MICROFINANCE IN INDIA

Approaches, Outcomes, Challenges

EDITOR

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Microfinance in India

This volume, enquiring into the working of microfinance in India through incisive cases and commentaries, sets itself as a distinct contribution that raises socially-relevant questions often missing in the surge of 'functional' literature on the 'reach' and 'success' of microfinance.

— **Y. C. Nanda**, Former Chairman, National Bank for Agriculture and Rural Development (NABARD)

The Indian microfinance sector is defined by the state, diverse non-state actors from the international to the local scale and the poor, who are most often women. Tara Nair has once again pushed the limits of scholarship on this dynamic, complex and widely contested field. The outstanding contributions through this volume draw out the key tunes from within the cacophony of claims and counter-claims. A must-read for everyone engaged with the microfinance sector.

— **Kuntala Lahiri-Dutt**, Senior Fellow, Resource Environment and Development Group, Crawford School of Public Policy, ANU College of Asia and the Pacific, Australian National University

A thoughtful collection of studies, all sharing the conviction that however compelling microfinance may be as a concept, its transformative potential is deeply contingent on local conditions.

— **Loraine Kennedy**, Director of Research, Centre d'Études de l'Inde et de l'Asie du Sud, Ecole des Hautes Etudes en Sciences Sociales, Paris

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Preface

Scarcity of writings is not exactly a problem that afflicts Indian microfinance. In fact, the last two decades have witnessed a deluge of literature on what ails and aids the working of microfinance in the country. Many positive and provocative writings that emerged internationally have looked closely at the microfinance scene in India too. This volume, hence, does not stake any claim of a 'pioneering work'.

However, pioneering effort it is in that this volume does not seek to find evidence to falsify or otherwise any theoretical notions of how finance ought to work for the poor, particularly, women. The idea to put together these writings germinated in the discomfort with the dominant view of microfinance as a sheer financial device, powerless and value free. This view has informed much of the research in the area and has made certain positive empiricist methodologies assume primacy over other more nuanced and qualitative ones. Longitudinal surveys trying to uncover the processes of change using multiple methods have given way to quick and efficient surveys that quantify the outcomes of, say, use of microfinance by borrowers. Good old impact studies have gone out of circulation as leaner and standardised formats have been mass promoted by donors and investors who are keen on 'cross cultural' and even 'cross sectoral' comparisons of microfinance outcomes. Research itself has lost much of its intellectual sheen as every data generating agency has taken on the mantle of a research organisation.

These indeed can be seen as progressive tendencies. There are multiple agencies producing 'hard numbers' now, making it easy to measure the extent of reach of microfinance. Significant progress has been made in capturing the non-economic indices of how microfinance is practiced by the intermediaries. Every self-help group is expected to be graded and its quality assessed. In fact, extensive knowledge base has been created on the issues that affect the quality of groups. At the same time, the critical issues that bothered the earlier researchers — for instance, how this new resource redistribution mechanism, though led by the market logic, rearranges the social order — have become redundant and immaterial. With microfinance beginning to traverse the path of institutionalisation and commercialisation, these concerns have further been relegated to the backyard of research.

This volume makes an attempt to reclaim at least a part of the space that has been lost to the 'scientific enquiries' on the working of microfinance as also to the number-churning smart surveys. As stated in the introduction, the essays included here engage with very different aspects of microfinance using diverse methods of enquiry; but the central concern of all is to unravel the working of microfinance within distinct socio-spatial and organisational contexts. Importantly, we begin by acknowledging that microfinance, though represents a standard methodology of credit delivery, interacts differently with different social, political and cultural settings to produce often singular outcomes which demand serious policy and political attention. Second, these papers urge that too much attention on standardising the methodology of microfinance should not sacrifice organisational diversity as also innovative capacity. These writings, we hope, would contribute towards enhancing the current understanding of the theory and practice of microfinance.

Most among the group of young authors presented in this volume had spent many years studying microfinance either as part of their doctoral work or as independent researchers. The depth of their engagement with the phenomenon of microfinance, I am sure, is reflected in their writings.

Acknowledgements

Many individuals and institutions contributed to making this volume possible. The Gujarat Institute of Development Research, Ahmedabad, has been a wonderful place to be in given its flexible structure and respect for free thinking. I must put in a special word of thanks to Y. C. Nanda, former Chairman, NABARD. Over a prolonged and candid conversation, he helped me make sense out of the early history of Indian microfinance.

I am fortunate to have got a group of serious scholars to contribute to this volume. Many of us have been discussing microfinance among ourselves for a while and writing and publishing independently. Coming together for a project like this was exciting, but not without hitches. A couple of authors chose to drop out on the way as the project took longer than expected to fructify. The microfinance sector went through spurts of crises and recovery through the three years that I held on to the idea of this volume. My warmest gratitude to Kalpana, Anurekha, Maren, Yeswanth, Isabelle, Navin, Savita, Lina, and Rutwik for keeping their faith in this endeavour.

