Microfinance: analytical issues for India

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Abstract

Poor households face many constraints in trying to save, invest, and protect their livelihoods. They take financial intermediation seriously and devote considerable effort to finding workable solutions. Most of the solutions are found in the informal sector, which, so far, offers low-income households convenience and flexibility unmatched by formal intermediaries. The microfinance movement is striving to match the convenience and flexibility of the informal sector, while adding reliability and the promise of continuity, and in some countries it is already doing this on a significant scale. Getting to this point – reaching poor people on a massive scale with popular products on a continuous basis – has involved rethinking basic assumptions along the way. One by one, the keywords of the 1980s and 1990s – women, groups, graduation, microbusinesses, and credit – are giving way to those of the new century – convenience, reliability, continuity, and a flexible range of services. We describe the elements that we feel have contributed most and that are most relevant for India.

Introduction: financial services and the poor

Since the early national plans, independent India's government has emphasized the link between improving access to financial markets and reducing poverty, a stance that has had influence globally.[1] The early strategy gave the lead role to state-run banks, who were charged with loosening the grip of traditional informal-sector moneylenders through the use of targeted low-priced loans (Reddy, 1999). Newer approaches in India include the partial deregulating of interest rates, new institutional forms for cooperatives that put the emphasis back on intermediating the savings of their members, and a nationwide attempt, pioneered by nongovernmental organizations and now supported by the state, to create links between commercial banks, NGOs, and informal local groups ('self-help groups', or SHGs).[2] Surveys show, however, that informal-sector lenders remain a strong presence in rural India, still able to deliver services that are not yet provided as well by the formal and semi-formal sectors.

Much has changed in India since the early credit strategies. The rural economy has diversified, the cash economy has expanded, the service sector has developed, and mobility has increased. These changes have gained speed in the past decade, and with those changes come opportunities to re-think financial sector interventions, including new ways of thinking about how the poor use financial services and which kinds of services they require. Users were once seen primarily as small farmers, nearly always male, needing credit for crop production or livestock rearing at better terms than those available from informal lenders. The 1990s saw something of a shift to women's needs for credit, to support opportunities for investment in off-farm microbusinesses. Now, typical microfinance clients might be better understood as men and women from poor households seeking a wide range of savings and loan services to support a diverse set of consumption needs and investment opportunities.

Although the SHGs, and the work of NGOs such as SEWA, a women's group, are receiving increasing international attention, the best-known recent

[1] The focus on poverty and finance was articulated most famously in the 1954 RBI report on the All-India Rural Credit Survey of 1951-52 (RBI, 1954).
[2] On SHGs, see Seibel (2001) and the chapter by Malcolm Harper in Fisher and Sriram 2002. For a broader overview of recent developments in India, see, for example, Meyer (2002) and Sinha and Pantole (2002).

innovations in financial services for the poor have happened outside of India.[3] The microfinance sector is booming in Bangladesh, with too much competition, rather than too little supply, emerging as a tension. In Indonesia, the Bank Rakyat Indonesia, a state-owned commercial bank, has developed an efficient, profitable arm that serves roughly three million rural and urban borrowers and nearly ten times as many savers. Elsewhere, smaller programs are piloting new approaches like flexible savings accounts, insurance services, and novel applications of information technology. In an economy as large and varying as India's, there should be even greater scope for diversity and new approaches, and the government has an important role to play in creating space for innovation and a flexible architecture for new, independent institutions. What might they look like?

Even in a relatively homogenous economy like Bangladesh, diverse approaches have emerged. The group-based microcredit model of the Grameen Bank operates alongside the integrated vision of BRAC (providing training, inputs, and marketing assistance alongside credit); the highly-efficient minimalist approach of ASA; the financial product differentiation featured by BURO, Tangail; and the flexible saving and borrowing vehicles of *Safe*Save.[4] Recently the Grameen Bank itself introduced a new approach ("Grameen Bank II") and rolled out new loan, pension, savings, and insurance products (Yunus, 2002).

Despite the diversity of approaches to microfinance in Bangladesh and Indonesia, common elements underlie the most successful innovations, and India can learn from the story of how financial services for poor people developed in the last twenty-five years elsewhere in Asia and beyond. Our aim is to describe the elements that we feel have contributed most and that are most relevant for India.

The clearest lessons are about understanding the core features of good microfinance, and these are dealt with in Part I of this paper. The more complex questions about how India is to achieve good microfinance on a massive scale are discussed in Part II. Part III uses the insights to consider the most innovative and exciting recent development in Indian microfinance, the movement to link self-help groups to banks. Part IV draws conclusions.

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[3] The Self-Employed Women's Association, based in Ahmedabad. Other programs gaining international recognition include the Non Banking Financial Companies (NBFC) SHARE, and BASIX, both based in Hyderabad.

[4] Grameen is a specialized bank for the rural poor, working under a tailor-made Ordinance of 1983. BRAC and ASA, now known by their acronyms rather than their original titles, and BURO, Tangail, are non-government organizations recognized by the government's NGO Bureau. For ASA see Rutherford (1996) and Ahmmed (2002), for BURO, Tangail see Wright 2000, for *Safe*Save, see www.safesave.org and Hickson (1999). Stuart Rutherford, an author of the present essay, is the founder and current chairman of *Safe*Save.

