

W P : No.

PROFORMA FOR WORKING PAPER

Title of the Paper : **The Transformation of Microfinance in India: Experiences, Options and Future**

Name of the Author(s) : **M S Sriram and Rajesh Upadhyayula**

Under which Area do you like to be classified? : **CMA**

Would you consider giving a faculty seminar based on your study? : **No**

If the Working Paper has any relation to the Research Project(s) you are handling, please give the title of the Research Project. : **No**

**ABSTRACT
(within 250 words)**

The paper looks at the growth and transformation of microfinance organisations (MFO) in India. We first, define microfinance and identify its “value attributes”. Having chosen only those MFOs that have microfinance as the core, we look at the transformation experiences.

To understand the transformation experiences better, we identify issues that trigger transformation viz: size, diversity of services, financial sustainability, focus and taxation. Having identified these we look at transformation experiences internationally. We examine the Bolivian, Kenyan, Bangladeshi and the Indonesian experience.

We then look at the Indian experiences. We argue that the transformation experiences in India are not large in number. However, we have found that there are three forms of organisations that seem to be popular in the microfinance sector – the Non-Banking Finance Companies, the Banks – both Local Area Banks and Urban Co-operative Banks and the Co-operatives. We then argue that in the Indian case, we find that the MFO spins off from the NGO rather than the NGO transforming itself. Having examined various options, we conclude that there is no ideal or easy path for MFOs to mainstream in India. This has implications for regulatory framework. We argue that there should be regulatory changes that allow smaller MFOs to get into more complex forms as they grow organically. We also argue that NGOs should be allowed to invest in the equity of MFOs and MFO promoted banks, as is the case in Bolivia and Africa. We maintain that entry norms on capitalisation for the current forms of organisations (NBFCs, Co-ops and Banks) need not be changed to ensure only genuine MFOs make use of the legislation and not other organisations masquerading as MFOs.

Date: September 2002

Signature of the Author (s)

The main objective of the working paper series of IIMA is to help faculty members to test out their research findings at the pre-publication stage.

The Transformation of Microfinance in India: Experiences, Options and Future[♦]

M S Sriram[♦]
Rajesh S Upadhyayula[♦]

Abstract

The paper looks at the growth and transformation of microfinance organisations (MFO) in India. At the outset, we try to define microfinance and identify the “value attributes” of microfinance, which differentiates MFOs from other forms of organisation. We then look at the setting of MFOs – identifying who promotes MFOs, and what would be their objectives. The setting helps us to map various organisations undertaking microfinance and how central is it to the NGOs developmental agenda. Having chosen only those MFOs that have microfinance as the core, we look at the transformation experiences.

In order to understand the transformation experiences better, it is important for us to find out what are the issues that trigger transformation. We identify five issues that trigger a movement for the microfinance operations to move away from an NGO format to the mainstream format. These issues are, size, diversity of services, financial sustainability, focus and taxation. Having identified these issues, we look at transformation experiences internationally to understand the type of responses that have come in from the international arena. We examine the Bolivian, Kenyan, Bangladeshi and the Indonesian experience. Each of these countries have important lessons on transformation to offer, which is examined in detail.

We then move to look at the Indian experiences. In the Indian case, we argue that the transformation experiences in numbers are not significant enough. However, we have found that there are three forms of organisations that seem to be popular in the microfinance sector – the Non-Banking Finance Companies, the Banks – both Local Area Banks and Urban Co-operative Banks and the Co-operatives. We then argue that in the Indian case, we find that the MFO spins off from the NGO rather than the NGO transforming itself.

Having examined the various options for moving into the mainstream, we conclude that there is no ideal or easy path for MFOs to mainstream in India. This has implications for regulatory framework. We argue that there should be regulatory changes that allow smaller MFOs to get into more complex forms as they grow organically. We also argue that NGOs should be allowed to invest in the equity of MFOs and MFO promoted banks, as is the case in Bolivia and Africa. We maintain that entry norms on capitalisation for the current forms of organisations (NBFCs, Co-ops and Banks) need not be changed to ensure only genuine MFOs make use of the legislation and not other organisations masquerading as MFOs.

[♦] Paper presented at the SIDBI workshop on “Key Dimensions in Transformation – from NGOs to Formal Institutions”, Held at the Indian School of Business Campus – 12th to 14th December 2002.

^{*} Faculty member, Centre for Management in Agriculture, Indian Institute of Management Ahmedabad

[^] Fellowship Student, Economics Area, Indian Institute of Management Ahmedabad

The Transformation of Microfinance in India: Experiences, Options and Future

M S Sriram¹ and Rajesh S Upadhyayula²

Introduction

From small efforts of starting informal self-help groups (SHG) to access the much-needed savings and credit services in the early 1980s, the microfinance sector has grown significantly today. The fact that national bodies like Small Industries Development Bank of India (SIDBI) and National Bank for Agriculture and Rural Development (NABARD) are devoting significant time, energy and financial resources on microfinance is an indication of the reckoning of the sector. The strength of the microfinance organisations (MFOs) in India is in the diversity of approaches and forms that have evolved over a period of time. While India has its home-grown model of SHGs, and mutually aided co-operative societies (MACS) there is significant learning from other microfinance experiments across the world, particularly Bangladesh, Indonesia, Thailand and Bolivia.

The fact that microfinance has grown in several forms, and has drawn lessons from several experiments, takes us back to basics. What does microfinance actually mean? It appears that what microfinance means is very well understood, but not clearly articulated. There are some definitions of microfinance offered in past literature. Robinson (2001) for instance says “microfinance refers to small-scale financial services – primarily credit and savings – provided to people who farm, fish or herd.” However, she later admits that the definitions could be narrower and more focussed, depending on the typology of lending. She however maintains that it would be good to keep the definition to “refer to all types of financial services provided to low-income households and enterprises.”

In India, for instance, if a SHG gives a loan for kick-starting an economic activity, it is immediately seen as microfinance. But if a commercial bank does a similar loan on similar terms for the same person, as a part of its overall portfolio, this will not be immediately recognised as microfinance. This helps us to define microfinance in softer terms. It is assumed that microfinance, has several value attributes loaded on to it. Some of these are elaborated below.

Value attributes of Microfinance

First, microfinance is something that is done by the **alternative sector** – not the government, and or the commercial sector (later we shall see that there is an “alternative commercial sector” as well). Therefore by definition, a small loan given by a commission agent to a small borrower is

¹ Faculty member, Centre for Management in Agriculture, Indian Institute of Management Ahmedabad

² Fellowship Student, Economics Area, Indian Institute of Management Ahmedabad

not seen as microfinance. However when a Non-Governmental Organisation (NGO) gives a similar loan (and on similar interest rates and terms) it is hailed as microfinance. We should understand this clearly, so that we are able to identify the value attributes. It is assumed that microfinance, is done with a laudable intention and has institutional as well as non-exploitative connotation. In this case we are unable to define microfinance by the size and the purpose of the loan. We actually try to define it by the intent of the lender.

