Microfinance and the State:
Exploring areas and structures of collaboration[1]

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1.0 The Present[3]

1.1 Introduction

The microfinance sector has emerged from the efforts of Non-Governmental Organisations (NGOs), and as a response to the failure of existing structures to deliver financial services to the poor. The efforts by NGOs have emerged from grassroots and represent diversity. They do not fit into a straitjacket. Therefore, unlike the other structures like cooperatives, Regional Rural Banks (RRBs) and commercial banks, it is difficult to get statistics on microfinance. It is also difficult to make policy recommendations that impact the sector as a whole.

In the past decade, the state has seen microfinance as a tool to meet the financial service requirements of the poor. It has framed policies that enable the increased access to financial services for the poor. The pronouncements made in the annual budgets have been translated through a series of follow up measures by other institutions that are run/influenced by the state. The following have been the significant initiatives:

- Setting up of the Rashtriya Mahila Kosh to re-finance microfinance activities of NGOs
- Encouraging National Bank for Agriculture and Rural Development (NABARD) to set targets for the self-help group (SHG) – Bank linkage programme
- Emergence of Sidbi Foundation for Micro-Credit as a financier of microfinance institutions (MFIs)
- The pronouncements of the Reserve Bank of India (RBI) from time to time – such as
  - including lending to SHGs as a part of priority sector targets
  - exempting non-profit companies doing microfinance from registering as as an NBFC
  - permitting the establishment of local area banks (now withdrawn)
- Routing some poverty oriented schemes such as the Swarnajayanti Gram Swarozgar Yojana (SGSY) through SHGs
- The close linkage built by DWCRA schemes
- The initiatives of various state governments in promoting schemes such as Swa-Shakti (Gujarat), Velugu (Andhra Pradesh)

The state has built linkages with NGOs in order to reach the poor. In this paper we review the role of state and examine the linkages so that the resources state is leveraged effectively to benefit the poor in a sustainable manner.

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[1] An early version of this paper was presented at the Sa-Dhan annual conference in Delhi, September 12th 2003. The research for this is carried out under the Sir Ratan Tata Trust Fund for Research Collaborations in MicroFinance instituted at Indian Institute of Management Ahmedabad (IIMA)

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[3] All data unless otherwise acknowledged is sourced from "Trend and Progress of Banking in India" published by the Reserve Bank of India. Except for historical data all references pertain to the report for the year ended 2003.

The role of the state is intertwined with the function of the other players dealing with the poor. The major players are - commercial banks, RRBs and cooperatives. This paper focuses on the rural poor, while acknowledging that the problem of access to financial services to the urban poor is important. The need to work with the urban poor is often missed because of the nature of arrangement of data. However the state has to recognise that the urban poor have distinct problems. They also need to be addressed in an organised manner.

1.2 Commercial Banks and the rural poor

The public sector banks on the whole have been achieving the set target of 40% of net bank credit to the priority sector in the past years. It has risen from 39% in 1999 to 42% in 2003. The lending to agriculture has shown an increase, but still falls short of the 18% overall target set for agriculture. The lending to small industries has fallen. The advances to other priority sectors have shown an impressive increase in these years (from 9 to 15%).

The public sector banks have consistently failed to meet the target to reach weaker sections of the society. The target set for the weaker sections is 10% of the net bank credit, while the achievement of public sector banks was 6.76% in 2003, a fall from 7.3% in 2002. This indicates that while the banks have been able to reach the priority sector target in overall terms, their ability to penetrate to the weaker sections, or make small loans are inadequate. The growth in "other priority sectors" indicates a growth in export, housing and other priority areas rather than those that deal with the poor and the vulnerable.

The public sector banks have achieved a greater penetration compared to the private sector banks vis-à-vis the weaker sections. The achievements of the private sector banks in case advances to agriculture are 10.8% (Target: 18%) and for the weaker sections are as low as 1.48% (Target: 10%). The new generation private sector banks have not achieved any penetration vis-à-vis the weaker sections. We need to examine alternate mechanisms to ensure that these banks reach the poor.

The statistics on the non-performing assets (NPA) in advances to the weaker section is not encouraging. While it is futile to discuss the NPAs of the private sector banks since their advances are so miniscule, the figures for public sector banks indicate that NPA levels for this category of assets was 20%. The NPAs on the overall portfolio was 9.36%. Therefore the concern of lending to weaker sections may not be misplaced. However, the banks have to examine mechanisms of reaching the poor in a manner that is not risky.

1.3 Regional Rural Banks[4] and the rural poor

RRBs were created to have targeted lending in the rural areas. The performance of RRBs over the years has not been great. In the past few years the RRBs have turned around from their extended state of sickness. Even so, the loans as a percentage of resources at their command (Credit-Deposit Ratio) is falling, but for an improvement in 2003. The ratio of RRBs should be compared to the commercial banks. Over the years, the commercial banks had CD ratio of 60% as against the CD ratio of RRBs ratio of 40%. This means that the turnaround story of the RRBs has been at the cost

[4] Some aspects of the data on RRBs are available only upto March 2002. We have used the latest figures available.

of access to credit to rural areas. In the years where the deployment of credit was high (1997), the NPAs were also high at 36.8%, and the system as a whole was incurring losses. The NPA ratio has consistently fallen in the past years and now it is time for RRBs to get back to their basic business of lending. This co-incides with a stable and low interest rate regime and therefore opportunities for arbitrage in the money market and interest earnings from investments which were a major source of income in the past years, are going to have limited impact on the bottom lines of the RRBs. However, the fact is that RRBs provide an outlet for the rural people to save.

