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Micro-Finance in India
An overview

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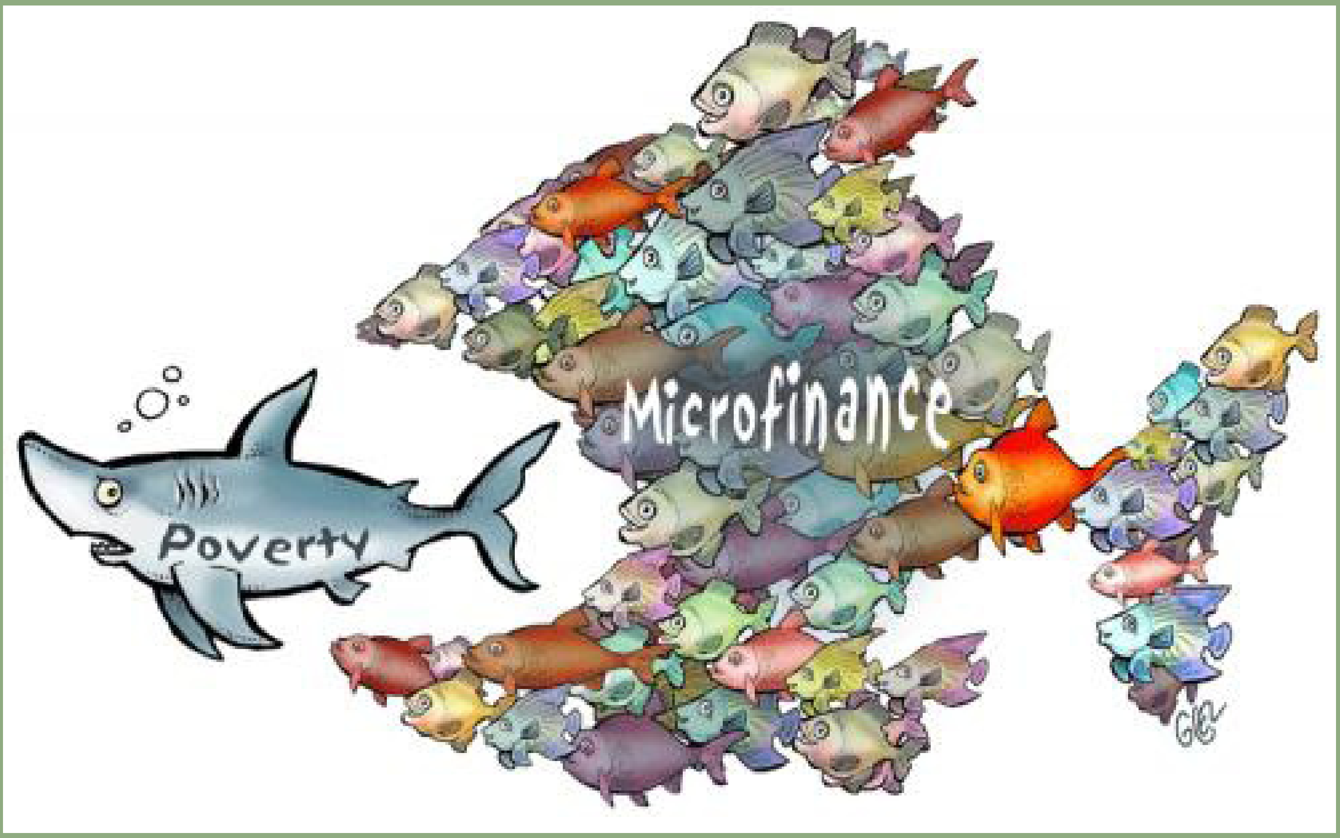

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Contents

2 Micro Finance in India
An overview of Micro Finance in India

7 RBI tinkering with Repo rate and MSF
What is this recent move by RBI all about? To know, read on..

9 Finzomania
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Micro Finance in India

An Overview

-By Paridhi Dixit

During my stint with an NGO involved in facilitating the formation and functioning of Self-Help groups in a rural area in Madhya Pradesh, I got the opportunity to get a glimpse of how policies and plans are actually executed at grassroots level. Taking cue from what I learnt there, here is an attempt to study the state of microfinance in our country and how it has progressed over the years.