Part I: Good microfinance

Our discussion of microfinance begins with what we know about its users and potential users. Research shows that poor people value financial services, want more of them, worry when they don't have them, but are often frustrated by them when they do get them.[5] They know that managing money is important, and that managing money well gives them a better chance to manage their lives and livelihoods well. Those lives and livelihoods are complex, diverse, dynamic and vulnerable, and the poor want their financial services to respond by being reliable, convenient, continuous, and flexible. They understand that financial services help them spend, at one time, income earned in other times, and because those incomes tend to be small, irregular and unreliable, they need the full armoury of intermediating modes – saving up for future spending, taking advances against future savings, and building cash reserves that can be called on at any time. They are aware that their most dependable forms of social security are their own money- and asset-management skills, so they need a wide range of intermediating terms, from a tiny advance of a few dollars to tide over a current food shortage, through loans for investment opportunities, to long term saving instruments that help them manage retirement, widowhood or disability.[6]

How poor households in urban and rural settings in Bangladesh and in India go about satisfying these needs has been revealed in depth through the 'financial diaries' collected by researchers from Manchester University's Institute for Development Policy and Management (IDPM) in a study done in 1999-2001.[7] 'Diaries', each a full year in duration, were prepared by poor, very poor and near-poor households through the help of two-weekly visits by researchers. They reveal the respondents patching a wide array of informal services and devices together with semi-formal and formal services.[8] All households in the samples, no matter how poor, engage in money-managing practices, and on average the Bangladeshi households push or pull through financial services and devices each year a sum of money ($839) equivalent to two-thirds of their annual cash income. In the Indian case, households enter a fresh financial arrangement – with a moneylender, money guard, savings club, or formal provider, among others – on average every two weeks. In

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[5] For India, Ruthven (2001) and Ruthven and Kumar (2002); for Bangladesh, Rutherford (2002); for East Africa Mutesasira (1999); worldwide, WWB (2002).
[6] For a discussion of ways that low-income households cope with risk, see Morduch (1999a).
[7] For the Department for International Development (DFID), UK official aid. See Rutherford 2002, Ruthven (2001), Ruthven and Kumar (2002), and the IDPM web site www.man.ac.uk/idpm.
[8] By 'device' we mean ways of managing money that can be carried out on a self-help basis by an individual or a group.

Bangladesh, a sample of just forty-two households were found to have used, between them, thirty-three types of service or device during the year: no household used less than four, and a third of them used more than ten.

These households see financial services as a day-to-day activity, not as a right or privilege nor as a reward or enticement for engaging in some form of approved behavior. When they look for financial service providers they seek reliable workmanlike partners rather than patrons. For example, they do not see loans as a social good in short supply of which they should receive their fair share, but as a tool to manage their financial lives. They do not believe that credit should be available only to women, nor invested only in microbusinesses, nor that financial services must be conducted only in a group setting nor invariably accompanied by other social development activities. They do not ask to be taught how to save, but seek opportunities to save, sometimes needing very liquid savings instruments, sometimes wanting longer-term less accessible savings plans, always preferring to have the choice of either or both. They do not expect to have all their financial service needs met by just one provider, or by just one type of provider: they are used to multiple portfolios.

In short, poor people want what many of the less poor already enjoy: reliable, convenient, and flexible ways to store and retrieve cash and to turn their capacity to save into spending power, in the short, medium and long term. And they want it on a continuing, not a one-off, basis.

In some parts of Asia poor people are beginning to enjoy such services. How this came about varies from place to place, and evolved over time, with pioneers contributing key elements rather than the full package, so there is no single blueprint to study.

> *Reliable* financial services are rule-bound services in which transactions are made on the promised date in the promised sum at the promised cost. Reliable financial services are not the same as regulated financial services: in Bangladesh NGOs are more reliable lenders than formal banks.

The case of Bangladesh illustrates this. Grameen Bank made the biggest breakthrough, but it has taken time for all of us – including Grameen itself – to distinguish the truly essential elements of its contribution. Because Grameen's highly successful strategy worked through groups, because those groups soon became almost exclusively female, because Grameen promoted credit as 'a human right', downplaying the role of savings, and because borrowers promised to invest their loans in ways that would directly generate income, it looked for a long time as if the key messages of microfinance were to do with women, group solidarity, microbusinesses, and loans. Early microfinance practitioners also saw microfinance as just a short-term jumping-off point before customers were able to enter into relationships with mainstream commercial banks, making "graduation" another message. It now looks more likely that the true key messages were more abstract and more universal: convenience, reliability, continuity and flexibility – the core values of basic banking services.

> *Convenient* financial services: the opportunity to make all kinds of transactions (loans and repayments, deposits and withdrawals) frequently, close to the home or business, quickly, privately and unobtrusively.

To see this, we need to shift our perspective to that of the users themselves. Before Grameen, Bangladeshi villagers made do with a variety of informal money-management systems. Such systems offered a wide range of ways of managing money, but none was both convenient and reliable. Saving money at home – dropped into a mud bank, tucked between roof-sheets, or tied into petticoats – was convenient enough, but very hard to protect from myriad tiny spending needs, and from the predations of mothers-in-law and cousins with hard-luck stories. Moneylenders were few in number, and might or might not be prepared to lend to you: even if they were prepared to lend they may not lend in the right amount, at the right time, or over the right term, and their price may include all sots of inconvenient non-cash elements. Money guards and casual debtors might or might not be able to repay you when you needed the money back. [9] Savings and loan clubs proved hard to manage on an ongoing basis: good book-keeping is hard for the illiterate and without good book-keeping such devices are prone to abuse, carelessness, and collapse.

Then, starting in the late 1970s, came Grameen Bank. Suddenly, villagers found themselves offered the opportunity to pay in small sums on a weekly basis, and to take the value of a year's worth of those pay-ins in the form of an advance. All this was done at a meeting point in the village, requiring no travel greater than a short walk. Rain or shine, the well-behaved bank workers turned up on time every week. They kept immaculate records. Unbelievably, they gave the advances in the sums promised on the day promised. Astonishingly, as soon as one advance was paid down, a new, often bigger one, was immediately available.[10]

> *Continuous* financial services: services that cater to continuing and long term needs, such as a sequence of loans, or storing lifetime savings.
> India's Integrated Rural Development Programme failed its intended users by lacking this quality: one study showed that only 11% of all IRDP borrowers borrowed more than once (Pulley, 1989).