Table 1: Results of RRBs over the years (Rs.Crores)

Details	1997	1998	1999	2000	2001	2002	2003
Resources Mobilised	16,971	20,978	26,319	31,306	38,696	44,873	50,190
Loans Outstanding	8,718	9,692	11,356	13,109	15,794	19,075	22,585
Interest income	1,606	2014	3286	3895	4625	5191	5501
Other Income	87	107	157	205	234	372	430
Operating Profits	(53)	133	335	530	730	774	714
Net Profits	(589)	76	247	428	600	608	524
CD Ratio	50.3	46.2	43.3	42.14	42.07	42.51	45.00
Investment Deposit Ratio	14.66	16.82	19.69	20.00	20.38	15.67	25.90
Standard Assets	63.2	67.2	72.2	76.9	81.2	83.9	n.a
Non-Performing Assets	36.8	32.8	27.8	23.1	18.8	16.1	n.a

Source: Trend and Progress of Banking in India, RBI (Various years)

In the past several measures were taken to improve the performance of the RRBs. These included a programme of recapitalisation to the extent of Rs.2,188 crores, examining of merger of RRBs sponsored by the same bank, and closing of non-profitable branches. In addition, they have been encouraged to issue Kisan Credit Cards, and use microfinance as a mechanism to reach the poor by encouraging them to promote and lend to SHGs. The de-regulation of interest rates has gone a long way in making RRBs competitive and market savvy. In 2002 a working group also submitted a report recommending changes in the RRB Act, which if implemented would change significant aspects of operations of the RRBs[5].

1.4 Cooperatives the rural poor

The cooperative structure has not been performing very well in the last decade. There are authors who argue that the emergence of the microfinance movement was due to the failure of the cooperatives in providing sustained access to credit to the poor. From Table 2, it is evident that the resource availability for cooperatives is falling in the past few years. If prudential norms applicable to the banking institutions were applied to the lower tier cooperatives, most of the primary and district cooperatives would be found wanting. From Table 2 it is evident that a significant part of the re-financing is for conversion of short-term loans to medium term – illustrating the extent of delinquency.

The state cooperative banks were, with 23 of them making profits as against 6 incurring losses. However the recovery performance of these banks was 81% - inadequate for a vibrant banking system. The greater cause for concern is that these banks stand at the top of an apex structure having an extremely weak foundation.

[5] Government of India (2002): Report of the Working Group to Suggest Amendments in the Regional Rural Banks Act, 1976. Delhi: Ministry of Finance.

The performance of the district cooperative banks and the primary cooperative societies are discussed below.

Table 2: Refinancing of agriculture by NABARD in the past years (Rs.Crore)

Details	2000	2001	2002	2003
Refinance for agriculture (Drawals)	6,848	7,295	8,286	5,055
Refinance for agriculture (outstanding)	3,611	4,384	4,440	4,887
Medium term loans	29	5		
MT Outstanding	106	69	40	21
SAO Conversion	5,186	11,971	30,743	1,818
SAO Conversion outstanding	35,053	29,732	44,292	35,575

Source: www.nabard.org

The district cooperative banks do not have a rosy picture on recovery percentages. In 2002, the recovery of these banks 66%. Of all the district cooperative banks, 258 were showing profits and 110 were showing losses. The most significant change in the balance sheets of these banks was the decline in the rate of growth of deposits and loans and advances. Investments grew faster. This indicates that the customers (borrowers and depositors) are moving away from the banks, and these banks are deploying funds in investments. While this added marginally to the profitability the movement was away from the clients. The health of the cooperative structure deteriorates as we move nearer the rural client. This does not bode well for the structure that has the best outreach to rural India. The data about the primary societies is not readily available, but the broad trend indicates that the channel continues to have huge NPAs. The data of the long-term credit structure is also depressing, but we do not deal with that in this paper.

1.5 NABARD

NABARD is the apex financial institution for agriculture and rural development. We examine the role of NABARD in microfinance later. But the linkage between banks and NABARD is worth a discussion. NABARD is expected to re-finance the rural portfolio of the banks and cooperatives. With the falling interest rates, banks do not find it attractive to borrow from NABARD. The other role that NABARD performs is to manage the Rural Infrastructure Development Fund (RIDF). In case the banks are unable to achieve the priority sector lending targets for agriculture, the banks are expected to deposit the shortfall with NABARD under the RIDF. This fund is used by NABARD to fund rural infrastructure projects. While the banks falling short of their targets have been depositing the amounts with NABARD, NABARD has not deployed these funds effectively. NABARD has disbursed only around Rs.13,000 crores out of the total corpus Rs. 23,000 crores available under various phases of RIDF. Therefore the amount that should have rightfully reached the rural economy has not reached them, either directly or indirectly.

1.6 Other schemes promoted by the state

The differential rate of interest scheme still introduced in 1972 is still implemented throughout the country. RBI has also mandated a target under this scheme to ensure that a certain percentage of the aggregate advances go to the weaker sections at a concessional rate. While the scheme is still in operation the banks are unable to achieve the targets.

One of the most popular schemes of the government is SGSY, launched in 1999. This is a revamped version of the Integrated Rural Development Programme (IRDP). Several of the anomalies that were identified in IRDP have been examined in the re-packaged scheme. A part of the loans under this scheme goes through SHGs. This has helped in beneficiary identification through participatory methods. The subsidy element is back-ended to have an incentive to pay back the loans. The rates of subsidy have been rationalised. In 2001-02 a total bank credit of Rs.1,109 crores were disbursed to around 8 lakh poor under this scheme. Around 40% of the beneficiaries were women. This scheme has helped in linking the state with the microfinance sector. MFIs are increasingly seen as an efficient delivery channel.

