Money lenders, microfinance, and poverty alleviation

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INTRODUCTION

It is well recognized in the literature that financial intermediaries provide the necessary link for mobilizing and channelling savings toward the productive investment required for economic growth. For growth to be inclusive, a prerequisite is that credit facilities be accessible especially to the poor. In India, however, a large proportion of the poor do not have access to formal credit institutions. This is primarily a result of the collateral-based lending policies of the formal agencies, which naturally keep credit out of the reach of the poor.

The formal agencies usually justify their position in terms of the high transactions costs they would incur if they dealt with a large number of smaller accounts. According to the new school of thought propounded by economists Karla Hoff and Joseph Stiglitz, the reluctance of formal lending agencies to deal with the poor is the result of the asymmetry of information about the borrowers and the consequent apprehension regarding default in repayment. To a limited extent, the rural farming class in India is able to access credit from the formal sector for production needs arising from the priority sector lending norms enjoined on them. Credit for essential consumption needs, such as for health or education, rarely comes from the formal sector.

ACCESS TO CREDIT: MACRO INDICATORS

Data gathered by the All India Debt and Investment Survey (AIDIS) and the Situation Assessment Survey (SAS) conducted as part of the 59th round of the National Sample Survey (2005), is the latest macro-level information available on credit accessibility especially by the poor, both from formal and informal sources. The AIDIS provides information regarding household debt and investment for 143,285 rural and urban households engaged in a variety of occupations. Unlike the AIDIS, the SAS confines itself to farming households and the sample size for this data set is 51,770 households.

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Our analysis of the data on farming households based on the SAS reveals that while 24 percent of the households with land holdings of less than 0.01 hectare have been accessing formal loans, this percentage increases to 70 percent for households with land holdings of 4 hectares and above. The poor access loans primarily from the informal sector and such borrowings are mostly used for non-income-generating purposes. The interest rate for the informal credit is charged at a 36 percent rate of interest (modal value); however, there are instances where informal lenders charge much higher rates of interest.

Loans advanced under such unfavourable terms and conditions, if used for non-income-generating purposes, can lead the poor borrower into a debt trap. Further, access to credit is unequal across different social groups. While 27 percent of male-headed households (both farming and non-farming together) are able to access credit, only 17 percent of female-headed households are able to access credit. These differences are prominent even between the male and female-headed farming households. Similarly, schedule tribe households—historically disadvantaged peoples or depressed classes—have much lower access compared with other households.

FINANCIAL INCLUSION AND THE CURRENT SCENARIO

Given that a large proportion of citizens still do not have access to the formal banking sector, the finance minister's 2007 budget speech emphasized the need for the Reserve Bank of India (RBI) through formal financial institutions to undertake a drive in favour of financial inclusion. This drive aims at bringing all citizens into the banking network, and one of the major instruments used to do so is the *no-frills account*. While such endeavours have deepened and widened the reach of the banks, the poor remain dependent on informal lenders.

A recent survey of farmers by the Institute for Social and Economic Change in the state of Karnataka revealed that even after the massive financial inclusion drive in the state, around 50 percent continue to depend on informal moneylenders. One of the major problems in accessing formal sector credit in Karnataka is the lack of proper land records. Land is transferred in the family across generations but legal issues arise because of unlawful land transfers to persons who really do not own that land. Even with the computerization of land records, this problem continues to persist. Informal lenders, on the other hand, provide loans without collateral, as the problems of information asymmetry and monitoring are minimal for them. Loan recovery is ensured largely through strong-arm methods.

MICROCREDIT IN INDIA

Against this background, the emergence of microfinance activities, in which people pool a small amount of money

monthly for a common village project financed by a loan from the group, are no doubt of great help to the poorer sections of society. Microcredit is advanced in India through two major institutions, (1) self-help groups (SHG) bank linkage programs (mainly initiated by the National Bank for Agriculture and Rural Development (NABARD)) and (2) microfinance institutions (MFIs).

SELF-HELP GROUP BANK LINKAGE PROGRAM

The self-help group bank linkage program (SBLP) of NABARD, introduced in 1992, is one of the most significant microfinance interventions in India. Under this program, self-help groups are formed by an NGO, a bank, or a government agency such as the Department of Women and Child Development. These groups meet regularly and make small deposits on a regular basis into a bank that, in turn, provides loans to the group.

This program has made rapid progress over the past 15 years, although there are certain areas that need strengthening to ensure a wider reach that will maintain the program's sustainability. The joint liability mechanism that ensures self-monitoring has proved that the poor are bankable.

In addition to its economic impact, there have also been significant social impacts—particularly on women. Women take part in various decision-making processes with their participation in the SHG regular meetings in addition to gaining familiarity with the banking system. Saving habits are thus promoted among the poor.

One shortcoming our survey in Karnataka reveals is the lack of bottom-up, group-based economic activities in a large number of groups. While the groups have social activities such as organized outings and cultural events, etc.; in the end, for the group members to derive continuous benefits from the SBLP, it is essential to include group-based economic activities, whereby the income-generating activities act as a binding force. During our interactions, we observed that when the groups were able to generate funds through their own savings and could access bank credit, they tended to divide the credit equally among themselves. These funds are then used according to individual needs. Often then, the loan amount per person remains small and does not provide enough to create a substantial income-generating activity. These groups would often look for further subsidized credit under government schemes such as the SGSY (rural self-employment program).

This mindset needs to be changed. Rather than looking for subsidized loans and subsidized rates of interest through participation in SBLP, group activities should lead to building the capacity to repay the loans from their own income. This is not to say that no income enhancement has taken place as a result of such savings and credit facility; however, the income enhancement possibilities can be improved manifold. Otherwise, after a few years, group members are likely to shift to MFIs for credit.

