# Understanding Microfinance: Challenges, Regulation, Way forward

## Introduction

The most important finding in the last two decades in the world of finance did not come from the world of the rich or the relatively well-off. More important than the hedge fund or the liquid-yield option note was the finding that how the poor can save, can borrow or can even decide to give loans to fellow poor and how can they certainly repay loans. This is the world of microfinance.

It is important to understand that the concept of microfinance is not new. The precedence for microfinance lies in the numerous traditional and informal systems of credit that have existed in developing economies for centuries, long before modern, western-based commercial banking came into the picture. Many of the current microfinance practices, in fact, derive from community-based mutual credit transactions that were based on trust, peer-based non-collateral borrowing and repayment. Transactional (ex. money lenders), mutual (ex. ROSCAs) or personal (ex. friends and neighbors) credit suppliers have always lent to the poor, providing the right quality and quantity of credit, at the right time and place, to low-income households.

For several decades, many economies, including the Indian, experimented with subsidized credit for the poor. But the only tangible outcome perhaps was the increase in Non-Performing Assets (NPA). Then came the realization that the core issue for the poor was access to credit rather than the cost of credit. In fact one of the contributions of microfinance can possibly be the ‘end of interest rate debate’. Microfinance has proved time and again that it is access and not interest rates that are a constraint for the poor. Another discovery followed, that the poor can and will save, and can indeed use a wide range of financial services such as remittances facilities and insurance products.

The concept of microfinance can be best described in short as, "Small, Short and Unsecured" - microfinance is the provision of very small loans that are repaid within short periods of time, and is essentially used by low income individuals and households who have few assets that can be used as collateral.

A good definition of microfinance as provided by Robinson is, 'Microfinance refers to small-scale financial services for both credits and deposits —that are provided to people who farm or fish or herd; operate small or microenterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and local groups in developing countries, in both rural and urban areas'.

## Microfinance

The term, micro-credit was replaced with a broader coverage than microfinance. It is a set of financial activities provided to the poor masses basically incorporating loans, savings and deposits, insurance, transfer services, etc. to enable them to utilize their limited resources and entrepreneurial skills including abilities to the fuller extent so as to improve the economic conditions and shield themselves against risks. Hence, micro-credit is a part of microfinance.

The characteristics of microfinance products include:

- Borrowers are from the low income group
- Short-term loans.
- Payment schedules attribute frequent installments (or frequent deposits).
- Installments made up from both principal and interest, which amortized in course of time.
- Higher interest rates on credit (higher than commercial bank rates but lower than loan-shark rates), which reflect the labor-intensive work associated with making small loans and allowing the microfinance intermediary to become sustainable over time.
- Loans are generally taken for income generation purpose.
- Application procedures are simple.
- Short processing periods (between the completion of the application and the disbursement of the loan).
- The clients who pay on time become eligible for repeat loans with higher amounts.

- The use of tapered interest rates (decreasing interest rates over several loan cycles) as an incentive to repay on time. Large size loans are less costly to the MFI, so some lenders provide large size loans on relatively lower rates.
- No collateral is required contrary to formal banking practices. Instead of collateral, microfinance intermediaries use alternative methods, like, the assessments of clients' repayment potential by running cash flow analyses, which is based on the stream of cash flows, generated by the activities for which loans are taken.

In the absence of commercial bank loans, access to microfinance affords low income groups to receive loans for their economic activity. Programs and organizations that provide credit to low-income groups make a clear match between the quality and quantity of credit, and the capacity of the poor to utilize that credit - at the same time being organizationally sustainable. Unlike government credit programs and formal bank credit that emphasize large loans for long repayment periods at very low interest rates, microfinance loans are for short periods that are repaid quickly, and made available at interest rates that keep the program sustainable and viable.

A bewildering range of players have jumped on to the microfinance bandwagon — for a variety of reasons. There have been NGOs which gradually metamorphosed into lending institutions, developmental professionals who have set up microfinance companies and banks that have experimented with working exclusively with groups and therefore have 'microfinance branches'. These range from not-for-profits that see microfinance as having a role in 'development', to commercial banks that view microfinance as 'good, sound banking', an excellent way of raising deposits, and lending at low risk. In fact the success of groups in microfinance has attracted the attention of wide-ranging players to use these groups for a range of purposes. Several governmental schemes are being routed through microfinance, including a very large project funded by the World Bank and being implemented in the state of Andhra Pradesh. Similarly organizations like Hindustan Lever have looked at the potential of these groups as a channel for retailing and have launched a program called 'Project Shakti' to tap the smaller villages through the microcredit channel. Microfinance leaders are gaining prominence and it is said that some of the leaders, particularly women, have been taking a more active role in other social spheres, including contesting elections for the Panchayat and so on.

The aspect of microfinance that has contributed to its success is its 'credit-plus' approach - where the focus has not only been on providing adequate and timely credit to low income groups, but to integrate it with other developmental activities such as community organizing and development, leadership training, skills and entrepreneurship management, financial management etc. The success and sustainability of microfinance programs has depended upon, and has fostered, these aspects.

There is a clear need, first of all, in establishing the viability and importance of microfinance as a poverty alleviation approach for low-income groups. It also helps in mainstreaming the concept of microfinance within the larger development economics thought. This is important to create a level playing field for microfinance, and its acceptance by macro players such as bankers and other financial institutions. Emphasis also needs to be placed on second tier organizations in order to support and promote microfinance initiatives.

Thus microfinance institutions and the governmental and non-governmental entities have to work in synergy for microfinance to become a viable tool for poverty alleviation and development and to do so they should focus on the following

- Firstly, there is a need for repackaging microfinance, focusing on capacity building of MFIs. Microfinance needs to 'graduate' from its dependence on grants and its charity orientation, to one of self-sufficiency and financial sustainability. Technical advisory, management tools, appropriate and timely information are some important inputs.
- Secondly, there is a need for mainstreaming microfinance, focusing on governance of MFIs. This calls for a facilitative and supportive legislative environment to be put in place by national and local government agencies and financial institutions - essentially as a complement to the growing trend of self-governance by MFIs.

## Origin and Concept of Micro Finance

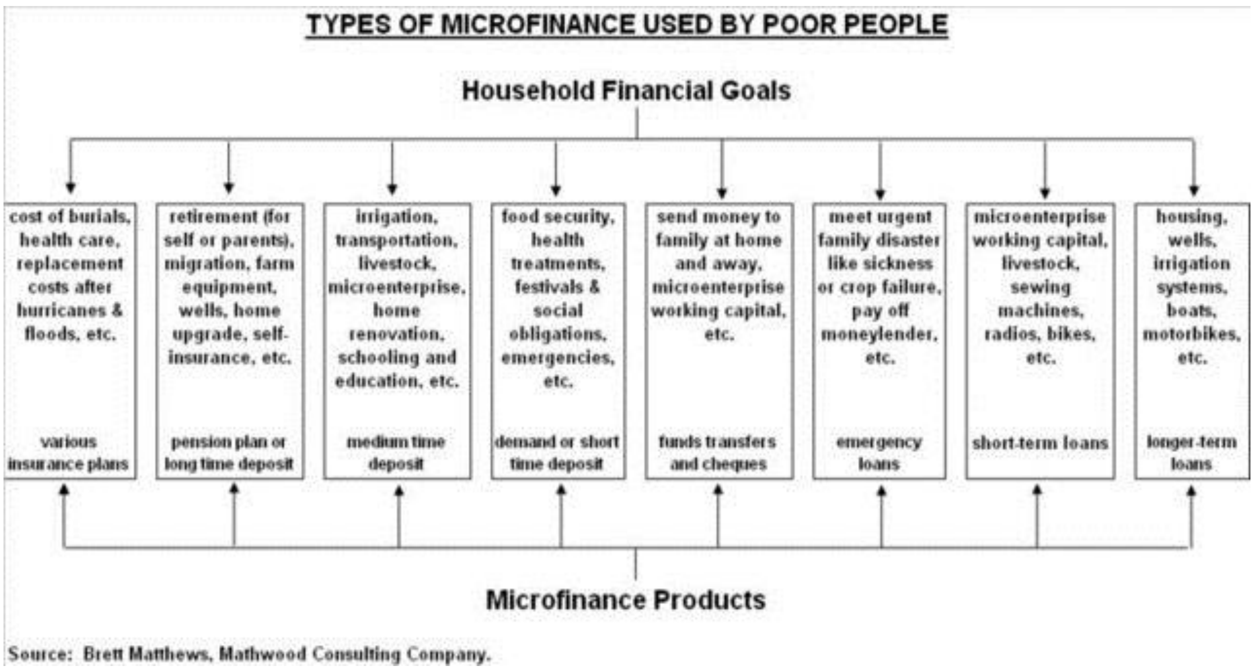
The concept of micro-credit is not new. There has been various savings and credit groups that have operated over the years in different parts of the World, such as "Susus" of Ghana, "chit funds" in India, "Tandas" in Mexico, "Arisan" in Indonesia, "Cheetu" in Sri Lanka, "tontines" in West Africa, and "Pasanaku" in Bolivia. The concept of microfinance was first developed by Jonathan Swift in 1700 in Ireland with a view to bring out the financial services to the door steps of the neglected rural poor by banks by establishing 'Irish Loan Fund System' through provision of short-period without collateral security. In 1800s various Self Help Groups and Credit Co-operatives began to emerge in Europe to assist the rural populace to breakout their dependence on money lenders and improve their financial conditions and welfare. In 1900s various adaptations of this model started in rural Latin America. Microfinance companies (SHGs, Cooperative society) came into being with specific motto of increasing the commercialization of rural sector as well as weaker sections manpower resource by mobilizing 'idle' savings; and increasing investment through credit, and thereon zeroing indebtedness. Unlike in Europe most of the banks for poor in Latin America were not owned by poor themselves but by the Government agencies and private banks .Over the years many of these banks in rural Latin America turned inefficient financial institutions. Many countries like Indonesia (1895), Pakistan (1957), Bangladesh (1976) and Bolivia (1980) started micro credit facilities by establishing various institutions. The modern concept of micro-finance can be traced out as Marshall Plan at the end of Second World War in the middle of 20th century.