In addition to schemes that targeted the poor, the Kisan Credit Card scheme introduced in 1998-99 continued to grow and provide access to financial services to the rural areas. RRBs and the cooperatives issued a significant proportion of the Kisan Credit Cards. To ensure that smaller farmers are also provided this facility, the floor limit of Rs.5,000 for the card was also removed.

1.7 SHG-Bank Linkage Programme

One of the most successful programmes supported by the state in the microfinance sector has been the bank linkage programme. The initiative is getting attention at the highest levels including in finance ministers' annual budget speech. By 2003, around 7 lakh groups were linked to the banks and around 5 lakh groups were refinanced by NABARD[6]. The cumulative disbursement of loans to these SHGs was Rs.2,048 crores. For the year 2003 a disbursement of Rs.1,022 crores was made, indicating a rapid growth. However the linkage programme is skewed in favour of the southern states, particularly Andhra Pradesh. AP accounts for 39% of the total linkage, while the linkage in Northern and North-Eastern region together is 5% of the total programme. This imbalance has to be looked into. From the figures, it is evident that the amounts being routed to the poor through the microfinance are small compared to the amounts required. This is in spite of microfinance grabbing significant mind, media and policy space.

The bank linkage strategy is a time consuming process. Achieving regional balance is not going to be easy. Some of the states – particularly in the north, east and north-eastern regions have a chequered history of dealing with formal credit. It therefore, calls for significant preparatory work to put an alternative credit mechanism in place. This process of capability building and social mobilization cannot be easily accelerated. The reason for success of the SHG-Bank linkage programme in states like AP is attributed to the existence of strong institutions involved in social intermediation and helping in formation of SHGs.

2.0 Exploring areas of collaboration

From the above discussion we can infer that formal agencies have limitations in reaching out to the poor. This is because these agencies are involved in multiple activities and cannot devote the attention that poor deserve. The cost structures do not permit them to undertake large number of small transactions, unless it is met

[6] NABARD Data is sourced from its website www.nabard.org

with risk free volumes. Unfortunately, the experience of the banks does not indicate that these volumes come without risk. When the exposures of the banks for this segment have gone up, the default rates have also gone up. This might be because banks have not applied appropriate methods for banking with the poor.

The state has been using these institutions to channel its developmental schemes. In the past, the state largely relied on the twin channels of cooperatives and rural branches of banks to direct its subsidy-based programmes to the poor. As these institutions have presence in the rural areas and also deal with finances, the choice was natural. However it had two effects.

1. The state wants to have a say in how the schemes are implemented. As a supplier of finances this should be expected. This resulted in an interference with functioning of the institutions often leading to a compromise on the assessment norms applied by these institutions. This not only affected the portfolio quality of the schemes driven by the state, but had a ripple effect on the residual portfolio.
2. Due to the weakening of portfolio and overall profitability of the institutions (particularly cooperatives), the state took responsibility to strengthen the institutions by infusing additional capital and "professional" workforce. This converted the state on one hand and the workforce on the other to behave like "patrons" than as providers of financial services.

