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Role of Commercial Banks in Microfinance

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Abstract – Micro finance is a very important tool for financing the poor. The term "microfinance" (MF) refers to the provision of banking services to lower-income people, especially the poor. In the history of MF, microfinance institutions (MFIs) have been the first to identify the large unserved demand for microcredit in developing countries, develop methodologies for delivering and recovering small loans, and begin credit programs for the poor. Given their nature, though, MFIs can normally meet only a fraction of the demand for microloans in their service areas. Commercial banks have begun to see MF as a potentially profitable business and are starting to venture into this field. Micro finance activities have gained much popularity, now days due to accelerated growth rate of banking services. In a narrower sense, micro finance means 'Banking for the poor.' It includes the provision of extending credit and other financial products and services to the poor. It includes the provision of extending credit and other financing products and services to the poor people, in small amounts. The paper deals with the introduction of micro finance and micro financing in India. This paper aims at exploring the main aspects related to commercial banks' provision of microfinance services and the future prospects for this activity. This paper helps to analyse the relationship of commercial banks with microfinance.

Keywords: Microfinance, Commercial banks, Micro Credit.

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INTRODUCTION

Poverty is one of the few challenges that every single country in the world has to deal with and the numbers say it all. According to the World Bank, 2.7 billion people lived on less than $2 a day in 2001. Despite the difficulties involved in changing this situation, there are solutions and microfinance is one of them. **Microfinance** is a form of financial services for entrepreneurs and small businesses lacking access to banking and related services. The term "microfinance" (MF) refers to the provision of banking services to lower-income people, especially the poor. These services include small loans for microenterprises and individuals, savings, money transfer services, means of payment and insurance.

According to International Labour Organisation "Micro finance is an economic development approach that involves providing financial services through institutions to low income clients." The above definition throw the light on the fact that the basic characteristics of micro credit operations are small loans to poor households in rural and urban areas for income generation through self- employment. Microfinance is an important tool for financing the poor. In simple and narrow sense, it can be termed as "banking for the poor." Most of the transactions under micro finance involve small amount of money. In broader sense, it is a powerful tool to eradicate poverty, and strengthen the social fabric. It is very much beneficial for the women empowerment. Micro financing is considered to be an easiest way to provide financial assistance to less privileged people.

The demand for microfinance services has rarely been met by the formal financial sector, and this may be due to several reasons, including the following:

- failure to perceive the poor households' demand for financial services;
- belief that microfinance cannot be profitable for banking institutions;
- existence of public, legal and regulatory policies that ignore MF;
- high operating costs;
- lack of specific experience in the provision of microfinance services;
- Lack of adequate platforms for the provision of microloans.

However, it has been proven that this demand can be met profitably and on a large scale, and many commercial banks have already identified the business opportunities of MF. Commercial banks have now ventured into microfinance in many countries, where microfinance is at different stages of development. In its most advanced form, in banks and other formal financial institutions, all microloans are fully financed by savings, commercial debt and retained earnings. However, in most developing countries, the formal financial sector still does not serve microfinance clients on a massive scale.

PURPOSE OF THE STUDY:

Micro finance and micro finance activities have gained much popularity now a day due to the expansion of banking services and so these activities have grown to the new heights. So the main purpose of this study is to:

- Present the reasons why commercial banks are best able to serve the goal of microfinance.
- Examine the obstacles of commercial banks in microfinance.
- Examine the comparative advantages of commercial banks in microfinance
- Outline the micro financing in India
- To understand the delivery models of micro finance used in India

LITERATURE REVIEW

Some relevant literature was reviewed by the research especially in the areas relating to the intervention of commercial banks into the field of microfinance.

Accordingly, Baydas, Graham & Valenzuela, (1997) have concluded in their study; microfinance within commercial banks is largely attributed to the efforts of a single person or to a small group of people to promote these activities. Some of these individuals have been close to and aware of the NGO operations in microfinance. With few exceptions, microfinance in commercial banks has seldom been based strictly on profit-seeking motives. (Berenbach and Craig Churchill, 1997). Prudential regulation, with few exceptions, does not seem to discourage microfinance activities in most of the banks. No additional requirements, other than what is typically reported by commercial banks to the supervisory authorities, are requested of commercial banks because of their microfinance activities. (Chaves and Claudio, 1996). Most commercial banks largely use their own deposit base for microloans. Donor funds and government rediscount lines still represent cheaper sources of funds for a number of organizations, but some conditions and limitations restrict use of these resources. The current outreach of commercial banks in microfinance is at best modest in scope.

