

Africa Economic Analysis

SCALING UP MICROFINANCE IN EASTERN AND WESTERN AFRICA WITH LESSONS FROM INDIA

BY

SULTAN REHMAN SHERIEF

Professor, Magnus School of Business, Chennai.

E-Mail:rehman30@yahoo.com

AND

S.TAMEEM SHARIEF

Lecturer and Research Supervisor,

PG and Research Department of Commerce, The New College, Chennai.

E-mail: irfana_sharief@hotmail.com

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I. INTRODUCTION

One of the most intractable economic problems for poor countries has been the high price or outright unavailability of credit in rural communities. Primarily because of weak institutional infrastructure in rural areas, formal sector banks have faced seemingly insuperable information asymmetries and consequently have experienced persistently high costs and default rates. Screening potential borrowers, monitoring borrower behavior after loans are granted, and enforcing credit agreements are all extraordinarily costly where documented credit histories do not exist, businesses are very small, and legal systems are undeveloped, unreliable, or inaccessible. To these difficulties, formal sector lenders have often responded by engaging in “credit rationing,” leaving a large number of would-be borrowers without access to institutional credit. Although local moneylenders have sometimes been willing to fill the gap left by formal sector banks, rates charged in the informal sector are extremely high, sometimes monopolistically so. Consequently, very poor rural communities are typically left either without credit at all, or with credit available only at exorbitant interest rates.

One of the few concepts that have succeeded in expanding the availability of credit in poor, rural communities has been “microfinance,” a practice that involves the provision of small loans to borrowers without conventional collateral. The term of the loans is short (usually less than two years), and the microfinance institution (MFI) normally requires that the loan proceeds be used for investment in productive capital — for example, in agriculture, trading, crafts, or processing industries — rather than consumption.(Bornstein,1996)

Interest rates are usually somewhat higher than those charged by formal sector banks, but are substantially lower than those charged by local moneylenders. Microfinance appears to have defied the conventional wisdom about rural credit markets. Although most MFIs are financed, at least initially, through grants or low-interest loans from aid organizations or donor governments, very many have achieved operational and financial self-sufficiency.

Small enterprises and most of the poor population in sub-Saharan Africa have very limited access to deposit and credit facilities and other financial services provided by formal financial institutions. For example, in Ghana and Tanzania, only about 5-6 percent of the population has access to the banking sector. This lack of access to financial services from the formal financial system is quite striking, when one considers that in many African countries the poor represent the largest share of the population and that the informal sector is an important part of the economy. (Basu, et al, 2004)

To meet unsatisfied demand for financial services, a variety of microfinance institutions have emerged over time in Africa. Some of these institutions concentrate only on providing credit, others are engaged in providing both deposit and credit facilities, and some are involved only in deposit collection. **PRIDE Africa (PRIDE)**, which has extended more than 60,000 loans of between \$50 and \$1000 in East Africa. (Retrieved from the website of Pride Africa) **The Kenya Rural Enterprise Program (K-REP)** has lent to over 12,000 borrowers reporting repayment rates of higher than 95%. (Charitoneko, 1998)

However, over the past few years, several microfinance organizations and practitioners have found setting up of sustainable microfinance systems in rural Africa very challenging. In the absence of voluntary encouragement from a donor, deprived rural areas in Africa may continue to be shunned by the majority of microfinance operators because of the cost and risks associated with working there. Low population density, lack of basic infrastructure and scarce economic fabric are constraints that compound the difficulties associated with sustainable microfinance. They affect sub-Saharan Africa even more than other regions.

Whatever the geographic environments and cultural contexts, microfinance promoters face similar experiences everywhere. By comparison, the most successful microfinance institutions in Asia were often developed in rural areas characterized by high population density, good communication infrastructure and much greater rates of input-output trading within the rural economy. Those features had a major impact on transaction costs at the client and institutional levels, on MFI growth rates and on the ability of the institution to become financially sustainable within a relatively short period of time.

This paper intends to identify a number of stylized facts and trends from the experiences of African countries and India. While quantitative data is very limited, tentative conclusions are provided based on a qualitative assessment of recent developments in the surveyed countries, supported by background material and studies undertaken by the IMF (International Monetary Fund) and the World Bank. The main contribution of the paper is to compare experiences across Africa with those in India, and identify the difficulties and challenges faced by the MFI's that may guide public policy in the sector.