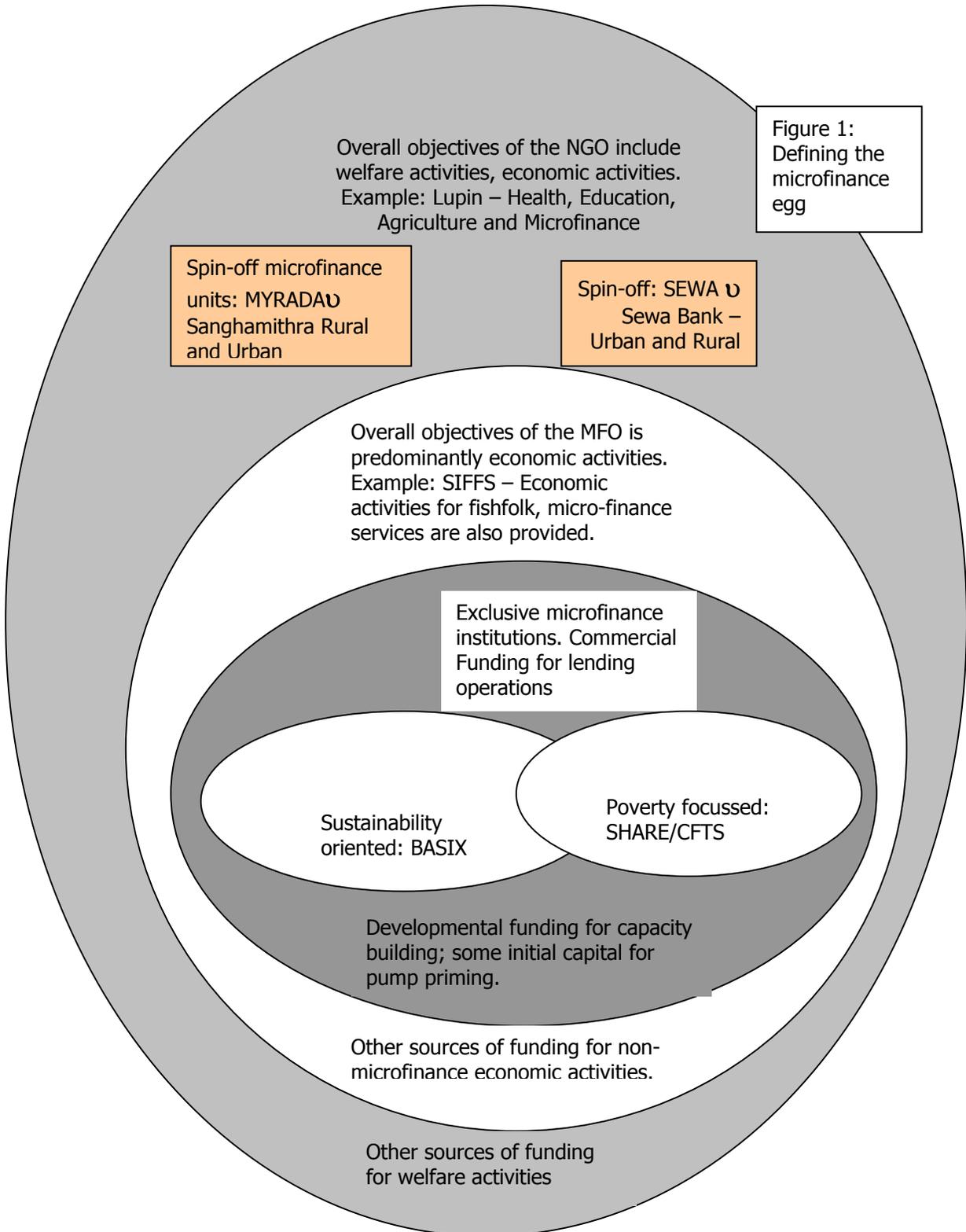
Second, microfinance is something done exclusively or predominantly with the **poor**. Again, the banks do not qualify to be MFOs because they do not exclusively or predominantly cater to poor. However, to the extent that the banks have got into the business of linking SHGs, they are considered as providers of finance to MFOs and in some cases promoters of microfinance, but not as players of microfinance. There are of course, some counter examples for this – particularly with the Bank Rakyat Indonesia (BRI) which transformed its lending practices around 1984 to qualify for the label of microfinance to be attributed to it. Even in India, we are ambivalent about the Regional Rural Banks (RRBs) and the new Local Area Banks (LABs), and in normal course would not ascribe the value attribute of a MFO to them. Rutherford (2000) highlights the difference between the providers and promoters of microfinance – providers being those who do microfinance on their own books and promoters being those who help formation of groups. By this definition, banks typically will have to be classified as promoters, rather than providers.

Third, microfinance grows out of **developmental** roots. This is what can be termed as “alternative commercial sector.” This encompasses the first two points – the organisations are promoted by the alternative sector, and targeting the poor. However the new organisations growing out of these roots need not necessarily be “developmental” in the form of incorporation. There are MFOs that have been offshoots of NGOs run on commercial lines. There are also instances where new MFOs are promoted on commercial lines. People who have worked with NGOs in the past and have “developmental” credentials usually promote such MFOs. The lending and related activities done by such MFOs are usually understood to be microfinance. Very rarely do we find commercial organisations setting up “microfinance businesses”. It is important to understand this before we look at the transformation NGOs to commercial MFOs.

Lastly, the Reserve Bank of India (RBI) has defined microfinance by specifying criteria for MFOs to seek exemption from registration under the Non-Banking Finance Company (NBFC) guidelines. This definition is limited to not-for-profit companies and as of date only two MFOs in India – Sanghamithra Rural Financial Services (SRFS), and Indian Association of Savings and Credit (IASC) – qualify to be classified as microfinance companies.

The Root of the Matter

Before grapple with the growth and transformation issues, we look at how microfinance activity is carried out in India. It is possible to find microfinance at three levels or typologies of organisations. This is described in the Figure 1: Defining the Microfinance Egg.



There are organisations that do a range of developmental activities. These NGOs are in as diverse fields as health, education, and livelihood enhancement – but also have a component of microfinance. Microfinance here is seen as one more addition to the portfolio of developmental activities being carried out. Such NGOs can be classified as both promoters and providers of microfinance – depending on whether a “revolving fund” has been instituted or whether they are only promoting groups. But microfinance is not the fulcrum of the activity in such NGOs. A good example of such an organisation is the Aga Khan Rural Support Programme (AKRSP) in Gujarat.

Box 1: AKRSP’s Microfinance Programme

Aga Khan Rural Support Programme’s (AKRSP) savings and credit programme started off by conserving “programme savings”. The initial groups formed were for a given village and had a membership of around a 100 people. The formation of the groups were more on the basis of the other work undertaken by the beneficiaries, rather than on an explicit need of having to save and rotate money amongst themselves.

AKRSP has been working on watershed management, natural resource management and management of wastelands and forest resources in tis area. Several of these activities require the involvement of the stakeholders. The involvement includes labour contribution. One common method followed by AKRSP, is to get the communities involved in soil and water conservation by constructing check dams and undertaking contour bunding. If AKRSP is undertaking the activity of watershed management with the involvement of the communities, it is expected that the community contributes part of the labour free and a part of the labour is paid for. AKRSP might also bear some other out-of-pocket costs.

Whenever there was work undertaken on a common property a component is paid to the community as wages. In order to encourage the habit of thrift, AKRSP had initiated the practice of dividing up the wages into three components. For every payment of Rs.50/- to be made Rs.35/- was paid out to the workers in cash while Rs.10/- was put into a common fund to take up activities was benefited to the village at large and Rs.5/- was retained in the name of members as voluntary savings. All these savings – though termed “voluntary” are as a result of check-offs from wages. Since these were check offs from payments related to programme implementation, these were called as programme savings.

The above fund till recently, was managed with the village as a unit. These groups undertook lending among themselves. Here, the microfinance programme (having both the savings and credit component) was an integral part of the other programmes carried out by AKRSP.

Under the same category we have MYRADA. MYRADA was one of the pioneers of SHG methodology. This organisation started off as a “promoter” of microfinance – linking the groups to the banks, but ultimately decided to address the problem by also taking on the role of “providing”. For this purpose, MYRADA decided to spin off a separate MFO. The spin-off MFO – SRFS is not only doing rural microfinance but also addressing urban poor through urban groups. It is interesting because, urban poverty is an area where the parent organisation itself has not worked in the past. The Self Employed Women’s Association (SEWA) movement of Gujarat also decided at a fairly early stage that the women need to have their own financial institution.