Further, Bell, Harper and Mandivenga (2002), by a case study done on two different commercial banks in Zimbabwe and Kenya, has concluded that there are still very few cases of privately owned commercial banks downscaling to microfinance for purely business reasons. One of the most important reasons they have identified is the effect of liberalizing markets; as local banks face increasing competition from new, start-up local banks, and foreign banks entering the market, they are obliged to seek alternative markets to survive.

Isern and Porteous (2005) are in their view that commercial banks that wish to take advantage of the opportunities in microfinance should carefully evaluate the considerations, specifically their own goals, the potential market size and competition, the regulatory environment, and their current infrastructure and systems.

MATERIALS AND METHODS

The data for the present study is collected from secondary sources. Various magazines, research paper, referred journals and books have been studied and used for the collection of data.

MICRO FINANCING IN INDIA

Loans to poor people by banks have many limitations including lack of security and high operating cost and so Microfinance was developed as an alternative to provide loans to poor people with the goal of creating financial inclusion and equality.

Muhammad Yunus a Nobel Prize winner introduced the concept of Microfinance in Bangladesh in the form of the "Grameen Bank". NABARD took this idea and started concept of Micro Finance in India. In this concept, there exists a link between SHGs (Self-help group), NGOs and Banks. The SHGs are formed and nurtured by NGOs and only after accomplishing a certain level of maturity in terms of their internal thrift and credit operations. They are entitled to seek credit from the banks. There is an involvement of the concerned NGO before and even after the SHG-Bank linkage. The SHG-Bank linkage programme, which was undertaken since 1992 in India, had financed about 22.4 lakh SHGs by 2006. It involved commercial banks, Regional Rural Banks (RRBs) and cooperative banks in its operations.

Micro Finance is defined as, **financial services** such as **Saving A/c**, **Insurance Fund** & **credit** provided to poor & low income clients so as to help them to raise their **income** & there by **improve** their **standard of living**.

From this definition it is clear that main **features of Micro Financing**:

1) Loan are given without security

2) Loans to those people who live BPL *(Below Poverty Line)*

3) Even members of SHG enjoy Micro Finance

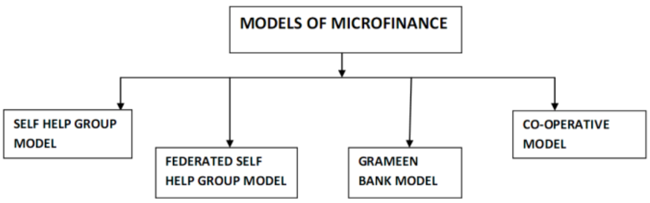
4) Maximum limit of loan under micro finance Rs25,000/-

5) The terms and conditions given to poor people are decided by NGOs

6) Micro Finance is different from Micro Credit-under Micro Credit, small amount of loans given to the borrower but under Micro Finance besides loans many other financial services are provided such as Savings A/c, Insurance etc. Therefore Micro Finance has wider concept as compared to Micro Credit.

DELIVERY MODELS OF MICROFINANCE:

Microfinance is a dynamic field and there is clearly no best way to deliver services to the poor and hence many delivery models have been developed over a period of time. Each delivery model has its share of problem and success. In India, various delivery models have been adopted by microfinance institutions and they can be categorized in to following broad categories, discussed one by one.



- **Self Help Group Model:**

The Self Help Group (henceforth, SHG) model has evolved in the NGO sector and works on the belief that the poor can help themselves and the NGOs can provide networking and education to them. Almost 90% of the SHGs in India are female only due to known fact that world's poorest households tend to rely the more heavily on income generated by women of the house. In India, SHGs have been the most popular way to help the poor and make them bankable. An SHG is a small group of about 20 persons from a homogeneous class, who come together voluntarily to attain certain collective goals, social or economic.

