

## Microfinance: A tool for the socio-economic development of poor

<sup>1</sup> Aanchal Singhal, <sup>2</sup> Dr. Bindu Arora

<sup>1</sup> Faculty-DMS, JSS Academy of Technical Education, C-20/1, Sector 62, Noida, Uttar Pradesh, India

<sup>2</sup> Professor, Kanya Gurukul, II Campus, Gurukul Kangri University, 47 Sewak Ashram Road, Dehradun, Uttarakhand, India

### Abstract

Microfinance is “the provision of financial services to low-income poor and very poor self-employed people”. Microfinance has a very important role to play in development according to proponents of microfinance. UNCDF (2004) states, studies have shown that microfinance plays three key roles in development. It helps very poor households meet basic needs and protects against risks, is associated with improvements in household economic welfare, helps to empower women by supporting economic participation and so promotes gender equity.

Microfinance programmes like the Self Help Groups (SHGs) in India, are playing a vital role in extending micro-finance to the rural poor. SHGs have been increasingly promoted for their positive social and economic impact and their role in the empowerment of rural poor. A number of studies have been undertaken regarding the relationship between microfinance and socio-economic development of poor.

The present paper constitutes an environmental scan in order to get an overview of the delivery models of microfinance and models which are prevailing in India to empower the rural poor. It was decided to undertake a literature scan through the internet and collect secondary data, wherever possible, of published and unpublished reports/research studies brought out by the state, NGOs as well as by research institutions. An attempt is made to collate the information that has been collected from these various sources. This paper contributes by putting forth the statement that microfinance can be a way out to empower poor socially and economically and enable them to become self-reliant. The main objective of the study is to know the delivery channels of microfinance for the socio-economic development of rural poor.

**Keywords:** social and economic impact, microfinance, poverty alleviation, rural poor

### Introduction

In developing countries, financing to the rural poor through formal financial services failed to meet the credit requirements of the rural poor people. The main reason of failure was absence of any recognised employment and hence absence of collateral with the poor. The high risk and the high transaction costs of banks associated with small loans and savings deposits are other factors which make them non-bankable. The lack of loans from formal institutions leaves the poor with no other option but to borrow money from local money-lenders on huge interest rates. In different countries including India, efforts have been made by their governments to deliver formal credit to rural areas by setting up special agricultural banks/rural banks or directing commercial banks to provide loans to rural borrowers. However, these programmes have also not worked well due to various reasons. The common reasons found by many researchers are the political difficulty for governments to enforce loan repayment and the selection of relatively wealthy and influential people, rather than the poor, for bank loans. This leaves the bottom poor without access to financial services apart from those provided by money-lenders and family. Thus, the inability of formal credit institutions to deal with the credit requirements of poor effectively has led to emergence of microfinance as an alternative credit system for the poor.

In 1976, Muhammad Yunus, a professor of Economics at Chittagong University, Bangladesh initiated an experimental research project of providing credit to the rural poor. He gave a small loan of 856 Taka (\$27) from his pocket to 42 poor

bamboo weavers and found that small loans radically changed the lives of these people and they were able to pay back the loans with interest. The success of this idea led Yunus to establish Grameen Bank in 1983 in Bangladesh. This programme showed astonishing growth rates in Bangladesh, particularly during the 1980s and 1990s. It encouraged social innovators and organisations all over the world to begin experiments with different microfinance delivery methods to bring financial services to the poor. It is now adopted worldwide in the countries of different continents.

Microfinance scheme provides a wide range of financial services to people who have little or nothing in the way of traditional collateral. It helps them to build up assets, survive crises and to establish small business to come out of poverty. Except extending small loans (micro-credit), microfinance programme provides various other financial and non-financial services such as savings, insurance, guidance, skill development training, capacity building and motivation to start income generating activities to enhance the productivity of credit. This innovative programme is reaching the poor people especially women and has an impact on their socio-economic development as well as their empowerment.

