

Enhancing Inclusiveness of the Indian Financial Sector - the Role of Microfinance¹

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ABSTRACT

An outstanding economic growth and a bright future prospect notwithstanding, poverty reduction is still the most daunting challenge for India. Strengthening access to financial services for the rural sector, particularly the rural poor, is essential for attaining income poverty as prescribed in the Millennium Development Goals (MDGs). Despite various initiatives taken for the expansion of the commercial bank branch network into the rural and semi-urban areas of the country to promote lending to key disadvantaged and underprivileged economic sectors, their socio-economic impact did not match expectations as planned. India needs to develop a more inclusive financial market by enhancing direct access to finance for poor communities and small rural businesses. This paper examines the current - and potential - role of the financial sector, particularly microfinance, in developing a more inclusive and robust economy. This paper which examines rural finance for the poor and its impact on income poverty also analyzes the performance of the rural financial services system in India and outlines trends and patterns in farmers' access to financial services over the course of the past half-a- century. In particular, it analyzes the performance of microfinance institutions (MFIs) in the rural area, with particular emphasis on commercial bank-linked, largely successful Self-Help Group (SHG) programs. Finally, the paper proposes appropriate measures and policies to strengthen the accessibility of financial services to the targeted group of rural poor and discusses how a variety of financial institutions can be mobilized to serve the rural poor most efficiently and effectively. We find that India needs to, among other appropriate policy interventions, restructure the formal rural banking system, and implement cost effective, flexible and convenient ways to reach rural farmers. For reference, we provide an outline of current policy on priority-sector subsidized lending.

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1. Introduction

In spite of having over 1 billion people, diverse regions, languages and communities, and a vibrant democracy, India has made remarkable progress in recent years on a scale, size and pace that is unprecedented in its own history. As a result of 15 years of economic reform, India is poised to become the world's fastest growing economy by 2013-2015, with an accelerated growth rate of 9-9.5 percent according to a new report by Morgan Stanley in August 2010³. India expects to grow at the steady rate of 8.2 percent to 8.7 percent from 2010-2011 (Asian Development Outlook, 2010). The economy of India is the fourth largest in the world as measured by purchasing power parity (PPP). With a GDP of US \$3912.991, it is behind only USA, China, and Japan. By 2020, India is expected to become the third largest economy in the world⁴. However, with India's huge population, its per capita income is \$3,100 at PPP (CIA - The World Factbook, 2009).

Nonetheless, in spite of the outstanding economic growth and a bright future growth prospect, reducing poverty is still the most daunting challenge for India. While poverty in India has reduced significantly, a considerable proportion of Indians still live below the national poverty line. According to the estimates of poverty incidence by the Planning Commission of India (2008-2009), the headcount ratio of consumption poverty at national poverty line (the proportion of the population with monthly per capita consumption expenditure below the official poverty line), in 2004-05 (based on URP consumption) is 27.5 percent, which is comparable with the poverty estimates of 1993-94, which was 36 percent. The poverty ratio at the national level is estimated as 28.3 percent in the rural areas, 25.7 percent in the urban areas in 2004-05 using Uniform Recall Period (URP, in which the consumer expenditure data for all the items are collected from 30-day recall period). India witnessed a significant reduction in headcount ratio between 1993-1994 and 2004-2005; however, there is a large disparity between rural poverty and urban poverty.

It is important to point out that around 193 million (74 percent) of these poverty ridden individuals reside in rural areas and most of these poor households belong to landless, marginal or small farmers (Basu, 2006). As a result of the high incidence of poverty, the percentages of children under 5 who are moderately or severely underweight (48.5 percent in 1999 compared to 53.4 percent in 1993) and undernourished as a percentage of the total population (20 percent in 2002 compared to 25 percent in 1991) are still quite high even though some progress has been made in these areas (UNESCAP et. al., 2006)

If we consider the international definition of poor, namely people living on less than \$1 a day, the situation is worse for India compared to other Asian nations. According to the World Bank estimate (2005), the estimated total poor in India is 456 million at \$ 1.25 a day (2005 PPP\$) compared to 208 million poor in China in 2005.

³ "India to become world's fastest growing economy by 2013-15: Morgan Stanley" *The Economic Times* [17th August 2010]. Available from <http://economictimes.indiatimes.com/news/economy/indicators/India-to-become-worlds-fastest-growing-economy-by-2013-15-Morgan-Stanley/articleshow/6322333.cms>

⁴ Euromonitor International from IMF, International Financial Statistics and World Economic Outlook/UN/national statistics

According to the World Development Report of 2000-2001 (World Bank, 2000), *“Access to financial markets is important for poor people. Like all economic agents, low income households and micro-enterprises can benefit from credit, savings, and insurance services. Such services help to manage risk and to smooth consumption... And allow people to take advantage of profitable business opportunities and increase their earnings potential. But financial markets, because of their special features, often serve poor people badly... Since poor people often have insufficient traditional forms of collateral (such as physical assets) to offer, they are often excluded from traditional financial markets... transactions costs are often high relative to the small loans typically demanded by poor people. And in areas where population density is low, physical access to banking services can be very difficult... ”*

In order to reduce income poverty, it is essential to improve access to finance for the unserved and underserved poor, low income households, and farmers with small enterprises. At the same time, access to finance should be improved for micro, small, and medium sized-enterprises (MSMEs) that are situated in rural areas and are involved in labor-intensive activities. The necessity stems from the fact that rural MSMEs can provide steady employment to the poor and thus to a great extent alleviate extreme poverty in a sustainable manner. Usually, a medium-sized enterprise with a good managerial capability and business acumen is in a better position than an individual rural household to exploit economies of scale, purchase required assets or machines, and utilize good business processes to generate employment opportunities for the local poor, thereby increasing potential for further expansion of the business in a sustainable fashion (Karani, 2007).

The availability of labor or the ability to work is the most abundant, possibly the only, asset belonging to the majority of poor individuals in India and this makes employment their primary source of income. Work can provide the poor with income to meet their material needs, reduce social isolation, and impart a sense of dignity and self-worth. Therefore creating opportunities for the quality and quantity of jobs for the rural poor can directly contribute to poverty reduction (World Bank, 2007).

Unfortunately, the rural financial market is not yet fully robust and inclusive in India as a large portion of the rural poor still do not have access to legitimate sources of finance from formal financial institutions such as banks.

Recently, the country’s Finance minister Pranab Mukherjee highlighted the importance of financial inclusion by clearly stating at a conference that “ Financial inclusion is a necessary part of our growth process -- an essential part of [India’s] future.”⁵

Financial inclusion can be defined as the process of ensuring access to timely and adequate credit and financial services by vulnerable groups at an affordable cost. Moneylenders and other informal sector lenders are still very active in rural areas. At the same time, the poor households in rural areas have to face considerable problems in accessing credit and savings from formal financial institutions. A robust and inclusive financial market will serve the poor majorities in rural regions by providing a wide range of financial services, such as credit, insurance, deposits and money transfers services etc. which are required by them. Robust and inclusive markets will also foster a healthy rural

⁵ MacRae, Penny. " India's poor need to join the banking mainstream: minister." *AFP* [updated 19 July 2010]. Available from http://www.google.com/hostednews/afp/article/ALeqM5gHIKfwx7G_3KE4yzdUca-G6kEdzG

economy thereby ensuring India's overall robust economic growth (currently India posted 8.6 percent expansion in the last fiscal quarter)⁶.

Despite significant progress over the years, the socio-economic impact of the above mentioned initiatives did not match expectations as planned, primarily due to the inability of commercial banks in serving the rural sectors of the economy in a cost-effective and sustainable manner. Such lending is considered a social, more pertinently, a regulatory obligation by the banks. One of the major problems in providing financial services to the rural poor is that it is difficult and costly for banks, primarily because there is a lack of requisite information on the targeted clients. In addition, most poor people do not have collateral or personal credit history. Banks also have to provide poor clients a high frequency of small transactions in inaccessible geographic locations, resulting in high transaction costs, thereby making them commercially unattractive and unviable. At the same time, most poor customers, being illiterate cannot typically handle the usual complex paperwork and formalities required by banks. In terms of a cost-benefit analysis, these customers are not attractive to the banks and thus, bank staffs do not have any special incentive in lending to these poor customers. However, micro-finance institutions are suitable and viable for catering to these customers as they are able to bring about innovative approaches in terms of contracts, management structures, and attitudes (Duflo et al, 2007). Some innovative rural financial schemes in India are presented later in this chapter.

Section 2 of the paper examines the relationship between attaining income poverty related MDGs and access to rural finance for the poor. Section 3 presents the performance of the rural financial services in India since the 1950s followed by Section 4 on the trends and patterns of farmers' access to financial services. Section 5 analyzes the performance of microfinance institutions (MFIs) in the rural area, particularly, their commercial bank-linked Self- Help Group (SHG) programs that have been successful in empowering segments of the rural poor in order to learn lessons from their experiences. Section 6 proposes measures to strengthen the access to rural finance. The concluding section recommends certain policies to strengthen the accessibility of financial services to the targeted group of rural poor and discusses how a variety of financial institutions can serve them more efficiently and effectively.

2. Relationship Between Rural Finance and Income Poverty

Though rural sectors in India predominantly account for the presence of extreme poverty in the country, it is important to recognize that there exists significant untapped economic opportunities in the rural area. According to a recent study by World Resource Institute and International Finance Corporation (2007), there are 924.1 million poor people (95 percent of total population) at the base of the economic pyramid with incomes of less than \$3000 in domestic purchasing power per year. Their incomes are below \$1.56⁷ a day (in 2005 dollar purchasing power parity). However, this population segment at the bottom of the pyramid could become profit generating customers for financial institutions. Their annual expenditure is \$1,205,668.5 million (84.8 percent of total annual expenditure). These individuals hailing from rural parts of the country, largely un-served or under-served, are forced to rely on the informal economy and remain relatively unproductive and less

⁶ MacRae, Penny. " India's poor need to join the banking mainstream: minister." *AFP* [updated 19 July 2010]. Available from http://www.google.com/hostednews/afp/article/ALeqM5gHIKfwx7G_3KE4yzdUca-G6kEdzg

⁷ US dollar is in 2005 dollar (adjusted for purchasing power parity.)

competitive compared to the rest of the nation's economic sector performance. Most people at the base of the economic pyramid do not possess bank accounts and largely lack access to financial services from formal financial institutions.