[9] Informal lending , seen from the lender's point of view, is often a way of saving: of getting cash out of the house to protect it from trivial expenditure.
[10] There is a huge literature on the Grameen Bank. One of the best accounts of Grameen's work at the field level is by Helen Todd (1996).

Grameen encouraged borrowers to invest the loans in microbusinesses, and discouraged certain forms of expenditure such as dowry. These messages were reinforced through the ‘sixteen decisions’ that the clients, gathered in their forty-strong groups, recited at each weekly meeting. But in practice this did not stop borrowers from using the service in whatever way appeared most rational to them at the time. Here was a way of turning their capacity to save, conveniently and reliably, into usefully large chunks of spending power, and it released a wave of spending that allowed households to retire older more expensive debt, to invest in education, medical care, home improvement, land, and marriage alliances, to export surplus labour to the cities or abroad, as well as to put more cash into their regular livelihood activities on or off the farm. Able to manage money better, they managed their lives better.

Spurred on by its well-deserved popularity, Grameen expanded. Hundreds of emulators joined in (see chart 1). By the mid 1990s Grameen and Grameen look-alikes were serving several million rural and urban households. The key breakthrough had been achieved. A new way of doing business with poor people – the regular, mundane, everyday business of helping poor people manage their cash flow and turn their savings into spending power – had been established.

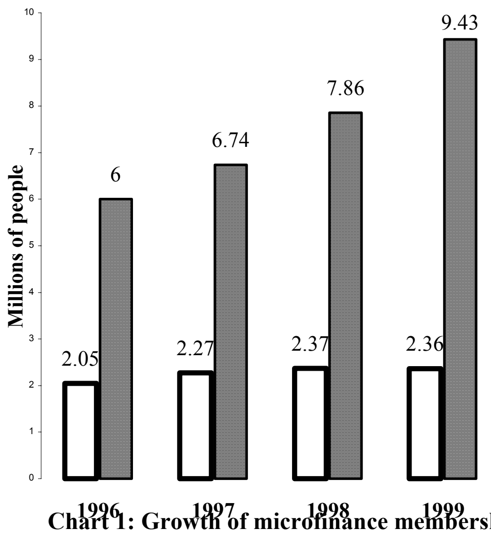

Chart 1: Growth of microfinance membership, Bangladesh: Grameen Bank (white rectangles) and all NGOs (grey)
Source: Table 2 of Ahmmed (2002), from CDF Statistics.

Meanwhile, and increasingly since the mid-1990s, the essence of the Grameen experience became better understood. This sometimes uncomfortable process involved the dropping away of some features and their replacement by others. The focus on investing loans only in microbusinesses softened: practitioners came to see that in reality microfinance users spent their money in a wide variety of ways, and that since money is fungible (that’s why it was invented) there is little point in trying to prescribe the way it is spent. The gendered nature of Bangladesh microfinance practice continued – most microfinance institutions

> *Flexible* financial services allow poor people to make pay-ins (savings deposits and loan repayments) in any sum at any time, and to take out sums (loans and savings withdrawals) in a wide range of values, quickly and conveniently. Services that are not flexible in this way fail to serve the poor well because they fail to match their fragile and unpredictable cash-flows and spending needs.

(MFIs) still have a registered clientele that is mainly or exclusively female – but practitioners became more comfortable with the observed fact that once loans entered the household they may well be used and serviced by men. The group came to seem less and less important: some major MFIs quietly dropped the insistence on group meetings, sending workers to the village to meet with clients at a central spot on a regular date and time, but not requiring a meeting, and not enforcing any strong form of joint liability. Credit lost its privileged position as the only form of personal financial intermediation offered to clients: several MFIs began expanding the range of savings plans available, including open pass-book schemes, time deposits, and contractual plans, and early experiments with insurance began.[11]

At the same time, the maturity of microfinance in Bangladesh – its twenty-five years of experience – has begun to pay dividends in another way. In the early days standardisation was, quite properly, understood as a vital instrument of internal control – a necessary antidote to rent-seeking and a way of keeping things transparently simple. The fixed-value compulsory weekly saving, and the invariable one-year loan term with its fixed-value weekly repayments (on which pre-payments were not allowed) had been established early on as norms. More recently, the disadvantages of these rigidities have been recognised at precisely the same time that the MFIs' vast experience is giving them the confidence to experiment with alternatives. For example, very poor households, such as those that depend on seasonal work like agricultural labour, find it hard to make a fixed value payment week-in week-out for a full year, and this problem lay behind the realisation that despite much rhetoric about reaching 'the poorest of the poor' it was in fact the case that many such households dropped out of MFIs, or never joined. For those households, more flexible repayment schedules, or shorter term loans, or both, make sense. The desire to match services better to the cash-flows of the very poor became one of the motivations behind recent experiments with more variable terms and schedules.[12]

A similar story of increasing flexibility can be told at the other end of the low-income spectrum: MFIs are also designing loan products with terms and schedules attractive to upper-poor businessmen and women. This is in keeping with the waning of enthusiasm for the idea of graduating top customers to mainstream commercial banks. Top customers have, as a result, shown little interest in moving on, and keeping top customers has been an important way to enhance profitability for MFIs. The bigger savings of these upper-end clients provides a source of modestly-priced capital, and their

[11] In Indonesia, the spread of communications technologies is spurring interest in making cheap funds transfers and payment services.
[12] An important innovation of Grameen Bank II is loans that can be paid in weekly installments of different amounts in different seasons.

higher-value loans contribute to larger retained earnings, enabling the institution to expand its outreach to all kinds of clients more rapidly.

Thus, one by one, the keywords of the 1980s and 1990s – women, groups, microbusinesses, credit, and graduation – have given way to those of the new century – convenience, reliability, continuity, and a flexible range of services. 'Grameen II', a fundamental redesign of the way the Grameen Bank does its business, features loans with a range of terms and with variable repayment schedules, new savings instruments including a hugely popular contractual plan (the 'Grameen Pension Scheme'), some of which are offered to the general public (including men and children) as well as to group members, and new arrangements for the extreme poor under which they do not need to join groups.[13] By mid 2002 Grameen II had been introduced into all of Grameen's branches, which number over one thousand.