## Difference between Microcredit and Microfinance

There is a significant difference between microcredit and microfinance. Microcredit category consists of various types of loans disbursed by financial institutions which may be provided to poor people or people who don’t have any collateral but want to make a living by owning small businesses. So, it suffices the basic requirement of providing money to people without which they may be unable to operate their activities.

Whereas, microfinance is a concept which tries to improve the living condition of poor and unemployed in long term. Microfinance provides financial services to people with no access to capital and commercial banking services. In this way it plays a significant role in modernizing the developing countries. The difference between microcredit and microfinance can be made clear with the example, if a person is willing to launch a startup; he may approach to a microfinance institution and can apply for microcredit loan.

Microfinance provides a wide range of financial services to individuals who can not avail banking services. Modern form of microfinance can be attributed to several organizations established in Bangladesh specially Grameen Bank. Grameen bank considered to be the first microcredit institution was founded by Nobel Laureate Muhammed Yunus, so he is considered originally as the father of Microfinance.




## Challenges in Microfinance

MFIs can play a vital role in bridging the gap between demand & supply of financial services if the critical challenges confronting them are addressed.

1. **Sustainability:** One of the principal challenges of microfinance is providing small loans at an affordable cost. The global average interest and fee rate is estimated at 37%, with rates reaching as high as 70% in some markets. The reason for the high interest rates is not primarily cost of capital. Indeed, the local microfinance organizations that receive

> zero-interest loan capital from the online micro lending platform Kiva charge average interest and fee rates of 35.21%. Rather, the main reason for the high cost of microfinance loans is the high transaction cost of traditional microfinance operations relative to loan size. Microfinance practitioners have long argued that such high interest rates are simply unavoidable, because the cost of making each loan cannot be reduced below a certain level while still allowing the lender to cover costs such as offices and staff salaries. The result is that the traditional approach to microfinance has made only limited progress in resolving the problem it purports to address: that the world's poorest people pay the world's highest cost for small business growth capital. The high costs of traditional microfinance loans limit their effectiveness as a poverty-fighting tool. Offering loans at interest and fee rates of 37% mean that borrowers who do not manage to earn at least a 37% rate of return may actually end up poorer as a result of accepting the loans.

According to a recent survey of microfinance borrowers in Ghana published by the Center for Financial Inclusion, more than one-third of borrowers surveyed reported struggling to repay their loans. Some resorted to measures such as reducing their food intake or taking children out of school in order to repay microfinance debts that had not proven sufficiently profitable.

In recent years, the microfinance industry has shifted its focus from the objective of increasing the volume of lending capital available, to address the challenge of providing microfinance loans more affordably. Microfinance analyst David Roodman contends that in mature markets, the average interest and fee rates charged by microfinance institutions tend to fall over time. However global average interest rates for microfinance loans are still well above 30%.

The answer to providing microfinance services at an affordable cost may lie in a rethinking of one of the fundamental assumptions underlying microfinance: that microfinance borrower need extensive monitoring and interaction with loan officers in order to benefit from and repay their loans. In 2009, the US-based nonprofit Zidisha became the first online person-to-person lending platform to link carefully vetted, computer-literate microfinance borrowers in developing countries with individual lenders directly, without any loan officers or local intermediaries to manage the loans. Dubbed an "eBay for microfinance", Zidisha operates on the assumption that microfinance borrowers can be trusted to participate responsibly in an online lending community and repay loans on their own, as do residents of wealthy countries. This approach allows Zidisha to outsource many of the record-keeping and communications functions that have traditionally been performed by brick-and-mortar lending institutions to Zidisha's online user community, as lenders dialogue directly with borrowers and track their performance via eBay-style feedback ratings. Eliminating local intermediaries reduces the interest and fee cost to just 8% on average, of which 5% covers Zidisha's administrative costs and 3% represents interest paid out to lenders. To the surprise of many observers, Zidisha borrowers have maintained a repayment rate of 98%. Zidisha's success suggests that it is possible to provide microfinance services on a large scale at substantially lower cost.

1. **High Transaction and Service Cost:** Since, the average micro finance loan is small in size hence the transaction cost on a percentage basis is high in microfinance. Also, in the case of a large loan the microfinance institution will need to evaluate the creditworthiness of the client thereby increasing the cost. The operational costs of a microfinance institution is very high because of the services which it has to offer like door to door service and little or no deployment of information technology. There is cost involved in continuous monitoring and repeated interaction. The most popular model of microfinance lending is the JLG model which incurs peculiar costs such as group formation cost, cost of training the borrowers with respect to the procedures to be followed, high degree of supervision as well as higher frequency of installment payments. Microfinance institutions are facing the challenge to reduce their lending as well as operating costs. Technology innovation, educating the borrowers, improved rural infrastructure and urban microfinance are few ways to mitigate high transaction cost. Increased competition also can improve the quality of service, wider range of products and lower lending and transaction costs.
2. **Credit risk:** Credit risk is the risk that borrower will not be able to repay the loan amount and interest. Although in India, many microfinance institutions have achieved repayment rate of 98% but still the credit risk is very in microfinance. The reasons for high credit risk are given as follows:

- Irregular flow of income due to seasonality: Seasonality of agricultural activities and the unique requirements of financing such activities. The loan is generally taken before the sowing season and the payback of loan can take place only after harvesting.
- High dependence on monsoon: Traditional farming practices, it is not very uncommon to see a farmer using the same bull and plough technique which his ancestors were using. Heavy dependence on monsoon and high dependence on seasonal income makes it difficult to assess the borrower's repayment capacity.
- Uncertainty of market conditions: Risk arises because of the nature of uncertainty involved with agricultural output in terms of yield and price.
- Lack of skills leading to Un-Employability: Due to lack of proper education and vocational skills, their employability in non-farming jobs is very difficult.
- Lack of Tangible proof for assessment of income: Absence of land deed, no records like IT returns, irregular flow of income constitute lack of tangible income proof.
- Need for Information Sharing & Better Technology: Adverse selection of borrowers, over-indebtedness of clients and moral hazards due to lack of information about credit worthiness of potential clients.

3. **Non-availability of funds:** Inability of MFIs to raise sufficient fund remains one of the important concern in the microfinance sector. Though NBFCs are able to raise funds through private equity investments because of the for-profit motive, such MFIs are restricted from taking public deposits. Not-for-profit companies which constitute a major chunk of the MFI sector have to primarily rely on donations and grants from Government and apex institutions like NABARD and SIDBI. In absence of adequate funding from the equity market, the major source of funds for MFIs are the bank loans, which is the reason for high Debt to Equity ratio of most MFIs.

   MFIs receive debt from banks against their equity and in order to increase their portfolio size they need to increase their debts for which they further need to increase their equity. After the Andhra crisis, it is reported that banks have stopped issuing fresh loans and even though currently few banks have resumed, they want MFIs to increase their equity to get fresh loans. So the only mode for the MFIs to increase their portfolio size is to increase their equity. The problem of inadequate funds is even bigger for small and nascent MFIs as they find it very difficult to get bank loans because of their small portfolio size and so they have to look for other costlier sources of fund.

4. **Dropouts and migration of group members:** Majority of the microfinance loans are disbursed on group lending concept and a past record of the group plays an important role in getting new loans either through SHG-Bank linkage or through MFIs. The two major problems with the group concept are dropouts (when one or more members leave the group) and migration (when one or more members move to another group). Most MFIs lend on the basis of the past record of the group i.e. SHG or JLG and also on the individuals repayment performance. In absence of a decent past record, members are deprived of getting bigger loan amounts and additional services.
5. **Regulatory Issues concerning MFI's:** MFIs have come under severe political criticism for sometimes charging interest rates as high as 40% and for allegedly using coercive methods to recover the money from borrowers. The sector suffered badly following the intense political heat over the lending practices that could push small borrowers into a debt trap. Conditions worsened after some politicians urged borrowers to stop paying back MFI companies. Following the outcry, the board of the central bank had late last year set up the Malegam panel to suggest long-term structural changes in the functioning of MFIs. The panel had recommended an interest rate cap of 24% and a margin cap of 10% for MFIs with a loan portfolio of 1 billion rupees ($22.5 million) and 12% for smaller MFIs. The new regulatory framework comes in response to suggestions made by a panel headed by Y.H. Malegam. In its guidelines RBI said, loans to microfinance institutions will only qualify as priority sectors loans if interest rates are capped at 26%. Bank loans to all MFIs, including NBFCs working as MFIs on or after April 1, 2011, will be eligible for classification as priority sector loans under respective category of indirect finance only if the prescribed percentage of their total assets are in the nature of 'qualifying assets' and they adhere to the 'pricing of interest' guidelines to be issued in this regard**.** The Bill also proposes registration of all MFIs with a minimum net owned fund of Rs5 lakh against a comparable limit of Rs2crore for non-banking companies.