According to the taskforce on Policy and Regulatory Framework for Microfinance, "Micro finance is the provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards".

There are broadly two models in India that link the formal financial sector with lending to low-income households. The first is the bank-led Self Help Group (SHG) model, promoted by the State through commercial banks, which lends to groups of 10 to 20 women formed with the help of NGOs supported by the National Bank for Agriculture and Rural Development. The other model is that of micro-finance institutions (MFIs) under which private sector entities lend to small groups similar to the SHGs.

Since independence, steps were taken to provide financial services to the rural poor. In the year 1969, when 14 commercial banks were nationalised, they were directed to lend 40 percent of their loanable funds, at a concessional rates to the priority sector (mainly including agriculture and other rural activities). Also, the credit scheme, Integrated Rural Development Programme (IRDP) was launched in 1980 to empower the rural poor.

However, little was achieved from these measures and it was found that 70 per cent of landless/marginal farmers did not have a bank account and 87 per cent had no access to credit from an official source. The microfinance revolution in India began with the formation of informal Self Help Groups (SHG). India's first Microfinance Institution 'Shri Mahila SEWA Sahkari Bank' was set up as an urban co-operative bank, by the Self Employed Women's Association (SEWA).

Table-1

Share of Rural Household Debt by Source, India, 1951- 2010(%)

Credit Agency	**1951**	**1961**	**1971**	**1981**	**1991**	**2010**
Cooperatives and Commercial Banks	5.7	10.3	24.4	58.6	58.8	52.8
Government and other formal sources	3.1	5.5	5.5	4.6	7.5	7.8
All Institutional Agencies	**8.8**	**15.8**	**31.7**	**63.2**	**66.3**	**60.6**
Professional and Agriculturist Moneylenders	68.6	62.0	36.1	16.1	17.5	18.2
Traders		7.2	8.4	3.1	2.2	4.8
Landlords		7.6	8.6	4.0	4.0	5.7
Relatives and Friends	14.4	6.4	13.1	11.2	4.6	4.4
Other Sources	8.2	0.8	2.1	2.4	2.3	4.6
All Non-Institutional Agencies	**91.2**	**84.0**	**68.3**	**36.8**	**30.6**	**37.7**
Sources not specified	0	0.2	0	0	3.1	1.7
Total	**100**	**100**	**100**	**100**	**100**	**100**

The SHG – Bank Linkage Programme started as an Action Research Project in 1989. In 1992, a pilot project was designed as a partnership model between three agencies, viz., the SHGs, Banks and NGOs. It was mainstreamed in the period from 1996 to 1998. Since then, it has grown exponentially over two decades and around 74.62 lakh SHGs are linked to different Banks as of June 2013. Of these nearly 65 per cent have direct credit links with banks.

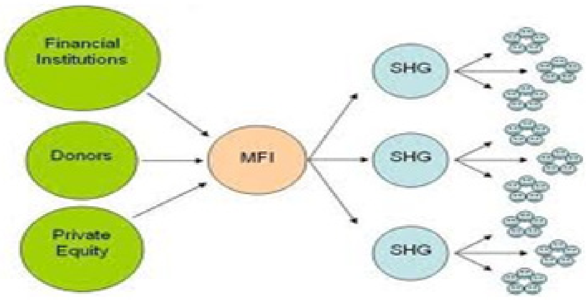
The dominant theme so far has been of extending micro-credit through Bank-SHG linkages, with NABARD playing a leadership role and micro-finance institutions, mainly NGOs, playing a catalytic as well as an enabling role at the ground level.

Interesting examples of SHGS include Rickshaw bank (auto rickshaw drivers), Usha Bank (sex workers) and Karunya (rural women) wherein 15-20 members from the same community come together and start to save, lend, invest and put their money to use.

Of the total SHGs formed more than 1.6 million have been linked with 35,294 bank branches of 560 banks in 563 districts across 30 States of the Indian Union. Cumulatively, they have so far accessed credit of Rs.6.86 billion.