Bank Rakyat Indonesia has also made convenience, reliability, continuity, and flexibility core elements of its mission. To do this, it underwent a radical make-over in 1983. The bank had started as a government-owned rural

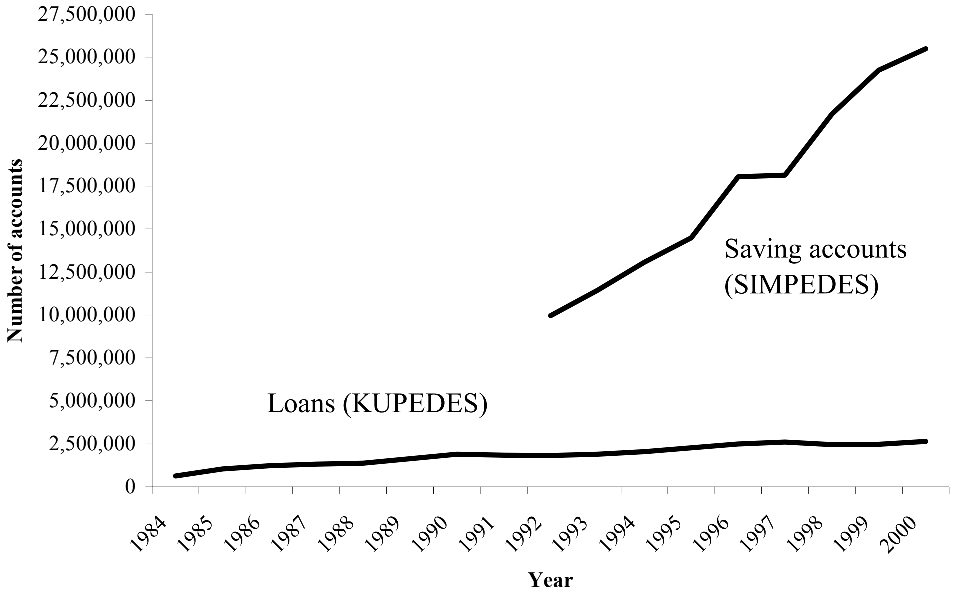

Chart 2: Numbers of borrowers and depositors, Bank Rakyat Indonesia 1984 – 2000.

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[13] Yunus (2002) provides the historical background to Grameen II and its main elements.

development bank in 1968, charged with helping to spur agricultural production. To help both borrowers and depositors, the government mandated that borrowers pay interest rates of 12% while depositors received 15% under the national savings program *Tabungan Nasional* (TABANAS). The intentions were good but the negative interest rate spread was untenable, and by the late 1970s the bank was suffering huge operating losses. Indonesia de-regulated banks in 1983, and BRI transformed itself with the aim of becoming financially viable without subsidies. The staff turned to the villages to studylocal financial markets to better understand what households really needed, and in 1986, after a year of field work, BRI rolled out the new "village savings" product, *Simpanan Pedasaan* (SIMPEDES). It was quickly popular, despite not paying interest at all on small deposits and paying at most 12% for the largest deposits – relative to the 15% returns offered by TABANAS. [14] But while TABANAS restricted withdrawals to two times per month, SIMPEDES offers unlimited withdrawals. Patten and Rosengard (1991, p. 72) argue that "although very few TABANAS savers actually withdraw funds twice a month, this limitation is an important psychological barrier to the people in rural areas, who seem to fear that they will not have access to their TABANAS savings when they need them."

With BRI's extensive network (at the end of 2002 it had 3,916 unit offices), depositors can bank close to work or home, and as a fully-regulated institution, depositors know that the security of their savings are guaranteed at BRI.[15] Convenience and reliability have thus proved more important to customers than having the very lowest cost.[16] Today, BRI handles over 25 million individual SIMPEDES accounts with an average balance of $75 (the population of Indonesia was roughly 225 million people in 2000). Chart 2 shows that in the wake of the financial crisis of late 1997, BRI in fact attracted depositors, rather than lost them. By the end of 2000, the total size of BRI's deposits was two and a half times the size of BRI's loan portfolio.

[14] BRI also provides depositors with coupons for a semi-annual lottery. The chance of winning is proportional to the size of account and lotteries are much–anticipated local events. Awards range from a car or motorcycle to clocks, radios, and washing machines; overall, the value of awards in 1995 was about 0.7% of balances. (*BRI Unit Products*, p. 17. Jakarta: BRI.) In January 2003, the maximum interest rate on SIMPEDES deposits was 9.5% per year.
[15] Data are from the BRI internal document, "Key indicators, BRI units", updated 21 March, 2003.
[16] One way in which BRI deposits have not been convenient is that depositors have been restricted to making deposits and withdrawals at their local unit only. Now, as the individual units are networked together using newly-available communications technology, BRI depositors are beginning to be able to bank anywhere that they find a unit.

Part II: Getting good microfinance

How did Bangladesh and Indonesia arrive at the beginning of the new century with booming, expanding, good-quality yet still-improving microfinance reaching large proportions of its poor populations? How have programs targeted their customers? What are the lessons for interest rate policy and practice? What has been the role of government and donors? How have management practices mattered? How has the mix of financial and non-financial development interventions been managed, and with what results? This section reviews the influence of some of these factors.

Targeting

Microfinance involves, by definition, banking for the poor. Each institution may define what it means by "poor" somewhat differently, but it's hard to escape the need for a clear vision of the target population. Microfinance in Bangladesh has earned a reputation for maintaining a focus on women from functionally landless households (although, as we noted, this has softened in practice). BRI has also focused on serving the under-served, but, in contrast, it has focused on low-income households (and not just those below the poverty line) and most clients are men.[17]

The dual pursuit of social ends and financial profits is an ongoing tension for all in microfinance. Mission drift is a common fear as pressures mount to serve richer clients with larger loans (and thereby to earn higher profits per loan since transactions costs per rupee tend to fall with loan size[18]). Keeping focused on their respective target populations has thus been central to the missions of the successful institutions in Asia.