### Delivery Models of Microfinance

The concept of microfinance involves informal and flexible approach to the credit needs of the poor. There is no single approach or model that fits in all the circumstances. Therefore, a number of microfinance models emerged in different countries/states according to the suitability to their local

conditions. Broadly, the microfinance delivery methods can be classified into six groups as follows:

### **Grameen Bank Model**

Grameen Bank model is one of the oldest and most successful models of microfinance, developed in Bangladesh. In this model microfinance programme participants are organised into groups of five members. They make mandatory contribution to group savings and insurance fund. Each member maintains her individual saving and loan account with the bank and after contributing to the savings fund for a fixed time the group members receive individual loans from the bank. But the group is not required to give any guarantee for the loan repayment by its member. Repayment responsibility solely rests on the individual borrower and there is no form of joint liability, i.e. group members are not responsible to pay on behalf of a defaulting member. Loans are provided for six months to one year duration but repayments are made weekly. Bank staff make periodic visits to the groups, maintain individual records of group members and facilitate all the financial transactions.

### **Joint Liability Group Model**

In this model, 4 to 10 individuals are organised in a group known as a Joint Liability Group (JLG). The group members can avail bank loans against mutual guarantee and there is no condition of their own saving fund. All members sign a joint liability contract, making each one jointly liable for repayment of all loans taken by all individuals in the group. Thus, only social collateral is provided to the lending institution. The JLGs are intended primarily to be credit groups and regular savings by the JLG members are not mandatory. NABARD is using this model for providing credit to the tenant farmers, cultivating land either as oral lessees or share croppers, and small farmers who do not have proper title of their land holding.

### **Individual Lending Model**

In this method, individuals can get loans without any membership of a group. This is a straightforward credit lending model in which micro-loans are given directly to the borrowers. In this model, the financial institutions have to make frequent and close contact with individual clients to provide credit products customised to the specific needs of the individual. It is most successful for larger, urban-based, production-oriented businesses.

### **The Group Approach**

The group approach delegates the entire financial process to the group rather than to the financial institutions. All financial activities like savings, getting loans, repayment of loans and record keeping are managed at the group level. In this method, 10-20 members are organised to form a group. These group members make regular savings of fixed amount in a common fund. The amount and frequency of savings is mutually decided by the group members. After the successful working of such a group for some months the group is linked to a financial institution for getting credit. The financial institutions issue loan in the name of group and whole group is considered responsible for repayment. The amount of loan depends upon the total accumulated amount of saving of the group. In India, the group based credit delivery method known as SHG-BLP is a predominant method of providing microfinance.

### **Village Banking Model**

This village banking model is an expansion of the group approach. This model was developed in Bolivia during the mid 1980s by the Foundation for International Community Assistance (FINCA), a non-profit microfinance organisation. In this model, a Village Bank is developed by grouping 30 to 100 low-income individuals who seek to improve their lives through self-employment activities. The bank is financed by internal mobilisation of members' saving fund as well as loans provided by the sponsoring MFIs. The MFIs lend capital to the bank, which then lends the money to its members. Members themselves run the village bank, they choose their members, elect their own officers, establish their own by-laws, distribute loans to individuals and collect savings and payments. Loan amounts are linked to the aggregate amount saved by individual bank members. Loans are repaid weekly in small installments. Thus, village banks have a high degree of democratic control and independence.

### **Credit Unions and Co-operatives**

A credit union is a democratic, not-for-profit financial co-operative. It is owned and governed by its members, who are at the same time the owners and the customers of their co-operative society. Co-operatives are often created by persons belonging to the same local or professional community or sharing a common interest. Co-operatives generally provide their members with a wide range of banking and financial services. Members participate in all the major decisions and democratically elect officers from among themselves to monitor the administration of the co-operative. Loans are granted only to the members.