The advantages of micro-financing through SHGs are many. Micro-finance for women has recently been seen as a key strategy in meeting not only Millennium Goal 3 on gender equality, but also poverty reduction, social empowerment, health awareness, innovation and prosperity. It has significantly reduced the dependency on exploitative and unfair lenders.

The Indian Government and the RBI have a policy of "financial inclusion". As part of this policy, the government requires Indian banks to lend to priority sectors. The banks comply to this "priority sector" lending mandate by lending money to Micro Finance Institutions who then lend funds primarily to poor women across rural India. The banks are happy because, they charge the MFIs 12-13% interest on the loans granted and enjoy 100 per cent repayments.



The MFI lending model

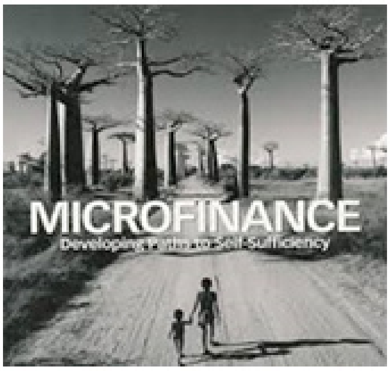
Challenges facing Microfinance in India:

The banking system has not able to internalise lending to the poor as a viable commercial activity and considers it a social and legal obligation. The poor are not viewed as borrowers but beneficiaries who are being provided assistance; hence the reluctance. The banks also argue that in areas where loan per borrower is low, the administrative and fixed costs of lending become very high.

Another important criticism of SHGs involves absence of interest rate caps due to which some SHGs charge exorbitantly high rates of interests from their members (Chavan and Ramakumar, 2006). This cannot be justified giving the rationale of what they charge is also the SHG's income because malpractices like these defeat the very aim of monetary self sufficiency of the poor. It also leads to an increase in the non-performing assets of bank loans to SHGs.

Adding to that, different State Governments take varying approaches to the microfinance institutions – including subsidising interest rates. The nature and spread of microfinance movement also differ significantly across States. For example, NGOs in Tamil Nadu and Andhra Pradesh have progressed faster in empowering the rural population as compared to any other states our country.

How the money is put to use is crucial in deciding the fate of development plans. Between the concern of the policy makers and the quality of the effort there has been a gap. We were not able to achieve the success envisaged for a variety of reasons mainly due to highly bureaucratic set up and infirmities in implementation.



The Road ahead:

RBI and NABARD recognise the growing importance of micro-finance and are committed to enable its healthy growth. However, several issues, both in regard to regulation as well as development of the MFIs must be comprehensively addressed.

The recent plan of government towards licensing more banks with mandates for providing disbursements to the identified rural regions is a welcome step. But a lot remains to be done on both the ends to address the problems which banks have been facing and bring about a transformation in their attitude towards micro finance. The initial costs might be high and unprofitable but if worked upon, the banks will see good business and will operate in rural areas without the need of any forced mandates in the years to come.

The developments in technology and emergence of a unique identity 'AADHAR' seem to provide a window of opportunity to reduce the transaction costs and thus enable microfinance to be a commercially profitable activity and make the whole process convenient. Needless to say access to finance along with education and infrastructure in a must to help communities to climb out of poverty. It is therefore necessary to align these goals together.

All said, it is necessary to focus on extending financial services in both rural and urban areas for ensuring financial inclusion of all segments of the population and to understand the fact that creating one set of banking and financial institutions to cater to the poor or the unorganised, and another for the rest will not solve the problem. The objective should be to ensure inclusion of all segments in the mainstream institutions while taking advantage of the flexibility of multiplicity of models of delivering a wide range of financial services to everyone.

RBI Expected to Hike Repo Rate and Slash MSF Rate

RBI is expected to hike the Repo rate on 29th October by 0.25 percentage points. Repo rate is the rate at which a central bank lends to the commercial banks, depending on the level of money supply it decides to maintain in the country's monetary system. To temporarily expand the money supply, the central bank decreases repo rates. To contract the money supply it increases the repo rates.