Access to financial services, particularly credit for rural farmers can empower these individuals, and can assist them in utilizing more favorable economic opportunities, create assets, better manage risks, and become more resilient to external shocks. Subsequently, in this manner, they can be removed from the vicious cycle of poverty, and will over time be able to catch up with the rest of the economy. Since India's independence in 1947, various initiatives have been made to encourage the expansion of the commercial bank branch networks into the rural and semi-urban areas of the country, in order to establish local subsidiary banks, namely regional rural banks, and promote lending to key disadvantaged and underprivileged economic sectors.

It is important to note that there exist formal, semi-formal and informal sources of credit in the rural areas. National and State banks, regional rural banks, private banks, cooperatives, and microfinance/micro-credit schemes are considered formal and semi-informal sources of finance whereas relatives, friends, and money lenders are deemed to be informal sources. Two decades ago, a small percentage of rural farmers had access to financial services from formal and semi-formal sources, the primary proportion of financing consisting of informal sources of credit. The scenario has changed considerably recently but still the access to finance falls short of the huge need of the rural poor across the country (Basu, 2006).

The presence of financial institutions plays a crucial role in rural development and hence considered as a key factor with regards to the issue of poverty alleviation in a developing nation like India. Empirical research has shown that direct access to finance can assist the poor in increasing and smoothing their income, thereby insuring against risk and enlarging investment opportunities⁸.

If poor people in India can have proper access to financial resources in a timely and cost-effective manner, then they can exploit investment opportunities. Access to finance also reduces vulnerability of the poor to external shocks, and promotes economic growth. However, the rural poor face a persistent problem of lack of credit in a timely fashion and at reasonable rates. The main reason for this is the collapse of the cooperative credit system in India. A large proportion of the poor are forced to depend to a large extent on informal sources of financing for obtaining credit, typically at exorbitant interest rates as the formal financial sector could not deliver credit to them. As a result, rural farmers are in excessive indebtedness (Planning Commission of India, 2008-2009).

A cross-country study by Honohan (2004) concludes that financial development explains poverty in terms of the number of people living with income less than \$1 or \$2 a day. Financial sector development in terms of better access to finance by the poor reduces credit constraints which in turn decrease child labor and increases education, including the opportunity costs of foregone child labor services. The provision of micro-insurance also insures the poor against shocks (Morduch, 2003). In this way, rural financial sector development reduces poverty. Therefore, one can conclude, in general, barring a few exceptions, that direct and better access of financial services by poor people can significantly affect the attainability of each of the MDGs, particularly the poverty

⁸ Why Inclusive Financial Systems Matter?, Access to Finance (2006), World Bank Website, <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTFINANCIALSECTOR/EXTINCLUSIVEFINSYS/0,,contentMDK:20914297~pagePK:210058~piPK:210062~theSitePK:1945848,00.html>

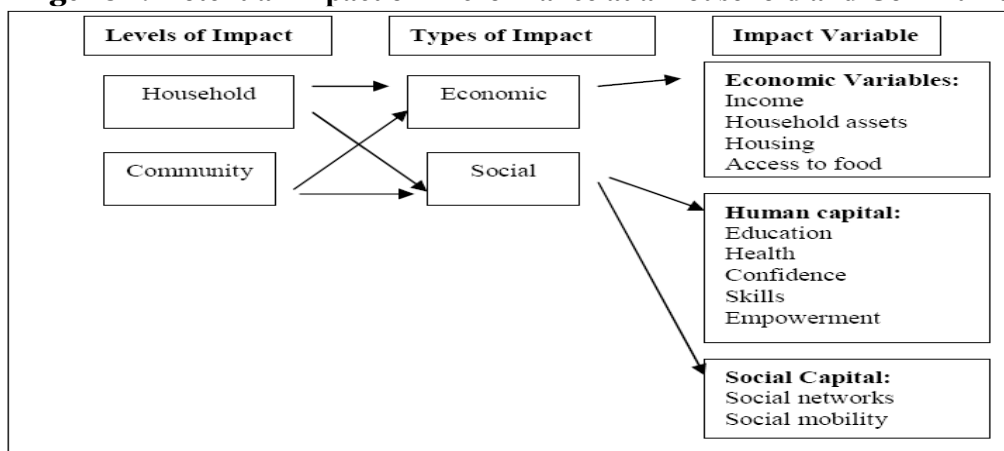
related ones. Access to finance also allows the poor to afford public services in health and education (Claessens, 2006).

One of the major concerns for India is the country’s low agricultural productivity. India is facing a crisis of stagnating agricultural productivity. The agricultural sector accounts for the livelihood of nearly 60 percent of the population and its growth is essential for attaining food security. From 2002 to 2007, the country’s agricultural sector witnessed an average growth of 1.7 percent per annum. In order to attain MDG targets 1 and 2, the standard of living of people engaged in agriculture needs to be enhanced. According to the 11th five-year plan, it will be essential to double the growth rate achieved in the 10th Plan with around 4% percent agriculture growth. To achieve the above growth rate without high inflation, a matching rise in demand for agricultural output with the corresponding supply side response through productivity enhancement will be necessary (Planning Commission of India, 2006).

One of key factors that have an adverse impact on agricultural productivity and on the income of poor farmers is inadequate access to credit. The goal to raise the income levels of the poor increases with proper access to credit and related financial services. As noted earlier, finance allows them to build their assets, and make themselves more resilient against external shocks. Adequate finance gives poor farmers an opportunity to plan for their future instead of merely focusing on subsistence living. Consequently, these farmers can utilize this residual finance for other opportunities such as better education, health, housing and nutrition. Thus, access to financial services, particularly credit for rural farmers, can empower these farmers, and remove them from the vicious cycle of poverty; thereby allowing them to catch up with the rest of the economy. Based on the above mentioned reasons, there is a urgent need for the development of a sustainable financial services system for the poor. Therefore, it is very important for India to find appropriate policies and strategies to strengthen access to financial services for needy farmers.

It is worth noting that the impact of rural finance goes beyond the individual and household levels. It can have a far wider impact than just at the household level. Figure 1 presents a framework 1 (Wrenn, 2005). A model /framework (Fig 1) is presented below for measuring the potential impact of rural finance and demonstrating the effectiveness of specific poverty interventions at the household and community level.

Figure 1: Potential Impact of Microfinance at a Household and Community Level



Source: Wrenn, 2005.

Various studies indicate that the rural finance interventions targeted at households had positive externalities beyond uplifting the lives of their intended clients. According to a study by Mosley and Rock (2004), the finance provided by six African microfinance institutions (MFIs) to non-poor clients was able to reduce poverty by “*sucking very poor people into the labor market as employees of microfinance clients.*” Microfinance services often strengthen human capital through increased spending on education and health that may extend to poor households through intra-household and inter-generational effects.

Microfinance (micro credit⁹) can be defined as the provision of thrift, credit, and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas to support the rural poor in increasing their income levels and subsequently attaining a better standard of living. MFIs are those which provide these financial services.

MFI finance can generate employment for poor people. MFIs provide credit for agricultural production, trading, processing and transport. This results in an increase in the use of agricultural inputs and increased output of agricultural production. Therefore, more employment opportunities in these sectors are available for the poor (Zohir and Matin, 2004).

Another model or framework which could be used for impact analysis of rural finance is the *Sustainable Livelihoods Framework* (DFID¹⁰, 2001).

Sustainable Livelihoods Framework

“The livelihoods framework is a tool to improve our understanding of the livelihoods of the poor. In particular, the framework: (i) provides a checklist of important issues and sketches out the way these link to each other; (ii) draws attention to core influences and processes; and (iii) emphasizes the multiple interactions between the various factors which affect livelihoods” (DFID, 2001).

This framework measures the impact of rural finance on livelihood security. A livelihoods impact assessment assists in understanding the significance of a microfinance project to the livelihoods of project beneficiaries and other local people in a village. A livelihoods framework is *“people-centered and aims to explain the relationships between people, their livelihoods, (macro) policies and all kinds of institutions”* (Neefjes 2000).” The four major components of the livelihoods framework are:

- (i) *people live within a vulnerability context i.e. they are exposed to risks such as sudden shocks, trends over time and seasonal change;*
- (ii) *people have a number of capital assets (financial capital, physical capital, human capital, natural capital and social capital) which they draw upon to make their livelihoods;*
- (iii) *these assets are drawn upon within people’s livelihood strategies;*
- (iv) *policies, institutions and processes help to shape people’s assets, livelihood activities and the vulnerability context within which they live”* (Brocklesby and Fisher, 2003).

⁹ Microfinance and micro-credit are used interchangeably but micro-credit is a component of microfinance as microfinance includes credit as well as other related financial.

¹⁰ Department for International Development- Complete reference needed.