The paper begins with a brief review in Section II of the current level and pattern of access to formal finance for India's rural households, with a focus on the poor. Section III provides a review of the Microfinance institutions in Africa. Section IV highlights inadequacies in microfinance approaches to serve the financial needs of the rural poor in Africa. Section V concludes by providing some suggestions, based on lessons learned from India, on what needs to be done to scale-up access to finance for Africa's rural poor.

II. NEW APPROACHES TO DELIVERING FINANCE TO THE POOR

a) Microfinance in India

Since the early national plans, successive governments in independent India have emphasized the link between improving access to finance and reducing poverty, a stance that has had influence globally. The need to improve financial access for India's poor, the overwhelming majority of whom are concentrated in rural areas, motivated the establishment of a vast network of rural cooperative credit banks in the 1950s, followed by a drive to nationalize commercial banks, launched in 1969. This led to thousands of new bank branches in rural areas across the country.

The strategy during the 1970s and 1980s gave the lead role to the nationalized (state-owned) commercial banks, which were charged with loosening the grip of traditional informal sector moneylenders through the use of targeted low-priced loans. The 1990s saw the partial deregulation of interest rates, increased competition in the banking sector, and new microfinance approaches. Most notable among them was the nationwide attempt to create links between commercial banks, NGOs, and informal local groups or 'self-help groups' (SHGs). Better known as 'SHG Bank Linkage', this approach has grown dramatically over the past decade, and while its outreach is still

modest in terms of the proportion of poor households served, many believe it is destined to become the country's dominant system of mass-outreach banking for the poor. (Basu, et al, 2005)

Self Help Groups (SHGs) form the basic constituent unit of the microfinance movement in India. An SHG is a group of a few individuals – usually poor and often women – who pool their savings into a fund from which they can borrow as and when necessary. Such a group is linked with a bank – a rural, co-operative or commercial bank– where they maintain a group account. Over time the bank begins to lend to the group as a unit, without collateral, relying on self-monitoring and peer pressure within the group for repayment of these loans.

An SHG consists of five to twenty persons, usually all from different families. Often a group like this is given a name. Each such group has a leader and a deputy leader, elected by the group members. The members decide among themselves the amount of deposit they have to make individually to the group account. The starting monthly individual deposit level is usually low – Rs. 10 or Rs. 20 (about 20-40 US cents). For a group of size 10, this translates to Rs. 100 to 200 (about \$2 to \$4) of group savings per month. On the basis of the resolutions adopted and signed by all members of the group, the manager of a local rural or commercial bank opens a savings bank account. The savings are collected by a certain date (often the 10th of the month) from individual members and deposited in the bank account.

Loans are then given out to individual members from out of these funds upon application and unanimous resolution drawn at a group meeting. The bank permits withdrawal from the group account on the basis of such resolutions. Such loans, fully funded out of the savings generated by the group members themselves, are called “interloans”. The repayment periods of loans are usually short, 3-6 months. After regular loan issuance and repayment for six months, the bank considers making a bank loan to the SHG. The maximum loan amount is a multiple (usually 4:1) of the total funds in the group account. This limit is also reached gradually starting from a lower (2:1 or 1:1) figure. Thus a 10 member SHG with individual monthly deposit level of Rs. 20, completing a six-month successful “inter-loaning”, accumulates total savings of Rs.1200/- (part of which may be

lent out to individual members) and is eligible for a maximum bank loan of Rs. 4800/- (Chakrabarti, 2003)

b) The role of Non-Governmental Organizations in Microfinance

Self Help Groups are almost always formed with outside assistance. Developmental NGOs, often with considerable history of working in a particular area for projects like literacy, sanitation etc., take to organizing SHGs, bringing together people, explaining the concept to them, attending and helping coordinate a few of the initial group meetings, helping them maintain accounts and linking them with the banks. Of late, some of the rural banks themselves are being designated as Self Help Promoting Institutions (SHPIs) and they help in the formation and ‘nursing’ of SHGs.

