

Sustainable Financial Services for a Developing Rural Economy: Establishing Needs and Prospects for Growth through Microfinance Institutions (MFIs)

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KEYWORDS Microfinance. Financial Exclusion. Self-help Group. Rural Financial Institutions. Microfinance Institutions. Credit Risk

ABSTRACT Financial exclusion of poor in rural areas of a developing country such as India is a major bottleneck in generating economic growth. The study suggests that building micro-finance institutional network would mitigate the effects of financial exclusions to a great extent and help generate economic growth in rural areas and in particular the marginal and poor villagers who are entrepreneurial but lack the wherewithal.

INTRODUCTION

Modern economy has two broad inter-related sectors—real and financial. The real sector is concerned with actual production and distribution of goods and services whereas financial sector provides lubricating environment for real sector to function properly by provisioning of financial services such as savings, credit, insurance and money transfer in the economy. Further, there is a clear divide in developing economies that pertains to rural and urban. The distinction between the two is largely in terms of kinds of economic activities and availability of basic amenities of life. Rural economy is dominated by agriculture and allied activities and generally lacks in basic amenities of life such as adequate and quality health, education and infrastructure facilities such as all-weather roads, uninterrupted electricity supply and safe drinking water. Therefore, from development point of view, rural economy assumes greater importance in developing countries due to its large size and urgency of sustainable development issues. The sustainable development is defined as a process of socio-economic betterment that satisfies the needs and values of current generation while maintaining natural resources and diversity for posterity. The concept of sustainability in relation to financial services is about making the financial services accessible to rural people on an on-going basis in the long run. It implies provisioning and access of these services to rural people in a hassle free and cost-effective

manner. It also implies financial sustainability, broadly without any subsidy, of institutions providing these services. Sustainable financial services play a definitive role in reducing poverty and promoting rural development (Fisher and Sriram 2002). Rural financial services are also used to provide incentive to promote sustainable use of natural resources and use of alternative energies such as solar energy thereby leading to environment friendly development. The Watershed Development Program and Solar Lighting Program by Government of India and National Bank for Agriculture and Rural Development (NABARD) in India are such Initiatives.

The major objective of this study is to highlight the need and prospects of developing sustainable financial services for the rural development, especially in the Indian context. More specifically, it aims at: establishing the need for financial services, describing the financial institutions in brief, reviewing challenges in providing sustainable financial services in rural area, types of interventions made and their impacts on the rural economy, and finally creating sustainable net work of microfinance institutions (MFIs).

The material of this study is organized under eight sections. Section 2 describes the importance of financial services in rural areas. Section 3 deals with formal and informal sources of financial services in rural areas. Challenges faced in providing financial services to rural people are discussed in Section 4. Section 5 presents

some key lessons learned from the past interventions. Section 6 deals with evolution of microfinance industry along with the requirements of microfinance sector that need to be addressed so that MFIs are able to provide the services to meet the needs and aspirations of rural people. Summary and conclusions are discussed respectively in sections 7 and 8.

DEMAND FOR FINANCIAL SERVICES IN DEVELOPING RURAL ECONOMY

Main financial services in rural areas or elsewhere are – savings, credit, money transfer and insurance (SDC 2008). Savings and insurance are two closely inter-related financial services. These services support villagers to cope up with income and consumption variability and vulnerability. Crop insurance or agricultural income insurance in some form becomes crucial for small and marginal farmers who depend largely on agricultural income that is received in bulk at the time of harvest.

Agriculture is the mainstay of the rural people in India as majority of rural population is dependent on agriculture for livelihood. As we know, agriculture is an industry dependent on climatic and weather related factors which are unpredictable and at times disastrous. Therefore, there arises the felt need for insurance services that would save small and marginal farmers from weather induced and market related risks. Provision of such insurance products at affordable cost is a far cry till date. The experience of agricultural insurance schemes all over the world shows that such insurance schemes are financially not sustainable because subsidization in some form or government subsidies are essential for such schemes to function and sustain. However, a financial product that combines features of savings and insurance can serve the purpose until a self-sustaining insurance product is developed and made available to farmers.