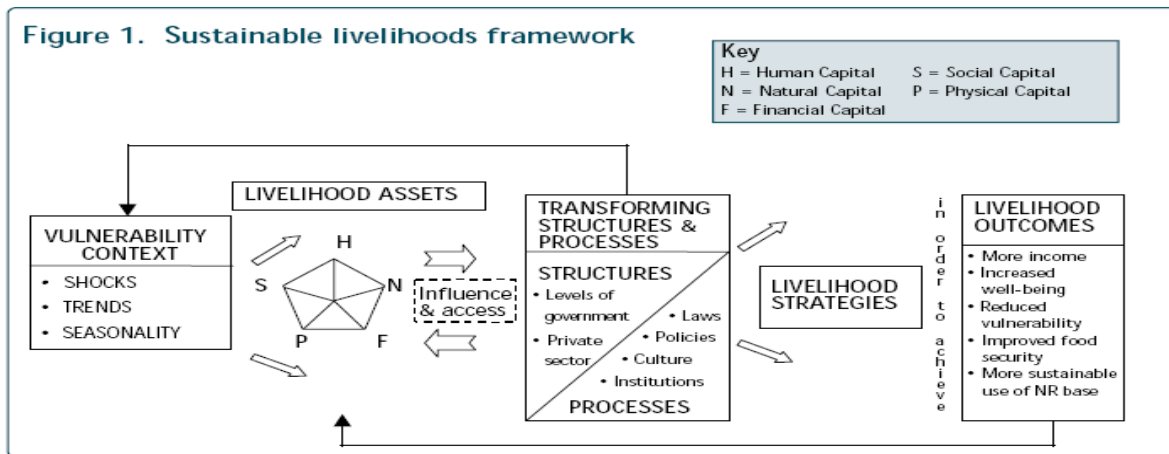
This model has been used by Department for International Development (DFID) for impact measurement. Figure 2 presents the framework which can be used to assess the impact of rural finance on the beneficiaries' livelihoods by focusing on its impact on their five capital assets.

Under this framework, one can examine the ways in which a rural finance project directly and indirectly affects people's livelihoods. The impact of finance on the five capital assets – financial capital, physical capital, human capital, natural capital, and social capital, can be examined. This will provide a holistic impact analysis of people's livelihoods. The level of vulnerability of financial beneficiaries to shocks and trends will strongly depend on the quality and quantity of these capital assets. At the same time, these assets are also impacted by policies and institutions, which along with the beneficiaries' own vulnerability context effect their livelihood strategies which in turn dictate their livelihood outcomes as depicted in Figure 2 (Carney, 1998).

The development of appropriate financial institutions in a village will provide the poor with more secure and easy access to financial resources, such as savings, credit and insurance. The poor need financial capital for getting out of poverty. Effective and tailored financial institutions for the poor will increase the productivity of existing savings and financial flows. The reputed, accessible and well-known financial organizations will encourage people to save. These organizations can also help in transiting remittance income more efficiently to final recipients. Access to financial services to the poor should be enhanced by removing barriers regarding their lack of collateral. This can be achieved either by providing some sort of umbrella guarantee or by identifying mechanisms that enable people's existing assets to act as collateral. The government should provide appropriate safety nets for the poor (including pensions). The financial services organizations should be sustainable, as in poor people should have the trust that these financial organizations will persist over time and will continue to charge reasonable rates of interest. Unless they have trust, the poor will not give their savings to these organizations or be reliable in making their loan repayments (DFID 2001).

Providing financial capital through micro-credit may not be adequate to resolve all the problems of poverty. The poor may not have the capacity to utilize their financial resources to productive use due to (i) their lack of appropriate knowledge cannot be purchased this with the small amounts that credit provides, or (ii) the constraints arising from inappropriate *Transforming Structures and Processes*, for example, from underdeveloped markets fosters a policy environment that hinders micro-enterprise, etc. Therefore, the poor should be provided with these supports together with credit facility. A group-based lending approach can solve some of these problems (DFID, 2001).

Figure 2: Sustainable Livelihoods Framework



Source: Department for International Development (DFID) Sustainable Livelihoods Guidance Sheets, Section 2, 2001.

In attaining the poverty related MDGs, microfinance has an important role to play through direct interventions, and at present these institutions have emerged as a commercially successful mechanism in alleviating extreme poverty in India. It is a need-based policy program aimed at empowering conventionally neglected groups in rural societies. This instrument is used to improve access to credit for poor people (in particular women and farmers) in rural and semi urban areas under poverty alleviation programs initiated by the Indian government and development organizations.

In the last decade, microfinance programs have been successful in using scarce development funds to reduce poverty. The relationship between microfinance and attaining MDGs is as follows: MFIs provide credit and other related financial services to poor people. This will enable the rural poor to initiate or expand micro-enterprises, and thus raise their income levels. As a result, they break out of the poverty cycle. In addition, the access to credit and the opportunity to start or expand a micro-enterprise, in which they are sole/joint proprietors, provides opportunities for empowering the poor.

3. Performance of Rural Financial Services System in India

Rural financial institutions should be able to provide a range of financial services including credits to fulfill the varying demands of rural customers at competitive prices. They should be able to provide savings, credit, insurance and money transfer services through flexible schemes with low transaction costs and at a reasonable rapid speed, so as to meet the rural poor's unforeseen or emergency expenditures (Basu, 2006).

This section presents the performance of the rural financial services system since the 1950s including formal financial sectors, such as commercial and regional rural banks and informal financial sectors, such as money lenders.

3.1 Commercial Banking Sector

A major portion of the formal banking sector in India consists of commercial banks, cooperative banks and regional rural banks, and is owned by The Government of India. With respect to credit opportunities in India, there exist formal, semiformal and informal sources of credit. National and state banks, regional rural banks, land development banks, private banks, cooperatives and micro credit schemes offer formal and semi-informal sources of finance. There are ten main sources of credit available to rural farmers: (i) government, (ii) cooperatives, (iii) commercial banks, (iv) regional rural banks (RRBs), (v) agricultural money lenders, (vi) professional money lenders, (vii) landlords, (viii) traders and commission agents, (ix) relatives, and (x) others. Here, "others" include non-institutional sources, other than friends and relatives and moneylenders, such as traders, agriculturist money lenders, and landlords.

Since 2003 the commercial banks were successful in almost doubling the flow of agricultural credit. However, this remarkable increase in commercial bank credit did not significantly enhance access to finance for the poor, particularly for small/marginal farmers and tenants who suffered due to poor banking support. Therefore, these farmers' distress as a result of excessive indebtedness still persists. Further improvements are necessary in rural financial services system to remove these problems (Planning Commission of India, 2006).

At present, there are 66,500 bank branches in India. Public sector commercial banks own most of these branches. The government owns most of the formal banking sector. With respect to rural branches, 32,000 branches belong to commercial banks (mainly public sector commercial banks) and RRBs, about 14,000 branches belong to cooperative banks, and around 98,000 branches belong to primary agriculture credit societies (PACS). Additionally, a gigantic post office system with 154,000 branches is involved in providing deposit services and money transfers as well as regular postal services in the country (Basu, 2006).

In spite of the large size and depth of the financial services system in India, particularly in terms of the high average population and average geographical area served per bank branch, a large proportion of the rural poor are not provided with access to formal financial services. Many rural credit programs were formulated and implemented in developing countries as an instrument to assist

poor farmers in increasing their income. In spite of these efforts, most small farmers were not integrated into formal rural credit programs and did not have access to this credit. Furthermore, the farmers who borrowed under this program were not successful in their business and thus continued to borrow from informal credit market lenders (Adams, 1971).

In 1955, the State Bank of India (SBI) was established to extend banking facilities on a large scale, particularly to the rural and semi-urban areas in the country, and also to serve various other public purposes. To strengthen financial access to the poor, the Indian government nationalized the commercial banks in July 1969 when a major portion of the banking system (i.e. fourteen big commercial banks) were brought under the public sector to progressively better serve the development needs of the economy in conformity with the country's national policies and objectives. Further, six more banks were nationalized in April 1980. India undertook a massive drive for bank branch expansion, particularly in the rural areas in the 1970s and 1980s. In addition to SBI, RRBs were created to cater to the needs of rural farmers. As a result, India witnessed a phenomenal growth in its formal rural banking system¹¹ not only in terms of geographical spread, but also with regards to deposit mobilization and disbursement of credit. Table 3 presents the trends in banking growth in the post-nationalization era. Public sector banks account for more than 90 percent of the commercial banking business. Table 3 shows that the total number of bank branches expanded by more than seven times during 1969 and 1997 reaching 63,550 whereas rural branches witnessed phenomenal eighteen time expansion. This resulted in significant (more than four times) reduction in population per office reaching 15 thousand people per office in 1997 from 64 thousand per office in 1969. Scheduled commercial banks' advances in priority sector increased by 186 times during this period reaching Rs. 2.78 billion in 1997. The year 2005 witnessed further expansion (more than four times) to reach rs. 11.24 billion. The share of priority sector advances total credits of scheduled commercial banks increased by 2.4 times during this period reaching 34.8 Percent.

Table 1: Trends in Banking Growth in Post-Nationalization Era in India

Banking Parameters	June 1969	March 1997	March 2005
(i) Number of offices (including branches) of which:			
Rural	8,262	63,550	68,355
Semi-urban	1,833	32,915	32,082
(ii) Population per office (in thousands)	3,342	13,766	15,043
(iii) Deposits of scheduled commercial banks (in Rupees. 10 million)	64	15	16
(iv) Credits of scheduled commercial banks (in Rupees. 10 million)	4,646	499,763	1,732,858
(v) Scheduled commercial banks' advances in priority sector (in Rupees. 10 million)	3,599	278,401	1,124,300
(vi) Share of priority sector advances total credits of scheduled commercial banks (in percentage)	504	93,807	400,775
	14.0	34.8	36.7

Sources: Table 1.1, Progress of Commercial Banking at a glance, Basic Statistical Returns, Reserve Bank of India, May 04, 2006, website, <http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/70133.pdf>

¹¹ Include commercial banks, regional rural banks, primary agricultural cooperative societies, and land development banks.

In addition, the government introduced a mandatory policy for banks to provide subsidized finance to rural households. Under this policy, at least 40 percent of commercial bank lending was mandated to be in the priority sector, consisting mostly of agricultural activities. Thus, the government made attempts to transform a predominantly commercial banking sector into a social banking platform. At the same time, various policies aimed at social banking were implemented. Targeted credit or poverty alleviation programs, such as the “Integrated Rural Development Program” involving subsidized financing for rural poor farmers and “Differential Interest Rate” were also introduced. However, these programs were not successful due to various deficiencies in its implementation (see Government of India, 1985, and Srivastava, 1986 for details).