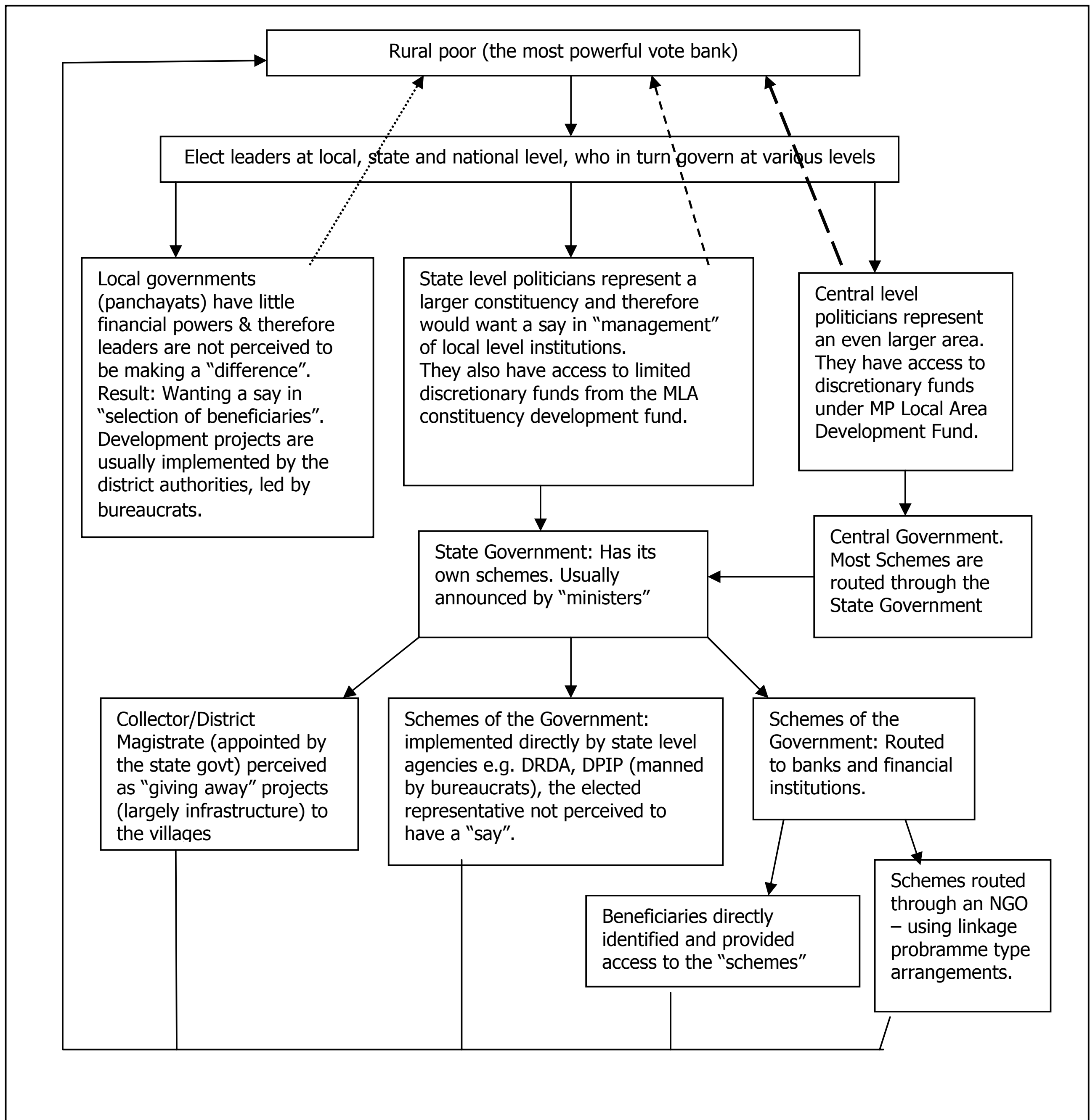
In addition to the above is the involvement of the elected representatives in "beneficiary identification" process through formal committees or through informal influence to ensure that their role is visible in the process. This was sharply evident in the Velugu project of the AP government. In Velugu the state chose an unconventional method to reach out the state sponsored schemes to the poor, by deciding to run it as an independent unit. They used SHGs (both existing and freshly promoted ones) as the main vehicle of implementation at the grassroots level. This was topped by village level and mandal level organisations that federated the grassroots SHGs. This design did not involve the elected representatives in any manner. As this was one of the largest programmes implemented by the state, there were legitimate demands by the elected representatives to be involved. They wanted to have an influence on how the project could be implemented in their respective constituencies. This is natural in any state-sponsored scheme, and the state ultimately yielded.

We have to recognize that when there is a movement away from the direct delivery towards delivery through independent channels, the distance between elected representative and the electorate increases. This creates tension. While discussing collaborations, it is necessary to build this into the planning process.

2.1 Levels of involvement of the state: direct, partnerships and regulatory

The state could get involved at various levels in developmental activities. When it comes to providing financial services the state has two choices – the first being implementing the schemes directly through its bureaucracy or through specialized agencies like Velugu. Direct implementation has worked in some parts, but in the context of financial services, it has not worked effectively.

Figure 1: Examining the linkages between electorate and the elected.



Sometimes the success of a project in a certain pocket in itself turns out to be the undoing of the project because of the urge to replicate a successful model in a rapid manner[7]. Usually in such cases the essence of the original is lost. We have seen this in replication of Anand Pattern dairy cooperatives. The project met with varying degrees of success depending on the location and therefore we have to remember that a common design may not work in different settings.

We have seen a pattern in routing of poverty oriented schemes. During the early plan periods the state explored the option of partnering with cooperatives. Later with the bank nationalization, it used the nationalised banks for delivering the schemes. At various stages the state tried promoting new institutions to address the issue – like RRBs and hybrid cooperatives promoted by commercial banks. Except for some pockets all attempts to get a mix of commercial activities with a developmental goal were met with limited success. The state has to re-think on its intervention strategy.

Given the trend of the state moving away from direct intervention in strategic sectors like petroleum, aviation and power, a similar approach could be expected in rural financial services sector as well. This does not mean that the state gives up its welfare orientation. Not when the incidence of poverty continues to be high. The involvement of the state is important. However the state has to structure its relationships with the sector that offers financial services. Now that controls even on the public sector banks are slowly being relaxed an atmosphere must be created to encourage banks to explore collaborations to provide financial services to the poor effectively. In the following part we examine the possible role of state through direct involvement, partnerships and through regulatory and policy support.

2.2 Role of the State through Direct Involvement

In the chain of benefits that flow from the state to the rural areas and poor have several stakeholders. It is critical to recognize the role of these stakeholders. The elected representatives, bureaucrats and NGOs have been taking up the "developmental" cause. We also have formal and informal institutions taking up the "commercial" cause.

The developmental cause is served at two levels.

1. Address the needs of a particular region. This involves creating livelihood opportunities, infrastructure facilities, ensuring information flows and providing access to markets. Most of these activities are taken up with the direct involvement of the state. In most instances the state implements these projects. Even if these are outsourced, it is the face of the state that is visible.
2. Address the needs of individuals among the poor. This involves getting individual households out of poverty by directly addressing their needs through a system of subsidies and access.

These roles have to be approached differently. The involvement of the bureaucrats and elected representatives will be crucial to ensure that we get the priorities right and are also responsive to the developmental needs of any geographical area. This also ties in very well with the discretionary funding that the elected representatives have for the overall development of their constituency.

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[7] Sisodia, NS (2003). This observation was made by Mr.Sisodia, Banking Secretary, Ministry of Finance, Government of India in an address at the Sa-Dhan annual conference, September, 12th 2003.

