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Role of Micro-finance in Rural Development

Nidhi Mishra
Assistant Professor,
Deptt. of Psychology,
D.A.V. College,
Kanpur

Shreya Sharma
Assistant Professor,
Deptt. of Management,
Kanpur Institute of Technology,
Kanpur

Abstract

India lives in its villages, and while the cities have grown immensely over the last years, rural areas have not seen that kind of development. For India's economy to be strong, the rural development is necessary. One of the greatest challenges before India is to remove poverty. Government of India with its concern started various poverty alleviation programs but they have failed to deliver the objectives to the level which is desired. The micro-finance has come forward to fill up the gap. But the outreach is too small as compared to the requirement and potential. However there is some progress in this regard after active role played by NABARD and formation of SHGs groups. This sector play an important role in beginning and expanding the small business by offering small loans to lower income groups which generate income and employment to local communities. Thus no doubt, micro-finance has been treated as an important tool for economic development. However, there are huge masses of people especially in rural areas who are still remaining out of the ambit of the outreach programmes. Further, with phenomenal growth in micro-finance, there are some glaring challenges also reality of this sector. Thus, The present paper discusses concept of micro-finance, the role of micro-finance in rural development and the challenges of this sector in India.

Keywords: NABARD, Self-Help Group, Rural Development, NPAs.

Introduction

Rural development has always been an important issue in all discussions pertaining to economic development, especially of developing countries, throughout the world. Rural areas are still plagued by problems of malnourishment, illiteracy, unemployment and lack of basic infrastructure like schools, colleges, hospitals, sanitation, etc. This has led to youth moving out of villages to work in cities.

Rural

Is an area, where the people are engaged in primary industry in the sense that they produce things directly for the first time in co-operation with nature. Rural areas are sparsely settled places away from the influence of large cities and towns. Rural areas can have an agricultural character, though many rural areas are characterized by an economy based on logging, mining, oil and gas exploration, or tourism.

Development

It refers to growth, evolution, stage of inducement or progress. This progress or growth is gradual and had sequential phases.

Rural Development

Rural development is the process of improving the quality of life and economic well-being of people living in relatively isolated and sparsely populated areas. **According to Agarwal (1989)**, rural development is a strategy designed to improve the economic and social life of rural poor. For the development of rural areas poverty alleviation is necessary. Government of India with its concern started various poverty alleviation programs but they have failed to deliver the objectives to the level which is desired. The reasons may be many such as failure to reach the target group, loopholes in the system etc. India experimented with subsidized credit which only led to increase in the NPAs. More than subsidies poor need access to credit. Absence of formal employment make them non 'bankable'. This forces them to borrow from local money lenders at exorbitant interest rates. Then the concept of micro-finance has come.

Micro-finance is defined as "financial services such as savings, insurance, fund, credit etc., provided to poor and low income clients so as to help them raise their income, there by improving their standard of living".

Objectives of Study

The present paper seeks to achieve the following objectives:

1. To understand the concept of Micro-finance.
2. To understand its significance for the development of rural economy in India.
3. To understand the present status of micro-finance in India and its impact on beneficiaries.
4. To make suggestions for ensuring effective implementation of the micro-finance system in India.

Concept of Micro-finance

In India, the history of micro-finance dates back to establishment of Syndicate Bank in 1921 in private sector. During the early years, Syndicate Bank concentrated on raising micro deposits in the form of daily/weekly basis and sanctioned micro loans to its clients for shorter period of time. But micro-finance came to limelight only when **Dr Yunus** gave it a mass movement in **Grameen Bank** experiment.

Micro-finance can be called a novel approach to provide saving and investment facility to the poor around world. Improved access and efficient provision of savings, credit, and insurance facilities in particular can enable the poor to smoothen their consumption, manage their risks better, gradually build their asset base, develop their business, enhance their income earning capacity, and enjoy an improved quality of life.