However, overall, access to credit for rural poor improved. Two decades ago, a small percentage of rural farmers had access to financial services from formal and semi-formal sources. According to the first “All India Rural Credit Survey” conducted in 1951 by the Reserve Bank of India, moneylenders and other informal lenders accounted for more than 90 percent of rural credit while banks only contributed about 1 percent of the total rural household¹² credit. As a result of the bank nationalization scheme mentioned above, with massive branch expansion and social banking policies, the banks’ contribution to rural household debt rose to around 29 percent in 1981, remaining at that level in 1991 (Basu, 2006). Table 4 presents the distribution of rural credit by various sources of finance for the period 1951-1991.

Table 2: Distribution of All India Rural Credit by Various Sources of Finances 1951-1991 (in percentage)

Year	Banks	Cooperatives	Government	Sub Total ¹³	Relative/ Friends	Moneylenders	others ¹⁴
1951	1.1	4.6	3.1	8.8	14.4	68.6	8.2
1971	2.4	20.1	6.7	29.2	13.8	36.9	20.1
1981	28.6	28.6	4	61.2	9	16.9	12.9
1991	29	18.6	5.7	53.3	6.7	15.7	24.3

Source: All India Rural Credit Survey, Reserve Bank of India, Mumbai; All India Debt and Investment Survey, National Sample Survey Office, New Delhi and Basu (2006).

However, in spite of the remarkable achievement noted above, the banking system did not produce all the desired results. The proportion of rural poor securing credit from formal rural banking institutions was lower than their share in the total rural population (DSACS¹⁵, Reserve Bank of India, 1990). Major reasons behind this failure to reach out a larger proportion of the rural poor include: (i) the uneven spread of the banking system across various states (Nair, 1991) and wealth groups (Tandon, 1988, and Subba Rao, 1980) in India; (ii) insistence in demands for collateral against borrowing which often cannot be provided by the rural poor; such demands are further propagated by the widespread notion that the poor are not bankable; (iii) complex and unimaginative lending procedures; (iv) political intervention in the banking system and lending policies (Rajasekhar and Vyasulu, 1991); (v) defective lending policies (Kahlon, 1991), (vi) lack of provision for consumption credit, (vii) low awareness by the rural poor on various banking schemes (NIBM, 1986), and (viii) inadequate and inappropriate banking facilities, such as distant location, short and inconvenient

¹² Household is defined to be a group of people living together permanently and taking food from same kitchen. It may be made of persons related by blood or unrelated.

¹³ Formal Institutions

¹⁴ “Others” include non-institutional sources, other than friends and relatives and moneylenders, such as traders, agriculturist moneylenders, and landlords.

¹⁵ Department of Statistical Analysis and Computer Services

banking hours, and cultural gap between bank officials and rural borrowers (Khusro, 1900, NIBM, 1986).

The rural poor who secured credit could not get the desired results because finance was inadequate and not timely due to managerial inadequacies within banks (Rajsekhar, 1996). In addition, the borrowers lacked experience and knowledge of agricultural activities where loans were supposed to be invested. There was an absence of credit linkages with marketing of agricultural products. Moreover, no working capital loan was provided with investment credit. Also, the banks' transaction costs for providing small sized credits to a large number of rural farmers were very high (Khusro, 1900). Moreover, most rural poor do not have business or entrepreneurial expertise or experience.

As most rural branch expansions were undertaken by large public sector banks with high costs of operation, the return on these large numbers of small lending was not adequate compared to the cost of transactions. A large number of public sector banks with extensive rural branches became sick or incurred losses. As a result, banks faced with high growth of non-performing loans and lower profit margin, were reluctant to provide further credit to needy rural poor. In response to the poor quality of credit from the formal rural banking system, informal credit agencies such as money lenders and chit funds reemerged (Rajsekhar, 1996).

Private moneylenders have an important role to play in providing appropriate finance to rural poor. Rural poor have been finding solutions for their money management problems in various ways. They have invented a variety of solutions to save and borrow without involving regulated formal institutions. These solutions are called "informal financial service mechanisms". They include (i) savings clubs that poor people run themselves, (ii) savings clubs managed by other people, e.g. religious or welfare organizations or paid commercial managers, and (iii) informal providers such as private money lenders, pawnbrokers or deposit takers. Informal mechanisms or arrangements, such as private money lenders, are still the most important in many poor communities. They are often vital to people's livelihood strategies even if they are considered as inappropriate or exploitative¹⁶. *"Moneylenders have been interpreted as structurally supporting capitalism because they provide marginalized people who are beyond the scope of banks with purchasing power for the commodity markets based upon credit"*(Schrader, 1994).

As shown in Table 4, informal financial sectors, particularly private money lenders played an important role in rural finance since the 1950s. Even in the 1990s, about 47 percent of rural credit was provided by informal sources. Informal financial arrangements, particularly moneylenders, played a major role in rural areas by providing the financial services which were not provided by the formal financial sector. As evident from the World Bank-National Council of Applied Economic Research (NCAER) Rural Finance Access Survey 2003 report, poor rural families are dependent significantly on informal finance, particularly from moneylenders to meet various financing needs, such as, consumption and emergency finance and investment loans. Households that borrowed from moneylenders and other informal lenders at least once in the preceding 12 months account for 44 percent of total rural households. The interests for informal loans are, on an average, 48 percent per annum. Therefore, moneylenders are important for the poorest households which do not have any access to formal finance. Moneylenders have advantage over formal financial institutions, such as banks because they know their clients much better than formal institutions. Therefore, they are in a

¹⁶ Rural Finance Learning Center, <http://www.ruralfinance.org/servlet/CDSServlet?status=ND0xNjQyOC4xNzk0MiY2PWVuJjMzPWRvY3VtZW50cyZzaG93Q2hpbGRyZW49dHJ1ZSYzNz1pbmZv#koinfo>

better position to enforce contract with clients and offer more flexible financial services (Basu, 2006).

3.2 Trends in Microfinance Industry in India

Microfinance industry in India follows two major operational approaches, namely SHGs, and microfinance institutions (MFIs) or microcredit institutions. The concepts of microfinance, micro credit and SHG are explained below.

“Microfinance involves the provision of financial services such as savings, loans and insurance to poor people living in both urban and rural settings who are unable to obtain such services from the formal financial sector” (Wrenn, 2005). “A SHG is a registered or unregistered group of micro entrepreneurs having homogenous social and economic background, voluntarily coming together to save small amounts regularly, to mutually agree to contribute to a common fund and to meet their emergency needs on mutual help basis. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment thereof. In fact, peer pressure has been recognized as an effective substitute for collaterals”. Micro Credit is defined as provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards. Micro-credit institutions are those which provide these facilities¹⁷.”

In recent years, microfinancing is gaining importance in banks' lending program by providing social and commercial funds. In particular, financing through SHGs which usually involves informal groups of women to the commercial banks received an impetus with banks which more than doubled loan disbursements through such groups. Linking banks and SHGs has become one of the largest and fastest growing microfinance programs in India. According to NABARD, in March 2005, microfinance reached 1.43 million SHGs with 21 million members, making a difference to the lives of over 100 million poor people. In 2005-06, the total number of SHGs that received bank loans was over 2 million with an increase of more than 960,000 SHGs over last year.¹⁸ At present, SHG schemes has become the biggest outreach initiative for microfinance activities in the world. The total number of MFIs is around 3 million, according to NABARD, with links to about 500 banks serving more than 11 million households¹⁹

Bhattacharyay (2009) performed an impact analysis of microfinance institutions in the Indian state of Uttarakhand to find SHG member's age, years of education and the number of years as a member of SHG are significant factors in explaining the current income of the respondent²⁰.

However, microfinance has so far attained limited success in attaining the MDGs in India. One of the reasons for the limited success of MFIs and micro credit programs is the problem with the viability and sustainability of these micro enterprises. Most micro-credit borrowers are involved in

¹⁷ [Personal Website of R.Kannan](http://www.geocities.com/kstability/learning/banking2/micro2.html#help), <http://www.geocities.com/kstability/learning/banking2/micro2.html#help>

¹⁸ Microcredit as a development tool, <http://www.empowerpoor.com/backgrounder.asp?report=442>

¹⁹ George, M., **A Primer on Microfinance in India: History, Challenges, Impact: The Building Blocks of Indian Microfinance**, <http://www.microfinancegateway.org/p/site/m/template.rc/1.26.9150>

²⁰ Bhattacharyay (2009), Performance Assessment of Self Help Groups in Poverty Reduction in the state of Uttarakhand, India, a Research Paper submitted to GRIPS (primarily based on the data and information provided by an unpublished report on “Poverty and SHG Movement in Uttarakhand: Role of Institutions and Policies for Performance Assessment of Self Help Groups in Poverty Reduction in the state of Uttarakhand in India).

subsistence activities with little or no competitive advantage to run a micro-enterprise profitably. Banerjee, et al (2006) highlighted the problems faced by the poor in running a micro-enterprise. The Indian poor who are self-employed do not generally pose any specialized skill and usually are involved in multiple occupations. Most of these enterprises are involved in very small-scale businesses with few or no employees and very constrained assets and hence limited capital. These micro-enterprises usually operate in arenas which have low entry barriers and very high competition. Furthermore, due to low productivity, the income earned is not significant enough to remove the poverty of the rural poor.