Still, there has been much debate about how stringently to target, and how best to do it in practice. Grameen and BRAC employ eligibility rules to restrict attention to households holding under a half acre of land. Grameen expands the definition to also exclude households with more than the equivalent of an acre's worth of assets. BRAC similarly excludes households without a manual laborer. Others, like *Safe*Save, rely on geographic targeting, restricting attention to specific slums in Dhaka.

The eligibility rules, though, are less stringent than they would seem at first. In practice, both Grameen and BRAC staff make exceptions to the half-acre rule, and some estimates suggest that as many as 30% of borrowers may be

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[17] Most loans are co-signed by husband and wife, though, in recognition that the loans are "household" loans.

[18] This is not always so, as Kenya's K-REP learned: larger loans may also carry more risk and ultimately undermine profitability.

over the half-acre line.[19] The deviations may reflect that land is low-quality or that households are large so that per capita holdings are relatively low. At other times, the rules may be stretched simply to give access to community members who will be promising program members.

The stretching of rules is kept in check by other practices which have a strong bearing on who is attracted to microfinance and who is turned away. Those practices include how products are designed, how staff are compensated, what messages are delivered from headquarters, and who is recruited onto staff.

Highly-educated staff members, for example, may be good colleagues, but may not work comfortably with the poorest clients. In response, *Safe*Save hires its deposit and loan collectors from the slums in which they work (CGAP, 2000). Similarly, rewarding staff for the volume of loans they make, rather than the number of clients served, can push staff toward making large loans to fewer people, rather than seeking to get smaller loans to more people. Keeping true to mission may also be rewarded explicitly. Under Grameen Bank II, for example, staff are given rewards both for maintaining high repayments and for poverty reduction in their branches.

Product design is another means of targeting. Lending in groups and sending staff to villages has been credited with much of microfinance's appeal in Bangladesh. A critical but less-heralded breakthrough for Grameen was to create a loan product that allowed borrowers to repay in small, weekly installments. This suited poor households well, since they could repay out of the regular bits of income coming in daily or near-daily. When BRAC experimented with repayments every two weeks, arrears jumped up as poor households had difficulty holding onto money over the two-week interval; BRAC quickly went back to weekly collections[20]. BRI too asks for weekly repayments from its smaller-scale clients (i.e., those borrowing around Rp. 1-2 million or less). [21] Charging appropriate interest rates has also helped stem leakage of resources from target populations to those richer or politically-favored, as we discuss further below.

On the savings side, BRI has tried to encourage broad access by maintaining very low minimum balances ($0.57 or 27 Rs.) and low minimum deposits for

[19] Morduch (1999b) reports that "mistargeted" households held, on average, about 1.5 acres of land, so rules may be stretched considerably. See Zaman (1998) for more on targeting (and its logic) in BRAC's program.
[20] In Dhaka, some slum-dwelling clients of NGOs that require monthly loan repayments use *Safe*Save's daily collection service to save up for their monthly installments.
[21] As of April 1, 2003, $1 = Rp. 8905, so Rp. 1-2 million = $112-$225. In Indian rupees, it equals 5329Rs. – 10,658 Rs. ($1 = 47 Rs.). BRI's clients are clearly borrowing on a much larger scale than SHG clients in India, where average loan sizes are about 1200 Rs. (Correspondence with Priya Basu, 3/24/03). $1 is also roughly 60 (Bangladesh) takas.

opening accounts. New depositors can start an account with 10,000 rupiah (just over $1 or 53 Rs.), and the new savings products have given BRI its most notable success in serving the poor. On the borrowing side, BRI requires borrowers to put up collateral to secure loans, but the bank has chosen to be very flexible in what it will accept, so that collateral is not a major constraint when seeking poor clients. A survey completed in 2000, for example, shows that 88% of non-customers had acceptable collateral of some sort.[22] In order to push still further, BRI has instituted products that require no collateral at all for loans up to Rp. 2 million ($225 or 10,658 Rs.), offered at the discretion of the unit manager.

Interest rates

Few issues in microfinance have been as contentious as those surrounding interest rates, but the experience in Bangladesh and Indonesia show that debates may have been unnecessarily polarizing. A large part of the success of microfinance in Bangladesh and Indonesia has been to find a comfortable middle ground. Programs have taken important lessons from those who argue that if interest rates are raised to cost-covering levels, programs can ensure sustainability over time, thereby guaranteeing their ability to offer clients long-term continuous service. They have also been sympathetic to the concern that raising interest rates too high may undermine the social and economic impacts on clients and steer deserving customers away from microfinance.

The middle ground has involved working hard to keep costs low so that interest rates can be kept relatively low as well.[23] Once fees are added in, leading institutions charge roughly between 24% and 48% per year, with the Grameen Bank at the bottom of the range and most others in the center of the range (with annual inflation rates hovering around 10% in most years in both countries).

Microlenders have also worked hard to maintain quality standards, with the aim to charge a fair rate for a good product. By stressing convenience, reliability, continuity, and flexibility, programs have delivered products that are both much cheaper than those available from the informal sector and *higher quality* as well. The transformation at BRI in the mid-1980s did not

[22] The value of collateral is determined by the *notional* value of the asset, not the expected sale value. Land without a certificate of title, for example, may be nearly impossible to sell without the cooperation of the borrower and the local community. It thus has very little value to BRI if the client is hostile. BRI thus sees collateral as an indicator of borrower intent and a guarantee that all borrowers have resources to use if they should gets into repayment difficulty.
[23] ASA has been the most determined to find innovative ways of keeping costs low: see Fernando and Meyer 2002. ASA has thereby achieved rapid scale (1.12 million borrowers in 2000) and profitability, while keeping its interest rates in the middle of the range quoted here.

involve simply raising fees. The important shift was from delivering lower-quality products at lower interest rates under the national BIMAS loan program to delivering new, higher-quality products at prices that covered costs.