Therefore – in line with SEWA's style of setting up a new organisation if it does not fall into the core objectives of the parent, they set up an Urban co-operative bank. Infact, the SEWA Bank is termed as one of the oldest microfinance institutions in India. It had developmental roots, but was set up in the commercial arena as a co-operative, rather than a NGO.

The second level of NGOs help the poor by taking up sectoral economic activities. They satisfy the conditions laid out earlier – purpose is developmental, focus is poor and working in the alternative sector. An example is the South Indian Federation of Fishermen's Societies (SIFFS).

Box 2: The experience of SIFFS

SIFFS was established in 1983. It is a society and an apex body of a three-tier structure for artisanal fishermen. At village level there are more than a hundred fishermen's societies in six districts of Kerala, Tamil Nadu and Pondicherry. SIFFS works with a membership base of 6,000 who are directly members of the village societies and also around 14,000 crewmembers that work as a part of the team. The objectives of SIFFS are to work with poor fishermen and provide marketing and technological support to them. Initially, SIFFS was mainly involved only in technology development for the artisanal sector. Now, SIFFS continues to be active in technology development and dissemination, but offers more. The activities of SIFFS can be categorised as commercial and non-commercial. The commercial aspect of the programme includes a network of 12 boat building centres, and the microfinance programme for fishermen.

The credit activities were started by the individual fishermen's societies even before the federation came into being, as early as the 1970s. The first stage was resorting to savings check-offs. This was done on payments due for fish at the end of the day. It was dovetailed into the economic activity. When the Federation was established, the activity reached the second stage, where it actively worked with the local banks in providing linkages with the societies and then with the fishermen. The third stage (late 80s) was when SIFFS turned out to be the guarantor for the loans given by the bank. This was the stage when SIFFS realised that the amount of loan forthcoming from the banks were insufficient and several times inefficient. The fourth stage was establishing revolving funds at the district level. In the fifth and the final stage SIFFS directly entered the arena by providing bulk loans. This is a clear indication of the increasing importance of microfinance in this sector and how a "promoter" organisation eventually turned out to be a "provider."

SIFFS is one of the few institutions in India that undertakes microfinance activities predominantly with men. Most of the other programmes are targeted at women.

At the third level the core is microfinance. There are examples of stand-alone MFOs. But as we stated earlier, the roots of these organisations are developmental. The forms they have taken are those of commercial organisations – mainly NBFCs. Therefore we have MFOs with different orientations incorporated under the same legal form. MFOs that fall under the sustainability school as well as the poverty school are incorporated as NBFCs. They are different in their operational details.

This paper would largely focus on NGOs/MFOs that have microfinance as the “core”, and will address the issues of transformation of these NGOs from their developmental roots towards the commercial sprout. In some cases the promoter/organisation has retained its original identity and spun off the microfinance into a new entity. In some cases, the promoter/organisation has metamorphosed into microfinance significantly, or fully.

Issues that trigger transformation

In this section we examine the significant issues that trigger transformation of NGOs into MFOs. It is evident that NGOs have existed for a long time and never in the history has this issue of transformation come in under such a detailed scrutiny. When we examine these issues, we will be confronted with some generic issues – the ones that affect MFOs across the world and some specific issues – these are pertaining to the local laws. The specific issues on transformation will be discussed in the context of India only.

Size

The most significant issue that triggers a transformation is growth. Both promoters and providers of microfinance encounter this – though at different stages of growth. Invariably the promoters of microfinance find that the existing institutions are unwilling to provide finance at the same pace at which the providers expect them to provide finance. Working with the attitudes of these organisations is not an easy task. For instance, MYRADA in India was working hard on linking SHGs to the local banks and often found that the mainstream organisations have their limitations. In several cases the initiative was individual driven – and depended on the manager. In such a situation impatience creeps in and the NGO would get into action to either start lending on their own (they need not necessarily transform, but open a division for microfinance), or set up a MFO. The story appears familiar with several Indian MFOs, if one looks at their genesis carefully.

Diversity of Services

A trigger for transformation is in the diversity of financial services offered. While in most cases credit is the trigger to start microfinance activities, MFOs soon realise the need to provide other support services. One service is risk mitigation. How does one ensure that the loan given does not turn bad? Microfinance sector has evolved good systems to address the issue of willful default through the mechanism of group guarantees. However the issue is also of non-willful default. This is to be addressed to a combination of self-insurance, group insurance and re-insurance. Savings is one mechanism of self insurance. However when MFOs get into savings services, it is seen that the NGO format is not suited and they have to look at transformation options.

Financial Sustainability

This issue is closely linked to the growth. Beyond a level of operations, the MFOs will have to seek external funds. Donor money can only start up a microfinance activity. Donors cannot be a sustainable source of funding. Then, the only alternatives left for the MFO would be to either seek investments or loans. When MFOs seek investments or loans from the mainstream organisations, questions will be asked on the ownership structure and capital adequacy. For a MFO to survive in the long run, it has to transform itself into a financial institution that is accountable. For instance in the Bolivian context the main constraint the MFOs faced was that they were dealing with "other people's money." NGOs have clear-cut ownership structure and making people liable under the NGO format is a problem. If one were to be sustainable and grow, there is no option but to deal with mainstream institutions (Rhyne, 2001).

Focus

In several NGOs, there is a need to maintain focus of the original mandate. Carrying out microfinance related activities is transaction intensive and requires a different orientation and skill sets. There is always a conflict between microfinance stream – which earns returns, and therefore could be called "commercial" and other activities that are promotional in nature. The NGO might trigger a spin off because of this. Obviously, when the spin-off is with the clear mandate of working in the arena of microfinance, the form of incorporation would have to be in the arena where the mainstream financial institutions operate.

Taxation

In the Indian context, significant issues pertaining to taxation are raised in some fora. The argument is simple. If a NGO – that usually tax-exempt entity, carries out commercial activities (microfinance) on a large scale, then it would attract the attention of the taxation authorities. It is possible that in the process of building up a microfinance NGO, we might jeopardise the tax status of the other activities, making even grants taxable. This is one of the concerns of NGO-MFOs. This triggers a search for an alternative where microfinance could be kept isolated.

Transformation Experiences: International

This section attempts to review the transformation of microfinance from NGO to MFO internationally. We first examine the Bolivian experience of transformation from NGO to MFO.

Bolivia: Mainstreaming Microfinance

In Bolivia, NGOs triggered the microfinance revolution, like in many other parts of the world. However, the circumstances under which the Bolivian model of microfinance emerged has its

roots in the economic turmoil that Bolivia saw in mid 1980s. However, today Bolivia has an array of MFOs – including mainstream banks, NGOs and Fondos Financieros Privados (FFPs). Among the banks, the most celebrated is BancoSol, an off shoot of an NGO called Prodem. Most NGO run microfinance programmes tend to become FFPs when they reach a critical stage. Very few get to the level of full scale commercial banks like BancoSol. In fact apart from BancoSol, there is no other bank that has a significant microfinance portfolio in Bolivia except for a relatively young bank – Banco Economico (Rhyne, 2001).