In recent years, India is experiencing a huge expansion in terms of households linked to microfinance, more specifically linked to Self Help Groups (SHGs). An average annual growth rate of 82 percent was observed from March 1993 to March 2006, in relation to a 110 percent growth rate in terms of credit amounts. The SHG Banking Linkage Program is one of the most successful and important programs in the country. It has become one of the largest and fastest growing microfinance programs in India to provide micro credit opportunities to the rural poor. Working with 620,109 SHGs during the financial year 2005-2006, it incorporates more than nine million households into the financial sector (Fouillet and Augsburg, 2007).

Several private sector institutions in India implemented innovative products to support the needs of the rural poor successfully and profitably. The examples of Indian Tobacco Company (ITC) and BASIX are highlighted below:

ITC introduced an innovative product, called e-Choupals (“electronic gathering places” or “electronic village squares”) which assisted in procuring agricultural products in a more cost-effective and efficient manner and in lifting the incomes of a large segment of the rural population in India through the development of new markets for consumer products. It is an electronic standalone work station which offers: “(i) information on weather forecasts, market prices, news affecting agriculture; (ii) best practices on farming and risk management, (iii) sources from which to purchase agricultural input supplies and consumer goods; and (iv) marketing opportunities for the sale of agricultural production”. Both buyer and seller of agricultural products benefit as the e-Choupal-mediated transactions “shaves 6% off the transaction cost”²¹ (World Bank, 2005a).

On the other hand, BASIX, a new generation Indian livelihood promotion institution established in 1996, introduced several innovative risk mitigation approaches. BASIX has been working with over 190,000 poor households in 44 districts and eight states in India. Its main objective is “to promote a large number of sustainable livelihoods, including for the rural poor and women, through the provision of financial services and technical assistance in an integrated manner”. These innovative approaches are: “(i) Utilization of group-specific lending methodologies to increase repayments; (ii) portfolio limits and standard operating procedures that mitigate BASIX’s aggregate risk; and (iii) insuring customers’ risk to reduce BASIX’s own risk”. Their innovative financial services program coupling insurance schemes with new loans has been highly successful (World Bank, 2005).

Recently, SKS Microfinance, India’s largest microfinance institution, launched its first Indian Microfinance IPO. The shift towards the commercialization of microfinance and tapping into commercial markets reflects the increasing unmet demand for affordable credit for the poor—a

²¹ Prystay, (2003)

market currently estimated at 50 billion²². This also proves that microfinance can assist in making the financial sector more inclusive by providing finances to poorer communities and small businesses commercially.

According to an estimate by George et. El. (2007)²³, the total demand for microcredit in India is between \$ 5.7 and 19.1 billion per year with the assumptions of a market size of total poor population— 58 to 77 million as customers; and loan sizes ranging between between \$100 and \$250. In case the market size includes small and marginal farmers, landless agricultural laborers, and micro-entrepreneurs, the total demand increases significantly to \$ 51.4 billion per year for around 245.7 million individuals.

4. Trends in Access to Finance in the Rural Banking system and the Non-Banking Sector

In order to strengthen the rural farmers’ access to financial services, one needs to identify the present level of rural access to finance by various types of household segments from the formal rural banking system, and also there is a need to identify the factors that have so far prevented the formal rural financial institutions from reaching out to the poor. This chapter discusses the trends and patterns of access to rural finance by (i) types of household segments; and (ii) formal banking sector and informal non-banking sector. It also analyzes the structure of loans which can explain factors responsible for poor outreach of the formal banking system.

In 2003, the World Bank and National Council of Applied Economic Research (WB-NCEAR) of India conducted a survey of 6000 households and micro-enterprises in two states -- Andhra Pradesh and Uttar Pradesh (see Basu, 2006 for details). The survey attempted to find out how well the formal rural banking system was directly satisfying the needs of the rural poor. Table 5 presents the trends in access to deposits and credits by rural farmers. In the table, marginal, small and large framers are considered to be households with landholdings less than 1 acre, between 1-4 acres, and greater than 4 acres, respectively. Commercial households with or without lands have income from non-farm sources exceeding half of the total household income. Other farmers are placed under mixed households with non-farm commercial income less than half of their total household income and land.

The results of this survey reveal that the rural poor farmers (marginal farming households) without any bank deposits account for 70% of the rural population and those with no access to finance from the formal rural banking system account for 87%. Thus, based on the survey results, the formal banks are mainly catering to richer farmers as evident from the fact that about 66% of large farmers have bank accounts and 44% have access to finance. Therefore, it can be inferred that marginal and rural farmers are either underserved or excluded from the banking system.

Table 3: Distribution of Household Categories by Access of Deposits and Credits (in percentage)

Access to Deposit/Credit	Marginal	Small	Large	Commercial	Others	Total
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²² Khan, Fontella, James. " SKS Microfinance plans to raise \$350m in IPO." *Financial Times* [updated 20th July 2010; cited August 15th 2010]. Available from <http://www.ft.com/cms/s/0/1879f6e4-9422-11df-a3fe-00144feab49a.html> .

²³ George, M., Maheswari, A. and Pandian, N (2007), **Inverting the Pyramid - The Changing Face of Indian Microfinance, October**, available from <http://www.microfinancegateway.org/p/site/m/template.rc/1.26.9150/p/site/m/template.rc/1.9.26137>

Without Deposit Account	70.4	44.7	34.0	58.0	39.1	58.5
With Deposit Account	29.6	55.3	66.1	42.0	60.9	41.2
With Formal Loan	87.0	69.2	55.6	83.2	70.5	79.0
With Formal Loan Outstanding	13.0	30.8	44.4	16.8	29.5	21.0

Source: Rural Finance Access Survey, 2003, WB-NCEAR

Table 4 clearly depicts that the debt of rural and urban households from moneylenders or other non-bank sources accounted for 43 percent and 25 percent respectively. There is a clear urban and rural divide. This shows the importance of the non-bank sector, particularly moneylenders. Rural household debt from moneylenders increased between 1991 and 2002 while urban household witnessed a decreasing trend over this period. Non-cultivators in the rural area are more dependent on moneylenders and other informal sources of finance than cultivators and their dependency has increased in 2002 to 54 percent compared to 45 percent in 1991 (Vaidyanathan, 2007).

Table 4: Trends in Household Debt by Non-Bank Sector (Percentage share of non-institutional category in outstanding debt as on 30 June 2005)

Occupational Category	1981	1991	2002
Rural:			
Cultivator	37	34	39
Non-Cultivator	63	45	54
All(Rural)	39	36	43
Urban:			
Self-employed	42	31	33
Others	38	26	20
All Urban	40	28	25

Source: Vaidyanathan, 2007: Computed from "Household Indebtedness in India", Ministry of Statistics and Program Implementation, New Delhi, December 2005.

Other major difficulties faced by farmers in securing a loan include lengthy processing time and high bribes. Table 5 presents various aspects of loans from formal banking sources that inhibit poor rural people to utilize banking services. More than one-fourth of the borrowers reported demands for bribes against commercial and regional rural banks and government schemes. The amount of the bribe was very high compared to the loaned amount. It is particularly high (42 percent of loaned amount) for government schemes. As a result, in spite of moderate interest (11 percent to 14 percent the effective cost of the loan to the farmer is very high. At the same time, 73 percent 87 percent of loans need collateral. Furthermore, the amount of collateral required for government schemes is also very high (58 percent of the loan amount). In the case of most poor farmers, their sole asset is their land which is frequently used as collateral (Basu, 2006). Unfortunately, in several cases, a large proportion of these poor farmers does not have clear land titles and, therefore, cannot even use their land, their only asset, to serve as collateral.

Table 5: Structure of Loans from Formal Rural Banking System

Parameter	Bank	Regional Rural Cooperatives	Government	Others	Bank Schemes
Median Interest Rate (% per year)	12.5	11.0	11.0	14.0	14.0
Percentage of households reporting bribes	26.8	27.0	9.7	27.3	23.2
Bribe as Percentage of Amount Approved	10.1	18.2	19.9	42.3	8.3
Time (in weeks) taken to process a loan application	33.0	28.5	24.0	8.9	4.3
Collateral Required (% of loans)	87.0	89.3	72.9	58.3	83.1
Value of Collateral as % of loan volume	9.1	9.5	11.0	26.8	24.3

Source: Rural Finance Access Survey, 2003, WB-NCEAR

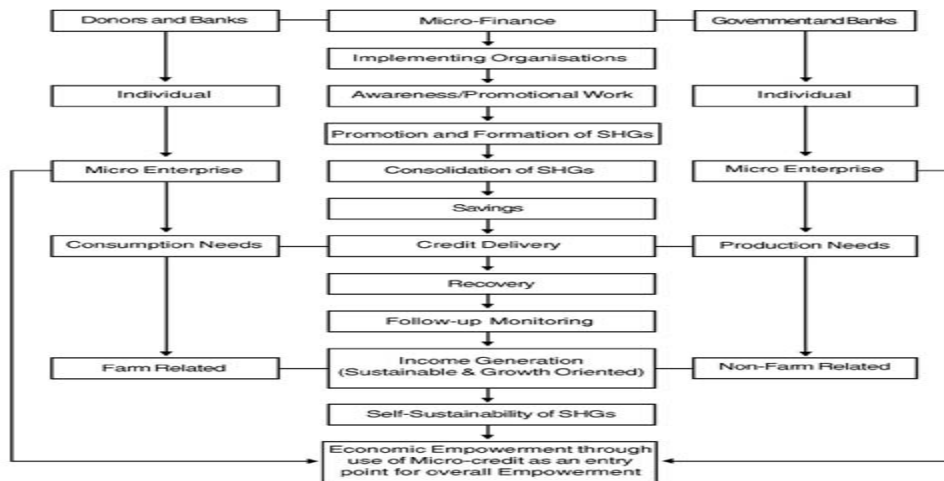
Furthermore, it is important to point out that even though there is a high demand for life insurance products, the supply is very limited. According to Rural Finance Access Survey (2003) survey, only 15 percent of households availed of insurance facilities; 73 percent of them used life insurance followed by crop insurance use of approximately 19 percent. Moreover, although the most preferred insurance product for 73 percent of households is life insurance, only 13 percent of households possess life insurance.