Loan or credit services are of crucial importance and are needed by rural people for investments that are required for income generating activities and purchase of agricultural inputs such as high yielding variety seeds, fertilizers, irrigation, etc. Loan services are required for meeting block capital as well as working capital requirements. Consumption loan during emergency situations may help in saving assets of

the households. It is important to remember, however, that loans are not always good for poor as at times they face difficulties in paying back the loans due to illness, theft, natural disasters, etc. or due to lack of technical and managerial know-how leading to wrong investment decisions. However, access to entrepreneur-friendly loan service is essential for establishment of micro- and small-enterprises in rural areas that are needed to mitigate the poverty and unemployment situation in these environments.

Remittances are of great value to migrant workers and their families back home (Koshy and Zak 2010). Therefore, reliable and cost effective money transfer services are needed by migrants to send their savings in terms of remittances back home for their family members.

The description above shows that savings, insurance, loans and money transfer services are an integral part of rural economy and its growth. This fact has been acknowledged by policy makers and formal financial institutions, particularly banks. The emergence of MFIs after 1980s has, however, strengthened the fact underlining the necessity of financial services in rural areas. Nonetheless, a significant proportion of rural people till date are financially excluded from the fold of formal financial institutions such as banks. The main reasons for financial exclusion are high transaction costs and high risks in rural lending. Also the financial products offered by formal institutions are not always customer friendly (Satish 2010). Agricultural investment lending poses its own challenges in terms of its long term nature and dependence on seasonality of agriculture production i.e. largely dependent on weather conditions and market factors.

NEED FOR FORMALIZATION AND DEVELOPMENT OF RURAL FINANCIAL INSTITUTIONS

Financial services in rural areas are provided by formal rural financial institutions such as banks, NBFCs, credit unions, NGO-MFIs and a host of informal institutions such as moneylenders, commission agents, traders, etc. (Kumar et al. 2007). These institutions provide financial services to farmers, input suppliers, processors and exporters dealing with agricultural produce. Also, in their fold are rural non-farm sector activities relating to manufacturing and service

enterprises in rural areas. The financial services provided by these institutions include savings, credit, insurance and money transfer as mentioned earlier.

It is generally observed that agriculture is not a profitable business. Therefore, it is difficult for rural financial institutions to serve farmers in a manner which is sustainable. In many countries, governments have supported programs that have credit and insurance subsidies for the benefit of farming community (Satish 2010).

Public sector banks, private sector banks, credit unions, insurance companies and microfinance institutions are the main formal financial institutions providing these services. In recent years these institutions are trying to obtain organizational, financial and environmental sustainability which is termed as 'Triple Bottom line'. Though, there is a huge latent demand for financial services in rural areas, the formal institutions are not forthcoming to provide these services in a significant manner (Mahajan et al. 2000). Consequently, most people in rural areas in developing countries are excluded from the fold of formal institutions. For India, it is reported that less than 50 per cent farmers have access to loan services of any kind (Karmakar 2008).

As the financial services from formal sources are difficult to come by, rural households, in general, depend on informal sources such as friends and relatives, moneylenders, traders and Self Help Groups (SHGs). Lending among friends and relatives in time of need is a common practice in developing countries. Rural entrepreneurs draw on family deposits or take loans from friends and relatives to start a small business. Similar arrangement for meeting financial needs during emergency situations is also done. These loans normally do not carry any interest.

As formal institutions are not easily available for providing loans to rural people, moneylenders fill in the blank. Loans from moneylenders are, though accessible easily, however, carry excessive interest rates. Also recovery methods used by moneylenders are painful and at times use violence. Nonetheless, moneylenders provide loans during emergency situations without any collateral. Loan facilities to farmers are also provided by traders. The repayment of such loans from traders is tied up with sale of agricultural produce to traders by farmers. Thus, money lenders and traders have certain merits and certain demerits to their credit facility.

Self Help Groups (SHGs) and other community based savings and credit institutions such as rotating savings and credit associations (ROSCAs) are meaningful institutions that promote small savings, provide micro credit and micro insurance at reasonable costs. The Self-help group bank linkage program of India is reported to be the largest microfinance program in the world with an estimated outreach of 50 million households (Sharma 2009).