### **Institutional Arrangement and Disbursement of Microfinance in India**

In India, there is a wide variety of institutions in public as well as private sector which provide microfinance to the poor. These institutions can be broadly divided into two types. First type is the traditional formal financial institutions, while the second type is Microfinance Institutions (MFIs). The traditional financial institutions comprise of commercial banks, regional rural banks and co-operative banks. They provide microfinance services in addition to their general banking activities and are referred to as microfinance service providers. On the other hand MFIs are different types of financial institutions whose main financial activity is providing microfinance only. Many of these institutions are NGOs, Mutually Aided Co-operative Societies (MACS) and Non-Banking Financial Companies (NBFCs). In case of traditional financial institutions both private and public ownership are found but the MFIs are mainly in the private sector. These financial institutions use a hierarchical network starting from the apex wholesale level to the retail level financial institutes. The retail level banks and MFIs borrow funds from apex financial institutions and use their branch network to provide microfinance at the doorstep of poor people. Some of these apex and retail level financial institutions have been discussed below:

#### **Apex Financial Institutions**

The formal microfinance service providers include a number of apex financial institutions. Some of them are like National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI),

Rashtriya Mahila Kosh (RMK), Friends of Women World Banking (FWWB), Housing Development Finance Corporation (HDFC), Housing and Urban Development Corporation Limited (HUDCO), and Rashtriya Gramin Vikas Nidhi (RGVN). They provide bulk amount of funds to retail level banks and MFIs for on-lending to the poor. There are different terms and conditions associated with each apex financial institute. In addition to these apex financial institutions, many MFIs get funds from investors, lenders and donors also.

### **Retail Level Banks**

At the retail level Commercial Banks, Regional Rural Banks, Co-operative Banks, and different types of MFIs provide microfinance services. In India, there are about 60,000 retail credit outlets of the formal banking sector in the rural areas.

### **Microfinance Delivery Models in India**

In India, microfinance is provided through the SHG-Bank Linkage Model (SHGBLM) and Microfinance Institution (MFI) Model. The SHG-BLM developed by NABARD is widely prevalent throughout the country. In this model, the informal SHGs are credit linked with the formal banking system. On the other hand, MFI model is used by the various MFIs which emerge to reach the rural poor people in the areas not served by the formal banking sector. These MFIs provide financial services to the individuals or to the groups like SHGs, JLGs and Grameen groups.

### **Self-Help Groups (SHGs) and their Functioning**

SHGs are small, informal and homogeneous groups of 10 to 20 members each. These groups are formed by the bank officials, NGOs and various other institutions at the village level. Members of almost equal economic and social status are chosen to minimise any mutual conflict. Each such group is given a name and each group has a head, cashier and secretary, democratically elected by the group members to manage the group affairs. The members are encouraged to make a voluntary thrift on regular basis. The group members mutually decide about the amount and frequency for individual savings to be deposited in the group account. They use this pooled resource to make small interest bearing loans to their members within the group. This process, known as inter-lending, gradually builds financial discipline among the group members and they learn to handle resources of a size that is much beyond their individual capacities. The SHG members begin to understand that resources are limited and have a cost. Once the groups show this mature financial behaviour (generally after six months of group formation), banks are encouraged to provide loan to the SHG in certain multiples (three to four times) of their accumulated savings. The bank loans are given without any collateral and at specified interest rates. Banks find it easier to lend money to the groups rather than providing small funds to individual members. The peer pressure ensures timely repayments and replaces the collateral for the bank loans. Generally, the banks charge between 9-10 per cent rate of interest per annum from the SHGs. The group members themselves decide the terms of loans and the criteria of dividing the loan among the group members. If only some of the group members use the whole loan then they have to pay interest to the group account also. The rate of interest is mutually decided by the group members. The group gets the

second loan from the bank only after repaying the first loan successfully and so on. The conceptual thinking behind SHG initiative is that the mutual help within the participants of the programme can be a powerful vehicle in the upward socio-economic transition of the poor.

### **SHG-Bank Linkage Model**

SHG-Bank Linkage Model (SHG-BLM) is developed in India to provide microfinance with the help of vast rural network of the formal financial sector. In this model, the informal SHGs are credit linked with the formal financial institutions. The SHG-BLM has emerged as a dominant model in terms of number of borrowers and loans outstanding. This model is flexible, independence creating, and imparts freedom of saving and borrowing according to the requirements of group members. Due to widespread rural bank branch network, the SHG-BLM is very suitable to the Indian context. Microfinance movement started in India with the introduction of SHG-Bank Linkage Programme (SHG-BLP). The programme uses SHGs as an intermediation between the banks and the rural poor to help in reducing transaction costs for both the banks and the rural clients. Banks provide the resources and bank officials/NGOs/ government agencies organise the poor in the form of SHGs. Under this programme, loans are provided to the SHGs with three different methodologies:

**Model I: SHGs Formed and Financed by Banks:** In this model, banks themselves take up the work of forming and nurturing the groups, opening their savings accounts and providing them bank loans.