5. Success of Microfinance: Self Help Group-Bank Credit Linkage Program

With the presence of microfinance, the rural poor, conventionally considered ‘un-bankable’, can now access credit and other financial services that have been exclusively available to the upper and middle-income segments of the population. Figure 3 presents the development process through microfinance of SHGs. Results from past experience involving costly large-scale development programs in providing sustainable benefits to the poor is not at all encouraging, particularly during the period when funds have dried up leading to project failures. Thus microfinance is now being seen as one of the most effective and sustainable interventions for economic empowerment of the poor²⁴.

²⁴ <http://www.nabard.org/microfinance/successstories.asp>

Figure 3: Development Process through Microfinance



Source: <http://www.un.org.in/iawg/icecd/section1.htm>

“Empirical evidence has demonstrated that participants in microfinance programs have improved their living standards at both the individual and household level, and that this has provided increased educational opportunities for children. For example, the clients of the Bangladesh Rural Advancement Committee increased household expenditures by 28 percent and assets by 112 percent. It was also demonstrated that Bangladeshi children were sent to school in larger numbers and stayed for a longer time – almost all girls in Grameen Bank-client households had some schooling, compared with the rate of 60 percent in non-client households” (World Bank, 2005).

Through availing microfinance schemes, many poor people could get themselves out of abject poverty and were able to send their children to schools they would not otherwise have been able to afford. Another important contribution of microfinance is to empower women by providing them with more economic clout in their homes. However, microfinance cannot as of yet be considered a panacea for world poverty (Field, 2005).

In 2006, the Nobel committee awarded the 2006 Peace Prize to Muhammad Yunus and his Bangladesh bank as it successfully lifted millions of people out of poverty with the medium of micro financing. The international community, such as, the United Nations, the World Bank and other non-government organizations (NGOs), have strongly supported the concept behind microfinance as a powerful tool in aiding developing nations such as India in reaching the MDGs. This concept of giving small loans to those too poor to qualify for traditional credit is considered a socially inclusive development strategy, as noted by World Bank Director Elizabeth Littlefield (head of SE-GAP), a global organization for the microfinance industry who mentioned that, *"Promoting social inclusion as part of a conflict prevention strategy, [which] means making sure that all poor people have opportunities for gainful employment, are hopeful about their future and have reasons to be comfortable that they're able to take care of their families. The effective use of micro financing in the end can improve other areas of the Millennium Development Goals, such as improved health and greater rights for women"*²⁵. Furthermore, according to Alexia Latortue of the Consultative Group to

²⁵ http://cgap.org/press/press_coverage54.php

Assist the Poor ²⁶(CGAP), “*there is clear and unequivocal evidence that microfinance provides benefit from increased nutrition, increased ability to respond to life-cycle challenges, such as paying for funeral and healthcare*”²⁷.

Thus, based on the current wave of enthusiasm for microfinance as a possible route to poverty alleviation and attaining the MDGs, there is an urgent need to examine the performance of the rural banking system including MFIs in India, and the trends and patterns of farmers’ access to financial services. This will lead to appropriate policy measures aimed at strengthening the accessibility of financial services to the group considered as rural poor.

Traditionally, microfinance was used to be considered as one of the many charitable activities conducted primarily by NGOs. The formal financial institutions were not interested in this activity. However, recently commercial banks in India are entering in this arena. These banks have now recognized that these low income and unserved segments are indeed bankable and profitable, while uplifting the lives of the rural poor.

The recent involvement of commercial banks, including foreign banks in microfinance proves that microfinance business can be commercial, profitable and sustainable. The major form of microfinance in India is that based on women's SHGs, which are small groups of 10-20 members. These groups collect savings from their members and provide loans to them. However, unlike most accumulating savings and credit associations (ASCAs) found in several countries, these groups also obtain loans from banks and on-lend them to their members. The following section presents the experience of one of the most successful microfinance program in India, namely, SHG - Bank Credit Linkage Program of State Bank of India (SBI).

5.1 Self Help Group - Bank Credit Linkage Program of State Bank of India

SHGs are groups of 10-20 people from a homogenous class (predominantly women). They form these groups to address their common problems. Usually, the group members utilize their pooled resources for making small interest bearing loans to its members. Eventually, banks start to lend without collateral to the groups once they mature in their financial behavior.

One of the successful microfinance programs in India is SHG-Bank Credit Linkage Program of SBI. SBI allowed these SHGs to open savings accounts and borrow from the bank. NABARD started SHG-Bank Credit Linkage Program as a pilot project in 1992. SBI had been involved in microfinance involving NGOs and voluntary agencies since 1976. The main target groups for this program are families without access to finance from formal financial organizations. These families usually depend on informal sources of financing and moneylenders. Furthermore, as in most cases in developing countries, the majority of these SHGs are women SHGs. Therefore, this program also assists in gender development.

²⁶ A consortium of 28 public and private development agencies working together to increase access to financial services for the poor in developing countries

²⁷ http://www.developmentgateway.com.au/jahia/webdav/site/adg/shared/Microfinance_Macro_Impact.pdf

SBI has actively participated in SHG-Bank Credit Linkage program since its inception in 1992. The SBI website²⁸ provides more details on this program. The performance of the program in financing SHGs has been remarkable. SBI had only 12,200 SHGs in 2000. Tables 8 and 9 present the trends in progress of the scheme during 2003-2006 and yearly growth of its key parameters respectively. Table 8 shows that there has been continuous and steady growth of all key parameter in last four years. The year 2004-2005 witnessed maximum growth in all key parameters. The number of SHGs expanded by 5 times reaching more than half a million in March 2006 compared to March 2003. During the same period, the number of beneficiaries increased by 6 times reaching 7.56 million, and SBI disbursement expanded by 7 times amounting to 22.6 billion rupees. All SHGs are maintaining savings accounts. Furthermore, SBI plans to double SHG link to 1 million SHGs with approximately 15 million women members by March 2008.

Table 6: Trends in the Progress of SHG-SBI Credit Linkage Program: 2003-2006

Year	March '03	March '04	March '05	March '06
SHGs linked (financed)	107,553	174,666	343,691	540,481
No. of beneficiaries	1,233,660	2,150,752	4,811,674	7,568,842
Amount disbursed (in 10 million Rupees)	324.84	614.87	1,311.45	2,262.95
Amount outstanding (in 10 million Rupees)	269.43	462.77	872.08	1,459.89
No. of SHGs maintaining savings account in the bank	279,466	369,568	508,396	636,067
Amount in savings account (in 10 million Rupees)	261.36	348.31	411.82	434.07

Source: SBI Website²⁹

Here it is important to note that SBI was the largest player in the microfinance sector and is also is the largest commercial bank in India. SBI has been the market leader among Indian commercial banks in credit linking of SHGs. Its market share is around 47 percent of total SHGs financed by commercial banks as of March 2006. One of the advantages of SBI is its large branch network spread throughout India. It has 9,241 branches and 198,774 employees³⁰. SBI has formulated and implemented several innovative measures which contributed towards its success, widening its SHG network. For example, it has introduced a very successful housing loan product, 'Sahayog Niwaas' for SHG members. These loans are provided to the SHG members without any mortgage of house or land. In terms of insurance subsidiary, SBI Life has launched a pioneering life insurance product tailored to the needs of SHG members. Under this scheme, the entire insurance premium amount paid by the member is refunded after 10 years on maturity. SBI also has started to provide SHG network members with various financial services beyond credit delivery³¹.

²⁸ <http://www.statebankofindia.com/viewsection.jsp?lang=0&id=0,8,67>

²⁹ <http://www.statebankofindia.com/viewsection.jsp?lang=0&id=0,8,67>

³⁰ Basic Statistical Returns, Reserve Bank of India, Website, <http://www.rbi.org.in/scripts/AnnualPublications.aspx?head=Basic%20Statistical%20Returns>

³¹ SBI Microfinance Initiatives, ICFAI, Center for Management Research <http://www.icmr.icfai.org/casestudies/catalogue/Finance/FINC043.htm>

Table 7: Yearly Growth of the key parameters of SHG-SBI Credit Linkage program: 2004-2006 (in percentage)

Year	March '04	March '05	March '06
SHGs linked (financed)	62.40	96.77	57.26
No. of beneficiaries	74.34	123.7	57.30
Amount disbursed (in 10 million Rupees)	89.28	113.29	72.55
Amount outstanding (in 10 million Rupees)	71.76	88.45	67.40
No. of SHGs maintaining savings account in the Bank	32.24	37.56	25.11
Amount in savings account (in 10 million Rupees)	33.27	18.23	5.4

Source: SBI Website³²

The bank staffs are the main driver of this program. SBI is sensitizing its entire staff from manager to messenger working in rural and semi-urban branches towards the program through appropriate training. Training programs in SHGs are being conducted at its 54 established training centers. It also conducts special training at the State Bank Institute of Rural Development in Hyderabad.

NGOs are the main drivers in the formation and nurturing of the SHGs in order to assist the poor in becoming economically self-sufficient. SBI staff at branch level and region level keeps close contact with NGOs in their area to enhance to continually update and enhance the program. Staff conducts regular meetings with NGOs to seek their support. At the same time, major branches have special SHG cells. SBI has established rural training institutes for providing free training rural youth in self employment

SBI also supports lending to credible NGOs or federations of SHGs on a selective basis which are providing social services to disadvantaged people. For example, it has sponsored and financially supported a NGO, called 'Samanwita' in collaboration with the Government of Orissa. This NGO is involved in supporting the socio economic upliftment of the tribal communities and other disadvantaged groups in the poorest and most backward segment of the Kandhamal district in Orissa, keeping in mind that around 52 percent of the population of the Kandhamal district is tribal. The NGO is aimed at empowering poor members of SHGs, particularly several women SHGs, through the development of human resources.