Over the last quarter century, a few organizations, outside the purview of the public sector, have succeeded in effective poverty alleviation through micro-credit. Self Employed Women’s Association (SEWA) in the Western Indian state of Gujarat and Working Women’s Forum in the Southern state of Tamilnadu were among the pioneers in this effort. The sector received a major boost in the 1990s with the entry of several non-government organizations. NGOs provide the leadership and management necessary in forming and running such groups in most cases. They also act as the crucial link between these groups and the formal banking system. Presently well over 500 NGO-MFIs are actively engaged in microfinance intermediation across the country. Thus, Self-Help Groups (SHGs) among the poor, mostly women, have rapidly become a common rural phenomenon in many Indian states.

The main advantage of Self-Help Groups lies in their joint liability and consequent “peer monitoring” of member borrowers. In association with sponsoring NGOs, they serve to reduce the transaction and monitoring costs of small lending for the banks as well as reach credit to the absolute poor. It is therefore hardly a surprise that they have attracted considerable attention in the rural banking sector as well as from the government in recent years.

Several alternative models of SHG-NGO-bank relationship have emerged in recent years. One such model is where the bank lends directly to the SHG and the latter further lends it to individual members. As a variant of this model, an NGO may provide training and guidance to the SHG still dealing directly with the bank. This has been the most popular

model in the Indian context. Alternatively, the NGO itself may act as an intermediary between the bank and the SHG, borrowing from the bank and lending it to (usually multiple) SHGs. Yet another model involves the bank lending directly to the individual borrower with the NGO and the SHG acquiring an advisory role. Here the NGO assists the bank in loan monitoring and recovery.

While most of the SHG formation/nursing process has initially been in non government hands, the developmental potential of the SHG-based microfinance process has not gone unnoticed by the government. In recent years, government developmental programs have also sought to target the poor through the SHGs.

c) The Government's role in aiding Microfinance in India-The Swarnjayanti Gram Swarojgar Yojana

Swarnjayanti Gram Swarojgar Yojana (SGSY) has emerged as a main anti-poverty program instituted by the government in recent years. The goal of the program is to enable the poor attain income generating assets. The SGSY strategy includes identifying a cluster of activities at the block level and funding SHGs to perform these activities. Though financing is a very important part of SGSY, it is not the only element. Identification of activity clusters, recognizing training needs of the poor, imparting proper training and building the capacity of the groups and group members in the selected activities are all essential elements of the program.

d) Banking Sector and Microfinance

The formal banking sector has played an important role in microfinance in India. Much of the microfinance initiative in India has involved Self-Help Groups (SHGs), predominantly of poor women. NABARD's(National Bank for Agricultural and Rural Development) Bank Linkage Program, pilot-tested in 1991- 92 and launched in 1996, has been a major effort to connect thousands of such SHGs across the country with the formal banking system. A few studies commissioned by NABARD attempted an assessment of the program. The findings indicate that the program has emerged as the largest microfinance network in the world with some impressive statistics.

As of March 2002 the program covered 461,478 SHGs with total cumulative lending of Rs 1,026 cores (US \$ 218.27 million). The accumulated savings in SHGs exceeds Rs 875 crores (US \$ 186.31 million) by unofficial estimates. 90% of SHGs financed were

exclusive women groups. 444 Banks (121 RRBs, 209 cooperatives banks, all 27 public sector banks and 17 private banks) with a total of 17,085 branches participated in the program providing credit to about 7.8 million poor households in 488 districts. Average loan sizes are Rs 22,240 (US \$ 463) per SHG and 1,300 (US \$27) per member. Today, the program is estimated to cover well over 500,000 SHGs with cumulative loans exceeding Rs. 1200 crore reaching over 8 million households. (Kropp and Suran (2002) and Seibel and Dave (2002)).

III MICROFINANCE INSTITUTIONS IN AFRICA

a) Microfinance in Western Africa

Three major types of microfinance systems characterize the Western African sub-region: credit unions (“Systèmes Mutualistes”); solidarity group systems (based on the replication of the Grameen model), and; village-bank type systems (“Réseaux de Caisses Villageoises”).

The credit unions were set up on the basis of European (Raiffeisen) or North American (DID, WOCCU) experiences. Although they have been in existence since the 1960s, they only started to expand rapidly in the 1980s following the collapse of most of the rural development banks in the sub-region. Significant credit union systems were developed in Bénin, Burkina Faso, and Togo.