As mentioned earlier, the formal financial institutions such as banks are not accessible in rural areas for money transfer. The service is provided by informal sources such as co-workers, shop owners, bus, truck and train drivers. The services of these informal sources are less costly compared to formal sources of money transfer but are less secure and less reliable compared to formal sources. Though the prevalence of informal sources of financial services in rural areas does indicate the existence of demand for such services, these informal sources such as friends, relatives, SHGs are not adequate to take advantage of economic opportunities for investment in rural areas. Further, during emergency because of natural disasters such services are not available as the whole area is affected by the disaster. Also, loans from moneylenders and traders are usually too costly and lead to debt-trap.

Given the scenario presented above, there is a felt need for formal financial institutions such as banks and MFIs that can offer financial services at reasonable cost. The point here is not to replace informal sources but to complement them with formal sources so that rural people have wider choices for availing various financial services. Also, formal financial institutions are part of the whole economy and contribute to economic development of rural areas directly and indirectly by their operations in rural areas.

CHALLENGES IN PROVIDING SUSTAINABLE RURAL FINANCIAL SERVICES

It remains a big challenge for farmers and rural entrepreneurs to access financial services from formal financial institutions in most developing countries. Rural people as well as rural financial institutions are faced with a variety of challenges. Some of the main challenges in this regard are mentioned below:

High Transaction Costs

Provision and access to rural financial services involve high transaction costs. These high costs relate to providers of financial service as well as customers of these services in rural areas. One of the main reasons for high transaction cost is the inadequacy of infrastructure in terms of transport facilities and Information and Communication Technology (ICT) networks. Rural customers travel long distances to make financial transactions be it in terms of small savings or repayment of installment of loan. This, most times, costs them loss of whole day wages. On the other hand, provision of these services is expensive for rural financial institutions due to smallness of these accounts leading to high unit cost. Due to these factors, rate of interest paid by rural customers is usually more than the rate paid by their counterparts in urban areas.

High Credit Risk

Rural financial institutions and customers are reported to experience high risks. Income of rural customers is largely dependent on seasonal agricultural production which is volatile due to varying weather conditions, outbreak of pest and diseases, market fluctuations, etc. Also, rural households have difficulty in offering suitable collateral as many a time they do not have legal title to their house or land. Thus, the credit risk is seen high in case of rural customers

High Illiteracy

Illiteracy rates are high in most developing countries. Rural illiteracy rates are still higher making it worse for rural people to access financial services from formal financial institutions. They are not able to assess the viability of a loan or benefits of a Savings Scheme. They also find it difficult to execute the documents that are needed while applying for a loan. They do not, most often, understand the terms and conditions of loan contract. On the other hand, some rural financial institutions do not clearly indicate rate of interest and commission to customers in a transparent manner. Sometimes, the terms and conditions of contract are printed in small letters which are not easily readable and therefore, not noticed by rural customers who are made to pay these rates at the time of repayment.

Lack of Rural Oriented Staff

Financial Institutions who want to increase their outreach in rural areas find it challenging to hire, train and retain rural oriented staff that is willing to stay and serve in rural areas (Karmakar 2008). Thus, there is a dearth of committed rural oriented experienced staff in rural financial institutions.

LESSONS FROM PAST INTERVENTIONS

Many interventions have been made in the past several decades to tackle the challenges pertaining to rural financial services. In the decades of 1970s and 1980s, many governments in developing countries provided subsidies for credit through nationalized banks, NGOs and Development Projects. The intention behind these interventions was to increase the availability of credit for agriculture and rural development. Unfortunately, these interventions were not financially sustainable and also large number of rural people remained outside their fold.

Later on, during the second half of 1980s, a more demand driven intervention was introduced with the objective of providing inclusive and sustainable financial services. These interventions assessed the demand of rural entrepreneurs, farmers and others for savings, credit and insurance and built their delivery mechanisms on that assessment. In fact, when financial products were offered which were tailored to the needs of poor people, they showed great interest in them and the financial institutions experienced scaling up of their rural businesses manifold. The experience also showed that rural people are able to save though small amounts and repay loans in time with interest and pay insurance premiums in time to cover risks. Thus, it was a win-win situation for both, that is, rural people as well as rural financial institutions. Bank Rakyat Indonesia (BRI) and Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand are two such examples. Some specific lessons in this regard are briefly described below.