# History of Micro Finance in India

India constitutes approximately one sixth of the world's total population. It is the world's largest democracy and a key emerging market alongside China and Brazil. The picture of growing GDP and rising foreign investments in early 90s showed an environment where wealth was increasing for the nation. Due to its large size and population of around 1000 million, India's GDP ranks among the top 15 economies of the world. However, around 300 million people or about 60 million households, are living below the poverty line. It is further estimated that of these households, only about 20 percent have access to credit from the formal sector. Additionally, the segment of the rural population above the poverty line but not rich enough to be of interest to the formal financial institutions also does not have good access to the formal financial intermediary services, including savings services.

The history of microfinance in India can traced to Self Employed Women Association (SEWA) in Gujarat. SEWA started in the year 1972 and was registered as a trade union in Gujarat (India), with the main objective of "strengthening its members' bargaining power to improve income, employment and access to social security." In 1973, to address their lack of access to financial services, the members of SEWA decided to found "a bank of their own". Four thousand women contributed share capital to establish the Mahila SEWA Co-operative Bank. Since then it has been providing banking services to poor, illiterate, self-employed women and has become a viable financial venture with today around 30,000 active.

It is in this background that the idea of organizing Self-Help Groups began to take shape in India. Self-Help Group is a group of about 10 to 20 persons from a homogenous background who come together for addressing the common problems. They collect voluntary savings on a regular basis and use the pooled resources to make small interest bearing loans to their members. At a later stage, these groups are able to obtain credit from outside sources to support income-generating activities. Very often there is a Self-Help Promoting Institution (SHPI) which enables the Self-Help Group to function effectively. A stimulus to the rapid growth of Self-Help Groups was provided when the **SHG-Bank Linkage Program** was initiated in 1992. It was a pilot project for promoting 500 SHGs. As the idea gained acceptance from the banking system and the results were promising, the Reserve Bank of India encouraged this positive initiative by issuing instructions to banks in 1996 to cover SHG financing as a mainstream activity under the priority sector lending portfolio. A working group set up by the RBI in 1994 came up with wide ranging recommendations on SHG and bank linkage as a potential innovation in the area of banking with the poor.

India is country where the history of microfinance, poverty alleviation, welfare and rural development are interwoven, to understand any of these we should take the consideration of other factors as well.

After independence the development strategy adopted by India perceived institutional credit as a major instrument for enhancing the production and productivity for alleviating poverty .There was a view of that lending to poor will be the part of normal bank business. To achieve the production and productivity and poverty alleviation, the policy of rural credit was to ensure that sufficient and timely credit reached the rural population as early as possible, that too at reasonable rate of interest .Regional Rural Banks were chosen as important vehicle to achieve this target .Regional Rural Bank was set up in the year 1975 as low cost institution, focused to reach the credit deficient area of the country.

In late 80's and early 90's the financial health of Rural Financial Institutes (RFI) was not satisfactory .The basic aim of financial sector reforms at that time was to improve the efficiency and productivity of all credit institutes including the RFIs. In regard to RFIs, the reforms sought to enhance the areas of commercial freedom, increase their outreach to the poor and stimulate additional flows to the sector. The reforms included far reaching changes in the incentive regime through liberalizing interest rates for cooperatives and RRBs, relaxing controls on where, for what purpose and for whom, RFIs could lend, reworking the sub-heads under the priority sector, introducing prudential norms and restructuring and recapitalizing of RRBs.

Microfinance in India is currently being provided by three sectors: the government, the private sector and charities. These three sectors, as large as they are, have only a small fraction of the capital and geographic scale required to meet the overwhelming need for finance amongst India's rural poor. Some of the private micro finance companies are SHARE Microfin Ltd, Asmitha Microfin Ltd. The top 10 private sector microfinance providers in India together serve less than 5% of the unbanked population of India – approximately 20 million clients.

## Legatum Ventures contribution to Microfinance sector in India

In 2007, Legatum Ventures invested $25 million in SHARE, which was at the time the single largest private equity investment globally in microfinance, to help the company scale its operations to reach more clients while also improving its governance and operations. At that time, SHARE was in distress due to the "Krishna crisis" (where local politicians told borrowers they no longer needed to repay MFIs). With Legatum Ventures' equity infusion, SHARE was able to survive the Krisha crisis and grow. Over the last four years, SHARE, together with its sister organization, Asmitha, has expanded from under one million clients to over five million. The combined company has grown from operating in 3 states to 18 across India. As of the beginning of March 2011, the combined company had an outstanding loan portfolio of almost Rs 4,300 crore ($970MM) and 10,000 employees.

## The Need of Micro Financial Services

The need for financial services, to be provided by institution and agencies, arises on account of the following reasons.

- **Poverty alleviation**

The first and foremost reason for making available the micro financial services is the need to alleviate poverty. Poverty alleviation can be accomplished by through the promotion of sustainable livelihood, by providing easy and affordable access to credit and other complementary services required for promotion of livelihood. Microfinance is considered as potential instrument for combatting poverty in a sustainable manner. For instance empowerment of can be promoted through Self Help Groups and other forms of groups , and collectives at grass roots pioneered through micro finance movement.

- **Harnessing Talent**

Micro financial services are also needed to help harness the latent leadership and entrepreneurial abilities of the poor. Further the micro financial services facilitate enterprise development and provide for large scale employment generation in remote rural areas where poor can obtain employment opportunities through micro finance system.

- **Women empowerment**

Micro financial services are also essential adjuncts for the empowerment and upliftment of women. This happens by mobilizing the women ,organizing them in groups ,building their capabilities for self-management at the grass root level and enabling them to access wide range of services including credit savings ,insurance and business development .They are important as far as the help unleash the hitherto hidden and untapped potential of the poor and the women.

- **Credit delivery**

Micro financial services are needed to ensure effective credit delivery system. The system seeks to ensure rational allocation of resources in the form of subsidized credit especially in rural areas. Micro financial services take care of distribution of credit to the rural poor.

## Status Quo of Microfinance in India

Indian policy making always shows special concern on inclusive growth. The Government of India and the Reserve Bank of India have taken several initiatives to expand access to financial systems to the poor. Some of the salient measures are nationalization of banks, prescription of priority sector lending, differential interest rate schemes for the weaker sections, development of credit institutions such as Regional Rural Banks, etc.

Despite these policy efforts, there still exists a gap in the availability of financial services in rural areas. In these areas people depend on local money lenders who charge very high interest rates and this dependence continues, especially for meeting emergent requirements. Such dependence is more pronounced in the case of marginal farmers, agricultural laborers, and petty traders and rural artisans belonging to socially and economically backward classes and tribes whose capacity to save is too small. Against this backdrop, the concept of microfinance emerged in India.

Microfinance in India can trace its origins back to the early 1970s when the Self Employed Women's Association (SEWA) of the state of Gujarat formed an urban cooperative bank, called the Shri Mahila SEWA Sahakari Bank, with the objective of providing banking services to poor women employed in the unorganized sector in Ahmedabad City, Gujarat. The microfinance sector went on to evolve in the 1980s around the concept of SHGs, informal bodies that would provide their clients with much-needed savings and credit services.

The Self-Help Group (SHG)-Bank Linkage Program (SBLP) which was launched in 1992 on a pilot basis grew significantly. As per the latest estimates, SHGs enable 97 million poor households' access to sustainable financial services from the banking system and have an outstanding institutional credit exceeding Rs. 31,200 crore as at the end March 2011. SBLP is considered to be the fastest growing microfinance initiative in the world. The other model of microfinance, i.e. MFI model comprising of various entities, such as, non-banking financial companies (NBFCs), non-governmental organizations (NGOs), trusts, cooperatives, etc. has also been growing significantly in the recent years. Today, the top five private sector MFIs reach more than 20 million clients in nearly every state in India and many Indian MFIs have been recognized as global leaders in the industry.

Microfinance- both SBLP and the MFI sector- has posted an impressive growth in the past few years with the combined client outreach increasing from about 4.8 crore in 2006-07 to 8.6 crore in 2009-10. Loans outstanding to SHGs were Rs. 28,038 crore while loans disbursed to MFIs by all agencies amounted to Rs. 13,955 crore at the end March 2010.

**Recent developments in Microfinance Sector**

The microfinance sector in India has gone through turbulent times in the past couple of years. The southern state of Andhra Pradesh, the biggest market for the country's microfinance institutions, was at the center of the storm, and populist moves by politicians led to mass default of loans of more than US$ 1.5 billion. Operations are almost at a halt there. On the back of these developments, the MFI segment has taken a severe beating with rising delinquency ratios and downgrades by rating agencies. Lenders have turned wary leading to drying up of funding channels seriously impinging on the business. It is reported that disbursements by MFIs in Andhra Pradesh plummeted significantly in the second half of 2010-11. The recovery rates that were 99 per cent reportedly fell to a meager 10 per cent, leading to huge NPAs which are causing significant stress on the functioning of MFIs. While the loans given to MFIs during 2010-11 declined to Rs. 8448.96 crore from Rs. 10,728.50 crore in 2009-10, the amount of outstanding loans reduced from Rs.13, 955. 75 crore in 2009-10 to Rs.13, 730.62 crore in 2010-11.