Over time, microlenders in Bangladesh and Indonesia also came to see that raising interest rates to cover costs has helped them to better serve target populations. Some have argued that interest rates should be raised to allow institutions to serve a greater number of under-served households, and the fact that millions of clients are served in Bangladesh and Indonesia attests to the assertion. But microfinance organizations have found that raising interest rates has allowed them to improve quality as well.

If interest rates were simply costs imposed on borrowers, it would strengthen the brief for minimizing interest rates in the cause of social progress. But interest rates play other important roles; most importantly they function as rationing and incentive mechanisms, and they provide organizations with resources to reward savers. In Bangladesh and Indonesia, cost-covering interest rates have helped to steer loans to the most efficient users to such a degree that fears of diversion of loans to non-target groups or to the politically privileged have been minimized. In addition, microfinance institutions can now afford to pay depositors interest rates that foster accumulation. The Grameen Bank's popular new pension product, for example, will nearly double the money of depositors who make steady monthly deposits for ten years.[24]

Part of the shift in Bangladesh and Indonesia also involved reducing hidden costs that clients had often had to pay when dealing with highly-subsidized programs (non-interest fees, perhaps bribes, and costs associated with applying and waiting for loans).[25] By unburdening borrowers of these hidden costs, the difference in the "true cost" of borrowing from a microlender at, say, 36% per year and the true cost of borrowing at substantially-subsidized

[24] The implicit interest rate for Grameen's pension product is 12% per year (Grameen Bank, 2002).

[25] Y. V. Reddy describes some of these costs, drawing from his experience with rural banks in India: "Transaction costs associated with formal credit include fees for procuring necessary certificates (open), travel and related expenses including loss of wages etc., and informal or unofficial commissions (hidden)...uncertainties and delays usually associated with formal credit can also be treated as additions to the transaction costs. To the extent some transaction costs are fixed, the effective cost of borrowings for smaller loans tends to be relatively higher than for a larger loan." (Reddy, 1999, p. 56). See Marguerite Robinson (2002; p. 211) for a Jaipur farmer's description of the hidden costs involved in applying for a 5,000 rupee loan at his local RRB; the farmer reckoned that the total cost of applying was over 900 rupees (he was ultimately turned down for bureaucratic reasons).

"below-market" rates elsewhere turns out to be far narrower than the difference in advertised interest rates suggests (Reddy, 1999).[26]

Credit plus? Assessing integrated service provision

When we write that poor people value convenient, reliable, continuous, and flexible financial services, we are not saying that is all that they value. Access to other kinds of interventions and opportunities may be even more critical to helping people effectively invest for the future, cope with periodic difficulties, and maximize the use of resources. In Bangladesh, BRAC in particular has coupled microfinance with other kinds of services. BRAC borrowers may send their children to BRAC schools, get health problems seen to at BRAC clinics, learn about legal rights at BRAC training sessions, and sell merchandise through BRAC retail outlets.

BRAC is not alone in thinking beyond finance. Grameen Bank started a schools program early on, for example, and ASA originally put a half hour aside at weekly meetings for discussions of health and social issues. Given that a well-targeted group of poor but motivated villagers were already assembling each week for microfinance transactions, it made sense to begin adding such activities. Recent evidence suggests that many of those sessions have been meaningful for clients.[27]

Over time, though, those activities have been de-emphasized at Grameen and ASA, and BRAC does much of its development work outside of the context of weekly microfinance meetings. In part, the activities were reduced not because they failed, but rather because they were successful. Partly because of the early work by NGOs, health, hygiene, and social practices have now taken root, and the microfinance institutions realized that continuing training sessions would for many amount to little more than triple-underscoring well-understood messages. Rather than being a valued add-on, sitting through repeat training sessions would start to impose growing costs. At the same time, other, specialized NGOs and the government became better able to take on training tasks and the provision of basic health and education.[28] ASA and

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[26] By the same token, where group-lending has ceased to provide clients with meaningful benefits, the imposition of regular weekly meetings also imposes hidden costs. ASA's move away from group meetings reflects their vigilance in keeping costs down, whether they be monetary costs or not.

[27] See Syed Hashemi et al. (1996). Some of the impact may result simply from meeting in groups or just being treated with respect.

[28] In Indonesia, the government's commitment to providing health and education for the rural poor meant that a bank like BRI never even considered providing integrated services. As a commercial bank, BRI is focused only on providing the best possible financial services for low-income clients.

Grameen could then make the development of good microfinance their core business.

De-emphasizing integrated services also gave ASA and Grameen the freedom to make microfinance work better for their clients. If ASA had kept its training sessions, it would have meant keeping the original group meeting format. By moving away from training, ASA was able to drop formal group meetings, allowing clients the freedom to transact their microfinance business quickly, one-on-one with loan officers. De-emphasizing training also allowed ASA and Grameen to train staff to be competent at finance, without needing to worry about whether they were particularly good educators as well. This has been critical to maintaining efficient, low-cost operations. ASA, in particular, has made a virtue of simplifying its practices so that less-educated staff can handle financial tasks with ease. As a result, most of their credit officers are young and lack college degrees; they are highly-motivated but not especially well-equipped to sit with village women and discuss, authoritatively, oral rehydration therapies, breast feeding best practices, or options for divorce.