Need Orientation

As mentioned earlier, the need orientation of rural people is different from urban people due

to their overwhelming dependence on nature and a variety of sources of income at the household level. Thus, the financial institutions that offer products that match with the needs of rural people would definitely perform better than those who are not sensitive to needs of rural people. The repayment schedule or saving products have to match with cash flow of rural households to be financially sustainable.

ICT Applications

Information and communication technology (ICT) applications have played a significant role in increasing outreach and reducing cost of delivery. These ICT applications include use of mobile branches, hand-held devices / Point of Transaction (POT) Devices, mobile phones, business correspondence with ICT devices, etc. These devices are powerful and have the potential of improving access to financial services and reducing the cost of delivery. However, there are ground level challenges in making them work to the satisfaction of rural people.

Using SHGs

Self Help Groups have proved to be a good collateral substitute. Financial institutions in rural areas often find it difficult to get collateral from borrowers. SHGs can be used to reduce the risks involved in lending to rural people who are members of these SHGs. SHGs are informal groups of 10 to 20 rural people who come together to meet their financial needs through the group. SHG is linked with the bank through one account i.e. in the name of the group. Thus, the bank reduces its transaction cost by opening one account and serving 10 to 20 rural poor. The experience of SHG Bank Linkage Program in India has been excellent in terms of women empowerment and recovery percentage being more than 90 percent compared to usual recovery rates of around 60% in similar situations. Also, SHGs of women have proved to be better repayment masters than SHGs of men members (Sharma 2009).

Encouraging Competition

Rural areas, by and large, are under-served in terms of availability of options in terms of financial institutions. There is a lack of competi-

tion among financial institutions in rural areas. When there are many players in the market, rates of interest tend to come down over a period of time. Competition has been encouraged whenever there has been a favorable regulatory environment. Thus the learning is that more competition among institutions providing rural financial services, the better for rural people. However, the problem of overlap by multiple institutions would have to be tackled. Some instances of overlap have been reported from Bangladesh where many MFIs have entered the field of rural financial services. It is desirable to have a forum of rural financial institutions where such matters are discussed and resolved with mutual understanding and without inconvenience to customers. A Credit Bureau type of institution wherein all customers with loan liabilities are registered could be another institutional arrangement to address the issue of overlap in rural areas.

Credit plus Intervention

As mentioned earlier, there is a large section of rural population in developing countries that is not able to access financial services till date. This is particularly true for poor people who are excluded from access to formal financial institutions. Experience has shown that poor people do not necessarily require credit to start with. In fact, their vulnerability demands more emphasis on saving and insurance services. Launching of affordable and functioning small savings and micro insurance schemes is particularly important for poor people. Also, they might need capacity building, financial literacy and credit counseling services. Provisioning of all financial services to poor is the domain of microfinance. The microfinance sector has grown rapidly in recent years (Srinivasan 2010).

EVOLUTION OF THE MICROFINANCE INDUSTRY

Microfinance clients have been largely women and poor (NCAER 2008). Microfinance sector in recent years has grown on its own without any incentive from the governments. Also, some responsible MFIs have come up with performance standards. These performance indicators are good for the healthy growth of the sector. Further, the success of some big MFIs have enthused other institutions to enter the microfi-

nance sector. In fact, many NGOs have entered the microfinance sector. The tremendous growth of NGO-MFIs shows the huge potential of the microfinance services that need to be met in developing countries

Financial sustainability of MFIs is a precondition for successful MFIs to serve the poor. The concept of financial sustainability is about providing financial services based on commercial borrowings and savings mobilization within the financial regulation of the country. Savings are a very important component of microfinance both for MFIs as well as clients. Therefore, governments need to provide regulation such that it encourages evolution of a variety of healthy and sound MFIs. There are certain requirements for evolution of a responsible, strong and healthy microfinance sector as mentioned in the following sub-sections (Sa-Dhan 2011).

Building Transparency and Performance Standards for MFIs

Commonly agreed performance standards, transparency and accountability are keys to building solid and responsive financial services for poor households - for both regulated and unregulated microfinance institutions (MFIs). These measures increase the entire industry's integrity as well as highlight why the industry's unique character must be reflected in the kinds of performance measurements used.