It is possible for the state to define what the local level projects are. These may be development of storage infrastructure, roads, telecom, market access, and information dissemination. It will also be possible to lay out a sub-plan for targeting such as – methodology for identification of the poor; strategies for poverty alleviation and creation of self or wage employment opportunities.

The state must involve the elected representatives in prioritization of projects where there is no patronage dispensation at an individual level. This also dovetails very well with the discretionary funding available for the members of parliament and legislative assemblies for constituency development. The state then scraps its direct involvement in all schemes that involve targeting of the poor and beneficiary identification. This role can be taken up through partnerships.

2.3 Role of the State through Partnerships

Involving elected representatives in schemes that address the needs of individuals, will convert this into patronage dispensation. The routing of "developmental" schemes for individuals, it is better done by an independent institutions based on proper appraisals. The provider of this service may want to resort to participatory techniques to ensure that the identification is not only objective, but is seen to be objective. For achieving this, the provider of these services should not be an "interested" party. Therefore this task is best done by professionals such as bankers.

We know that the routing of poverty oriented schemes through the banks has created huge NPAs in the past. Therefore there is no incentive for the banks to be looking at this sector as a valid business proposition. The viability of the schemes was under question for two reasons. The first is improper identification of the borrowers or purpose of the loan leading to an adverse usage of the credit, resulting in NPAs. The second is a hard fact of high transaction costs involved in reaching out to the poor. These have to be unbundled and looked at independently.

The experience of microfinance indicates that it is possible to have high repayment rates if credit is dispensed in appropriately. The high repayment rates are evidenced in all the models of microfinance – SHGs, Grameen replications and the individual banking model. Therefore there are lessons to be learnt from the mFIs.

The SHGs have creatively built social collateral and peer pressure to ensure that the repayments come on time. The Grameen model not only has peer pressure but has a zero tolerance for default. The individual banking models have built a combination of peer pressure through formation of joint liability groups and also have a high level of customer contact. These are aspects that mainstream banks may find hard to replicate. Therefore banks may look at multiple levels of involvement with MFIs – direct lending where it is feasible and building a series of low-cost collaborations cum outsourcing models when it cannot have direct lending.

There is an issue of transaction costs. The performance of MFIs is a result of investments that they have made in formation of an informed and responsible customer base. This involves – formation of groups, training in book-keeping, and imbibing prudential processes. Usually these costs are subsidised by developmental funding from funding agencies. If the state wants to dispense poverty oriented schemes through these agencies, there must be a mechanism to meet these costs.

On the field we have found that some agencies have engaged themselves with these issues. With these examples is it possible for the state to catalyse the process of partnerships? We discuss three examples here: Sanghamithra, OBC and ICICI Bank.

Sanghamithra Rural Financial Services is a company promoted by MYRADA a leading NGO. Unlike other MFIs, Sanghamithra is unique in it orientation, reflective of the attitude taken by MYRADA – that in the process of working with the poor, there must be a convergence of various efforts. Right from its inception MYRADA worked in partnership with the state, leveraging schemes offered by the state – coupling them with the social mobilization skills of an NGO. Sanghamithra also has a similar orientation – it would work as a demonstration model for the bankers to emulate; not compete with the banks in the rural areas. The feature of Sanghamithra is in its objective of self-liquidation if the banks step in. It is a case where the success is gauged by the fact that it has been vanquished by the banking sector! Sanghamithra works in three districts in Karnataka and Tamil Nadu. A recent study has found that that the overall credit availability in the areas that it operated have gone up, the banks are aggressively lending to the groups and in fact in some places are creating hurdles for the operation of Sanghamithra, and poaching on their groups (Srinivasan, 2003)[8]. This is a case where the demonstration has led to aggressive linkage of the SHGs, far exceeding the banks' past records and also significantly higher than the other branches in the nearby areas. The banks have been able to reach financial services to the poor, by adopting cost-effective techniques of Sanghamithra.

The Oriental Bank of Commerce discovered that microfinance could be a profitable business through one of its pilot branches (Harper, 2002)[9]. The Rudrapur branch does exclusive business with the SHGs. For achieving this, a significant re-orientation of the staff had to be done. Firstly the manager of the branch was obviously concerned about his own performance evaluation if he invested too much time in nurturing SHGs – the necessary investment one has to make in building social capital in order to reduce future transaction costs and have greater repayment. Only when the manager was assured that the profitability of the branch would not be held against him in his performance appraisal did the concept work[10]. Now the branch caters exclusively to SHGs, and therefore has broken all accepted banking norms – the office of the branch is closed during working hours – because the manager and staff are out in the field attending SHG meetings and possibly carrying out bank transactions at the village centre. While this is an extreme example, it amply demonstrates that with appropriate demonstration and assurances, the banks can indeed adapt themselves to the local situation. It is said that this branch is profitable.

ICICI Bank has been aggressively looking at the microfinance market. While they may be looking at this market as one way to achieve targets for priority sector, they are also planning to go beyond and look at banking with the poor as a legitimate revenue generation model. At the basic stage the bank is encouraging promotion of SHGs in Madurai, Tamil Nadu. That is in the first level of involvement – fostering promotion of microfinance activity so that the poor could eventually borrow from the bank. At the next level they are leveraging the existing NGO-mFI network for acting

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[8] Srinivasan, Girija (2003): Impact Assessment of Sanghamithra: Sanghamithra Rural Financial Services (Mimeo)

[9] Harper, Malcolm (2002): *Self Help Groups and Grameen Groups – What are the differences?* In Fisher and Sriram: Beyond Microcredit. Delhi: Vistaar Publications.