The most innovative institutional structure that has been set up purely out of the articulation of the microfinance sector is the FFP. We have some indication on policy reform in India on these lines. Time and again, Sa-Dhan, the association of community development finance institutions has been arguing that there should be a new category of companies with a lower threshold of initial capitalisation and with a limited range of banking services (Sa-Dhan, 2002). Sa-Dhan has been arguing that such companies could limit their savings services only to the borrowers and not to general public. This is on similar to the FFPs of Bolivia, which have lower capital requirements, and are restricted from providing certain sophisticated services that the banks provide. There are some requirements pertaining to the diversity of the ownership of FFPs. We shall examine the issues pertaining to implementing such a regulation later in the paper. In Bolivia, while many a large NGOs converted to FFPs, there were other organisations such as Fassil and Acceso that came from pure commercial backgrounds. While Fassil survived, Acceso had to quickly close shop as it went on an overdrive in consumer credit. There are important lessons to be learnt from this experience of changing the regulatory norms to suit the current needs of MFOs, and the implications for the type of future entrants into the market.

Gabriel Schor (quoted in Rhyne, 2001) identifies that this route of transformation brought in the concept of an “ideal capitalist”. This arrangement brought in four key elements to the ownership. The NGO, came in for developmental roots and mission; Local private investors were motivated by public recognition without losing much money and getting returns; Public sector investors such as multilateral investment banks came in for safe investment and prestige; and International technical partners (Rhyne, 2001).

It is also important to remember that though in the process of transformation Prodem promoted BancoSol, Prodem itself continues as and NGO to address the developmental needs. Now Prodem largely caters to rural borrowers – a different client segment. It recently converted itself into an FFP – thereby having a double transformation.

Kenya: Building Partnerships

The Kenyan case was largely inspired by the Bolivian experiment. We discuss the Kenyan Rural Enterprises Programme (K-Rep) as an illustrative case. K-Rep was established in 1984 with funding from USAID. In 1987 it became a local NGO. Its approach in the initial stages was like other NGOs - providing on-lending, technical support and training to local NGOs. Despite efforts made by K-Rep over a period of three years to support the microfinance programme through intermediation, the programme through local NGOs did not meet the expectations on concerns of sustainability and effectiveness. In 1990 K-Rep changed its approach and got into direct lending, by offering two loan products. In 1999, inspired by the Bolivian experience, K-Rep established a commercial bank. The bank has equity contributions from K-REP Group Limited, the International Finance Corporation (IFC), Shorebank Corporation, FMO, Triodos Doen and the African Development Bank. The most interesting feature is that the most significant share holder of the K-Rep Bank – K-Rep Group Limited is a company with no share capital – it is limited by guarantee and its assets are held in a charitable trust.

The pattern is similar. The bank does the dirty finance business. While the non-financial services is done by K-Rep Development Agency (research and development) and K-Rep Advisory Services Ltd, (consulting and business development). These two do the “development” related work of the institution. The triggers for transformation were similar to the ones discussed above:

- a. Securing an appropriate and sustainable funding source from the financial markets and financial independence.
- b. Acquire appropriate institutional form and long-term institutional base, as well an appropriate corporate culture for providing financial services.
- c. Influencing policy and the finance sector, in favor of serving poor. Gaining recognition and legitimacy as a financial institution.
- d. Establish a stronger base for ownership, governance and management.
- e. Commercialize and integrate microfinance into the mainstream financial markets and to situate microfinance amongst legitimate financial institutions.
- f. Encourage entry of other players from financial markets, in order to expand outreach.
- g. Improve governance, management and transparency, through ownership and capitalisation.

www.k-rep.org

Indonesia: Transformation of the Mainstream

In case of Indonesia, the emergence of microfinance has taken the reverse route compared to the other countries. It is important to understand this perspective. The triggers for microfinance

to take the "supply" route could be different from the triggers of the "demand" route. In any case, it would be useful to understand this perspective if we were to look at convergence of the mainstream and the alternative structures in India.

In Indonesia, the microfinance movement did not move from organising people into groups and providing training. It also did not move from emergence of self-help groups. The pioneering institution in Indonesia's microfinance did not have any of the value attributes discussed earlier. Of the two most well known institutions, Bank Dagang Bali (BDB) was established in 1970 as a private bank. If we look at the evolution of microfinance purely as a market opportunity, Indonesia gives us the right example. The promoters of BDB were two enterprising people with first-hand experience of small enterprise and finance (M-Cril, 2002). The example set up by BDB was unconnected to the happenings in the microfinance world elsewhere. The bank grew and survived by innovation of products – sensing an opportunity for an arbitrage between the fairly low rates of interest paid on savings and high interests charged on loans.

The private bank became a model for the State owned Bank Rakyat Indonesia (BRI), thereby setting the mainstream to move downwards towards the poor – under the name microbanking. It was clearly in the direction of providing banking services (not just credit or savings) to the poor. The trigger was provided by BDB, attained nationwide coverage with the 1984 restructuring of the unit *desa*, or local banking, system of the state-owned BRI (Wardhana, 2001).

This has important lessons for us if we were to consider the embedding of the microfinance system in the general financial system. The BRI experience emerged out of the following trigger. The issue of providing access to financial services to the poor was the major trigger. In the old paradigm, the state would channelise its resources earmarked for the poor through the banking system – offering a different line of credit at subsidised rates of interest. However, the banking system soon realised that this could not be sustainable in the long run.

The state accepted the challenge to move from the old paradigm of subsidised credit delivery to sustainable microbanking. By moving towards packaging of credit to meet the needs of the poor, the system had sorted out problems of arbitrage between the cost of credit available from the institutions that were sponsored by the state and the local players. Even the problem of improper identification of the "beneficiary" – leading to a heavy leakage was plugged. The question of continuing access to these services was therefore successfully addressed by embracing the methods of microfinance. Now after a conscious shift towards microbanking – they offer complete financial services of a bank to the poor and to people who transact in small amounts.

Box 3: Bank Rakyat Indonesia

BRI is one of the five State-owned exchange commercial banks in Indonesia with the responsibility for providing rural banking services. It was established in 1968 and is one of the Indonesia's largest banks. The bank has network of 320 branches and 3600 retail units, known as Unit Desa System (UDES). UDES provides financial services to micro and small customers in rural areas.

UDES was established in the early 1970s to channel BIMAS (mass guidance) credit to the farmers to achieve self-sufficiency in rice. The interest rate was low. UDES operations could be sustained only through subsidies. By 1980 the lending volumes decreased and default increased to 50%. BRI was faced with a choice of either closing the UDES system or run it profitably. BRI decided to convert the UDES network to provide financial services in a flexible and sustainable manner. Viability was the cornerstone in the transformation.

The government decided to keep off the UDES system after its redesign in 1984. From 1983 onwards the Government supported self-sufficient market based rural banking network. Some of the transformations were:

- The collapse of the BIMAS credit program
- Deregulation of banks; Freedom to set interest rates; No restrictions on credit targeting; No access to cheap funds.
- The units are small and focused; have a separate entity and accounts. This instills accountability. Performance evaluation is based on the profitability, not on coverage.
- Savings integral to the banking philosophy. The products were introduced after due market research. Products covered liquid, semi-liquid and fixed deposit instruments.
- The products are standardized and simple – four variations of savings and one type of loan is available.
- Incentive system was designed for its unit managers, staff, depositors and borrowers.
- A strategy of lending risk management was devised which consists of
 - Collateral
 - Reducing lending risks by effective borrower selection, screening, monitoring
 - Adequate provisioning for doubtful loans and
 - Risk diversification
- The Central Bank regulates and supervises BRI as per international standards.
- External supervision has created pressure for BRI to adopt similar standards for the regulation and supervision of the units. BRI has a system of internal control that includes strong elements of built-in and functional control.

Since inception of these reforms, the UDES has considerably grown in strength. In 1996, there were 16.1 million deposit accounts and 2.5 million borrowers. The unit system in 1996 accounted for 25% of total BRI assets and 15% of loan portfolio. It contributes to 70% of total deposits and is a major fund provider for the bank.