Micro-financing is regarded as a tool for socio-economic upliftment in a developing country like India. Micro credit and micro-finance are different. Micro credit is a small amount of money, given as a loan by a bank or any legally registered institution, whereas, Micro-finance includes multiple services such as loans, savings, insurance, transfer services, micro credit loans etc.

Salient Features of Micro-finance

1. Borrowers are from the low income group
2. Loans are of small amount – micro loans
3. Short duration loans
4. Loans are offered without collaterals
5. High frequency of repayment
6. Loans are generally taken for income generation purpose.
7. It is one of the most effective and warranted Poverty Alleviation Strategies.
8. It supports women participation in economic activity.
9. It provides an incentive to grab the self employment opportunities.
10. It is more service-oriented and less profit oriented.

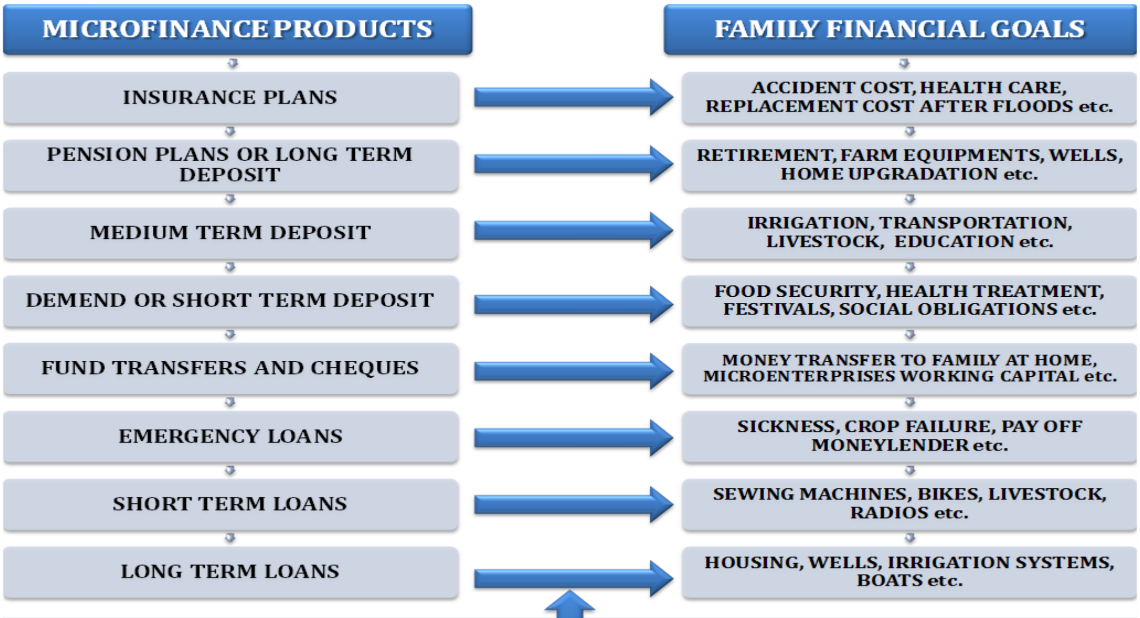

FIGURE 1: GENERAL TYPES OF MICROFINANCE USED BY RURAL PEOPLE

Source: www.scipress.com

Channels of Micro finance

In India micro-finance operates through two channels:

1. SHG
2. Micro Finance Institutions (MFIs)

Self Help Group (SHG)

The Self Help Groups (SHGs) is the dominant micro-finance methodology in India. In this case the members of Self Help Group pool their small savings regularly at a prefixed amount on daily or weekly basis and SHGs provide loan to members for a period fixed. SHGs are essentially formal and voluntary association of 15 to 20 people formed to attain common objectives. People from homogenous groups and common social back ground and occupation voluntarily form the group and pool their savings for the benefit of all of members of the groups. External financial assistance by banks augments the resources available to the group operated revolving fund. If SHGs are observed to be successful for at least a period of six months, the bank gives credit usually amounting 4 times more than their savings.