Many analysts attribute the current crisis to the irrational exuberance of some MFIs who entered the segment with the sole emphasis on business growth. They did not consider the vulnerability of the borrowers and the potential socio-political ramifications their aggressive approach could possibly lead to. The competition among MFIs led to these institutions chasing the same set of borrowers, by free riding on SHGs and loading them with loans that borrowers, possibly, could not afford. It is reported that as at the end of March 2010, the number of loan accounts per poor household in Andhra Pradesh was on an average more than 10. In their eagerness to grow business, the institutions had given a go by to the conventional wisdom and good practices such as due diligence in lending and ethical recovery practices. Over-indebtedness of the borrowers led to difficulties in repayments and the forced recoveries by some MFIs led to public uproar and the subsequent intervention by the state government.

The legislation enacted by the Andhra Pradesh Government has brought the customer protection issues to the center stage. The legislation stipulated mandatory registration of MFIs, disclosure of effective interest rate to the borrowers, ceilings on the interest rates and strict penalties for coercive recovery practices. One of the fall outs of these developments has been the severe dent in the MFI business due to dwindling resources.

The central government has now stepped in. Government of India has come out with the proposed Microfinance Institutions (Development and Regulation) Bill, 2012 which, among other things, puts the Reserve Bank of India as the sole regulator of microfinance sector covering all forms of MFIs in addition to NBFC - MFIs which are presently being regulated by the Reserve Bank.

Reserve Bank constituted a Committee, chaired by Y H Malegam, to study issues and concerns in the MFI sector. The Committee examined the issues and made recommendations to address the present concerns. Some of the significant recommendations are as follows:

- Loan limits: A limit on loans of Rs 25,000 to borrowers with household income of less than Rs 50,000. This could result in a disincentive for these clients to state their true income, or even to increase their household income for fear of losing access to finance from MFIs. And the millions of borrowers who now cannot avail themselves of microcredit will have limited alternatives, most likely needing to return to the village moneylender.

- A cap on interest rates and margins: It is well known that price controls create benefits for the few and shortages for the many - in this case, the result will be a shortage of available finance. To make broad-based financial inclusion a reality in India, the sector will need to attract billions of dollars from global capital markets. If the RBI chooses to set pricing and margins, instead of letting competition and the market set prices, this will dramatically reduce the amount of investment capital flowing to these MFIs, especially the equity capital they will need to maintain minimum capital adequacy going forward while still growing.
- Provisioning norms: The report recommends much higher provisioning norms than are currently in place. If these are implemented, because of the current situation in AP, many of the large MFIs will have to provide for and write-off their portfolios in AP which would ultimately lead to bankruptcy.
- Increased capital requirement: An increase in the minimum capital requirement from Rs 2 crore ($450,000) to Rs 15 crore ($3.4 million), represents a 7.5 fold increase for an industry with historical repayment rates of 98% and higher. Such a draconian and arbitrary requirement will make it nearly impossible for new companies to start or survive, therefore reducing competition and ultimately denying potential borrowers access to financial inclusion.

The recommendations of the Committee have brought out clarity in regulation of MFIs and led to the containment of the crisis without domino effect. Based on the recommendations of the Malegam Committee, the Reserve Bank of India has issued detailed guidelines permitting categorization as priority sector advance of bank credit to certain eligible MFIs. Such eligibility is linked to core features of microfinance, such as, lending of small amounts to borrowers belonging to low income groups, without collaterals, with flexible repayment schedules and with particular emphasis on measures to curb over-indebtedness.

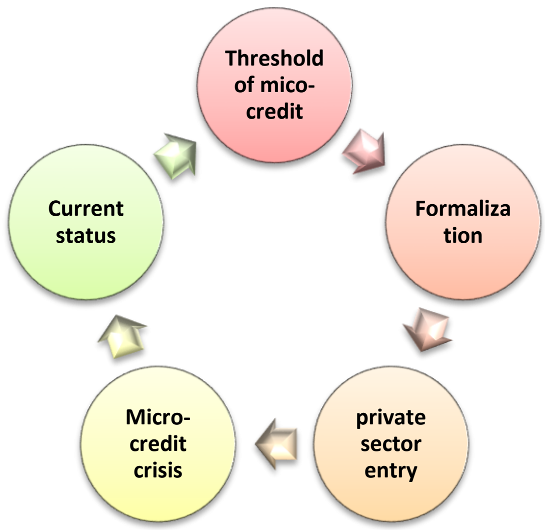
Margin caps and interest rate caps have also been stipulated to ensure protection of borrowers. Subsequently, the Reserve Bank of India created a separate category of NBFCs dealing in microfinance – NBFC-MFI and issued comprehensive guidelines covering, inter alia, fair practices in lending such as transparency in interest rates, non-coercive methods of recovery, measures to contain multiple lending and over-indebtedness.

# International perspective to microfinance industry

## MICROFINANCE IN BOLIVIA

Though Bolivia is on the poorest countries in Latin America with a domestic product per capita of about US$800, but it has one of the most advanced microfinance sector in the world. Its s 7.4 million people (constituting about 70% of the total population) living below the poverty line create a never ending demand for small scale credit. Though the Bolivian microfinance model is followed as a benchmark by many countries worldwide, its apex organizations—second-tier wholesaling mechanisms that lend and offer nonfinancial assistance to retailing microfinance organizations have a very negligible role to play in the success of microfinance in the country. Former and current Bolivian apex organizations have engaged in little market development. Some have provided some liquidity to microfinance organizations, but they have not played an indispensable role in the development of the sector. The NGO'S in the country took the responsibility of providing financial services to the low income social sectors in the 1990's with an objective of having a wide and deep coverage in the rural areas. In the later half of the 1990's, the NGO'S decided to formalize their working style to increase its coverage, both in number of clients assisted and in volume of financed resources. The formalization process helped them attract deposits also which later on turned out to be a major source of funding for the credit allocation purpose. Micro Finance Institutions across the country experienced steady growth in their outreach of both credit and savings services, fueled largely by a recent emphasis on expansion of service markets into previously unbanked rural areas. The Financial System Supervisory Authority (AFSI), created recently in the country, has defined new standards for the microfinance sector that reflect current changes in market conditions.

### 5 Stage Evolution model Of Microfinance in Bolivia




Stage 1) *Threshold of micro credit with NGO'S*

- At the beginning of the 80s, the first initiatives to create NGOs as a way to offer access to credit to those sectors with smaller economic possibilities arose.
- The main source of funding for the NGO'S was through donations, charities and subsidized funds.
- These institutions fulfilled a very important role in the incorporation to the financial system of micro-managers who had never had access to other sources of funds other than the informal ones (family, friends, moneylenders, etc.)

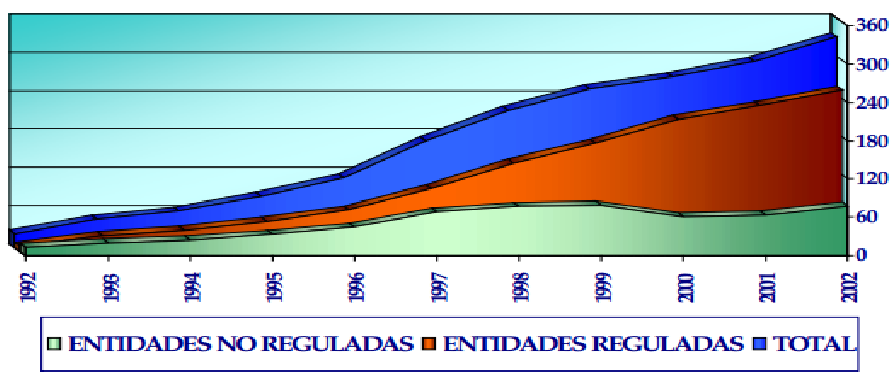
Stage 2) *Formalization of microfinance institutions*

- This era marked the formation of regulated financial institutions dedicated to microfinance that originated from traditional NGOs.
- This process was facilitated by the Government of Bolivia in 1995 when Supreme decree No 24000 was issued
- The decree relates to the creation and establishment of Private Financial Funds (PFFs) in Bolivia. The decree detailed their requirements for registration, licensing and operation.
- In July 1995, Caja Los Andes began its operations as the first FFP established in Bolivia on the basis of Pro-Credit Association. Later, other FFPs were created, some out of NGOs (FIE, Prodem, Ecofuturo) and others from entirely private business initiatives.
- The advantages of the formalization process:

- There was a huge increase in the coverage, both in number of clients and volume of funds. The portfolio of the four main organizations in later of 1990's d (Bancosol, Caja Los Andes, Fie and Prodem) before formalization was about US $41, 8 million with 90.121 clients, by December 2002 the portfolio reached to US $223,9 million providing assistance to more than 147.000 clients.
- Interest rates charged for the micro credit offered fell. And the rate of gross returns of the average portfolio of the four organizations before formalization was 37.2%, and by December 2002 this rate reached 24.3%.
- Thousands of low income households could safely and profitably deposit funds in the FFP's. By December 2002, the FFP'S combined had more than 1, 25,500 depositors.