Access to non-financial services remains important for microfinance clients in Bangladesh. The microfinance institutions played an important role when they helped to provide them.[29] But they have played an equally important role by de-emphasizing the activities at the right time. By not locking into particular modes of operating, the institutions have continued to innovate, ensuring that clients still have convenient, reliable, continuous, and flexible financial services.[30]

Aligning incentives of management and staff

Much attention in microfinance circles has been paid to the issues discussed above, and with good reason. Since they arise anew with microfinance, debates around targeting, interest rates, and added services have animated the microfinance "industry" as practitioners and policymakers have had to work out new solutions and assess contrasting views. No less important, though, are bread and butter management issues. A lesson from Bangladesh and Indonesia is the importance of creating professional institutions (irrespective

[29] BRAC carries on the tradition by providing integrated services for the very poor, and has recently strengthened it, notably through its IGVGD partnership with the World Food Programme and through its Targeting Ultra Poverty program. These programs are carried out, however, with specially targeted clients in special-purpose groups. See the CGAP Focus note prepared by Syed Hashemi.

[30] For a different view, strongly argued, see Fisher and Sriram 2002. The editors assert that '…if microfinance [inputs are] to achieve any development outcomes, the nature of these inputs must be shaped and guided by a clear understanding of the development outcomes sought… This is the key challenge of the microfinance industry.' [pp 21-22].

of their being subsidized or profit-making) in which staff clearly understand rules and in which incentives are aligned from the top of the organization to the bottom.

Some, like the main institutions in Bangladesh, maintain appropriate incentives for staff mainly through the promise of security of employment, reliable if modest salaries, and of advancement within the institution – very attractive characteristics in a country with severe underemployment and weak labor laws. Clear simple targets help staff understand the behavior that leads to rapid promotion, and 'awards' are used to publicly distinguish well-performing individuals and branches. Organizations have also been successful in making staff feel that they belong to a special kind of culture, peculiarly committed to serving the poor, and in this they both reflect and are helped by microfinance's historic evolution out of socially-committed private development agencies. Their staff training programs encourage this commitment: an applicant for a job at Grameen Bank, for example, is required to interview and write up a case history of a poor rural woman. Indonesia's BRI, on the other hand, with its strongly commercial orientation, creates "high-powered" incentives by basing a large fraction of staff pay on the performance of their unit; incentive-based pay is typically twice as great as basic salary.[31] The decision to allow some workers to earn more than others in similar posts was controversial at first, but because incentives were designed so that everyone can in principle gain through hard work (there is no "zero-sum game"), the move has been both popular and effective within the system.

Similarly, pushing for strong management information systems and timely reporting has aided oversight and the ability to quickly identify problems in time to avoid larger ones. Until recently, this has been managed without universal computerization, but increasing computerization has made the work quicker, cheaper, and easier. Quick access to clients' transaction records is a powerful aid to making services more reliable and making service providers more accountable to their clients.

Part III: The opportunities of self-help groups

There has been growing excitement about the Indian 'Self-Help Group Bank Linkage' movement, and some believe it is destined to become the country's dominant system of mass-outreach banking for the poor. It certainly appears to fit Indian history and circumstances. The idea of local savings-and-loan clubs enjoying access to formal financial services by becoming corporate customers

[31] Personal communication with Don Johnston, a resident advisor to BRI in Jakarta, January 29, 2003. In addition BRI provides discretionary bonuses and holds competitions to reward staff for meeting set targets. Annual incentives are roughly equal to two months' salary.

of banks is a good one and is practiced in a small way in many countries. A well-run club can keep its reserves at the bank and take bulk loans which it can on-lend to its members at a premium, covering its costs and rewarding its savers in the process.

The Indian version of this practice, the SHG movement, was started in the 1980s by social-development NGOs, many of whom took up group-formation (especially of women) as their main tool. Having group members learn how to pool savings into loans – mostly small short-term consumption loans – was seen as empowering disadvantaged women, socially and politically as well as financially. By 1992 the NGOs had, heroically, persuaded government to take the idea seriously. Legal obstacles were removed and subsidies made available so that SHGs could take bulk loans from banks that could be on-lent to group members who could use them to take up or expand microbusinesses. Banks were allowed to count such lending towards their legal obligation to direct a fraction of their loans to the poor, and they were given access to subsidized NABARD refinancing to do so. It seemed an ideal way to realize an old Indian dream – to make the vast network of rural banks key suppliers of loans to the poor. Growth in the numbers of SHGs formed, and the scale of their interaction with banks, has been very fast in the last three or four years, and is still accelerating. NABARD hopes to see a million SHGs serving 20 million households by 2008.[32]

However, in countries where mass-market pro-poor retailers such as Grameen and BRI have emerged, such 'linkage' schemes have not become widespread among the poor. Like the not-so-poor, poor people, given the choice, prefer an individual service, prefer the simplicity of having a reliable retailer look after the bookkeeping instead of having to do it themselves, and prefer to avoid the risks involved in owning and managing their own mini-financial institution. This is especially true of the very poor, who are often illiterate and ill-equipped to maintain a good set of books for anything but the simplest inflexible transactions over short periods.[33]

The prospects for the SHG movement are therefore far from certain. Even its most enthusiastic supporters recognize that much work needs to be done to upgrade and mainstream SHGs: ideas on how this may be done are set out in Seibel 2001, for example[34]. This is because the present system is unsustainable, for lack of clarity about who is to play the key role of maintaining quality, and

[32] Quoted in Seibel (2001).
[33] For more on why poor-managed group-based devices tend to be both very simple and time-bound, see Rutherford (2000) especially chapter three.
[34] Seibel believes that SHG-Bank Linkages may be particularly appropriate for geographically remote areas which are hard to reach with more intensive approaches that require frequent contact with clients. In Bangladesh, too, SHG work has done best among tribal groups in such areas (see Matthews 2003, writing about Ashrai, an NGO that uses SHG methods).

how the costs of doing so are to be met. If NGOs remain involved as promoters and 'minders' of the groups, they will need to be paid to do so, yet in the long run, with their social-development perspective, NGOs are not ideal candidates for this role, and nor is it clear who are to be their long-term paymasters. But the banks themselves, whose business *is* financial services, are unlikely to want to do more than ensure that their loans are safe, and will not take on the time-consuming task of helping groups manage the bookkeeping of their internal savings and loan accounts. Left to themselves, without outside assistance, most groups will have great difficulty maintaining quality, and the poorer they are the truer this will be. Mathew Titus reminds us that we shouldn't be naïve enough to believe that, just because a group of poor women come together to run a savings-and-loan club, they will be immune from the corrosive effects of poor management, confused accounting, capture of assets by the leadership, and other kinds of abuse. [35] If the SHG movement is to offer poor people reliable and convenient services on a continuous basis, it is most likely to do so by undergoing a transition into a more stable institutional form, such as the Credit Union system. Even then, the movement will find it difficult to compete with mass-outreach retailers of the Grameen or BRI kind, should they emerge in India.