There are three models of SHGs. The salient features are given below:

SHGs-Bank Linkage Model

This model involves the SHGs financed directly by the Banks viz. CBs(Public Sector and Private Sector), RRBs, and Co-operative Banks.

MFI-Bank Linkage Model

This model covers financing of micro Finance Institutions (MFIs) by banking agencies for on ward lending to SHGs and other small borrowers.

NGOs-Bank Linkage Model

Under this model NGOs promote the linkage between banks and SHGs for savings and credit.

Micro Finance Institutions (MFIs)

MFIs include NGOs, trusts, social and economic entrepreneurs, these lend small, sized loans to individuals or SHGs. They also provide other services like capacity building, training, marketing of products etc.

MFIs operate under following models

Bank Partnership Model

1. **MFI as Agent**

   In this model, the MFI acts as an agent and it takes Care of all relationships with borrower from first contact to final repayment.

2. **MFI as Holder of Loans**

   Here MFI holds the individual loans on its books for a while, before securitising them and selling them to bank.

Banking Facilitators

Banking facilitators/correspondents are intermediaries who carry out banking functions in villages or areas where it is not possible to open a branch. In January, 2006, RBI permitted banks to use services of NGOs, MFIs and other civil society organisations to act as intermediaries in providing financial and banking services to poor.

Role of Micro-finance

Micro-finance play an important role in beginning and expanding the small business by offering small loans to lower income groups which generate income and employment to local communities. Micro-finance plays vital role in economic development through following ways:

Credit to Rural Poor

Usually rural sector depends on non-institutional agencies for their financial requirements. Micro financing has been successful in taking institutionalized credit to the doorstep of poor and have made them economically and socially sound.

Poverty Alleviation

Due to micro-finance poor people get employment. It also helps them to improve their entrepreneurial skills and encourage them to exploit business opportunities. Employment increases income level which in turn reduces poverty.

Women Empowerment

Normally more than 50% of SHGs are formed by women. Now they have greater access to financial and economical resources. It is a step towards greater security for women. Thus micro-finance empowers poor women economically and socially.

Economic Growth

Finance plays a key role in stimulating sustainable economic growth. Due to micro-finance, production of goods and services increases which increases GDP and contributes to economic growth of the country.

Mobilisation of Savings

Micro-finance develops saving habits among people. Now poor people with small income can also save and are bankable. The financial resources generated through savings and micro credit obtained from banks are utilised to provide loans and advances to its members. Thus micro-finance helps in mobilisation of savings.

Development of Skills

Micro financing has been a boon to potential rural entrepreneurs. SHGs encourage its members to set up business units jointly or individually. They receive training from supporting institutions and learn leadership qualities. Thus micro finance is indirectly responsible for development of skills.

Mutual Help and Co-operation

Micro-finance promotes mutual help and co-operation among members. The collective efforts of group promotes economic interest and helps in achieving socio-economic transition.

Social Welfare

With employment generation the level of income of people increases. They may go for better education, health, family welfare etc. Thus micro-finance leads to social welfare or betterment of society.

Critical Issues for Micro Finance Institutions

Although the micro-finance sector is having a healthy growth rate, there have been a number of concerns related to the sector, like grey areas in regulation, transparent pricing, low financial literacy etc. In addition to these concerns there are a few emerging concerns like cluster formation, insufficient funds, multiple lending and over-indebtedness which are arising because of the increasing competition among the MFIs. Some critical issues for micro-finance organizations are as follows:

Staff Training

The quality of micro-finance services depends on the capability of human resources involved as service providers. Incompetent staff and undiversified credit leads to the poor performance over the period. Poorly trained or untrained human resources affect the functioning of MFIs.

Sustainability of MFIs

The interest rates charged by MFIs are a matter of concern. It has been noted that MFIs charge high rates of interest to attain sustainability and pass on the higher cost of credit to their clients who are “interest insensitive” for small loans. This may not be true when loan sizes increase. It is, therefore, necessary for MFIs to develop strategies for increasing the range and volume of their financial services to attain sustainability while charging reasonable rates of interest to cover costs and risks.