Thus within a decade of its transformation from a government sponsored programme based credit provider, the UDES has significantly changed from a dependent on BRI to its support for BRI for financial viability of its operations both in terms of funds and profits generated. Thus UDES, BRI provides an interesting experience of how a rural bank which was once started to facilitate credit operations under government led credit programmes into a successful and viable financial institution providing a wide range of services to the micro and small customers.

Bangladesh: Transformation of a Project

The Bangladesh experience is the most discussed in the field of microfinance. In case of Bangladesh there were not many issues pertaining to the transformation. This was because, unlike in other places – microfinance did not branch out of other developmental activities. Microfinance was the nucleus. It was in direct response to the failure of the Nationalised commercial banks, the Bangladesh Krishi Bank and other institutions to cater to the needs of the poor and marginalised. In the 1970s the loan recovery of these institutions averaged 65% of the amount repayable. During that period, the political parties also offered to waive the loans of the farmers (Montgomery, Bhattacharya and Hulme, 1996). It was around this time that Professor Yunus started his action research on effective delivery of credit to rural poor – which later grew into a mammoth microcredit programme, under the name Grameen Bank. In 1983, after seeing the success of the programme, the project was converted into an independent bank by government legislation.

Unlike the experiences of other countries, the Bangladesh experience looks at legitimising and legislating a successful experiment – rather than asking the experiment to go through to other forms of incorporation which might be inappropriate. The Bangladesh experiment gained overall approval – so much so, that it almost became a universal standard in microfinance. Today there are several replicators of the grameen model across the world.

While Grameen pioneered its brand of microcredit, there were other institutions in Bangladesh that also entered into this arena. For instance, The Bangladesh Rural Advancement Committee (BRAC), set up in 1970 got into organising groups under two pilot programmes of outreach programme (OP) and Rural credit and Training Programme (RCTP) in the first half of the 1980s. BRAC's methodology shared some similarities with Grameen. With the Grameen experiment being a worldwide fable, it was not very difficult for institutions in Bangladesh to get regulatory support. BRAC eventually did spin off a banking company to address these needs recently in 2001. In case of Association for Social Advancement (ASA) – the metamorphosis was even stark. Though ASA was established in 1978, as an organisation of social and political activists, it changed its focus to social and economic upliftment of poor in 1985. By 1991 they were fully focussed organisation using microfinance as a singular tool for achieving their objectives. (www.asabd.org)

However, with institutions like Grameen Bank, BRAC, ASA and other institutions pioneering microfinance and providing models for other countries to follow, they did not have an urge to transform. They could grow at the pace at which they were growing without transformation. It

was only when they reached a very large size and sophistication did they want to address other complex needs that a mainstream banking institution would address. In Bangladesh we have a dual example of something that started off as an MFO entering into other areas of development, and other NGOs picking tab from Grameen and launching their own successful microcredit programmes. So the transformation was two way, but unlike Indonesia, all the microfinance institutions in Bangladesh also carry the value attributes listed earlier in the paper.

The Transformation Experiences: India

The issues grappling the microfinance sector worldwide are usually the same. We have reviewed the literature pertaining to the experiences in the world to highlight the alternate approaches that have been adopted to get an identity for microfinance. The Indian MFOs are a Diaspora of various approaches. Surprisingly in spite of different orientation and focus, some transformation efforts look very similar on the surface. We examine the types of transformation that has taken place in the country in this context and also highlight the implications for growth of the sector.

We look at the transformation experiences of the Indian microfinance sector from two viewpoints. First we discuss the transformation responses for the issues raised in the earlier part of the paper. We then discuss the transformation processes of a few MFOs within the country.

Challenges Posed by the Issues that Trigger Transformation

Size

Much of the microfinance practice is developed by NGOs. However there are some questions about NGOs on aspects of effectiveness, management and efficiency. This includes the scale of the delivery. Some drawbacks of the NGOs in microfinance include:

- Difficulty in growing beyond a size. There are reasons why transformation gets triggered off due to the size of the operation. Typically NGOs have multiple developmental objectives and microfinance addresses a sub-set of the overall concerns. But microfinance activity is very visible and has scope to grow. However the form of incorporation of an NGO is not suited for financial activities. To the extent that the microfinance activity is small, it would be possible to carry on within the framework of an NGO, but growth means documentation, regulation, follow-up and money management (Sriram, 2002). To ensure that there is a clear demarcation between the charitable activities of the organisation and the activities that involve commercial aspects, it might be necessary to spin off microfinance to a separate unit.
- Growth needs infusion of funds for microfinance operations. The organisational form of an NGO does not allow it to scale-up borrowings or attract investments from outsiders.

- Since there is no capital base in an NGO, leveraging becomes complex. There are concerns on the nature of taxability of its operations if microfinance activities form the biggest chunk of the surplus earning activities of an NGO.

Share Microfin Limited demonstrates the transformation from an NGO to an NBFC due to growth in size and focus on financial services. The specifics of this transformation are discussed later.

Diversity of Services

This is closely linked to size. But need not necessarily be dependent on size. Apart from loans, MFOs would want to offer services of savings for the clients. This is useful, as it is an essential service for the clients. It also forms an important source to help the loaning services grow. Some MFOs would also want to offer insurance and other services. For instance, when SEWA wanted to work with poor women a few decades ago, one important gap that was perceived by them was that the women did not have an instrumentality to save. There were issues pertaining to social security. When we examine Sewa Bank, we realise that it was necessary for them to open a specialised institution for this activity rather than carry it out in the parent institution.

In fact it might be more apt to indicate that more than diversity of service, the trigger usually is the need to start savings services. Unlike micro-credit (where only loans are given), which is not as closely regulated, savings is very closely regulated and monitored. Therefore any foray into savings service will trigger the NGO to examine options of transformation.

Financial Sustainability

The trigger for sustainability could come from within, and from outside. For instance several donor agencies might be prime movers for an NGO, by granting seed money. However they would want the activity to continue sustainably. A good example is BASIX. The Ratan Tata Trust was willing to extend a returnable grant for BASIX for a period of one year to carry out pilot operations in microfinance. However, it was clearly understood that the grant would not be renewed or enhanced. BASIX started its operations in a not-for-profit company, but they had to get the rest of the act in place so that transactions could be carried out in a sustainable manner. Several donor agencies grant revolving funds for microfinance activity to start off. However, if the activities were to continue, on a sustainable basis, then transformation is necessary.

Focus

Some NGOs might spin-off an entity to manage microfinance exclusively. It might be because the NGO wants to continue its other developmental activities and sees microfinance diffusing its

focus. We have two instances of spin-off in the Indian context. The first is that of Sewa Bank – which was set up as a separate organisation by SEWA. As the activities of Sewa Bank grew, it not only focussed on financial services, but also provided a diverse range of financial services – savings, risk management and credit. Now that Sewa Bank itself has recognised that Insurance is a specialised function, they have decided to address the issue of providing risk products through a new organisation - Vimo-Sewa.

SRFS (see Box 4) was set up by MYRADA to address the specific needs of the self-help groups promoted by MYRADA and other organisations. MYRADA has been donning the role of a “promoter” of microfinance. However, when they realised that the embedding of the groups with the mainstream was not happening at the planned pace, they decided to also assume the role of a “provider”. This involved specialised systems and procedures and a change in the thought process. It was appropriate for them to build an arm’s length relationship between the developmental work of promotion and the commercial work of provision of services. Therefore, it can be seen that one of the sub-processes of transformation includes spin-off of new institutions.