[10] Yadav, Ravinder (2003). Mr. Yadav is General Manager of the bank. This was a part of the talk delivered at the Sa-Dhan annual conference, September 12, 2003

as agents to disburse loans on their behalf for a fee. This has been experimented in Madurai with Dhan Foundation and Mirzapur with Cashpor. At the next level – where microfinance meets high-finance – they are purchasing the portfolio of mFIs in a securitization deal. The larger plan of ICICI Bank is to build a portfolio, far exceeding their priority sector obligation targets and sell this as paper to the other banks for a margin. This is a case where a large bank has indicated that such a targeted lending to the poor is possible, if one takes the approach of partnerships - leveraging existing institutions and infrastructure.

The role of the state cannot be undermined in each of the cases. The banks lend to the poor not because the portfolio is extremely profitable compared to the overall portfolio. It is profitable within the chunk of priority sector advances, against other options or investing in the RIDF. That is why when ICICI does a portfolio buyout deal with an MFI, the pricing is not based on the argument of Prime Lending Rates (PLR) and premium or discount on it, but on the basis of cost of funds plus a margin.

The state has to accept that the delivery of the objects of the state would be done through external agencies in a partnership model. The case of ICICI bank's partnership shows how such collaborations could work – leveraging the strength of the NGOs (networking and social mobilization) and the might of ICICI Bank (deployment of capital on commercial terms). The NGOs need not have capital to do this on their own, and the bank need not have the specialist human resources to create community-based systems that reduce transaction costs and portfolio risk.

The issues pertaining to re-orientation of the direct delivery model that could potentially make it more effective are structuring the aid and delivery. Structuring has to be done through appropriate packaging. All directed finance to the poor through various schemes like DWCRA, SGSY, Swa-Shakti that reaches individuals could be covered under the partnerships model. If there are conditionalities to be imposed on issues like end-use interest rates or subsidies, these have to be packaged in a manner that does not put the basic financial product in peril. We assume that the financial institutions are able to package such products keeping the overall sustainability and longevity in view. If there are subsidies to be provided, they have to be package in consultation with the players to ensure that it does not jeopardize the commercial aspects of an implementing institution. Like it has been done in SGSY, it might be good to back-end the subsidies than give them up-front.

Then second issue is delivery. The scheme has to be routed through institutions that have the capability and the reach. The two major players are – the banks and NGOs/ NGO-MFIs. Both work with the poor. The delivery must happen without a compromise of the usual norms of assessment. This autonomy provides incentive for the larger institutions to come in. For instance, if subsidized loans to be directed to a certain category of poor, it is to be done through a normal banking transaction and not in the format of a loan mela. The beneficiaries have to see these services coming from the bank and not "bank as an agent of the state". The identity of the state in such transactions should take the back seat. The state may subsidise the financial institution for its transaction costs – by providing soft loans, and establishing a sectoral fund. Obviously the state when it devises such programmes will devise them on a broader canvas than what could be possibly handled by MFIs. Most MFIs in India work exclusively with women, but the state might want to broad base its schemes. Therefore an appropriate choice of a partner institution is also critical.

The routing of the packages through financial institutions ensures sustainability and continuity. In the field we find that most of the interventions of the state sponsored schemes happen on a "one-time" basis. One would find groups that were formed in villages to take the benefit of DWCRA scheme and these groups would have had a temporary life. Most of them were self-liquidating in implementation – treated as special purpose vehicles for implementing a particular scheme. If these schemes are routed through the banks with commercial appraisal, the banks may see these clients as long term customers. The customers in the process will also get used to dealing with banks and therefore one can hope that the relation continues beyond just the delivery of the scheme. However the key in such partnerships lies in identifying the deliverables, the non-negotiables and a good understanding of the costs involved, so that an appropriate fee for implementation could be structured into the partnerships.

2.4 State Intervention at Policy Level

At the policy level there are some interesting interventions that were discussed in the early part of the paper. However some more interventions are needed for promoting financial services to the poor. We need an institutional framework that regulates and manages the growth of the microfinance sector. For this we need to understand the institutions undertaking microfinance. At the top-end we have the banks. The limitations of these institutions in reaching out to the poor have been discussed. The state has put in place some targets, but disincentives for not achieving sub targets for reaching the weaker sections are to be put in place.