- **Federated Self Help Group Model:**

Self Help Groups have been very successful in empowering women by providing direct and indirect benefits to them. However, SHGs are small in size (usually 10-15 members) and are limited in the types of financial services they can provide. The Federated Self Help Group model is one such way to scale up the previous model. Federation of SHGs bring together several SHGs. Compared to a single SHG, federation of SHGs have more than 1000 members. In this model, there is a three tier structure the basic unit is the SHG, the middle tier is a cluster and the topmost unit is an apex body, which represents the entire SHG. Few notable examples of Federated Self Help Group model are PRADAN, Chaitanya and SEWA.

- **Grameen Bank Model**:

The Grameen Bank model has been a case of exceptional success in Bangladesh. It turns out that many organizations in India have adopted the Grameen Bank model with little variations and good success. Some of the notable examples are SHARE Microfinance Limited, Activists for Social Alternatives (ASA) and CASHPOR Financial and Technical Services Limited. Some of the significant features of Grameen bank model are low transaction costs, no collateral (peer pressure is sufficient), repayment of loans in small and short interval and quick loan sanctions with little or no paper works and no formalities. Repayment of loans in small chunk is one of the major reasons of high loan recovery rate of a Grameen Bank. Furthermore, loans are provided for all purposes like housing loans, sanitation loans, supplementary loans etc.

- **Co-operative model:**

A co-operative is an organization owned by the members who use its services. This model works on the principle that every community has enough human and financial resources to manage their own financial institutions. The members who own it are the members who use its services and can come from different sections of same community like agriculture, retail etc. Example is Sahavikasa or Co-operative Development Foundation (CDF). It helps in assisting rural women and men in the areas of operation in forming and developing self-sustainable co-operatives. It also provides education and training to the co-operators from its work area.

KEY ISSUES IN MICROFINANCE IN INDIA

- **Low outreach:** In India, MFI outreach is very low. It is only 8% as compared to 65% in Bangladesh. Data show the great potential of MFIs in increasing their outreach and scale of operations. MF mainly focus on women because they believed that women are better clients as they are more inclined to save than men, they borrow smaller amounts than men and their repayment performance is better than men. Women may be better and more reliable clients, but in order to increase their outreach MFIs cannot ignore men as clients.

- **High interest rate:** MFIs are charging very high interest rates, which the poor find difficult to pay. It has been argued that MFIs are private entities and hence need to be financially sustainable. They do not receive any subsidized credit for their lending activities and that is why they need to recover their operational costs from borrowers.

- **Negligence of urban poor:** It has been noted that MFIs pay more attention to rural areas and neglect the urban poor. Out of more than 800 MFIs across India, only six are currently focusing their attention on the urban poor.

- **Language barriers:** Language barrier makes communication with the clients is an issue that creates a problem in growth and expansion of the organization because around 54% language barrier has been identified in MFIs.

COMPARATIVE ADVANTAGES OF COMMERCIAL BANKS IN MICROFINANCE

At first glance, banks appear well positioned to offer financial services to ever-increasing numbers of microfinance clients and to earn a profit. Banks have several advantages over nonbank, micro lending NGOs:

- They are regulated institutions fulfilling the conditions of ownership, financial disclosure, and capital adequacy that help ensure prudent management.

- Many have physical infrastructure, including a large network of branches, from which to expand and reach out to a substantial number of microfinance clients.

- They have well-established internal controls and administrative and accounting systems to keep track of a large number of transactions.

- Their ownership structures of private capital tend to encourage sound governance structures, cost-effectiveness, and profitability, all of which lead to sustainability.

- Because they have their own sources of funds (deposits and equity capital), they do not have to depend on scarce and volatile donor resources (as do NGOs).

- They offer loans, deposits, and other financial products that are, in principle, attractive to a microfinance clientele.

All of these advantages could give banks a special edge over micro lending NGOs in providing microfinance services.

NEED FOR COMMERCIAL BANKS IN MICROFINANCE:

By definition, commercial banks are banks “that offer a broad range of deposit accounts, including checking, savings, and time deposits, and extend loans to individuals and businesses” and they are well suited to play a role in microfinance for the following reasons:

Commercial banks can involve in microfinance in several ways, ranging from indirect involvement while raising the capital to direct interaction with borrowers. Commercial banks have realized the growth potential, which can be achieved through microfinance, apart from the social needs. Commercial banks play vital role in microfinance through following ways-

- **Direct Lending:** Commercial banks can lend to entrepreneurs directly. This sort of participation of commercial banks is entirely targeted to serve the microfinance sector. Group lending includes providing a loan to every borrower of the group. However, new loans are not approved to borrowers if any borrower defaults his existing loan. The process of group lending entails an accountability on borrowers to repay their loan in more discipline way.