Box 4: Sanghamithra Rural Financial Services

SRFS was promoted by MYRADA. The objective of SRFS was to demonstrate that microfinance could be profitable and scalable. For meeting this, it was imperative that MYRADA transfers all MF related activities into a separate MFO that stood on its feet. This would demonstrate to the Bankers microfinance could be profitably carried out at scale.

The growth plans of SRFS were not ambitious. At the same time, activities had to be carried out on a commercial basis. While there were no issues of transformation to mainstream, there were issues of spin-off into a mainstream strategy for purposes of demonstration.

With these objectives, SRFS was incorporated as a company, with zero capital. The liability was limited by guarantee of the members. SRFS sought a large amount of donor money for corpus – this was like a revolving fund that any NGO gets. However, as SRFS had no concerns about aggressive growth the strategy was appropriate. With these objectives SRFS carries out microfinance in a limited area and intends to withdraw when bankers start financing SHGs.

If SRFS did not have these outer limits to growth, it would have needed to examine other forms of incorporation. Now, it needs to earn enough profits to show that it is operationally self-sufficient – thereby demonstrating to the banking sector that the activity could not only cover marginal costs, but also contribute back to the bottom line. However, unlike the banking sector, it does not have any pressure to service the equity contribution – but still has the need to demonstrate that the equity could be serviced on an imputed cost and financial self-sufficiency can also be demonstrated.

All MFOs may not choose this route, but for SRFS it serves the purpose of demonstrating the economics of the activity. Other institutions who see value in this might want to pursue a different route to transformation, while keeping the spirit of the design elements in tact.

Transformation of Institutions

It would be in order to state that the transformation process in the country is still at a nascent stage. The microfinance sector has really not grown to the size that warrants a full-scale study on the transformation processes. This is not because large-scale microfinance is not happening in the country, but rather, because there are a large number of small initiatives being carried out at various places. For instance the estimated number of microfinance institutions that have requested finances from SIDBI, have contracted rating agencies like M-Cril, PlaNet Finance and CRISIL for rating and the mutually aided co-operatives promoted by Co-operative Development Foundation (CDF) indicate the following legal incorporation.

Table 1: Estimated Number of MFI under different organisational forms*

Legal Status	Estimated Number	Important Institutions
Not-for-Profit Company	2	IASC, Sanghamithra
For-Profit Company (NBFC)	6	Samruddhi, SHARE Microfin, CFTS, Sarvodaya Nano Finance, Kosh, Asmitha
Local Area Banks	1	KBS Lab, Andhra Pradesh
Co-operatives:		
Co-op Society	6	AMCCS, JMSSM, Bhuttico, VYCCU, ICNW, , Pushtikar Samiti,
Co-operative bank	1	SEWA Bank
Mutually Aided Co-operative Society	250	SWDMACTS, Sneha MACS, PWDMACS, APDSFLMACS, Share India MACS and others including mens' and womens' thriftco-ops promoted by CDF – All in Andhra Pradesh
Public Society/Trust#	400	Assist, SKS, RASS, ASA, FWWB, GDS, Outreach, RGVN, SIFFS, WWF, VWS, YCO.
Estimated Number	666	

*Source: SFMC Database, M-Cril Database, C-Gap Rating Fund Database, CDF Annual Report.

#Source: Sinha, Sanjay: The role of Central Banks in Microfinance in Asia and the Pacific. Manila: Asian Development Bank (This is one of the estimates)

These are only indicative numbers that have come into the databases mentioned above. The number of Public Societies/Trusts is likely to be an under-estimate, whereas the other forms are likely to be more realistic.

Option I: "In good Company"

If we treat "For-Profit Companies" to mean transformation and mainstreaming, from the data above, we find that not much has happened on the field. We examine a few trajectories of transformation from the limited experiences that the Indian microfinance sector has had.

Let us look at instances of MFOs that have registered as NBFCs. Here, there are two approaches: One is an approach taken by Share/Cashpor Financial and Technical Services (CFTS). Both are

similar in orientation and focus. Both are inspired by the Grameen Bank and focus on reaching the poorest. Whereas Share operated as a public society for a long time before setting up a NBFC, CFTS started as a NBFC and is still trying to grapple with the norms applicable to NBFCs.

Share had a long association with its clients. The clients had enough accumulated savings because of their long association. Therefore the transformation was simpler. When it set up a NBFC – Share Microfin Limited (SML), it encouraged all its clients to convert a significant part of their savings into equity in the new NBFC. This meant the SHARE had adequate capital to start an NBFC. This route is familiar, and similar to that of the Bolivian model. The basic difference here is – in transforming from an NGO to a NBFC, it was difficult for Share to maintain the organisational links. It was possible for a Bolivian NGO to invest in an FFP (a similar arrangement was with K-Rep). In case of Share, they had to transfer all the clients to a new legal entity, slowly and gradually winding down the operations in the NGO and transferring the clients to the NBFC branch by branch (Sriram, 2001). This posed some instant problems for SHARE. First, as a NBFC, being governed by the prudential norms of the RBI, it was prohibited from accepting client savings. Even if SML had, at that point, got an investment grade credit rating, its flexibility of offering savings services to the clients was and continues to be very restrictive. Share found an innovative solution whereby it also promoted a MACS (Share India MACS) to collect savings. But this has obvious drawbacks, because both the institutions are incorporated under different legislation and have different governance structures.

In case of CFTS, the incorporation itself was a process of transformation. That is because CFTS has an NGO background – but when they set up their operations in India, they registered themselves as a NBFC. However, unlike Share they did not have prior operations in India as an NGO. It was therefore difficult to raise the start up capital. In fact even as of now, CFTS does not yet have adequate capital to register as an NBFC. CFTS has to go through the painful process raising client capital, by finding donor money that could go to the clients and then be re-invested in the company to reach a threshold size that gains economies of scale as well as recognition. The Activists for Social Alternatives (ASA, India) is another organisation which falls in the Grameen mould trying to transform itself as a company. They are attempting an innovative route of forming private mutual benefit trusts of clients who in turn hold equity in the NBFC. However, the scheme is yet to take a concrete shape and can be studied only after the implementation.

The case of BASIX was different. BASIX had a design that looked at mainstreaming right from the world go. Therefore the structuring of BASIX was per force complicated. BASIX sought a mix of developmental and commercial funding for its operations and had a separate vehicle through

with the operating entity was adequately capitalised. This involved setting up a holding company which had a heavy external borrowing from developmental sources such as Ford Foundation and Swiss Development Co-operation. However, as the formalities of getting clearances for setting up a mainstream organisation was going on, BASIX started its operations through an existing NGO – Indian Grameen Services and carried out operations for about a year. BASIX represents a mix of developmental capital flowing in on the promise of sustainability and commercial capital flowing in from the developmental windows of large financial institutions.

BASIX also has a new-generation LAB under its fold. The entry norms for LABs are more stringent than the NBFCs. While the NBFCs are expected to bring in a start-up capital of Rs.20 million, LABs are expected to start with a initial capital of Rs.50 million. There are further restrictions on LABs – they can only operate in a geographical area limited to three contiguous districts. Every branch of the LAB has to be opened with the licencing of the RBI. This could be stifling. While there is tremendous flexibility in launching savings products, it comes with some inflexibility in expansion and growth.

While SHARE and BASIX to a large extent have similar institutional investors, the shareholding in BASIX is not as disperse as in SHARE. Moreover, the laws have become more stringent since BASIX was established. Therefore it is almost impossible to replicate their model of financing.