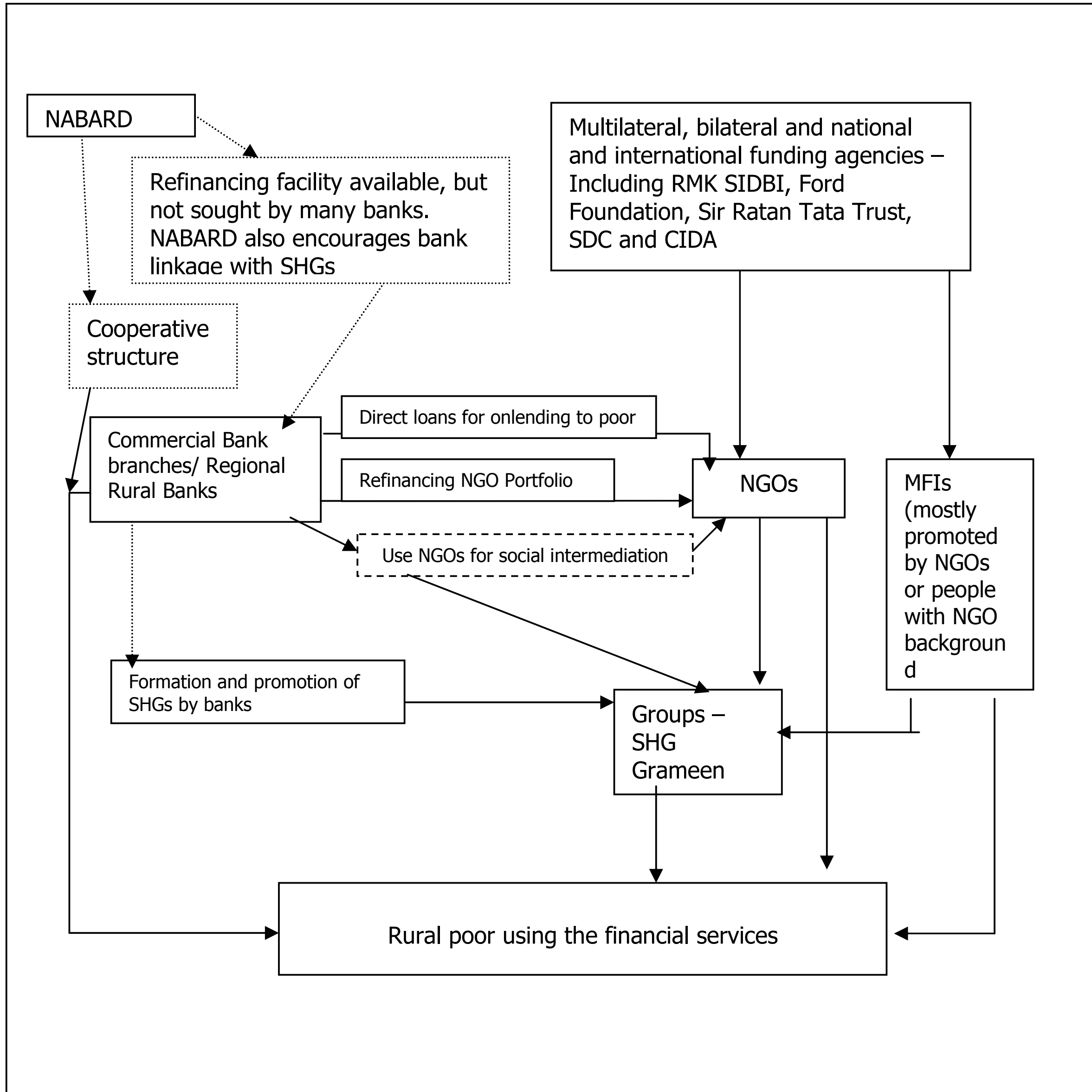
The institutions playing a major role in microfinance are the NGOs. As NGOs have entered into the commercial world of lending money, many are transforming themselves into regulated institutions – working under the law governing the world of commerce. The flow of funds to the microfinance clients can take several routes as depicted in Figure 2, where poor get financial services through NGOs, NGO promoted MFIs, SHGs or directly from banks. The cooperatives also play a significant role in the rural credit sector and have a great outreach. In the complex web of relations depicted in Figure 2, the route followed by NABARD is not complicated. NABARD works with a focused agenda of encouraging the formation of SHGs and linking them to the banks. A few years ago, NABARD relaxed its norms to allow banks to lend to intermediary MFIs who would ultimately lend to SHGs.

Apart from NABARD there are several initiatives. Most of these are microfinance activities promoted by NGOs or NGO-MFIs. The organizations undertaking these activities are incorporated under various legislations – trusts, public societies, cooperatives and for-profit and non-profit companies. Most of these entities are unregulated. Some of them are partially regulated – to the extent that they have sought grants from foreign sources and have to file annual returns with the Home Ministry. NBFCs operating in the field of microfinance - which are a few in number are regulated by the Reserve Bank of India.

2.4.1 Regulatory Issues

There is a need for a uniform regulation under which all such organizations could be recognized. Any intervention at the policy level would then become that much easier. The policy level interventions are about prudential norms, accounting norms and norms of good governance. Under the current dispensation where microfinance activity itself is not defined, regulation is extremely difficult.

Figure 2: Players in the microFinance Market and their Linkages



2.4.2 Cooperatives

Traditionally, what is today known of microfinance has been happening in the cooperative fold. The regulatory environment for cooperatives varies as it is a subject dealt by the state government. The logic of minimal regulation of financial cooperatives is that these are mutual benefit organisations, following the principle of open and voluntary membership and democratic control. Therefore the prudential norms that are required for financial institutions have not been applied with the same rigour as in the other financial sector organisations. The assumption was that cooperatives deal only with members. Norms applicable to financial institutions dealing with "public" funds need not be applied. However, we have seen violation of the cooperative spirit. On the one hand, there are several cooperative banks seeking deposits from the public by bringing them in as adjunct members without voting rights. On the other, there are state-sponsored institutions registered under the cooperative law. Most of the rural cooperative movement being state driven, there are restrictions in the area of operation, and on having multiple cooperatives in the same geographical area. In several states in India, a new liberal legislation on cooperatives has been enacted. This has enabled SHGs to grow into cooperatives.

The regulatory change needed for cooperatives is in enactment of the new act in states that have not passed the new legislation. There should be a sharper definition of "user" – so that these institutions remain member-user owned and governed.

In addition to the above, there is an urgent need to examine the possibility of reviving agricultural cooperatives. There are near about 100,000 such cooperatives with some basic infrastructure. One needs to quickly examine how this can be leveraged for a greater benefit of the poor.