The two fruitful years that I spent at the Friends of Women's World Banking, Ahmedabad, as head of its research programme exacerbated my anxieties about the limitations of provider-driven research agenda and reconfirmed my faith in critical, independent and discursive studies that could unravel the non-linear paths of transformation that microfinance can plausibly trigger. My young and bright colleagues there — Madhu, Nidhi, Ashwin, Rachayeeta, Binota, and Rutwik — must be appreciated for their camaraderie and spirited support which made it possible for me to cross many a thorny path.

I owe a special thanks to Das for his intellectual, emotional and moral companionship. Aparna Raj and Gani Memon stepped in at critical junctures to offer help.

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Vignettes in Transformation

Indian Microfinance since the 1990s

Tara S. Nair

Trying to tell the story of how microfinance was ushered in, took roots and expanded in India is no mean task. Over the past two decades since its official debut in the country in the late 1980s microfinance has traversed quite an eventful journey. Along the course, its role and relevance has been contested seriously in the circles of academia and development practice. It has been over-hyped for what it has done and severely under-rated for what it could have. It has been interpreted and examined in myriad ways — as an antipoverty strategy, as an approach to empower women, as a method for financial inclusion and as a way to nurture interaction between formal-informal financial sectors. The debates on Indian microfinance reflect the myriad imaginations and perceptions that surround its identity. Despite such inconclusive discourses, the reach of microfinance has expanded substantially across the country appropriating the spaces available within development planning and democratic politics.

The idea and technology of microfinance made its debut in India under peculiar circumstances. On the one hand the directed credit programmes[1] implemented since the 1970s in the country had come under serious criticism for their patently political and grossly inefficient ways of channelising financial resources to farmers and rural poor. It must be noted that starting from 1973 a series of research studies steered by a group of economists and funded by the United States Agency for International Development (USAID)[2] systematically projected the theme of the failure of state intervention in the financial markets of low income countries.[3] They questioned the legitimacy and efficiency of stated owned development financial institutions in reaching out to sectors like agriculture in particular and rural poor in general. The findings of these studies entered the global discourse on financial systems development through publications like the World Development Report of the World Bank and had a significant influence on the policy thinking of countries that were also dependent on international aid in financing their development.

In India, three broad streams of critique had emerged out of the studies that interrogated the process of implementation as also the impact of the Integrated Rural Development Programme (IRDP), which was introduced during the Sixth Five Year Plan period (1980–85) as the flagship targeted antipoverty programme. The enquiries pointed to many design and delivery problems with respect to the Programme like faulty identification of beneficiaries and economic activities, inadequate financial assistance, delays in providing actual assistance, poor loan recovery, corruption, lack of motivation among bureaucracy, lack of local level planning and bankers' indifference towards the poor (Kurien 1987; Saxena 1987; Swaminathan 1990). The inability of the beneficiaries to differentiate between grants and loans, channelisation of resources to the poor who lack the ability to handle such resources and the tendency on the part of banks to avoid the costly process of appraisal and monitoring in the case of low value advances are some of the specific factors highlighted by the evaluation studies as having led to poor performance of directed credit programmes (Wilson 2002).

The second set, though sparse in number, has delved deeper into the public policy aspects of IRDP. Rath (1985) questioned the very relevance of using assets and subsidy as strategies for helping the rural poor escape poverty:

> Only a small proportion could be helped; what is equally true is that only a very small proportion can be helped in this manner ... In a multipronged attack on rural poverty this approach surely has a legitimate place, but it cannot be the mainstay of such a programme (ibid.: 245).

Presenting some interesting evidence on the performance of IRDP, Dreze (1990) raised a few pertinent questions about the strategy of using subsidised loans for poverty alleviation. He argued that the obsessive concern of public policy with making the poor self reliant by extending them subsidised loans had led to the diversion of attention from a number of important influences on the living conditions of the poor. What they need is income, neither assets nor subsidy. Public policy should, hence, focus on the creation of more employment opportunities at least at the basic subsistence wage rate and public provision in health and education and social security measures.