All the three institutions have faced barriers in operating as a mainstream company. Most of the barriers they have faced is from the regulatory side and not from the side of the market. The major constraints are in the following areas:

- Steep entry norms to set up NBFCs. Considering the value attribute of the promoters being NGOs, or with “development” background, it is difficult for them to raise commercial capital to start a NBFC. Routing donor money into commercial organisations is not easy, though BASIX was able to do it with a lot of innovation and pain.
- Restrictions placed on the type of activity that can be undertaken even by these companies – especially in the area of accepting savings from clients. Restrictions on the diversity of services that can be offered.
- Restrictions on accessing finance from outside the country. These restrictions are more in terms of obtaining necessary clearances and permissions, and have eased over time.

Option II: Let's Co-operate

As debates rage in the microfinance world on issues of mainstreaming, initial capital norms and incorporation, there has been a silent revolution in some parts of Andhra Pradesh – particularly in

the districts of Karimnagar and Warangal. There are nearly 250 small thrift co-operatives with an average membership of around 500 carrying on successfully for more than a decade. All these co-operatives defy what is traditionally known in the microfinance world. While there are a good number of women's thrift co-operatives, there have been an equally large number of men's co-operatives. All these co-operatives have been promoted by CDF.

Unfortunately, microfinance world does not recognise traditional banking or credit union movement as a part of the microfinance revolution, unless of course they have adopted some of the symbolisms of microfinance. Even by that note, these thriftco-ops qualify to be called MFOs.

It started a decade ago. CDF till then was working with agricultural co-operatives in the area. However, with the State interference in the co-operatives being one of the main problems, CDF was looking for an alternative way of addressing the issue of financial services to the poor. While the interference of the State culminated in the nation-wide loan pardon scheme of 1989, CDF thought it was time to spin off the thrift and credit movement out of the co-operative fold. They actively started promoting informal mutual benefit groups in the area. Simultaneously CDF also lobbied for a change in the co-operative legislation for greater autonomy. This culminated in the passing of a new legislation – The MACS Act. MACS Act gives ample autonomy for co-operatives, particularly from interference of the State, provided they do not seek any funding from the State. Now all the mutual benefit groups promoted by CDF are registered under the new act. Simultaneously there are several other NGOs encouraging the groups promoted by them to formally register as a MACS, including a MACS promoted by Share – Sneha MACS.

The transformation of small groups into co-operatives has been usually painless. The advantage of a co-operative is that it can not only provide loans but also access various types of savings from its member-clients. It can also easily get its stake holders to decision making position through use of democratic processes. They could also organically grow by setting up federations as an when they have a need to wield clout and negotiate on matters of policy. However, until now, the federations have played a limited role in the context of the CDF Co-operatives.

The major drawback of co-operatives is in geographic limitation. Co-operation is governed by the state legislation, and even within that, usually the area of operations of a co-operative are clearly demarcated. The other problem that co-operatives experience is in accessing mainstream finance. This is because of the bad image that co-operatives carry. Co-operatives seem to be a good instrument to get the informal groups into a formal incorporation when they reach the limits

of size. However, there has been no single co-operative that has grown to the stature of crossing the Rs.10 million mark.

The success of the new generation co-operatives is limited to Andhra Pradesh, eventhough several other states have passed similar progressive legislation. The only exception to this is the Sewa Co-operative Bank based in Ahmedabad. However the Sewa Bank is not just a co-operative, it is also registered as a Bank – governed by the RBI. Sewa Bank is recognized as one of the oldest MFOs in India – being in existence for over 25 years. While there have been several urban co-operative banks across the country, none of the other banks are recognised as MFOs. Sewa Bank did not go through the pains of transformation, because the moment its parent SEWA decided that the poor women of Ahmedabad needed a financial service institution of their own, they lost no time in promoting a women’s bank independent of the NGO. Thus, though Sewa Bank has ideological parentage from SEWA, its ownership and governance structure has been as a co-operative. SEWA proves the point that if the client group and geographical focus exists, then there is no need to go through the painful process of starting as an NGO and moving towards mainstream. However, under the current norms, a to set up an urban co-operative bank, the start up capital needed is Rs. 5 million (Sinha, 2001). Though this is less than the amount needed for a commercial bank, but still is a steep amount if it were to be contributed by poor women to run as a self-governed institution.

Option III: Banking on Innovation

The third alternative that can be looked at is setting up a LAB. We have only one experiment that can be classified as “microfinance” in this form till now. Again, the setting up of this Bank was not a process of “transformation” but an integral part of the original design of the BASIX group. BASIX has started the Krishna Bhima Samruddhi LAB (KSBLAB) in 2001. KSBLAB is only one instance of how microfinance principles can be adopted in the banking sector. This does not necessarily mean that all the LABs will eventually turn out to be MFOs. Though licences were issued to other LABs along with KSBLAB, not much has been heard of their foray in microfinance.

The other possibility in the banking sector is to look at what RRBs can do. There are examples of some RRBs doing an excellent job of linking self-help groups and thereby bringing them into the mainstream banking sector. Harper (2002) has also given illustrations of commercial banks being active in promotion of microfinance. If the commercial banks and the RRBs do adopt some of the methods of microfinance institutions, there may be a possibility of the Indonesian experience being repeated in India.

The other area where microfinance could happen is in the co-operative banking sector. The co-operative banks have lower entry norms as compared to the mainstream banks and the LABs (See Table 2 for details). SEWA bank is one example as to how an NGO was able to promote a co-operative bank to offer an array of services. However, we do not have many other examples, though this option was always available to the microfinance sector. One reason why the entire banking option has not gained popularity is because of the urban focus that the banks might get. While there are several co-operative societies in the rural areas, banking has been restricted to the urban sector. However, recently there have been a series of bankruptcies in this sector and therefore it is likely that there might be regulatory tightening.

Table 2: Entry point norms for Urban Co-operative Banks other than unit banks\$

Category of Centre	Capital (Rs. million)	Membership (Nos)
A – population over 1.5 million	50	3000
B – population over 1 million but not exceeding 1.5 million	25	2500
C – population over 0.5 million but not exceeding 1 million	20	2000
D – population over 0.2 million but not exceeding 0.5 million	10	1500
E – population not exceeding 0.2 million	5	1000
Entry point capital for LAB	Rs. 50 million (area of operation restricted to 3 contiguous districts)	
Entry point for Commercial Bank	Rs.1,000 million (area of operation open across the country)	

\$Source: **Report of the High Power Committee on Urban Cooperative Banks**. RBI Bulletin. 14 January 2002. Mumbai: Reserve Bank of India (for urban co-op banks).

Transformation options and their implications

The various options available for transformation within India and their implication is detailed in the Box 5. In brief, we do not have an optimal route for transformation of NGOs into mainstream MFOs. NBFCs that could operate across the country will have to go through a steep entry hurdle and registration process. LABs have a double disadvantage of steep entry norms and limited geographical area.

Given the concerns of most microfinance institutions for community involvement and the existing legislations in India, the obvious choice co-operatives. But not all states have passed liberal co-operative legislation. The disadvantage of co-operatives is the geographic limitations to growth. However, co-operatives would involve the clients in decision making because of co-operative principles of users being members, and the democratic nature of governance. Since the co-operative sector has historical baggage, it is not glamorous to recognise co-operative institutions

as MFOs. This is because the credit union movement represents more individual banking model, with formal systems, while for microfinance there is a solidarity core – using groups, social collateral and creating social capital.