PORTFOLIO EVOLUTION FOR MICRO FINANCE INSTITUTION

(MILLIONS OF US DOLLARS)




Stage 3) *Entrance of private institutions in micro finance sector*

- This era was characterized by entrance of many independent financial entities and some specialized departments within traditional banks in the micro finance sector of Bolivia.
- These new players in the micro finance field came up with aggressive policies to win markets and earn higher profits. They increased their size of portfolio without concern for

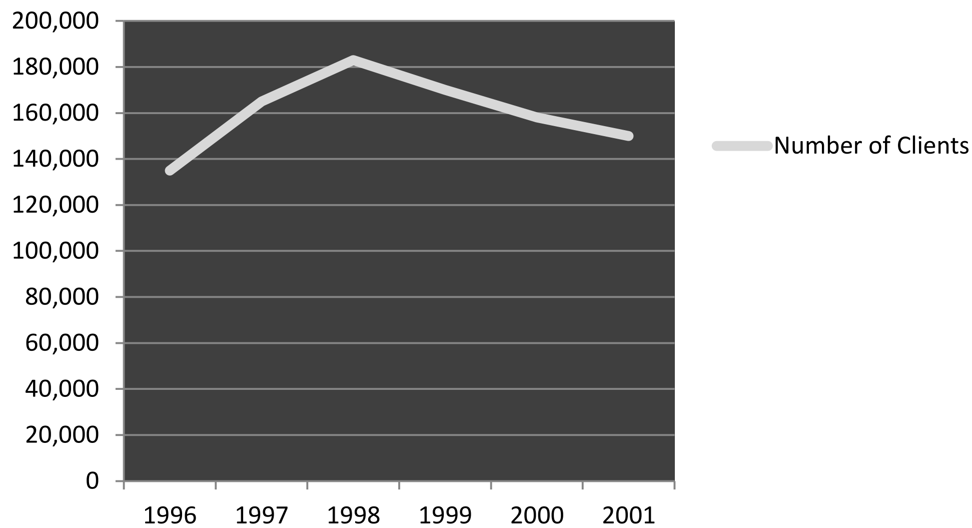
its quality, getting as a result much higher levels of overdue loans than those presented by the “traditional” micro finance institutions entities.

- This boom of credit supply caused many people to fall into the temptation of obtaining credit in different financial institutions for amounts much larger than their real payment possibilities, which led to “over indebtedness” for the financial institutions.

Stage 4) *The Micro-credit crisis of 1999*

- This period is characterized by a significant decrease in the levels of sales in most micro and small companies, due mainly to a reduced capacity for internal consumption, as a byproduct of the negative effect of the economic situation in other Latin American Countries, especially devaluations of national currencies in the Latin American Countries in the early 2000.
- The debt given by the financial institutions increased by large volumes with a small increase in incomes of these institutions against the debt levels. So the in-debtness of the financial system increased significantly.
- Since 1999, the number of clients' served by the microfinance system has decreased significantly as a result of the elimination from the portfolio of doubtful clients who had bad payment records or over indebtedness and of a deterioration in the quantity and quality of the demand of credit.
- The quality of the portfolio has deteriorated mainly in financial years 2000 and 2001. Delinquency indicators have increased 374 base points from 1999 to 200.

***CHANGES IN THE NUMBER OF CLIENTS (Till 2002)***

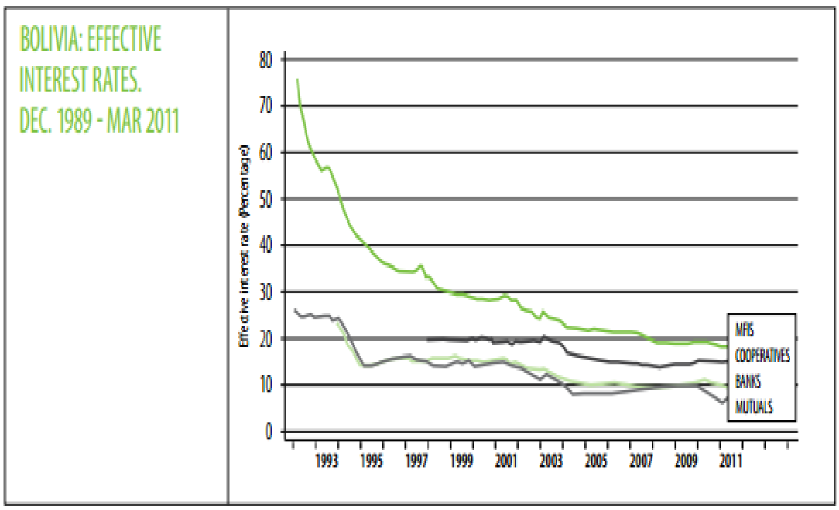



Stage 5) *Current status of the microfinance sector*

- The Bolivian government formed the Financial System Supervisory Authority in the year 2012, which are a set of regulations aimed to moderate the hyper-growth of consumption loans throughout the country, and in so doing head-off potential problems of over-indebtedness seen in other countries in the region.
- A network of MFIs, which includes both limited companies (sociedades anónimas (SAs) and NGOs, has set up a credit bureau, with positive and negative information now being shared among its larger members since 2011, with initially positive results.
- Microfinance forms a greater share of the national financial system's overall loan portfolio. As of March 2012, the loan portfolio of microfinance institutions represented 37% of that of the national financial system. This compares with 36% at end-2011 and 35% at end-2010. Regulated MFIs, such as banks specialized in microfinance and private financial funds (Fondos, Financieros Privados, FFPs), contributed to the bulk (33 percentage points) of microfinance loans, with 4 percentage points attributed to IFDs in the process of integration.
- Bolivia's score for the effectiveness and reliability of credit bureaus for microfinance has been upgraded from 3 to 4 (the highest score). This is based on the strong coverage of

Bolivia's public and private credit bureaus, particularly one that specializes in micro-finance and reports on even the smallest amounts.

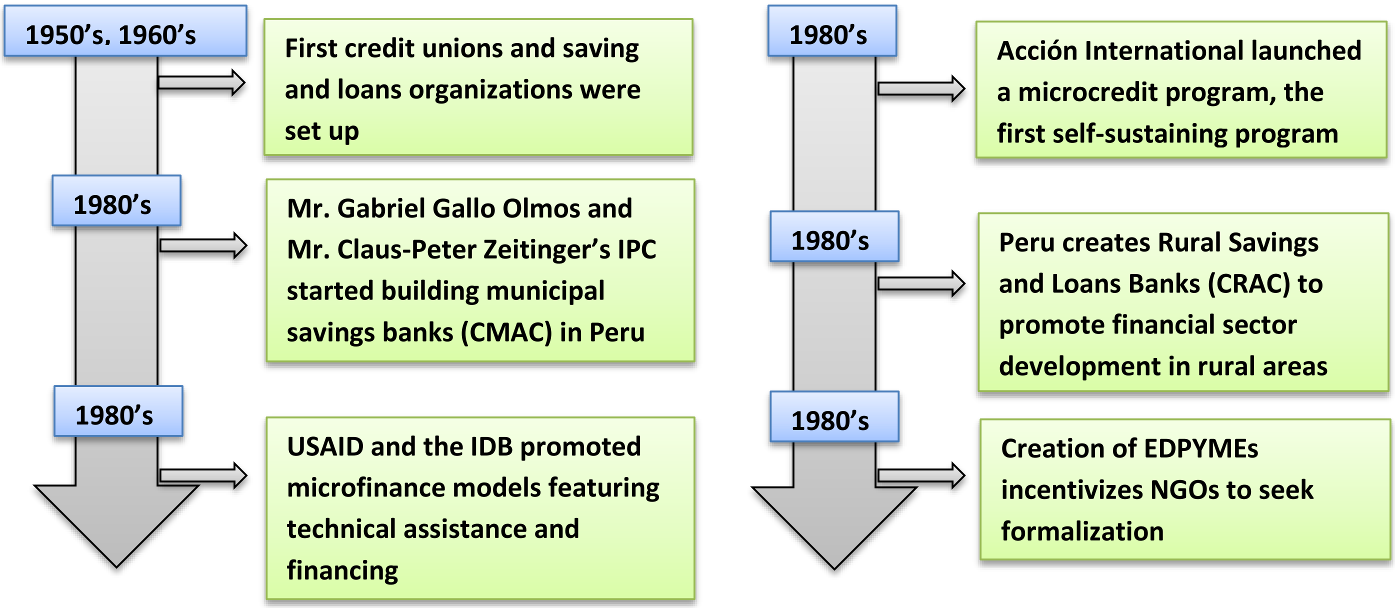
- The current government is using productive microcredit for the purpose of increasing lending to businesses as a part of its anti-poverty policy. In August 2011, the Crescer ("Growth") programme was launched in order to cap interest rates at 8% per year, instead of 60% previously, for loans of up to R15, 000 (around US$7,357). Subsidized credit (up to R500m or $US 246m per year) is being channelled through five state-controlled banks.