These systems share some common characteristics: membership conditions, the obligation to save prior to accessing credit, a two-fold structure based on elected members and professionals, and a pyramidal organization with three levels (local, regional, and national). In general, those systems have been extremely successful with respect to their saving mobilization strategies, and have maintained high level of repayment. However, some of the policies applied by those systems have been criticized in recent years.

For example, the pre-condition of initial savings to access credit has been deemed responsible for excluded low-income clients, and has concentrated membership within the relatively well-off population. Also, the three level structures are sometimes seen as resulting in too much centralization of decision-making, causing delays and inefficiencies. Finally, these systems face important governance issues, with unresolved tensions between elected members and technicians. They are presently entering a crucial

phase of institutionalization which constitutes a major challenge, as well as an opportunity, for consolidating their long-term sustainability.

The second microfinance system in West Africa is the “solidarity group” system. It has been developed, inter alia, in Burkina Faso and Guinea on the basis of Bangladesh’s Grameen Bank model. It provides small, non-targeted credit with repayments through weekly installments during meetings with the group members. It has reduced transaction costs to a minimum with simplified loan applications. This model has adapted some of its characteristics to fit the prevailing socioeconomic context.

Finally, “village-bank”-type institutions combine certain characteristics of both models above. The village banking approach is based on social cohesion and community solidarity at the village level. The local village bank (VB) is usually a structure managed by the villagers themselves according to rules they have established. On completion of the initial phase of the project, technical support to a network of VBs is provided by an external entity, which is sub-contracted by the network. Also, the network’s operations are financed largely through a credit facility negotiated with a local bank. Village banking systems have been successful in reaching the poorest, and have often been developed in remote and challenging rural areas. (Microsave, 2000)

b) Microfinance in Eastern Africa

The configuration of the microfinance industry in Eastern Africa is quite different from that of West Africa. Whereas it has harbored some microfinance success-stories, especially in Kenya and Uganda, credit unions have not experienced the successful growth and reputation of their counterparts in Western Africa. Moreover, the state control over the cooperative sector which prevailed for a long time in several Eastern Africa countries created a very different dynamic in the evolution of these systems. In fact, similar types of microfinance organizations in Eastern/Central and in Western Africa show contrasting achievements, on a number of indicators.

The emergence of the Savings and Credit Cooperative Organizations (SACCOs) dates back to the years 1965-70. They grew out of the credit systems of the old farming cooperatives which were common in cash crop areas, particularly where coffee was produced. At that time, the state controlled the production of coffee from farm to market. Farmers were organised into cooperatives, and financial services were provided by

“banking sections” (in Kenya the Union Banking Sections) where the farmers could save and obtain advances that were repaid using the income earned from the harvest.

In Tanzania the SACCO movement, is legally autonomous but closely linked to the farming cooperatives, experiencing mixed fortunes because of changes in government policy.

In Kenya these banking sections were progressively converted into SACCOs in order to formalise the separation between economic and financial functions, but not without generating a certain amount of resistance. The process took nearly 20 years, and is not complete even today. During the 1980s Kenya witnessed the emergence of “microfinance NGOs” which adopted the Grameen Bank model. These NGOs focused on providing microcredit to solidarity groups, operating in urban areas and targeting micro-enterprises. Five of these NGOs are noteworthy, with K-REP (Kenya Rural Enterprise Program) taking the lead and transforming itself recently into a commercial bank.

K-REP introduced a new type of member-based institution in Kenya known as financial service associations (FSAs) in order to diversify its client base and broaden its national coverage. These FSAs started operating two years ago in poor rural areas that were not covered either by the K-REP type solidarity group systems or by the SACCOs. Although they are still at the experimental stage, FSAs seem to be quite popular especially in areas neglected by other MFIs. Their low start-up and operating costs suggest that they might achieve autonomy despite the difficult economic environment in which they operate.

Under pressure from donors certain banks in Kenya have initiated microfinance activities simply by using concessional lines of credit or external guarantee funds to refinance MFIs. Only the Cooperative Bank, seems seriously interested in pursuing this course of action. Despite, or perhaps because of, this polarized situation these two types of MFI know little about each other and have had very limited. So much so that, for a long time, the financial NGOs in Kenya (and also their donors) thought that the SACCOs did not belong to the microfinance sector.