The third critique was concerned with the commercial viability of banks if such programmes continued to be financed through bank loans. Many studies have argued that subsidy and concessions eroded the portfolio quality of the banking system and resulted in the neglect of monetary saving facilities in the rural sector. The other factors highlighted by these studies included leakage of benefits to undeserving households and underestimation of the ability of the poor to save or pay 'market rate of interest' (ACRC 1993; Mahajan and Gupta Ramola 1996; Yaron et al. 1997). It must also be noted that by the early 1990s the policy-induced social banking phase had resulted in a rather uncomfortable relationship between the fiscal and financial systems wherein the former could arm-twist the latter to support even the overtly political agendas of the parties in power. As pointed out by the successive rural credit committees, the misuse of the financial system by the fiscal system in doling out politically motivated financial subsidies had led to the widening of the geographical and emotional gaps between rural clientele and banking bureaucracy. The following observation made by the Agricultural Credit Review Committee (1993) in its report throws ample light on the crisis of confidence that resulted from the fiscal-financial overlap:

> The targets are achieved mainly because the banks have been compelled to do so. In fact, considerable importance has been attached by government of India and other authorities to ensure that IRDP targets are achieved by banks without fail and this message has percolated to the field level. Several relaxations have been made by RBI in respect of eligibility criteria, procedures, rate of interest, collateral security and guarantee for the loan, etc, in view of the special status accorded to IRDP loans and these concessions have been extended despite the fact that viability of many of these loans is open to question.

These concerns received resounding support in the recommendations of the Committee on Financial System (1991, Chairman: M. Narasimham). The report underlined the need to enhance competitive efficiency, productivity and quality and range of banking services. The Committee expressed deep concern about the deterioration in portfolio quality and erosion of profitability of banks and held directed credit, directed investment and fixed interest rates largely responsible for these. Hence, it recommended phasing out of directed credit programmes and redefinition of the priority sector to restore the depositor and investor confidence.[4] While acknowledging the impressive growth of banking business in the post-nationalisation years, the Committee expressed its disapproval of 'micro credit direction bordering on behest lending' (Narasimham 1996–97: 224). As Narasimham puts it, the irresponsible and politicised lending operations during this period 'made the credit system the subject of competitive populism and a hostage of electoral politics' (ibid.: 224).

In short, the policy thinking in India around rural finance in the 1980s came to be heavily tilted against state intervention in financial markets, which, in turn prompted the development finance institutions like NABARD to look for institutional innovations that increase the outreach of credit without any rise in costs.

In Search for an Alternative: Group Lending as Financial Innovation

The experience of India with respect to directed credit programmes was shared by many low income countries in Asia, Africa and Latin America. Several of them had adopted the method of group lending to expand the flow of rural credit from formal financial institutions. Under this method, unsecured loans were given to informal groups with membership ranging from five to 30, which, in turn are distributed among members who hold joint liability for repayment (Adams and Ladman 1979). The proclaimed advantages of group lending over individual lending were (*a*) reduction in the lending costs of financial institutions; (*b*) use of peer pressure to reduce delinquency; (*c*) low per farmer cost of delivering technical assistance; (*d*) lower transaction costs for borrowers; and (*e*) increase in outreach without any escalation in costs (Ladman and Afcha n.d.; Adams and Ladman 1979).

A series of enquiries into group lending implemented by public sector development finance institutions in countries like Bolivia, Mexico, Ghana, Malawi, the Dominican Republic, and the Philippines led mainly by the researchers of the Ohio School and funded by the USAID generated an interesting debate on the advantages and limitations of group credit in the late 1970s.[5] While appreciating the rationale of group loans using per pressure/joint liability these studies largely concluded that 'it is most common that they (that is, group lending programmes) fail to live up to expectations' (Ladman and Afcha n.d.: 2.). In many instances the transaction costs were reported to be far greater than that of informal lenders. A major reason for the limited success of group lending innovation, according to these researchers, was the concessionary interest rate policies followed by the low income countries that make it unviable for financial institutions to carry on with a high cost innovation. Flexible interest rate policies, it was argued, would provide a more healthy economic and political environment for financial innovations like group lending (Adams and Ladman 1979).

The merits of group lending scheme as an arrangement that helps to both counter the limitations of informal finance and circumvent the problems associated with borrower selection and cost of lending had been rediscovered in the international development making circles with the success of Grameen Bank (GB) of Bangladesh. Started as an experimental project in 1976 it turned into a formal financial institution in 1983 defying every single tenet of prudent banking by substituting individual lending by lending to small groups with carefully crafted norms — poor women borrowers, small loans, market rates of interest and no collateral.[6] The GB model was the reigning paradigm of poverty lending in the 1980s through the 1990s. Its methodology came to be accepted unquestioningly as the sure-shot success formula for any rural credit initiative to be pro-poor and pro-women. The small group-based micro-credit approach employed by GB stipulates pooling of all the potential consumers whose risk profiles are assumed to be the same. They are offered loan contracts on identical terms. The important design feature GB approach is 'peer monitoring system' that involves incentives to the groups to monitor the actions of their members (Stiglitz 1990). Joint liability and denial of loans to groups with defaulted members were the incentives provided within the model for timely repayment. All these require careful formation of groups 'to weed out bad borrowers who could jeopardize the creditworthiness of the group as a whole ... and this induces a form of *self-selction* that no individual-based banking scheme can mimic' (Ray 1998: 579). These attributes of the GB have come to be hailed by development economists as efficient methods of information use (ibid.) and price