There is rapid convergence on definitions for these standards, which will make it possible for wholesale financing institutions, international funders, microfinance rating agencies, and country, regional and global networks to compare the performance of institutions around the world.

It is important that these performance monitoring systems not be seen as a substitute for building the changes in prudential regulations and legal structures needed to encourage sound microfinance by regulated institutions and the increased reliance on savings and commercial borrowings by microfinance institutions. They are, however, very important to build transparency, create shared commitment, facilitate the flow of funding, and help networks provide rich products and services.

Banking Regulation for MFIs

Central banks and commercial banks are beginning to see the importance of understanding

the nature of microfinance. This awareness has led to, in some cases, the modification of conventional regulatory requirements to fit the needs of microfinance operations. These special features of microfinance include the limited size of the microfinance market in relation to the financial sector as a whole, the replacement of traditional collateral by the demonstration of portfolio quality, high transaction costs, different approaches to branching and delivery systems, lack of scale and sophistication to deal with typical reporting requirements.

The key dimensions in policy, banking regulation and supervision adapted to the needs of microfinance include suitable interest rates, the evaluation of portfolio risk by looking at aggregate portfolio quality, with rigorous standards on loan loss provisioning and reserve and at the adequacy of systems, rigorous but simplified reporting requirements, and flexibility in branching operations.

Legal Structures for MFIs

Legal structures need to be built or adapted to enable a subset of strong microfinance NGOs to convert to regulated financial institutions that can mobilize public savings and rapidly expand commercial funding. This is necessary because many of the larger microfinance institutions will increase their reliance on these sources of funds in the near future. These legal structures are extremely important to protect savers, investors and the banking industry. While becoming a regulated institution is helpful in terms of seeking commercial funds and investments, it is essential in terms of mobilizing public savings. Several features must be present for these legal structures to encourage the growth of the microfinance sector, including: relatively low minimum capital requirements, appropriate capital adequacy ratios (generally more conservative than for commercial banks), flexible ownership structures, high performance standards, and appropriate tax treatment.

Finally, prudential regulation must be coupled with strong supervision. The systems of supervision for commercial banks are not easily transposed onto the microfinance industry. Central banks and commercial banks must recognize the importance of understanding the nature and nuances of microfinance in order to execute proper supervision.

Increasingly, financial sector policy makers are recognizing the importance of microfinance, understanding its special features, and working with local microfinance leaders to ensure that the needed changes are made in financial sector policies, regulations and support systems to encourage the growth of a sound, responsive financial system that works for the poor majority. While consensus exists on the key features of pro-poor financial systems, policies, regulations and support services need to be designed to respond to each country context including India.

CONCLUSION

The paper has highlighted the importance of sustainable financial services in rural economy of developing countries with focus on India. The providers of rural finance are both formal as well as informal institutions. Both have merits and complement each other. However, the challenges remain in making financial services accessible to rural people in a manner that meets their needs. There have been some successful examples of sustainable financial services, nonetheless. The study further presents the case of microfinance institutions as a solution to the problem of financial exclusion in developing countries. Important points are raised regarding making microfinance institutions serve the purpose they are supposed to serve in rural areas in terms of making the availability of financial services at affordable cost a reality for rural poor.

POLICY RECOMMENDATIONS

Governments need to provide regulation such that it encourages evolution of a variety of healthy and sound MFIs. The key dimensions in policy relate to interest rates, rigorous standards on loan loss provisioning and at the adequacy of systems – rigorous but simplified reporting requirements and flexibility in operations. Legal structures need to be built or adapted to enable a subset of strong microfinance NGOs to

convert to regulated financial institutions that can mobilize public savings and rapidly expand commercial funding. Finally, prudential regulation must be coupled with strong supervision. The systems of supervision for commercial banks are not easily transposed onto the microfinance industry. Central banks of developing countries must recognize the importance of understanding the nature and nuances of microfinance in order to execute proper supervision.

ACKNOWLEDGEMENTS

Authors acknowledge the help received from their institutions; however, opinions expressed here are those of authors, not of the institutions they belong.

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