Thus it can be said that although the sector has evolved over the last few years and is still undergoing significant change today, this evolution seems to be more strongly influenced by changes in the local environment than by meetings or confrontations between the

different approaches or the impact of increased competition among MFIs. (Microsave, 2000)

IV CHALLENGES FACED BY MFIs IN AFRICA

a) The challenges facing the West African networks

In the last few years, considerable efforts have been made by the mutualist networks to open up to new members, decentralize towards more remote areas, and develop a more diversified range of services more suited to the demands of its members. However, the movement is at a crossroads. A few large networks have folded following serious management problems, widespread fraud, and a significant deterioration in the quality of their loan portfolio. The following are some of the challenges facing these systems:

- **Controlled growth:** As a result of pressure from donors the networks have experienced high rates of growth that were too sustained to be adequately controlled. The governance structure of these networks, while well suited for managing locally based systems, is not appropriate for managing such an increase in the scope of activities. In addition, the networks experience difficulties with human resources; time and care need to be taken to select and train good staff and monitor their progress in the field. A number of networks have spun out of control precisely because they failed to take these issues into account.

- **Pursuing institutionalization:** When warranted by the volume of transactions, the creation of genuine Cooperative Banks that are subject to regulation and to more strict and rigorous banking supervision is necessary.

- **Ongoing efforts to make the apex structure profitable:** These include rationalizing the organizations, seeking economies of scale, and adopting a private sector approach to management (as opposed to a project approach), and could ultimately be combined with an increase in the level of autonomy at the regional level.

- **Research and development:** This encompasses a variety of issues ranging from methodology, financing techniques, products, services, and the definition of new objectives. The idea of establishing financial links among the different MFIs needs to be explored.

- **Competition with the banking sector:** Competition should be encouraged especially with banks that are interested in the same clientele (rural, micro-enterprises etc) and have developed the means to reach them directly.

b) The challenges facing the East African networks

The main challenges facing the East African networks are:

- **Market liberalization:** Currently the Savings and Credit Cooperative Organisations (SACCOs) are linked closely to the marketing systems of the Coffee Cooperatives and the Tea Development Office. But the liberalisation of the market for agricultural products is leading to the weakening and even the eventual disappearance of these cooperatives in the long-term, especially those dealing with export products. Fierce competition between private buyers should lead the SACCOs to re-organize and adopt a different way of doing business if they want to continue to offer loans, and above all recover these loans.

- **Rapid growth in outreach:** Recent years have witnessed acceleration in the growth of the largest SACCOs. In order to avoid being overwhelmed, the SACCOs need to revise their internal organization, their management style, their tools, and their approach to staff training.

- **The legal and regulatory framework:** SACCOs have been collecting savings from the public and providing banking services in the absence of a well-defined legal or regulatory framework or a deposit insurance fund.

- **Organizational development:** These institutions, be they urban or rural, need to adopt a shared outlook and a national strategy since these are the necessary prerequisites for achieving some form of synergy and avoiding duplication. The SACCOS will have to expand their membership to include other economically active groups beyond their current base which focuses on commodities. They will also have to decentralize their operations by opening autonomous “units” in villages and urban areas to facilitate access to services and rationalize management in the very large SACCOs. In order to improve governance they will have to strike a balance between existing members and the fast-growing number of new members, probably by enrolling users as members with full rights.

- **Operational development**: New products will have to be developed to meet the demand of farmers in a free market environment, as well as the demand from a category of client that has been neglected thus far, namely women. Likewise, these institutions will have to acquire techniques for issuing loans in order to make better use of excess liquidity, which is still considerable, for the benefit of their members. Refinancing activities between SACCOs could be considered as a form of financial cooperation within the movement. An increase in interest rates seems necessary to correspond more closely to markets conditions despite reluctance on the part of the movement's leaders.

- **Regulation**: A dialogue should be initiated with the government in order to define a national policy and a suitable regulatory framework. Supervisory and control responsibilities will have to be clearly defined, whether they are assumed by the self-regulating system that those working in the sector would prefer, or by the monetary authorities within a broader framework that would be conferred through integration into the financial sector. Some thought should be given regarding how to provide improved security for deposits.