Box 5: Transformation options and their implication

Form	Options	Organisational incorporation	Implication
NGO	Option 1: Spin off mF as separate Activity	Not for Profit MFI – a special vehicle only for purposes of demonstration at scale (SRFS)	Cannot grow beyond a point. While sustainability can be demonstrated, the organisation will have to be roving – withdraw from one location and move to another, or grow organically, and gradually.
		For profit Company (NBFC) – Transfer clients, investments and portfolio independently (SHARE, CFTS)	Issue of ownership and control. Initial capital contribution can come from the communities. Recapitalisation is complex. Diversification to savings and risk products is not simple under the current regulation. Even when permitted, the bouquet of products offered will be limited.
		For-profit co-operative either under the MACS Act or as a Co-op Bank	Can grow organically, but will have geographical limitations to growth. The geographic area of operation is demarcated. However, there is flexibility to offer savings products. Initial capitalisation requirement is not daunting.
	Option 2: Promote independent MFOs	Promote (informal) Self-Help Groups, (Pradan, Myrada), encourage them to form federations., (Dhan Foundation)	Can grow organically. However, scaling up and infusion of large amounts of external funds are not simple, as the movement is scattered across several independent informal or legal entities. Embedding in the banking system is a solution, but there are limits to growth. Chances of withering away if the NGO withdraws support.
		Promote (formal) mutually aided co-operatives and encourage them to federate. (CDF)	Problems are similar to SHGs mentioned above. However, since each of these are independent entities, dealing with banking institutions is likely to be simpler. Chances of withering away are low, if the systems are established.
Development Professionals with NGO background	Option 1	Promote NBFCs – seek developmental and commercial investments through complex mechanisms – private mutual benefit trusts, debt in holding company (CFTS, BASIX)	Problem in raising initial capital. Other limitations applicable to NBFCs discussed above also apply. It is difficult to pull off a complex structure of mutual benefit trusts and holding company structures.
	Option 2	Promote LABs, find equity for start up.	A difficult proposition due to two reasons: Steep initial capital requirements and complexity in licencing procedure of RBI and limitation in geographical area to three contiguous districts. Tremendous amount of flexibility in the offer of diverse products and services and great scope for customisation.

If we take the broader view taken by Robinson (2001) on what would be treated as microfinance institutions, then we look at addressing the issue head on. She has classified the institutions that are “expected” to operate in the microfinance realm under the following categories:

- Institutions that provide microcredit but are not permitted to mobilize savings from the public (most institutions that are not regulated and publicly supervised)
- Institutions that do well in lending but poorly in mobilizing savings (such as Bangladesh's Grameen Bank)
- Institutions that do well in savings but poorly in lending (India's Regional Rural Banks and China's Rural Credit Cooperatives)
- Institutions that fail in both (most microfinance institutions that provide subsidized credit are permitted to raise public savings, particularly state-owned banks).

Given the above definition, microfinance could not only happen by transformation of small NGOs into bigger institutions, but also by the transformation of larger financial institutions embracing the microfinance methodology and microfinance clients.

Implications for Regulation

Given the transformation experiences of NGOs, we need to worry about the implications for regulation of this sector. The microfinance industry represented by Sa-Dhan has been advocating easing of entry point capitalisation norms for microfinance "companies". This means that there would be a new company defined as a microfinance company with lower capitalisation norms which would be allowed to offer financial services on par with other NBFCs.

While this would help a large number of NGOs to hive off their commercial operations and help operations to grow organically, it does not prevent other individuals or institutions masquerading as MFOs. The recent experiences of a series of urban co-operative bank failures in Gujarat and Andhra Pradesh are an indication of what would happen when the easier entry norm is misused. For instance, the easier entry norm for co-operative banks must have been introduced because these were democratic institutions, member owned and member-driven. However, over a period of time, all these banks started transacting heavily with non-members. The institutions lost the "co-operative" nature for which the entry norms were eased, but turned out to be in the hands of a handful of "investors". When we are proposing regulatory reform, we need to be wary of the potential misuse of the easing of entry hurdles.

We also have a good number of residuary NBFCs that collect savings from the poor and the unorganised. While these are closely regulated, their leeway in providing credit is cramped. Therefore, MFOs have not seen RNBFCs as a viable option. In any case, the microfinance sector does not treat them as MFOs (offering savings service) for obvious reasons of "value attributes"

discussed earlier. When regulation of entry norms is eased, and several other institutions come in claiming to be MFOs, the microfinance sector will encounter similar credibility crisis.

When we look at the Bolivian experience, the FFPs were seen as an intermediary step for the NGOs to get into mainstream. The entry norms were steep, but the norms allowed an NGO to invest in a bank. In this scenario, it is possible for an NGO to convert the donor money received for pump-priming as equity in a new and proper banking entity. In case of K-Rep, the NGO is registered as a company limited by guarantee, and resources are held in a charitable trust that has invested in the Bank. It is obvious that in both the cases that while some norms were relaxed, all these new institutions were treated as proper financial institutions.

In case of the Indian legislation, the steps of graduating from an NGO to an NBFC to a LAB to a Commercial Bank appear impossible. It is impossible because the law does not provide for transformation. It is also not possible because the steps between these stages are really steep. The current legislation for instance does not easily provide for a co-operative society or urban co-operative bank to gradually increase its area of operation. A LAB can never hope to go beyond its area of operation of three districts. It would be useful if the microfinance sector can argue for a legislation that allows MFOs to graduate to bigger institutions – one on co-operative lines and another on corporate lines.

Another route that the microfinance sector can advocate is to adhere to the current norms of entry and capitalisation for NBFCs, and LABs – but seek permission for NGOs to invest in such for-profit entities, without prejudice to the tax status of the NGOs. This would mean that only NGOs that can raise enough funds from various sources could actually set up a mainstream-type NBFC. This gives no short cuts for the entrants from the non-NGO sector, since if they have to bring in substantial capital, for them, it does not make matters simpler if they can adopt the non-profit entity route. After all they will have to find somebody to put in money into the Non-profit entity in the first place.

References:

Harper, Malcolm (2002): Self-Help Groups and Grameen Bank Groups: What are the Differences? In Fisher, Thomas and Sriram MS: *Beyond Micro-credit – Putting Development Back into Micro-Finance* New Delhi: Vistaar.

Klaus Maurer Eschborn (1999): *Report of Working Group on Savings Mobilization, Bank Rakyat Indonesia (BRI)*, Washington DC: Consultative Group to Assist the Poorest (CGAP), The World Bank.

M-Ciril (2002): **Microfinance Rating: Risk Assessment of Bank Dagang Bali**. Washington DC: Consultative Group to Assist the Poorest. (www.cgap.org)

Montgomery, Richard; Bhattacharya, Debapriya, and Hulme D (1996): *Credit for the Poor in Bangladesh* in Hulme David and Mosely, Paul **Finance against Poverty**, London: Routledge.

Rhyne, Elisabeth (2001): **Mainstreaming Microfinance**. Connecticut: Kumarian Press.

Robinson, Marguerite (2001): **The Microfinance Revolution: Sustainable Finance for the Poor**. Washington DC: The World Bank.

Rutherford, Stuart (2000): **The Poor and Their Money**. New Delhi: Oxford University Press

Sa-Dhan: *Enhancing Financial Flows to the Poor: The Way Forward* – Summary of the Sub-Group Reports Presented to the Empowered Committee on Financial Flows to the Unorganised Sector. New Delhi: Sa-Dhan.

Sinha, Sanjay (2001): **The role of Central Banks in Microfinance in Asia and the Pacific**. Manila: Asian Development Bank.

Sriram MS (2001): *Case Study of SHARE Group* in Datta, Samar and Sriram MS: Flow of Credit to Small and Marginal Farmers in India – Report submitted to the Ministry of Agriculture, Government of India. Ahmedabad: Indian Institute of Management (Mimeo).

Sriram MS (2002): *Information Asymmetry and Trust: A Framework for Studying Micro-finance in India*. WP No. 2002-09-02. Ahmedabad: Indian Institute of Management. (Mimeo)

Wardhana, Ali (2001): *Introduction* in Robinson, Marguerite **The Microfinance Revolution: Sustainable Finance for the Poor**. Washington DC: The World Bank.