**Source:** Boulder Institute of Microfinance

## MICROFINANCE IN PERU

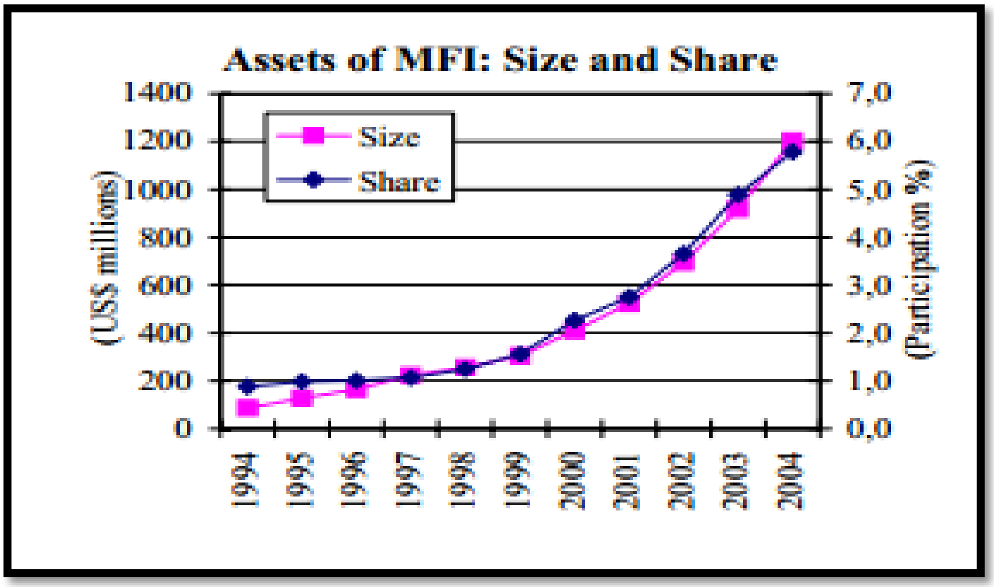
The Peruvian microfinance industry, centered on 40 regulated local banks, serves 3.5 million poor households at ever-decreasing costs. The sector experienced decreasing interest rates even though the profits of the microfinance industry were increasing in Peru. The rise of microfinance has been accompanied by a steady fall in official poverty rates as well as lower income inequality.




- The Microfinance institutions in Peru are composed of Municipal Savings and Loan Institutions (MSLI - also known as CMAC), Rural Savings and Loan Institutions (RSLI - also known as CRAC) and Entities for the Development of the Small and Microenterprise (EDPYME).
- MSLIs started their operations in the early 1980s, and were created with the cooperation of the German government to replicate the success of the German Sparkassen. They are owned by local governments and operate in provinces, helping small business to expand their services by offering them financial products from funds collected in the communities.
- RSLIs were created in early 1990, after the Agrarian Bank was closed due to the 1992 financial reforms. They are owned by local private entrepreneurs, and operate mainly in rural areas with large exposure in the agriculture and livestock sectors.
- EDPYMEs were created in the mid-1990s to formalize those NGOs that were granting loans to micro-entrepreneurs; this formalization became more important by the end of the 1990s when a law was passed which required NGOs to pay value-added tax on all interest from loans. Since NGOs did not have experience collecting deposits from the public, EDPYMEs were created as credit-only institutions.

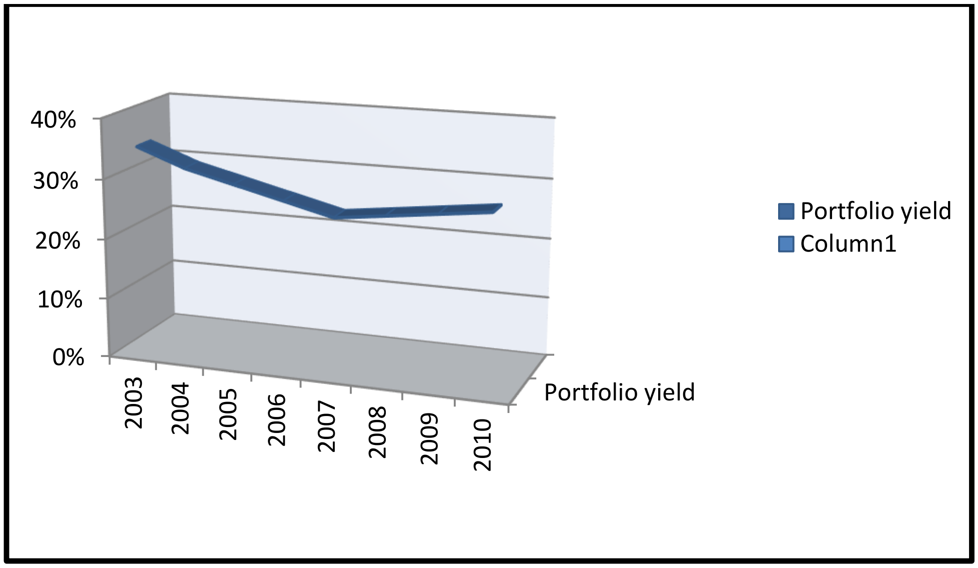
**Present Scenario**

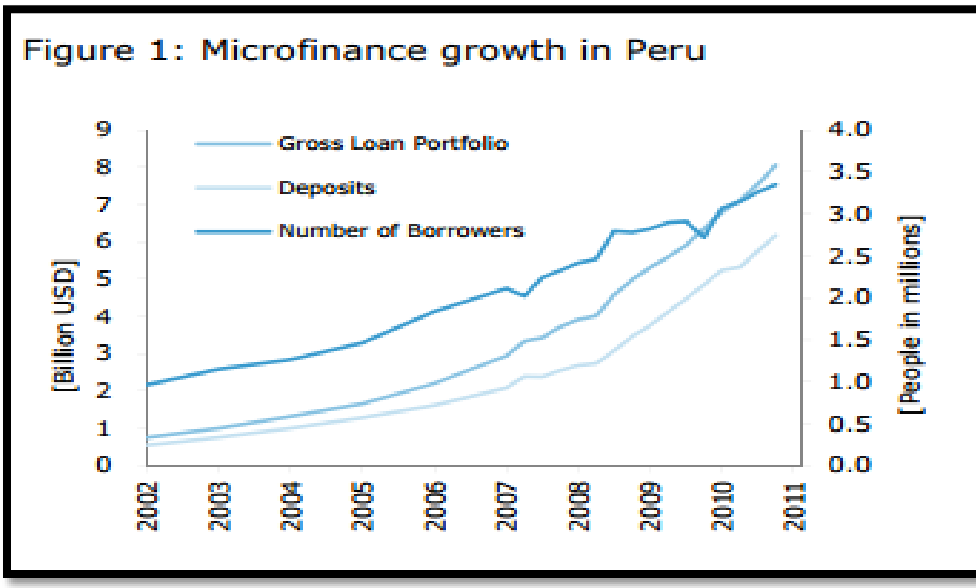
- According to estimates, the microenterprise sector in the Peruvian economy accounts for 42% of GDP and employs 75% of the working age population. However, and despite the fact that MFI assets have grown on average 38.5% annually over the last decade, and the growing interest from commercial banks in microfinance, the microenterprise portfolio is still the smallest loan portfolio in the entire financial system, with US$960 million, representing just 7.9% of the total loan portfolio.




- Profit margins consistently remained positive, even during the worst period of the financial crisis, due to the growth potential of the Peruvian economy and its fast-expanding domestic demand.

***Portfolio yield over time (Profitability of the MFI's)***




- Peru opted for transparency early on, enabling market actors to react to changing market signals. Thanks to the presence of constantly updated indicators in a clearly defined framework of rules, the strong expansion in Peruvian microfinance did not come at the price of extensive MFI failure or widespread Over-indebtedness.
- Banks saw that the profitability in the micro-credit sector is higher as compared to general loan portfolio, where their margins were getting slimmer and slimmer. And many banks got attracted started moving strongly towards this niche market. Banks have an

advantage in their larger network of branches to offer their services, their ability to offer a larger number of services to their clients, and more equity to invest in this market.

*Table 6: Microenterprise Loan Portfolio by type of financial institution (US$ millions and percentage)*

| Type of Institution | 2001 | | 2002 | | 2003 | | 2004 | |
|---|---|---|---|---|---|---|---|---|
| Banks | 273 | 52% | 248 | 43% | 298 | 41% | 469 | 49% |
| Finance Companies | 59 | 11% | 72 | 13% | 76 | 10% | 0 | 0% |
| MSLI | 124 | 23% | 169 | 29% | 240 | 33% | 340 | 35% |
| RSLI | 34 | 6% | 38 | 7% | 46 | 6% | 64 | 7% |
| EDPYME | 40 | 7% | 47 | 8% | 64 | 9% | 88 | 9% |
| Total | 530 | 100% | 575 | 100% | 723 | 100% | 961 | 100% |

**Regulations in the Peruvian microfinance sector**

- Entry Regulation
  - The basic requirements to enter the financial sector are established in Resolution no. 600-98. All applications, whether they are for banks, finance companies or microfinance institutions, have to follow this norm.
- Solvency risk regulation
  - Solvency is regulated and supervised by establishing and monitoring minimum capital by type of institution. Minimum capital requirements are readjusted each trimester by wholesale inflation in the period.
- Credit risk regulation
  - The regulation of credit risk in Peru is established in Resolution no. 808-2003, which defines the types of loans available in the financial system, the risk categories by type of client, loan-loss provisions, and collateral qualifying for lower provisions. Additionally, the General Law of the Financial, Insurance and

Private Pension System, Law no. 26702, establishes a number of limits on financing to a single client, to related parties and to board members and employees of the financial institution.