- **Innovation**: Different types of innovation will need to accompany the changes described above. It could arise from exchanges with other MFIs, particularly the financial NGOs and the Financial Service Association (FSA), concerning issues such as human resource management and the creation of management information systems, or even decentralization to the village and community levels.

- **An enabling environment**: An enabling environment has to be created by the Government which should be committed to allowing the microfinance sector to develop with the least possible interference.

- **An appropriate structure**: An appropriate structure at the secondary level with an apex body that is more familiar with the needs and concerns of the SACCOs, will be able to give advice, provide quality services, and help them to implement the reforms needed and combine forces.

- **Links**: Links should be formed with the financial NGOs so that innovation and techniques can be shared in order to promote change. The management style of the SACCOs should be modernized and professionalized with the introduction of computer systems, the training of management in the financial techniques used in the networked

banking sector, and the introduction of management to credit analysis and credit management techniques.

- **Extension of the Movement:** The extension of the movement to rural areas and to members other than coffee farmers should be adopted. (Microsave, 2000)

IV SUGGESTIONS TO SCALE-UP ACCESS TO FINANCE FOR AFRICA'S RURAL POOR- LESSONS LEARNED FROM INDIA

In large part, the success of SHG Bank Linkage may be attributable to the fact that it is well aligned with Indian history and circumstances, and capitalizes on the country's vast network of rural bank branches. The idea of local savings-and-loan clubs enjoying access to formal financial services by becoming corporate customers of banks is a good one and is practiced in a small way in many countries. In India, this practice seems particularly appropriate on two counts: *First*, the country has active NGOs that have been zealous in their efforts towards group formation; NGOs view SHGs as having many benefits (such as women's empowerment) beyond microfinance. *Second*, and perhaps even more important, SHG Bank Linkage seems particularly suited to India because the model capitalizes on the country's vast (and unique) network of rural banks that are otherwise unable to reach out to the poor.

Equally important, the success of SHG Bank Linkage underscores just how important a role skillful leadership, good policy, and a conducive legal and regulatory framework can play. Indeed, the role of government in establishing the necessary policy and legal framework, and the leadership role assumed by NABARD in championing the movement, cannot be underestimated. (Basu, 2005)

This section draws on lessons learned, on what to do and what not to do, based on the experience with SHG Bank Linkage and other microfinance approaches in India.

1) Enabling policy, legal and regulatory framework

An enabling policy, legal and regulatory framework is critical to scaling-up. Governments should play an important role in establishing an enabling policy, legal and regulatory framework for MFIs. While the success of individual MFIs is largely attributable to their visionary leaders, this is clearly not enough to mainstream the cause of MFIs. Advocates of MFIs argue that immediate measures needed include the following:

- (i) Reducing minimum start-up capital requirements to facilitate the transformation of MFIs into NBFCs (Non Banking Financial Companies);
- (ii) Encouraging multiple sources of equity for MFIs;
- (iii) Facilitating MFIs to raise debt, including permitting MFIs to mobilize savings, with safeguards;
- (iv) Developing a set of prudential norms that are more appropriate to institutions serving the poor, and set up supervision mechanisms around those norms. They argue that better policy coordination among the various government ministries/departments/agencies that cover MFI issues would also help greatly.

2. Clear targeting of clients

Equally important is the need to ensure proper targeting of clients. The dual pursuit of social ends and financial profits is an ongoing tension for all in microfinance. While analyses of SHG Bank Linkage have so far indicated that the model has so far successfully targeted the poorer segments, '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 transaction costs per rupee tend to fall with loan size). Keeping focused on its target population is thus critical to the success of microfinance.

There has been much debate about how stringently to target, and how best to do it in practice. A first priority is to clearly determine who is being targeted and define eligibility rules.

3. Appropriate products, services and good staffing are critical to ensuring effectiveness

The stretching of rules is to be 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 is compensated, what messages are delivered from headquarters, and who is recruited onto staff.

Group promoters from local communities are generally better able to target poorer households. 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 India.