There is a view that the SHG movement can, at minimum, serve as a quick way to deliver microfinance in an "interim" period, before other institutions can be developed or adapted.[36] The idea is to then graduate SHG members to these other institutions where they can access standard "individual" loans, possibly on a fully commercial basis. An immediate problem arises in that there are no obvious lenders for SHG customers to graduate to – none yet are close to offering the reliability, convenience, continuity, and flexibility of good microfinance for low-income customers. Nor is the notion of graduation built explicitly into the SHG design. In Indonesia, in contrast, Bank Rakyat Indonesia has worked closely with (and in fact supervises) the Badan Kredit Desa network, which has for some been a feeder to BRI. Even so, there is relatively little graduation overall from the BKDs to BRI, partly because BRI is only now developing products that work well for the smallest-scale clients. In Bangladesh, the pretext of graduation has been universally abandoned for lack of an appealing next step—and for the desire of NGOs to continue working with clients with whom they have developed relationships over many years.

If the idea of graduation is a serious one in India, strong efforts must be made now to reform institutions like the Regional Rural Banks with an eye to designing services and products appropriate for SHG clients. Moreover, it should be made clear what is to happen to the NGOs should their clients

[35] See Titus's essay in Fisher and Sriram (2002).
[36] Correspondence with Priya Basu (3/24/03), reporting on views presented from NABARD.

eventually graduate—can they simply be left to wither? The cumulative Asian evidence suggests that the most promising strategy is instead to aim for good, reliable, responsive, long-term institutions for the poor – rather than to focus on second-best "interim" measures.

Part IV: Conclusions

Poor households face many constraints in trying to save, invest, and protect their livelihoods. They take financial intermediation very seriously and devote considerable effort to finding workable solutions. As a result, the informal sector in India teems with lenders of different sorts and mechanisms offering widely varying ways to save and insure. The informal sector has, until recently, offered low-income households convenience and flexibility unmatched by formal intermediaries. But the informal sector also has many weaknesses and cannot do what a well-functioning formal sector institution can.

The microfinance movement is thus striving to match the convenience and flexibility of the informal sector, while adding reliability and the promise of continuity, and in some countries it is already doing this on a significant scale. Getting to this point – reaching poor people on a massive scale with popular products on a continuous basis – has involved rethinking basic assumptions along the way, and programs in Bangladesh and Indonesia are still developing new products and approaches. In Bangladesh, the unveiling of "Grameen Bank II" is the most dramatic recent example. BRAC too has been innovating, most recently with new ways to reach the very poor through its specialized Targeting Ultra Poverty program. *Safe*Save, an innovative cooperative, is building on its successes in the Dhaka slums to try new approaches in rural areas.

These developments can be attributed in large part to leaders with the self-confidence to learn from mistakes and the boldness to try new ideas in the face of counter-arguments. This has proved more important than legal identity, institutional type, or funding source, all of which vary considerably among the successful programs of Asia.

The past few years in India have demonstrated a welcome willingness to innovate and to think afresh about financial services for poor people. Off-the-shelf models designed for other contexts have been viewed with caution in India, and this attitude is sensible as long as it does not restrain local advocates of those models from experimenting in India if they wish to, so it is good to see MFIs like SHARE growing rapidly. The Indian self-help group-bank linkage model is an important example of home-grown innovation, and is currently receiving a much-deserved increase in attention at home and abroad.

But because SHGs are a very mixed bag in practice, their already rapid expansion will need to be matched by serious attention to their structural and funding weaknesses, and with much more thought about their long-term position in the national financial system.

Lessons from Bangladesh and Indonesia provide guides for what better solutions should look like. Necessary steps include: raising interest rates well above "cheap credit" levels (no matter what one's view on subsidy); clearly targeting customer groups (whether by product design, location, or explicit eligibility criteria); judiciously providing (or not providing) non-financial inputs; and managing and rewarding staff according to clear, performance-based criteria. Creating diverse, responsive institutions will also mean avoiding an exclusive focus on credit, or on "microenterprise credit", or on group-based solutions.

For the government's part, there is a role to play in further de-regulating interest rates to allow a broader array of institutions to serve the poor. Being permitted to raise interest rates has proved critical for Asian programs, even for successful pro-poor NGOs that remain subsidized. As a general rule, programs that take in savings should be regulated in order to protect depositors, though the Bangladesh experience shows that well-established lending programs can safely be allowed to accept both compulsory and voluntary savings from their clients, if not from the general public. Bangladesh - where most MFIs are lightly supervised by an NGO Bureau rather than by the central bank - also shows that programs that offer credit-only services can be safely left to evolve with little or no regulation. All programs, though, should be held to high professional standards with regard to timely and transparent financial reporting, an accomplishment not yet fully achieved in Bangladesh (and sorely missing with regard to the Indian SHGs).

The commitment in India to microfinance has been longstanding, starting well before the global movement was even given a name or considered a movement. But many early ideas did not work as expected, and the Indian economy has changed a great deal in the past twenty years, opening space for new approaches. In seeking those new ideas, lessons from elsewhere in Asia point to both cautionary lessons and important opportunities for India.

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