- Liquidity risk regulation
  - The main regulation with respect to liquidity risk is the minimum liquidity ratio, both in local and foreign currency. The liquidity ratio is defined as liquid assets over short-term. Financial institutions can have differences in risk categories assigned to a client up to just one level.
- Market risk regulation
  - The market risk to which MFIs are exposed the most is foreign exchange risk. There are limits to the exposures: for assets greater than liabilities in foreign currency, 100% of regulatory capital, and for the opposite, 5% of the regulatory capital. In the case of banks, additional capital must be made for 9.1% of the exposure of foreign exchange risk.
- Market exit regulation
  - The regulatory framework clearly establishes when the regulator can intervene in a financial institution and when the institution can be liquidated. Before liquidation, there is a surveillance period lasting up to three months, during which the financial institution has limitations in conducting its normal business and has to submit a rehabilitation plan within seven days after being put under surveillance.

**Implementation of Basel 2 norms in Peru**

The implementation of Basel II under the simple standardized approach could impact MFIs, because it is suggested that the retail portfolio, which in Peru is comprised of the microenterprise and consumer loan portfolio, should have a lower risk weight (75% rather than the current 100%), which could reduce the financial leverage these institutions have by reducing their risk-weighted assets. On the other hand, if Basel II is implemented using the internal ratings-based approach, MFIs would lack the information and systems required to calculate their own parameters (probability of default, loss given default, etc.); thus it will be very hard for them to determine their economic capital. Another way in which MFIs could be affected is that most of them do not have external ratings, meaning that any financing they receive from other financial institutions would be rated at a high level of risk, thus increasing the cost of capital. Peru has not yet decided how and when Basel II will be implemented, but apparently financial institutions could choose their internal ratings with approval by the supervisor, while other financial institutions would use the standardized approach with some modifications adapted to the Peruvian situation. MFIs could be among the latter type of institutions.

## Regulations

In the present microfinance scenario, some of the key problems emerged due to the mission drift in MF sector are over-indebtedness, private investors looking for quick growth and high returns, high costs for clients, multiple lending, improper governance, harsh repayment schedules and coercive repayment techniques used by some of the MF service providers. For successful and ethical implementation of microfinance activities, a good regulatory framework is a prerequisite.

The present regulatory scenario reveals that different kinds of banks such as commercial banks, RRBs, Cooperatives Banks, local area banks and other private banks are covered under Banking Regulation Act and also RBI/NABARD regulations related to microfinance. The Non-Banking Finance Companies (NBFCs) engaged in microfinance are being regulated by RBI whereas the NGOs, Trusts and other not-for-profit institutions functioning as financial intermediaries are out of the purview of the direct supervision of the RBI. The scenario of financial cooperatives is more complex as these institutions are being regulated by Registrar of cooperative societies and also by NABARD/RBI. This situation demands for a regulatory framework that can encompass different types of MF service providers.

Although the SHG-Bank linkage model is well managed in India by NABARD, there is no proper regulatory body for the supervision of MFIs. The presence of institutions with a variety of legal forms makes it difficult for the regulation of all such institutions by a single regulatory body in the current Indian legal structure. Though NBFCs, which cover the major part of the outstanding loan portfolio by the microfinance channel, are regulated by Reserve Bank of India, other MFIs like societies, trusts, Section-25 companies and cooperative societies fall outside the purview of RBI's regulation.

The acceptance of the Malegam committee recommendations by the RBI is a big step forward in addressing the above concern but again it will cover only a section of the MFIs i.e. NBFCs. The Micro Finance Institutions (Development and regulation) Bill, 2012 which was introduced in Lok Sabha on May 22, 2012 is the most recent and the strongest step taken by the government. The bill clarifies all doubts pertaining to regulation of the MFIs by appointing RBI as the sole regulator for all MFIs.

The broad features of the Bill include:

1. Defining microfinance broadly and beyond just lending, to include savings, insurance, money transfers, etc.
2. Inclusion of Non-banking Financial Company (NBFC) MFIs in its purview, in addition to NGO-MFIs.
3. Recognition of the Reserve Bank of India (RBI) as the sole regulator of NBFC MFIs and exclusion of MFIs from the purview of the Money Lender Act. The Bill seeks to empower the RBI to specify sector related benchmarks and performance standards pertaining to methods of operation, fair and reasonable methods of recovery of loans advanced by MFIs.
4. Strengthening of client protection norms – including the establishment of advisory councils at the central, state and district levels and restrictions on pricing and profitability. The Bill provides for the constitution of the microfinance development council to advise the Central Government on formulation of policies, schemes and other measures required to be taken in the interest of orderly growth and development of microfinance institutions. It also provides for the establishment of State Micro Finance Councils in each state or for two or more states, considering the extent of microfinance activities in such states. This council would have to report to the Central Government on the implementation of the measures undertaken for the promotion and development of microfinance institutions.
5. Establishment of a Microfinance Development Fund to enable lending, equity investment, capacity building and research. Under the proposal, the RBI will be

empowered to set up this fund, which can be applied for providing loans, grants or seed capital as well as for training of personnel engaged in microfinance institution services.

This Bill, which is currently under pending status, has the potential to herald the next stage of microfinance growth in India. Though it is important that there should not be over-regulation of MFIs, but a regulator like NABARD will help the MFIs avoid arbitrary controls from state governments and help streamline their working.

## Major Challenges for Implementation of Microfinance in the Developed World

Microfinance has been faced by several new challenges while expanding the industry into developed countries. For the microfinance business to survive and fulfill its mission of being poverty alleviating two major areas can be circumscribed; financial sustainability and social impact. There is an ongoing debate whether or not there is a trade-off between the two concepts.

**Financial Sustainability:** While many MFIs are still highly dependent on subsidies, some institutions have proven to be financially viable and profitable without subsidies, leading to a greater emphasis and pressure on MFIs to become financially sustainable. The shift towards commercialization is thus anticipated, but what does microfinance commercialization means in reality? Commercialization in its most basic form means “to manage on a business basis” but there is a variety of different definitions to microfinance commercialization. Microfinance commercialization basically stands for the movement towards financial sustainability. Microfinance commercialization is the “application of market-based principles to providing financial services to the poor”.

Commercialization of the microfinance industry is by many viewed as the only way to make the industry viable in the long-run and evidence that those MFIs that use a more business-oriented approach are the leading organizations in local markets. Commercialization means moving away from donors, a necessary step since donor subsidies are limited and sensitive to market fluctuations. Being dependent on donor subsidies also prevents organizations from growing, and commercialization is the only way for MFIs to grow exponentially. In order to become financially sustainable, there is hence a need for commercial sources of capital. She argues that turning to the traditional financial markets are the only dependable option for microfinance financing in the long-run. But, it can be difficult for MFIs to attract such capital unless they can lower operating costs and increase efficiency. Many of the MFIs trying on a commercial approach started as NGOs with social missions, they are therefore unlikely to have the management capacity to run a commercial business. Even if the underlying mission is of social nature, it is of great importance that the management has the capacity to operate the MFI as a financial sustainable organization.

**Social Impact:** Borrowers with assets and skills are able to make better use of credit and provide lenders with higher returns. In his study of characteristics of poverty dynamics in Bangladesh, Sen found that rural ascendant households had greater access to credit than chronically poor and descendent households, suggesting that access to financial capital was an important element in the climb out of poverty. At the same time, the ultra-poor and descendent individuals and households typically face barriers to joining traditional microcredit programmes, such as lacking the initial endowment (material and non-material collateral), high opportunity costs, and limited capacity for labor substitution. Even when included in microcredit programmes, some groups, such as landless casual laborers, are less able to benefit because they do not have a regular income that would enable them to commit to repayments, including interest. A loan for such borrowers only means increased insecurity and risk. It is generally acknowledged that traditional group-lending microcredit programmes are not appropriate for the ultra-poor.

Targeting is also gendered since microcredit generally focuses on women as efficient agents for the welfare of the household and as low-risk borrowers. Women present less credit risks, with default rates of only 3% compared to 10% for men. As debtors, women are seen as more passive, submissive, and vulnerable, making them more liable to make repayments. Repayments and debt collection can put significant pressure on women because they do not necessarily directly control household resources. While the burden of repayments is borne by women, the loan itself and income from microenterprise are often passed onto husbands or sons. This means that the ability of microcredit to empower women cannot be measured through client lists or timely repayments. Kabeer, instead, suggests that the measurement of empowerment needs to be within the local context, taking into account the perceptions of the beneficiaries themselves. Of course, impact is unlikely to be even. Women are not a homogenous group, and their contexts differ. Different individuals in different situations are likely to take advantage of different opportunities in different ways, or not at all. As previously mentioned, those with assets and skills, those closer to towns with access to opportunities for commerce, and those with more support from their families are more likely to benefit from microcredit. To participate in microcredit activities, women must negotiate *purdah* barriers and balance microcredit obligations with childcare, subsistence, and other domestic duties. Compared to entry into the formal labor sector (e.g. a job in a garment factory), microcredit is easier to accommodate with *purdah* restrictions and household and childcare commitments. Thus, microcredit can serve as an intervention to assist women and households in the transition from the declining agricultural sector into the formal sector. *Purdah* is a social and Islamic religious tradition that prohibits women from mixing with men who are not blood relatives, after the onset of menarche. Norms vary but generally *purdah* denies women access to productive capital and markets; women in *purdah* are not allowed to work, touch money, or go to the market. While restrictions are, to an extent, negotiable, adhering to *purdah* grants status and privilege, and conversely, violating *purdah* means loss of status and can be a sign of downward economic mobility. Typically, *purdah* confines women's work to the domestic sphere where it is under-valued and not remunerated. For example, if women work outside the household during the peak agricultural season, they would normally be paid in kind, not in cash to avoid violation of *purdah*. Restriction to the domestic sphere limits social networks, participation in civil society, and a voice in policy dialogue.