4. Inclusiveness and competition in the microfinance sector can generate high payoffs

The inclusiveness of SHG Bank Linkage, which has involved a partnership between government, NGOs, and a range of rural banks (commercial banks, RRBs, cooperative banks) has already generated a strong payoff. Further gains in terms of outreach and financial sustainability may be reaped through involving private sector banks and MFIs in SHG Banking. Recent experiments indicate good prospects for scaling-up models that are variations of SHG Banking, and involve MFIs as intermediaries between SHGs and private sector banks (who want to enter the market, but don't have the branch network). Encouraged by early results, the new private sector banks, most notably ICICI Bank, UTI Bank and HDFC Bank, are actively seeking exposure in the microfinance sector. While their current exposure to microfinance is too small to make a difference to their overall portfolio, these newer banks are pursuing innovative approaches to microfinance – as a potential business and not merely as a social or priority sector lending obligation.

5. Overcoming geographic concentration in microfinance

The presence of good quality NGOs with good experience and outreach who are willing to initiate microfinance programs in all parts of the country is of utmost importance. Expanding the reach of microfinance is not a challenge that can be met overnight. To begin with, overall economic growth has to pick up in several countries. Investments are required in areas such as watershed development, small-scale irrigation, livestock up gradation and forest regeneration. Unfortunately, none of these are amenable to the “small, short and unsecured” nature of microcredit loans. These require long term, lumpy public investments. However, once made, they unlock the potential for enhancing the livelihoods of millions of poor people, moving them up from subsistence production to surplus production and thereby increasing the demand for credit.

6. Making the Formal Financial Sector Better at Banking for the Poor

There is a view that microfinance can, at minimum, serve as a quick way to deliver finance in the interim; the idea is to then graduate microfinance clients to formal finance institutions where they can access standard “individual” loans, possibly on a fully commercial basis. Strong efforts must be made now to reform the rural finance markets

and institutions with an eye to improving the efficiency of the sector and designing services and products appropriate for small clients.

7. Improving the incentive regime and promoting competition

One obvious area could be for Governments to revisit its policy of setting interest rate “caps” on rural lending rates and “floors” on the deposit rates. Caps and floors have the opposite effect of what is intended – poor borrowers are cut off from access and end up paying higher interest rates to informal lenders. Meanwhile, banks face an implicit tax (cost) that is not insignificant.

Governments should also consider revisiting its policy on priority sector lending requirements imposed on banks. One option, that would allow the most competitive lender to emerge in rural areas and minimize distortions, is for the government to make the priority lending obligation “tradable”. The most competitive lender would then be paid by the less well placed banks to effectively take on their priority lending requirements for a price. Creating such a market for priority lending requirements would benefit both banks and the rural poor, who would be able to access finance from the most efficient and competitive institution.

Governments need to do what it takes to create an environment that would make it possible and profitable for interested private banks to enter the rural finance market. This would require liberalizing interest rates, so that lending to small, rural clients can become a more profitable business for banks. It would also require revisiting branch licensing policies. And it would require strengthening the supervision of rural banks so as to help wean out the good from the bad banks and create further space for new, private sector entrants. The entry of private banks could have a good demonstration effect for the public sector banks on how to reduce transaction costs in rural banking and how to make rural banking profitable.

Better laws and regulations governing financial transactions, a judiciary that can enforce contracts, the demarcation of property and improvements in land titling, better credit information, and an enhanced regulatory, supervisory and legal framework to support the development of price insurance products, price derivatives instruments and commodities futures markets can go a long way in helping India’s rural poor access finance on better terms.

CONCLUSION

All said and done, microfinance remains a powerful tool for development. It may be a drop in the ocean, but it has made people self sufficient. Evidence points to the several beneficial side-effects of microfinance, in particular, empowerment of women and the inculcation of financial training and discipline amongst the poor which will undoubtedly have long-term socioeconomic benefits. The principles of self-help thus hold the key to economic and socio-cultural freedom for Africa's millions of poor, opening the gates of a hitherto untapped reservoir of human enterprise.

Hence the task of policy makers should be to spread microfinance in Africa and bring down the cost of capital and the operating costs, thus strengthening the bonding between microfinance and the formal financial system. However, for sustainable development of the poor and rural economy, the focus should also be on the development of rural infrastructure and economy, otherwise there will be few activities requiring finance.

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