- **Partnership with Microfinance Institution:** Commercial banks create partnership with microfinance institutions. Banks lend to MIs in the form of retail and wholesale banking. However, MFIs are involved in collection, monitoring and origination of loan. MFIs enjoy lots of benefits by doing tie up with banks. As the higher amount of capital can increase the size of the loan, banks have greater reach through their geographical expansion.

- **Microfinance Subsidiary:** Banks can also choose their microfinance operations through the new subsidiary creation. Such kind of branches assist banks in mitigating the risk levels involved while lending to the poor. From the borrower’s perspective, specialized microfinance services provided by banks may create higher trust and shows the commitment of bank in poverty reduction.

- **Securitization:** Last but not the least, commercial banks play vital role in microfinance by raising funds in international as well as domestic market for the several lending operations of MFIs.

OBSTACLES FOR COMMERCIAL BANKS IN MICROFINANCE

Banks lack, however, some key ingredients - most of all, the financial methodologies to reach a low-income population. They also face thorny internal constraints that must be overcome before they can produce a large, successful microfinance program.

Our study of banks in microfinance identified at least six key related issues banks need to resolve to enter the microfinance market successfully:

- **Commitment:** the commitment of commercial banks (particularly the larger banks) to microenterprise lending is often fragile, and generally dependent on one or two visionary board members rather than based solidly in its institutional mission.

- **Organizational structure:** Microfinance programs need to be inserted into the larger bank structure in such a way that they have relative independence and, at the same time, have the scale to handle thousands of small transactions efficiently.

- **Financial methodology:** Banks need to acquire an appropriate financial methodology to service the microenterprise sector — financial innovations that permit a cost-effective analysis of creditworthiness, the monitoring of a large number of relatively poor clients, and the adoption of effective collateral substitutes.

- **Human resources:** Given that microfinance programs differ so radically from traditional banking, banks must recruit and retain specialized staff to manage these programs. Issues of recruitment, training, and performance-related incentives require special consideration.

- **Cost-effectiveness:** Microfinance programs are costly because of the small size of their loans and because banks cannot operate them with their traditional mechanisms and overhead structures. Strategies must be found to minimize processing costs, increase staff productivity, and rapidly expand the scale of their microenterprise portfolios — that is, increase the number of loans. Banks must cover the costs of microfinance operations and specialized training through scale economies.

- **Regulation and supervision:** Banks must communicate with banking authorities to ensure that reporting and regulatory requirements take into account the specialized nature of microfinance programs.

CONCLUSION

MFIs were the first to identify the unnerved demand for microcredit and to develop models for the provision of credits and other financial services to low-income people. During its relatively short history, micro credit has evolved into microfinance, reflecting the drastic change in the approach to the alleviation of poverty around the world.

"Microfinance presents itself as a new market-based strategy for poverty reduction". The goal of microfinance in the future is to become a transparent and regulated industry. In this respect, the most important development to be achieved is the linkage of microfinance to the commercial capital market in order to satisfy the growing needs of the clients of this industry.

Consequently, microfinance can be a commercial business in addition to its non-profit aspect; but it is a different one, not to be approached like consumer finances. The participation of commercial banks in microfinance requires that they first and foremost have an extensive network of branches, an understanding of local cultures, make use of economies of scale and train their credit agents for a successful monitoring of a loan.

Nevertheless, the direct involvement of a commercial bank in microfinance without experience can be costly. In this respect, a partnership with a microfinance institution or an indirect participation might be preferable. In any case, in the near future, we can expect more commercial banks to be involved in microfinance. This participation is most likely going to be in an indirect fashion such as securitization through microfinance bonds and funds. Indeed, this suggests that the microfinance industry is in the right direction, creating ties with the formal financial system in order to achieve the necessary scale to make the required changes for the financially deprived population of the world.

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