2.4.3 Cooperative Companies

The Centre has amended the Companies' Act to allow for cooperative type companies to be set up. However this covers only producer companies. This means that a cooperative set up for the purposes of economic activities can carry out finance as an ancillary activity, but this cannot be the main object of the operations. It would be useful finance could be added – but with a tight definition and disclaimer clauses on definition of user-members, thereby giving some choices for groups that want to set up MFIs having operations beyond the borders of a single state.

2.4.4 Regional Rural Banks and Local Area Banks

The RRBs have done a turnaround in the past few years. However their focus is to be re-oriented. RRBs are a small part of the sponsor banks and therefore do not get the strategic attention they deserve. Some churning may help. Allowing banks to sell or acquire RRBs, encourage mergers and even liquidation so that these banks are seen as strategic businesses. Changes in the RRB Act suggested by a recent working group should be given consideration[11]. The RRBs need to be recapitalized to make their size significant. While there are some banks that have only one RRB, banks like State Bank of India having multiple RRBs, It may be useful to rationalize on this. Norms including that of capitalization may be harmonized for RRBs and LABs.

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[11] Government of India (2002): Report of the Working Group to Suggest Amendments in the Regional Rural Banks Act, 1976. Delhi: Ministry of Finance.

RBI recently took a decision not to allow any further incorporation of LABs. An experiment that was done after a great deal of policy advocacy and thought was removed without much debate. There might be scope to carry on with modifications in the design. If RRBs can work there is no reason to believe that LABs will not work.

2.4.5 Commercial Microfinance Institutions

Let us examine the nature of the other independent MFIs to understand the type of intervention from the State that could help the sector. We shall not talk about the NGOs that only organize groups and link them to the banks, but concentrate on those efforts where there are microfinance related financial transactions.

Most MFIs in the country are promoted by NGOs or entrepreneurs with an NGO background. Usually the microfinance starts as a division of the NGO and grows large enough to warrant a spin off into a separate organization. However, organizations incorporated as Trusts, Public Societies and not-for-profit companies are not designed to undertake commercial activities of borrowing and lending. The intent of these forms of incorporation was to receive individual or bulk donations and carry out charitable activities. A legislation governing charitable activity is inappropriate for microfinance. We also know from experience that people with commercial capital are unlikely to invest in microfinance business. The skills required for running a microfinance business comes from social mobilisation – present in the developmental arena. Similarly, it is unlikely that MFIs will grow to large commercial banks. Though there are counter-examples for this in other parts of the world – such as Bancosol in Bolivia and the BRAC Bank in Bangladesh, these experiments are few and far between. By identifying the limitations of growth of mFIs and the source of capital we are able to advocate a regulatory framework for carrying out microfinance. We need to be sure that the framework thus provided is not vulnerable to misuse by the other players who are likely to come in the garb of providing microfinance.

Given this, the state has to recognize that there are interested developmental professionals, willing to work, have the necessary social mobilization skills but lack capital. Capital for MFIs flows through the charitable route because of the interests of the donor agencies. However there is no mechanism of getting developmental capital as risk capital. The donor agencies are prohibited from making equity investments in commercial companies. However, they are willing to institute a permanent fund that can be rotated and grown. These funds by definition are routed into the not-for-profit entity. These entities are not permitted to invest in commercial microfinance operations because of their tax status. While one recognizes the fact that no tax exemption is to be granted for commercial activities, the regulations do not permit partial taxation for the commercial division of a not-for-profit entity. As a result, there is a danger that the NGOs lose the tax exempt status even if they continue the microfinance operations under the inappropriate form of a charitable organization. Therefore it is best for the state to allow for not-for-profit entities to invest in commercial microfinance. The caveats to be taken here are:

1. having a definition of microfinance
2. defining the ownership (the experience of Bolivia in formation of FFPs is useful)
3. a plan to ensure that the operations of the commercial division are not subsidized by the non-profit entities
4. a plan to make these two entities de-mutualised over a longer time frame.

The issue of taxation should not pose a great problem as microfinance will be carried out by distinct commercial entities and therefore gain no special benefits. Since dividends paid to the promoters (including not-for-profit trusts) will be post tax (and under the current regime subject to dividend distribution tax) the state should not be worried about any loss of revenue. This would attract more capital and would help the private initiatives of microfinance grow organically.

3.0 Concluding Notes

In conclusion the role of the state can be seen in three perspectives. The first is to look at general development of infrastructure and support mechanisms for the poor – which could be done directly by the State or in collaboration with other players. The role of elected representatives in prioritizing and planning such activities should be enhanced, and also the developments can be harmonised with the elected representatives' local area development fund.

All support directed towards individual beneficiaries have to be routed through professional institutions. The identification of "beneficiaries" is to be done in professional manner. The model must avoid tones of patronage dispensation. Subsidies have to be back ended and the intermediary institutions should have a risk element to ensure that the professional assessments continue. Incentives could be general in nature and can be directed towards recovering high transaction costs rather than dealing with accounts of individual customers and write offs.

At the policy level, effort to revitalise the cooperative movement to leverage the existing structure; encouraging states to enact parallel liberal cooperative legislation and expanding cooperative companies to include the provision of financial services are important. In addition, rationalisation in the norms for RRBs, encouragement for new LABs with appropriate changes in prudential and priority sector norms has to be examined. Not-for-profit entities may be allowed to invest in companies undertaking finance for the poor without any prejudice to their tax status. Entry capitalisation norms for each category of institutions may be retained at the present levels.