The central bank is also expected to cut Marginal Standing Facility (MSF) rate in view of the stability of the Rupee. MSF rate is the rate at which banks borrow funds overnight from the Reserve Bank of India (RBI) against approved government securities. This came into effect in May 2011. Under the Marginal Standing Facility (MSF), currently banks avail funds from the RBI on overnight basis against their excess statutory liquidity ratio (SLR) holdings. Additionally, they can also avail funds on overnight basis below the stipulated SLR up to 2.5 per cent of their respective Net Demand and Time Liabilities (NDTL) outstanding at the end of second preceding fortnight.

The Reserve Bank of India (RBI) had reduced the marginal standing facility (MSF) rate to 9 per cent from 9.5 per cent to improve liquidity in the system in October.The MSF rate is expected to be cut by 0.25 percentage points to 8.75% keeping in mind the recent stabilization of Rupee and the increasing probability of delay in US Fed tapering of quantitative easing.

RBI may also widen the repo window back to 1% of total deposits. Banks have been borrowing on average Rs 40,000 crore under repo, Rs 20,000 crore under term repo and another Rs 30,000-35,000 crore under the MSF window.

The MSF rate is pegged 100 basis points or a percentage point above the repo rate. Banks can borrow funds through MSF when there is a considerable shortfall of liquidity. This measure had been introduced by RBI in 2011 to regulate short-term asset liability mismatches more effectively.

The difference between MSF and Repo Rate:

Under LAF (Liquidity Adjustment Facility) - Repo rate, Banks can borrow from RBI at the Repo -rate by pledging government securities over and above the statutory liquidity requirements.

However, in case of borrowing from the marginal standing facility, banks can borrow funds up to two percentage of their net demand and time liabilities, at the rates announced by RBI and this can be within the statutory liquidity ratio of 24%.

Change date	Percentage
September 20 2013	7.500 %
May 03 2013	7.250 %
March 19 2013	7.500 %
January 29 2013	7.750 %
April 17 2012	8.000 %
October 25 2011	8.500 %
September 16 2011	8.250 %
July 26 2011	8.000 %
June 16 2011	7.500 %
May 03 2011	7.250 %

Reasons for the change:

Repo rate is an important tool used by the RBI to control the supply of money in the banking system. If the rate is increased, the banks will find it difficult to borrow from RBI and the cost of fund will increase.

This will result in an increase in interest rate in the system. By reducing the Repo rate RBI can reduce the cost of borrowing and there by the interest rate in the system.

The key drivers for the repo rate hike would be to anchor inflation expectations and to move towards non negative real interest rates to improve the savings propensity in the economy.

The measure to cut MSF would tighten liquidity and arrest volatility in the foreign exchange market. The intent has been to maintain tight liquidity conditions at the short end of the term structure until the measures designed to alter the path of the CAD and improve prospects for its stable funding take effect.

Implications :

1. Repo Rate will affect the rate of interest charged by banks on various loans like Home Loan, Personal Loan, car loan etc.

2. Customers of various loans will be affected by these rates indirectly.

3. It may also send up the EMIs (Equated Monthly Instalments).

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1. In Indian economic scenario what significant reform was introduced by the Indian Government on April 1, 1957?
2. Who founded the famous Wall Street Journal?
3. Name the first private sector corporation which launched the gold fund in India?
4. Which financial services giant is referred to as the "Thundering Herd"?
5. What is an unusual service offered by Bank of Baroda at Tirupati?
6. What term became popular after the newspaper report of Watergate Scandal in the year 1973?
7. How does the transaction termed when a company borrow money to lend it at a profit, taking advantage of a short term rise in interest rate?
8. What is the exchange rate of one currency for another over a fixed period of time called?
9. In which country's coins can you find the following line imprinted, 'This is the root of all evils' ?
10. Name the person who introduced the 'Double Entry' book keeping concept?

Answers:
1.Decimal Coinage System was introduced
2.Charles Dow and Edward Jones
3.Dundee Mutual Fund
4.Merrill Lynch
5.Only bank in India to sell Prasada
6.Money Laundering
7.Round Tripping
8.Swap or Currency Swap
9.Vatican City
10.Lucas Pacioli

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