5.2 Programs of other Commercial Banks

ICICI Bank, the largest private bank in India has expanded its microfinance projects at a remarkable pace. It had 10,000 microfinance clients in 2001. In 2005, it has 1.2 million clients who were formerly not served by any formal financial institution, through its partner MFIs, and its lending level has jumped from Rs. 0.20 billion (US\$4.5 million) to Rs. 9.98 billion (US\$227 million). As a result of the entry of several banks in microfinance, interest rates decreased from 14 percent to 10 percent. The major reason behind the success of such projects in terms of the rapid growth of business lies in launching several innovative models and initiatives, such as the "Partnership Model". A

³² <http://www.statebankofindia.com/viewsection.jsp?lang=0&id=0,8,67>

typical model of microfinance involves MFIs borrowing from banks and lending to individuals, SHG or small business clients. However, the growth of these MFIs has been limited as their borrowing capacities from banks are low due to lack of adequate risk capital. At the same time, its risk-taking capacity is limited as the entire credit risk is to be borne by them. In view of the above, ICICI Bank launched a partnership model in 2002. In this scheme, the Bank appoints MFIs as collection agents instead of financial intermediaries and it provides mezzanine finance to the MFI. Mezzanine finance is a combination of debt and equity financing. In case of default, ICICI can convert the debt into equity. As this kind of financing will be treated like equity in the balance sheet, MFIs can secure more advances without additional equity which is an expensive financing source. As the contract of the loan is directly between ICICI and borrower, MFI does not have to bear the risk. Leveraging capacity is significant because MFI has access to a large amount of finance for expanding and deepening the credit market. On the other hand, ICICI can avoid the costs of entering the market directly but can still reach a large market by leveraging comparative advantages of the MFIs³³.

Additionally, a foreign bank, ABN AMRO, has been involved in microfinance through partnership with 8 domestic MFIs. In 2004, this business achieved breakeven point, and ABN AMRO has a plan to expand this service to one million poor women in the next five years. The bank's senior vice president has noted that "*one of the most important themes of sustainable development is to integrate the concept of triple P (people, planet and profit) in the business of the bank*"(The Banker, 2005).

³³ *Duflo, Annie*, ICICI Banks the Poor in India: Demonstrates That Serving Low-Income Segments Is Profitable, UNITED NATIONS CAPITAL DEVELOPMENT FUND Microfinance Newsletter, Issue 17 / October 2005, http://uncdf.org/english/microfinance/newsletter/pages/2005_10/news_ICICI.php

6. Measures for Strengthening Access to Finance

The major concerns regarding rural financial services system include: (i) most public sector banks are not financially viable in rural areas; and (ii) small and marginal farmers are still excluded from the financial system. There is a need to explore the types of financial institutions and products that can be used to provide poor farmers flexible and convenient access to financial services which will protect them against external risk.

Major reasons behind the low access to rural financial service by poor farmers are: (i) inflexible financial products and services which does not satisfy the income and expenditure pattern of poor farmers; (ii) poor accessibility in terms of location and hours of bank operations; (iii) high transaction costs for formal banking operation and processes; (iv) processes and procedures of account opening and loan approval are complex, time consuming and costly; and (v) the inability to provide collateral by poor farmers (Basu, 2006).

The first step towards addressing the above listed problem areas is an immediate need to scale up finance to rural poor farmers by developing proper institutions to address these issues. Furthermore, in order to strengthen the rural financial services system, financial services providers should have the capacity to identify potential profitable rural customer segments and develop innovative financial services which can minimize the cost and risks associated with serving them. They should be able to meet the diverse needs of poor farmers, such as savings, credit, and insurance facilities. Additionally, they should be able to mobilize adequate domestic savings and convert those to small loans as well as provide other required services to farmers such as life, health, fire, theft and crop insurances. Furthermore, to increase reach/accessibility to under-banked rural sectors, new products and services should be developed and offered, such as flexible, convenient and cost-effective agriculture and microfinance credit and other related programs. Moreover with new advances in banking technology, innovative products based on new technology like electronic banking and commerce should be introduced to increase convenience and cost-effectiveness in the rural sector of the economy. These modern technology solutions hold much promise for increasing farmer access to efficient and sustainable financial services and reaching clients in remote areas.

It is important to highlight that micro credit provided by MFIs has proven to be effective in providing finances to rural farmers who do not have access to the formal rural banking system. The experience of other Asian countries, particularly Bangladesh and Indonesia, demonstrate that good quality, reliable, transparent, responsive to borrowers' needs and long-term MFIs are indeed capable of strengthening rural farmers' access to finance on a sustainable basis (Morduch and Rutherford, 2003). The 2006 Nobel Peace Prize to the Grameen Bank (MFIs) in Bangladesh and its founder Muhammad Yunus ascertains the confidence of the Nobel Committee in the micro credit program in reducing poverty. Therefore, this approach should pragmatically be suitable for India which has a large population and great geographical spread. In addition to the public sector bank-supported micro financiers, private bank led or public-private partnership microfinance institutions should be encouraged to cover vast rural sectors of the country. As noted previously, the largest private bank in India, ICICI Bank, has planned a program, which will provide very small loans of around \$100 to 25 million rural borrowers in the next 5 years. A foreign bank, ABN AMRO has also been recently involved in microfinance and has a plan to provide this service to one million poor women in the next five years. The successful involvement of these commercial banks, including foreign banks in

microfinance enterprises proves that the microfinance industry can be commercial, profitable, and sustainable in the long run.

Tulchin (2006) studied Latin America as a case study to critically examine the sustainability of micro credit and what policies and strategies can increase the effectiveness of microfinance as a poverty alleviation tool as well as the role that government actors have in this process. The authors concluded that government agencies are influential in shaping the operational environment of MFIs, as well as developing and supporting linkages between microfinance and other financial sectors of the economy. Basu (2006) highlights the success of several institutions using new approaches and products to strengthen rural farmers' access to financial services. These include: (i) "SHGs-Bank Linkage" lending program developed by the National Bank for Agricultural and Rural Development of India; (ii) MFI approaches and products; (iii) Partnerships between private banks, micro financiers, and financial service providers; (iv) the Kisan (farmers) Credit Card; and (v) Agricultural Risk Management Programs for Farmers. In terms of success, the SHG-Bank Linkage approach is the most significant. At present, there are about 1 million SHGs linked to the bank. However, the proportion of poor farmers with access to SHGs is still quite low. In order to increase outreach, there is a need to develop high quality and sustainable SHGs with proper targeting of borrowers and proper pricing of loans to cover the cost. Policy interventions are also required to create a flexible architecture for microfinance innovations through an enabling policy, a superior supervisory and regulatory framework (Basu, 2006).

Another major challenge in promoting the rapid growth of the microfinance business is the lack of accessibility. Around 70 percent % of the population lives in rural areas. Therefore, there is a need for new, innovative and cost-effective channels of delivery. Access should be enhanced and transaction cost need to be reduced by introducing appropriate technologies such as kiosks and smart cards.

7. Conclusions and Policy Implications

As a result of past government policies, the "financial environment" has not been conducive to lending in general, and to rural banking in particular. The rural financial services system has been inefficient in delivering financial services because of (i) high fiscal deficits, (ii) the government's domination of rural finance institutions, (iii) persisting weaknesses in the regulatory and legal framework; and (iv) a set of rural financial sector policies that have been formulated to seek political patronage. This has also resulted in the distortion of risk/return signals and a dilution of the credit-creating role of rural banks (Basu, 2006).

In recent years, Indian policy makers are making serious attempts to enhance the access of finance to the rural poor through building inclusive rural financial markets. In his speech on 8 February, 2007, the then Indian Finance Minister Palaniappan Chidambaram stated: *"There are 115 million farming families, dispersed among more than 600,000 villages in India, whom growth has left behind. They are unable to increase their yields at the pace at which urban consumption is growing, causing prices to rise. The farm sector, which employs two-thirds of the country but accounts for just one-fifth of the economy, has grown at slightly more than 2 percent a year for the last several years"*. He had made a proposal to increase bank credit to induct five million more farmers into the formal banking system, and away from the murky world of moneylenders. He also proposed to extend death and disability insurance to eight million families of landless villagers (Giridharadas and Gentleman, 2007).

As has been indicated in the earlier sections of this thesis, strengthening access to financial services for rural sector is crucial for attaining the poverty related MDGs. India needs to build an more inclusive and robust rural financial system. Multilateral development banks, such as the World Bank and the Asian Development Bank can assist India by providing the knowledge of the most effective and best practices from the lessons learned from other countries. Based on this knowledge, the government of India needs to appropriately restructure the rural financial system.

At present, the Indian government has recognized the need to renew emphasis on improving the access to financial services for the poor. India's latest five-year planning document (2007-2012), 11th plan released in November 2006, highlighted inclusive growth together with raising economic growth as the basic policy objective. The plan involves renewing emphasis on facilitating access of the poor to credit as well as improving education and health facilities, raising agricultural productivity and providing basic infrastructure services. The objective of this plan is that effective implementation of these policies will assist India in attaining poverty related MDGs by 2015 (Planning Commission of India, 2006).

India's 11th plan has also recognized the importance of microfinance in the development of micro-enterprises. Indian financial institutions have gained considerable expertise in this area. There is a need to upscale and to expand various financial services offered to micro enterprises. These services can be used as the springboard for entrepreneurial development. The 11th Plan will support the development of microfinance by ensuring that policies are sufficiently flexible (Planning Commission of India, 2006).

The major areas of policy interventions include: (i) restructuring the formal rural banking system, particularly regional rural banks and rural cooperative banks to serve the needs of rural poor farmers; (ii) cost effective, flexible and convenient ways to reach rural farmers, e.g., flexible products, packaging financial services, easy and simplified process and procedures for banking operation, increased use of appropriate technology, improved staffing policy and door-step banking; (iii) review of the policy on priority sector subsidized lending; (iv) encouraging competition by allowing new private sector financial institutions in rural banking; (v) enhancing incentive regimes by removing interest ceilings on lending rates and "floors" on deposit rates; and (vi) strengthening bank regulation and supervision, and laws and regulation on financial markets and transactions (Basu, 2006).