**Model II: SHGs Formed by Agencies Other than Banks, but Directly Financed by Banks:** In this model, NGOs and other formal agencies in the field of microfinance facilitate organising, forming and nurturing of SHGs and train them in thrift and credit management. The banks directly give loans to these SHGs.

**Model III: SHGs Financed by Banks Using Other Agencies as Financial Intermediaries:** This is the model where the NGOs take on the additional role of financial intermediation along with the formation of group. In areas where the formal banking system faces constraints, the NGOs are encouraged to form groups and to approach a suitable bank for bulk loan assistance. This method is generally used by most of the NGOs having small financial base.

### **Conclusion**

Microfinance has been proclaimed a tool to lift poor people, particularly women, out of poverty by providing access to credit to fund business endeavours. Microcredit has expanded into microfinance, which consists of offering a variety of financial products to poor customers, including savings products, pension products, insurance products, and credit for non-business expenditures. This can provide them greater opportunity to improve their financial situation, prepare for a future, and offset financial risk, much like the traditional finance sector. It is very important and vital to address these issues and for this an integrated approach of Government, Banks and NGOs is crucial. The institutional efficiency needs to be increased. Speeding up the delivery process is also very important. Easy access to credit, flexibility in the repayment

schedule, conceptualization of new schemes for the poor should be considered. Role of NGOs, too, is equally important as they serve as the most important element to create awareness among the rural poor. They should give wide publicity to rural banking and its linkage programmes at local level and must enable the Rural Indians to participate in the decision making process at the bottom level. These measures can significantly make the Self Help Groups effective and efficient in order to boost the Rural Economy of India.

## References

1. Adams DW, Graham Douglas H, Von Pischke JD. Undermining Rural. Development with Cheap Credit, Westview Press, Boulder, Colorado, USA, 1984.
2. Asian Development Bank Finance for the Poor: Microfinance Development Strategy, Asian Development Bank, Manila, 2000.
3. Chandra S. Non-Government Organization: Structure, Relevance and Function. New Delhi: Kanishka Publishers, 2001.
4. Desai V. Rural development in India: Past, Present and Future (second ed.). Mumbai: Himalaya Publishing House, 2005.
5. Ghate P. Microfinance in India: A State of the Sector Report, Microfinance India Publications, New Delhi. 2006, 2007,
6. Ghate P. Microfinance in India: A State of the Sector Report, Microfinance India Publications, New Delhi. 2007, 2008.
7. Hulme D, Mosley P. Finance against Poverty, Routledge, London, 1996.
8. Kamdar S. Economic Growth and Human Development – A Study of Maharashtra. Mumbai: Himalaya Publishing.
9. Kay T. Empowering women through self- help micro-credit programmes. In: Bulletin on Asia-Pacific Perspectives 2002/03 (<http://www.unescap.org/>), 2002.
10. Kirkpatrick C, Maimbo M. The Implications of the Evolving Microfinance Agenda for Regulatory and Supervisory Policy, Development Policy Review, 2002; 20(3):293-304.
11. Mahajan Vijay, Nagasri G. Building Sustainable Microfinance Institutions in India”, Paper Presented in Seminar on New Development Finance, Frankfurt, Germany, 1999.
12. Narayanaswamy. Micro-Credit and Rural Enterprises. Journal of Rural Development, 2005.
13. NIRD. National Movement in SHG movement in the country and SGSY. Hyderabad 2001.
14. Sen A. The Argumentative Indian. New Delhi: Penguin Books, 2005.
15. Varma S, Pawar Y. Rural Empowerment: Through SHGs, NGOs and PRIs, National Slum Dwellers Federation in India. New Delhi: Deep and Deep, 2005.
16. Voluntary Action Cell National Policy on Voluntary Sector. Planning Commission: Government of India. 2007.
17. Yojana Magazine. Wikipedia, the Hindu & the Google.