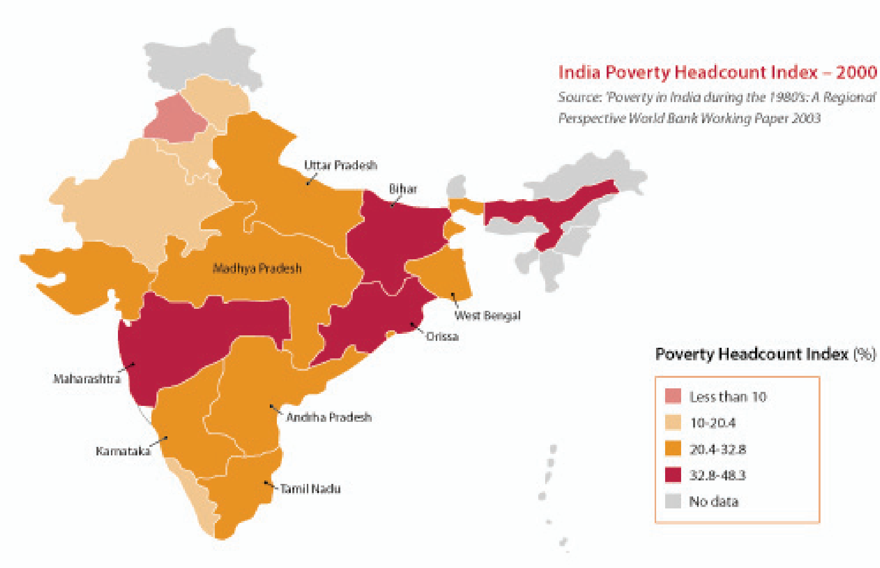
Access to other financial services, such as insurance, also remains limited among the poor. A 2003 survey showed that 82% of households surveyed had no insurance, with access particularly limited for the poorest households.[13]

Significant obstacles to expanding the commercial sector are likely to persist in the short to medium term. These obstacles arise from government imposed restrictions, and from the commercial sector's own policies, such as limited numbers of rural branches and employing few staff with local knowledge.

As a result of such obstacles, most microfinance institutions have been very region-specific, small in size and their collective outreach has been limited. By 2004, the microfinance sector, as a whole, had outstanding portfolios of around A$150 million, reaching less than two million people.[14] In comparison, MFIs in Bangladesh are reported to reach more than 60% of the poor in the country, with the larger programs - such as Grameen Bank, BRAC, Proshika and ASA - all reaching well over one million clients each.[15]

Though India has experienced strong economic growth at the national level in recent years, that growth has been uneven in its geographical distribution. Despite recent progress, India's lower-income regions have not seen growth accelerate. Bihar (a state in north India) averaged 2.2% growth between 1980 and 2004, compared to 7.2% in Karnataka (a southern India state).[16]

This skewed distribution of growth is mirrored in the extent and availability of microfinance across regions. India's lesser developed and low-income eastern, central, and north-eastern regions account for 54% of the population, but only 20% of outstanding credit and 29% of deposits.[17]



Slower economic growth in the central, eastern, and north-eastern states has also resulted in little demand for credit among subsistence poor people. This has been matched by an absence (for historical reasons) of good quality NGOs willing to initiate microfinance programs in these states.

Some 60% of the increase in India's population between now and 2050 is expected to come from four of India's most populous and poorest states where financial access for the poorest people is less prevalent.[18] Extending the scope and availability of microfinance is therefore particularly important given the population growth expected in India's poorest states over the medium to long term.

An opportunity for a new microfinance initiative

India's recent economic history is one of sustained and rapid growth. India's real GDP grew by 9.2% in 2006 and by just over 8% in the three years before that. This compares with a figure of around 6% in the 1980s and 1990s, and 3.5% in the three decades before 1980.[19] Though the economy remains mostly agricultural, business processing, information technology, telecoms and manufacturing have boomed in recent years. Looking forward, the government's five-year plan to 2011/12 is based on a target of 9% average annual growth. The consensus of economic forecasters in India is for growth of at least 8% over the next five years. However, there is also a broad consensus that weak infrastructure investment and bureaucratic red-tape present risks to India's economy. The government must address these issues to ensure sustained future growth.[20]

In the short term, growth is forecast to moderate slightly in 2007/08 and 2008/09 but domestic demand is expected to remain buoyant. This will provide a positive environment for business start-ups, as 97% of retail sales are made from microbusinesses.[21]

Accordingly, retail sales from these small businesses are expected to grow by A$77 billion in the next three to four years (from A$370 billion to A$447 billion).[22]

India's fiscal budget for 2007 has been depicted by the government as a budget for relieving poverty through *'inclusive growth, equity and social justice'*.[23] Boosting farm output and raising spending on education and health are two of the key measures in the budget.

The Indian government has also given approval for enactment of legislation on the microfinance sector in India. The Micro Financial Sector (Development and Regulation) Bill, 2006 will provide a legal framework for entities engaged in microfinance. The intention of the Bill is to facilitate greater transparency, more effective management and better governance of the microfinance sector.[24]

The entrepreneurial environment for poor families in India has also improved in recent years. For example, the availability of telephone and internet services has improved significantly in rural areas in the past five years. These services give instant, low-cost information on the relative prices of products and services in different market towns greatly improving an individual's bargaining power relative to more powerful/ wealthier traders. The internet has also made crucial information available to individuals that would previously have taken time and expense to access – for example, land records and passport application forms.

Conclusion

There is an enormous continued need for microfinance for the poorest people in India. India has been, for many years, a 'global laboratory' for anti-poverty programs. The political, regulatory and economic environment for microfinance has been steadily improving for many years now.

Recent strong growth in microfinance – albeit from a low base – suggests that the environment is favourable and demand for financial services is strong. However, coverage continues to be partial, with a huge number of poor households in India still unable to access finance.

Recent rapid growth in the east, continued deregulation and the current strong economic environment all suggest that there has probably never been a more favourable time for an initiative to increase the availability of microfinance across India.

Opportunity International Australia has developed a strategy for a national microfinance and enterprise development program in India which aims to reach millions of clients in the coming years. This strategy includes extension of microfinance to many areas in the north and northeast of India, where demand for financial services grossly outweighs supply.

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Opportunity International is a global leader and pioneer with over 35 years experience in providing microfinance and enterprise development to the working poor in developing countries. Microfinance includes the provision of collateral-free loans, savings, insurance and money transfers. Enterprise development incorporates a variety of training and support services for establishing and growing small businesses. Our desire is to see clients, their families and their communities transformed with dignity, empowerment and hope. Opportunity is inspired by Jesus Christ's call to serve the poor without regard to ethnicity, gender or religious affiliation. We are guided by four core values: respect, commitment to the poor, integrity and stewardship.

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