In terms of restructuring and reforming the rural banking sector, India has witnessed some recent positive developments. The government has approved and started implementation of the Vaidyanathan Committee report on co-operatives (Planning Commission of India, 2006). In August 2004 Indian government established a Task Force on the Revival of Rural Cooperative Credit Institutions under the chairmanship of A. Vaidyanathan. The objective of the Task Force was to prepare a practical reform action plan to strengthen rural credit cooperatives. Based on the final report submitted in February 2005, the government prepared a reform package for rural credit cooperatives after extensive consultation with the state governments. The main goals of the package are to achieve following results during 2005–06 to 2008–09: *"(i) financial assistance to wipe out accumulated losses (this, however, does not mean writing off loans that are yet to be repaid by borrowers; the cooperatives will have to continue to make efforts to recover these loans) in all three tiers of the rural credit cooperative structure and bring all the institutions to a minimum capital to risk weighted assets ratio of 7 percent in the first year, and further, within three years, to 9 percent for the Primary Agriculture Credit Societies and an Reserve Bank of India-stipulated ratio for the District central cooperative bank and State-level cooperative banks ; and (ii) introduction of legal, regulatory, and institutional reforms that are deemed necessary for the democratic, self-reliant, and efficient functioning of the rural credit cooperative structure"* (Basu, 2006).

Unfortunately, many states government are still unwilling to give up their control over cooperatives. As a result, implementation of the Vaidyanathan report recommendations' has been slow. The agenda of the reform does not address the problems of the long-term credit structure. In spite of the

large increase in commercial bank credit since 2003, access to finance for small/ marginal farmers and tenants did not witness significant improvement. On the other hand, the farm debt is increasing at a much faster rate than farm incomes. Another important issue of the overhanging debt stock is not under the present agenda for reform with the exception of a few state governments. It is true that banks have limitations to play a purely social banking role in today's more competitive environment. The good news is that under the 11th Plan, India will study in detail the barriers against social and developmental banking. The plan will propose financial innovations to enhance access and speed up one-time settlements while maintaining credit discipline and financial prudence (Planning Commission of India, 2006).

With respect to the appropriate policies for strengthening rural financial services, the government has to play a major role in formulating and implementing policies that scale up access to financial services to poor farmers. Appropriate schemes and programs for encouraging and protecting deposits should be developed. The government should not interfere with the rural financial markets and should not impose interest rate ceilings. At the same time, poverty alleviation programs with highly subsidized loan schemes should be avoided. These schemes are not sustainable and produce high default rate and market distortions. In order to reduce the cost burden of rural borrowers, the government should take a zero-tolerance policy against corruption, particularly on bribes for loan approval.

Microfinance is a relatively new development and this sector has witnessed rapid progress in India. However, the major challenge is to make this growth in the microfinance sector both effective and sustainable. As indicated previously, one of the reasons for the limited success for MFIs and micro credit programs is the problem with viability and sustainability of micro enterprises. In view of the above, conducive environment for micro-businesses should be created so that micro-enterprises can survive. There is a need to enhance accessibility, customization and comprehensiveness. Here it is important to point out that access to markets and associated infrastructure is most important among other considerations, as the absence of linkages of credit with marketing make micro enterprises unviable. Another area which needs attention is the identification of viable enterprises. Inadequate economies of scale and inefficiency in an enterprise may cause low productivity and thus make it uncompetitive and unsustainable in the long-term. MFIs need to identify viable and medium-sized entrepreneurs or enterprises with adequate managerial background, innovative ideas and business culture. They should provide these enterprises with adequate finance so that scale of economies works efficiently.

These enterprises should be capable of employing a large number of rural poor farmers, thus reaching a broader pool of the rural poor with respect to poverty alleviation. They need to provide the poor with services that are of value. This is the strategy behind the "microfinance plus approach." A typical component of these packages, is the provision of skill development training. In addition, health services, can also be included in these "microfinance plus" packages, given that ill health and morbidity have been identified as a primary factor in low productivity of the extreme poor³⁴,

As stated earlier, prudential regulations of rural financial markets, particularly that in the informal sector is becoming an important issue. The important question is what institutions will be regulated and what institute(s) will be the regulator. Usually central banks, like The Reserve Bank of India, do not regulate non-deposit taking institutions. Even if an informal rural financial institution is not taking deposits, it requires transparency, such as standardized charts of accounts and performance indicators, external audits and availability of financial statements. There is a need for risk-based supervisions for monitoring informal financial sectors (Vogel, 2006), particularly microfinance institutions. Proper supervision will make these organizations strong, effective and sustainable in the long run.

³⁴ Morduch, J. and Haley, B. 2002. Analysis of the Effect of Microfinance on Poverty Reduction. NYU Wagner Working Paper No. 1014. New York University, NY.

The Indian government has taken a bold step in introducing a new microfinance law to bring microfinance institutions under prudential supervision. The Union Cabinet has cleared the bill on 6th February 2007. The bill will be submitted in Parliament soon for approval. Under the provision of the bill, the National Bank for Rural and Agricultural Development (NABARD) will regulate the microfinance sector in India. All MFIs, operating in the form of trusts, societies and co-operatives will now be regulated by NABARD. However, non-bank finance companies will not come under NABARD. MFIs operating as co-operatives, trusts and societies have to register under the Microfinance Development Council, which will be promoted by NABARD. After registration, MFIs are allowed to raise savings or to provide deposit services to customers after obtaining specific approvals from the council. The bill kept wisely the minimum capital requirement at as low as Rs 100,000, with promoters of such MFIs having to contribute, at least, 50 percent of this amount. A microfinance ombudsman will be appointed. At the same time, some NABARD officials will be appointed to cater to the redressing of grievances arising from the participants of the sector. This apart, it is likely that the microfinance development fund, announced in the last budget, may now be made the centralized recipient of the grants received by MFIs, mainly from overseas institutions (Girish and Iyer, 2007).

The implementation of this bill should be implemented cautiously. One good point is that the capital requirement for registration for offering deposit services is not too high. NABARD is well familiar with MFIs under the SHG-linked banking program, and, therefore, their supervision will not be too harsh like traditional supervisory authorities. NABARD should supervise as well as promote MFIs. As stated above MFIs should be fully transparent. But NABARD should move away from “*traditional compliance-based supervision (e.g., “do’s” and “do not’s” which may lead to risk avoidance) toward a dedicated and thoroughgoing implementation of risk-going supervision*”. This will encourage MFIs to identify and manage risk of large numbers micro-enterprises instead of avoiding them (Vogel, 2006).

In view of the recent crisis in the microfinance institutions in Andhra Pradesh³⁵, the proper supervision and regulation assumes grave importance. At the same time, the provision of emergency liquidity to these institutions is becoming crucial in case of high non performing loans.

On several occasions, state governments imposed restrictions on MFIs in a manner in contradiction with the ground realities. It is to be noted that such excessive and harsh regulation can obstruct further development of a healthy and competitive micro-finance sector that could effectively compete with usurious money lenders. There is a need for removing these barriers to encourage MFIs throughout India. There are criticisms against the high interest rate charged by MFIs. But interest rates levied by MFIs have to be significantly higher than in the formal banking sector due to much higher transaction cost of doing business with large number of micro-enterprise involving large number of small transactions. However, MFIs interest rates still remain much lower than rates levied by money lenders. This allows MFIs to provide stiff competition to money lenders (Planning Commission of India, 2006).

Furthermore, under new central bank rules announced in 2006, MFIs “such as grocery store retailers, mobile phone outlets, gas station owners and others also can act as mini-banks to take deposits, send money and carry out other financial service.” While still in its nascent stages, “branchless banking” through the widespread use of mobile phones could allow Indian banks to reach a population of 600 million plus mobile phone customers, thereby bringing more people into the banking system.³⁶

³⁵ Dutt, Nidhi, “ India’s loan arrangers hit by crisis.” BBC [updated 9 November 2010], Available from <http://www.bbc.co.uk/news/business-11711617>

³⁶ MacRae, Penny. “ India’s poor need to join the banking mainstream: minister.” *AFP* [updated 19 July 2010]. Available from http://www.google.com/hostednews/afp/article/ALeqM5gHlKfwx7G_3KE4yzdUca-G6kEdzg

Despite the presence of some commercial banks, such as SBI, ICICI, and ABN AMRO in the microfinance business, in view of the large rural sector of India, these few banks and other formal financial institutions cannot sufficiently serve a large portion of poor customers. Thus, there remains a need for further research and studies to discover more profitable ways of delivering financial services to low-income people in rural areas. This will attract more financial institutions to provide services to a large segment of people who are deprived of access to formal financial services.

Furthermore, the government should provide funds and quality management to create sound and independent MFIs. Following Tulchin's (2006) recommendations, the Government of India needs to implement the following policy actions in order to successfully utilize the full potential of MFI as a MDG attaining tool:

- (i) There is a need to increase transparency within aid agencies that allow community stakeholders easy access to information on funding sources among other things;
- (ii) The government should create an enabling environment, which is an essential part of making microfinance sustainable. These enabling factors include managing currency value, upholding the rule of law, and maintaining a stable macroeconomic environment;
- (iii) There is a need to involve other stakeholders in decision-making, including community stakeholders such as MFIs, NGOs, and the poor who are the end-users; and
- (iv) The government should facilitate channeling remittances flows to productive uses through microfinance. These remittances that non-resident Indians send back to their family members in India usually go to similar recipients as microfinance loans. Therefore, the Indian governments will benefit significantly from moving remittances from the informal to the formal sector, and into institutional investment.

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