To satisfy the unmet demand for credit from the poor, microfinance institutions, often funded by foreign agencies, have emerged over time.

MICROFINANCE INSTITUTIONS: WELFARE MOTIVES OR PROFIT MAXIMIZING GOALS?

While the SBLP has helped marginalized women access credit, the amount of credit obtained is often inadequate because it depends on the savings generated by the group. Further, development of the SBLP is uneven across India; some states have low penetration of SHGs. To satisfy the unmet demand for credit from the poor, microfinance institutions, often funded by foreign agencies, have emerged over time. These institutions operate not only as pure financial intermediaries; they also have welfare motives, especially for eradicating poverty. As emphasized by Britta Augsburg and Cyril Fouillet, the first microfinance summit campaign held in Washington in 1997 echoed such goals to make credit available to the 175 million of world's poorest families for self-employment and other income-generating needs. In India, many microfinance institutions emerged over time to ensure the availability of credit to the poor in remote areas. Subsequently, the microfinance institutions receive credit from the Indian banks (at 11 to 13 percent interest rates), which they re-lend to households. In general, the funds are lent mainly to the poor in rural and urban areas through the local business correspondents, representatives, or agents of the MFIs who gather information about household assets, etc., to identify the poor and needy. These MFI representatives/agents at the local level examine the loan appraisals of the potential borrowers and, based on their reports, the MFI advances a loan.

The agents often take part in the formation of joint-liability groups (JLG) of potential borrowers to disburse loans. According to the Malegam Committee report (2011), a committee formed by the Reserve Bank of India to suggest policies to regulate the MFIs, the MFI defines a poor household as one with income not exceeding Rs 4.5 lakh per annum (that is approximately USD $1,100). According to the same report, most MFIs individual loans are Rs 10,000 to 15,000, usually repayable within a year with weekly or monthly repayment schedules. Given the repayment schedules, it is difficult to estimate the actual annual rate of interest charged by the MFIs, which vary substantially from one another. The Malegam Committee insists that this area should be completely transparent, and every MFI should clearly display their effective interest rates in a loan card issued to the borrowers and in their offices. An Andhra Pradesh Mahila

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Abhivruddhi Society (APMAS) study estimates the rate of interest to be around 30 to 36 percent.

A study conducted by APMAS in Andhra Pradesh shows that there has been intense competition among MFIs to lend at high interest rates while advancing multiple loans to poor borrowers. Frequently, defaulting borrowers were given larger loans in order to repay the previous loan. When loan burdens became untenable, reports indicated that some of the local agents of MFIs used coercive methods to ensure repayment.

If the loan was given to an individual member of a joint-liability group, often the group also pressured the borrowing member. Fear of losing standing in the community prompted many borrowers to consider suicide as the only way to escape the intense pressures created by their social network and the local MFI agent. This clash of interests between the borrower and the lender finally created enough political heat to force a reappraisal of the program.

The Reserve Bank of India established the committee, headed by Y.H. Malegam, to review the various issues concerning MFIs and to recommend regulatory steps to prevent the recurrence of such incidents. The committee recommended a number of reform measures including a cap on interest rates charged by MFIs (at 24 percent) and on the number of MFIs that can lend

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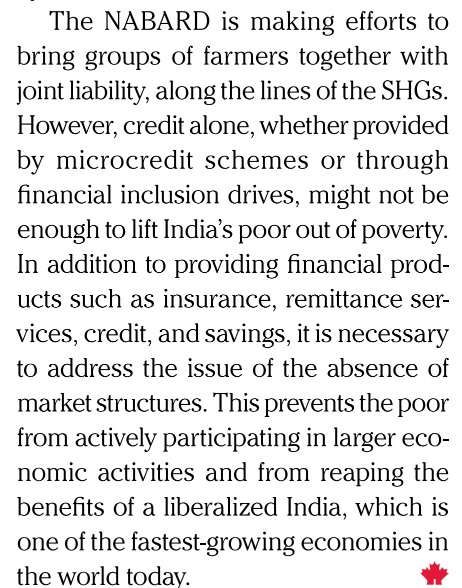
to one borrower. Some of the measures such as ensuring transparency, adhering to a code of governance, and strict prudential norms will possibly help to streamline the sector and benefit consumers in the days to come.

CONCLUSION

As a result of the reforms in the financial sector, banks currently operate under stringent regulations concerning prudential norms and non-performing assets. Banks have strict guidelines regarding the means for ensuring repayment of loans. Our survey of banks has revealed that the loan waiver packages announced by the government from time to time have had a severe impact on the repayment habits of farming households with a growing number of people defaulting on their payments. Banks operating under such compulsions formulate stricter norms that tend to discourage the poor.

Though microfinance institutions provide credit to the poor, the interest rates are more often than not usurious. A survey carried out by APMAS has revealed that borrowers find village moneylenders more lenient with regard to repayment due dates than the MFIs. Therefore, it is crucially important not only to keep the SHG bank linkage program alive but also to bring more groups under it. The SBLP provides credit that reflects the repayment capability of a borrower, and most importantly, the interest paid by the borrower becomes a part of the income of the group formed by the members.



The NABARD is making efforts to bring groups of farmers together with joint liability, along the lines of the SHGs. However, credit alone, whether provided by microcredit schemes or through financial inclusion drives, might not be enough to lift India's poor out of poverty. In addition to providing financial products such as insurance, remittance services, credit, and savings, it is necessary to address the issue of the absence of market structures. This prevents the poor from actively participating in larger economic activities and from reaping the benefits of a liberalized India, which is one of the fastest-growing economies in the world today.

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