## Looking Forward: Innovation in Microfinance

Till now we have seen various aspects of Microfinance such as historical facts, challenges faced and regulations regarding it. This portion of the report discusses the various innovative methodologies implemented which are based on microfinance. As the motive of microfinance is to connect the individuals lacking capital facilities with the institutions which can satisfy this capital requirement and also which can provide basic banking facilities to these individuals. This institutional lending is perceived as a risk to institutions as they get no collateral from these individuals' mainly poor people and this inherent risk can tempt to reduce the lending if the loans provided by them are not repaid on time. In order to bridge this gap certain institutions have implemented the securitization on microfinance. A portion of this report also discusses a variant of microfinance which exploits the concept of Islamic Banking resulting in Islamic Microfinance.

- ## Securitization in microfinance

  Last decade has witnessed a catastrophe in the financial world preceded by booming United States economy. Innovative methods have been adopted using financial engineering, which introduced new financial products such as CDO's and swaps. These products have been exploited using the securitization chain which made billions of profit by taking massive risks and left the world economy in unpredictable situation. The securitization chain has become a conspicuous instrument in global financial system. This report does not go into the technical details of securitization engineering; rather we introduce the concept of securitization at a fundamental level. **Securitization basically is the bundling of various asset classes (with a high probability of future cash flows being predictable) which are transferred off the books of original asset owner to a specially designed instrument called special purpose vehicle. This SPV can be effectively utilized to sell the rights to future cash flows to investors in the form of securities**. This way seller can reduce their risk profile and this will provide them an immediate capital and this would provide the investors with a desired market and diversifying their portfolios.

  This process will result in structured financial products which can be sold to anyone present anywhere in the world and these securities can be divided into different tranches and rated by the credit rating agencies(in **US mainly S&P, Moody and Fitch**).

  The whole process is administered by some third party who can provide the necessary setup for making these cash flows possible. In order to meet the funding requirements, financial institutions including the MFI's can implement securitization. Certain institutions like IFMR Capital have incepted in the field where if properly implemented with suitable risk management infrastructure, all participants of securitization chain enjoy the win-win situation.

The hike of microfinance in recent years has caused growth in asset size of these MFI's and securitization seems to be the best option for them to take off risk from their balance sheets to dedicated institutions which can manage this risk properly. It should be noted that the microfinance securitization can be implemented in the same way as securitization is implemented in other financial products. The fact that US banking came to collapse because unregulated swap market exacerbated that crisis situation, as the success rate of microfinance based loan repayment is high in India which does not require credit default swaps to be introduced in the Indian context.

Securitization in microfinance is also unique in the sense as this includes some MFI's originators as servicers also as the repayment methods may require originators to maintain the relationships with borrowers in often remote locations. This uniqueness is also bolstered with the fact that loans are often based on **Group Credit Mechanisms** to satisfy the requirement of collateral.

- **Process**

A rating agency is required to perform the due-diligence of the microfinance originator and which evaluates the loan portfolio of MFI. In order to achieve the desired rating MFI can perform the credit enhancement in the form of first loss guarantee or cash collateral.

This process is followed by rating the securities which are issued by SPV's and they are backed by micro-credit loans. The payment in securitization is same as in CDO's following the cascading cash waterfall. This tiered cash flow structure enabled SPV to offer higher returns to the investors holding the high risk tranches and low returns to investors holding priority tranches.

## Islamic Microfinance

This report tries to touch various perspectives on microfinance including new business models and variants of microfinance such as Islamic Microfinance. It is found that Islamic microfinance has proved to be an effective tool to reduce the poverty in various developing countries all around the world. This industry is expected to reach around $2B in 2012. It is continuously growing as it is based on the concept of interest free Islamic banking. **(Interest in Islam is called Riba).** This form of microfinance is considered to be a socially responsible investment as the underlying banking system is based on ethics mentioned in Quran and interest charging is strictly prohibited in Islam. Investors invest money in Halal projects, projects which could do some benefit to the country.

The difference between Islamic microfinance and traditional microfinance is characterized by the prohibition of riba in Islamic microfinance. This requires lenders or institutions to provide small loans without charging any interest. For this Islamic banking leverages an Islamic financial instrument **quard'l-hasan** which is basically the loan disbursed by the lender on the basis of goodwill and the borrower is required only to pay the principal without any interest, as ethics of Quran encourage people to help people who need the help in the form of capital. Islamic microfinance provides great opportunities to investors and institutional lenders to provide loans and get involved in projects which have worth and which can subsequently alleviate the poverty and provide benefit to the country. Islamic microfinance is considered as an innovative merge of two areas: Microfinance and Islamic banking, and mostly prevailed in Islamic developing countries. It does not only provide the capital to those who need it but it also inherits the concept of social responsibility by helping those who are less fortunate leveraging the best techniques of microfinance. Abdul Latif Jamaal Company Community Service Programmes in Middle East has used Islamic microfinance to help low income in UAE in order to raise their standard of living. There are alternative Islamic financial instruments available such as Murabahah and Musharaka which may facilitate the growth of Islamic microfinance and also they may help individuals to build new business models increasing the options available for alleviating the poverty in developing world.

In this way we see that that there are significant differences between Islamic banking system and traditional commercial banking system where commercial banking system uses the capitalist model of making profit by charging interest whereas Islamic banking introduces the concept of riba free loans and effectively manages to provide the banking services to Muslims. In way the functions of Islamic and commercial banks do not differ that much but the difference comes between them in terms of philosophy, operations and motives. The growth of Islamic microfinance can be seen in terms of its adoption by various commercial banks which have started offering Islamic banking services and instruments. For example, there are state-owned banks in Egypt, National commercial banks in Saudi Arabia, Klienwort Benson in London and the Swiss Banking Corporation.

The following statistics are important to show the growth of Islamic banking sector. Currently there 270 Islamic banks worldwide with total market of $13B. The financial investments made by Islamic banks are more than $400B. The growth in Islamic bank deposits is estimated to be around 10-20%.

## Somaliya: Need for Microfinance

In July 2011, famine hit the Somaiya which resulted in worst food crisis since last 20 years. According to United Nations report the famine existed in two regions of southern Somaliya namely Southern Bakool and Lower Shabelle. Around 3.7 million people across the country are experiencing the famine, food, malnutrition, poverty, and shelter crisis.

These all situations could be improved if financial services and capital can be made available in Somaliya and this is where the need of microfinance comes in. This way people would be able to redevelop their country and economy will be back on track again. Unfortunately there are very less options available in East Africa which is capable of reducing the poverty levels using microfinance.

# Conclusion

Businesses all around the world are involving themselves in corporate social responsibilities expecting these activities to help them in bolstering their profit. The motives may be rational and may be they are aligned with schemes of betterment of poor, but the poor is still far away from reaping these benefits. According to the words of Dr. Raghuram Rajan microfinance is the darling tool for enthusiasts of development and everyone wants to make stories of **cellphone ladies of Bangladesh** where poor ladies borrowed money from microfinance institutions to buy cell phones and sold minutes to villagers thereby making easy money. Even after the microfinance promises upliftment of poor, there are very few cases which have made small business owners rich. As loan origination is just the small fraction of the story but building even a small successful business in today's environment requires skills, education and management which are lacked in the models of microfinance. But the benefits obtained even from the current microfinance business models are large as in the regions of country where microfinance activities are in nascent stages, the poor people save their hardly accumulated money in small boxes which they utilize when they face emergencies, or when a relative starts grappling with the ongoing debt and asks for the financial support. Microfinance plays an important role when individual with lack of capital is surrounded with emergency conditions which require sudden contingency plan in order to deal with the situation. In emergency poor people prefer to ask loans from micro--financial institutions which can originate loans without any collateral and without any bureaucracy involved unlike commercial banks which could take months to complete paper work and often have bribery involved at many levels. The growing sector of microfinance is in booming phase even after surviving crisis in Andhra Pradesh and it needs a proper attention at regulatory level. It is possible to make money at the bottom of pyramid using innovative techniques like securitization by transferring risk and businesses can leverage new business models to provide opportunities to poor which they could not enjoy earlier.

If the topic of finance for poor is discussed anywhere, politicians and corporates suggest charities and subsidies which is not a viable idea. Instead the socially responsible frameworks should be leveraged using microfinance, like if a person needs a loan it should be disbursed only if his known persons such as relatives or neighbor have made the repayment of previous loans on time. This would introduce a sense of responsibility among the borrowers, as it is always inappropriate to default on government's loan which would stop all doors for further borrowing for others and this may possible increase the default rates due to the false assumption of government safety net. Having various ills, microfinance still remains the best model to serve the poor and time has come to save this field by conducting public scrutiny and to make sure that it can achieve its potential of serving the undeserved.