Lack of Capital

Another area of concern is that MFIs, which are on the growth path, face paucity of owned funds as a critical constraint for scaling up. Many of them are socially-oriented institutions and there by have little access to financial capital. As a result, they have high debt equity ratios. The Micro-finance Development Fund, set up with NABARD, has been augmented and re-designated as the Micro-finance

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Development Equity Fund (MFDF) for meeting the equity needs of MFIs.

Borrowings

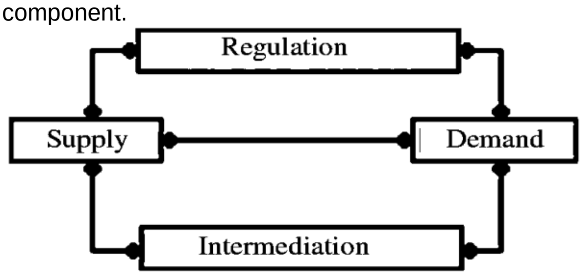
In comparison with earlier years, MFIs now find it relatively easier to raise loan funds from banks. This change has come after 2000, when the RBI allowed banks to lend to MFIs and treat such lending as part of their priority sector-funding obligations. Private sector banks have since designed innovative products (such as the bank partnership model of the ICICI Bank) to fund MFIs and have also started viewing the sector as a sound business proposition.

Capacity Building of MFIs

It is now widely recognized that widening and deepening the outreach of the poor through MFIs has both social and commercial dimensions. As the sustainability of micro-finance institutions and their clients complement each other, it follows that building up the capacities of MFIs and their primary stakeholders are necessary pre-conditions to the successful delivery of flexible client responses and innovative micro-finance services to the poor.

Suggestions and Recommendations

The four pillars of micro-finance credit system are supply, demand for finance, intermediation and regulation. Whatever may the model of the intermediary institution, the end situation is accessibility of finance to poor. The following tables indicate the existing and desired situation for each component.



Demand

Existing Situation	Desired Situation
fragmented	Professionally managed
Community Managed	Organized
Undifferentiated	Differentiated (forconsumption, housing)
Addicted, corrupted by capital & subsidies	Deaddicted from capital & subsidies
Communities not aware of rights and responsibilities	Aware of rights and responsibilities

Supply

Existing Situation	Desired Situation
Grant based (Foreign/GOI)	Regular fund sources (borrowings/deposits)
Directed Credit - unwilling	Demand responsive and corrupt
Not linked with mainstream	Part of mainstream (banks/ FIs)
Mainly focussed for credit	Add savings and insurance
Dominated	Reduce dominance of informal, unregulated suppliers

Intermediation

Existing Situation	Desired Situation
Non specialized	Specialized in financial services
Not oriented to financial Analysis	Thorough in financial analysis
Non profit capital	For profit
Not linked to mainstream FIs	Link up to FIs
Not organized	Self regulating

Regulation

Existing Situation	Desired Situation
Focused on formal service providers (informal not regulated)	include/informal recognize e.g. SHGs
regulating the wrong things e.g. interest rates	Regulate rules of game
Multiple and conflicting (FCRA, RBI, IT, ROC, MOF/FIPB, ROS/ Commerce)	Coherence and coordination across regulators
Negatively oriented	Enabling environment

There are following suggestions for the improvement in the field on micro finance-

Proper Regulation

The regulation was not a major concern when the micro-finance was in its nascent stage and individual institutions were free to bring in innovative operational models. However, as the sector completes almost two decades of age with a high growth trajectory, an enabling regulatory environment that protects interest of stakeholders as well as promotes growth, is needed.

Field Supervision

In addition to proper regulation of the micro-finance sector, field visits can be adopted as a medium for monitoring the conditions on ground and initiating corrective action if needed. This will keep a check on the performance of ground staff of various MFIs and their recovery practices. This will also encourage MFIs to abide by proper code of conduct and work more efficiently. However, the problem of feasibility and cost involved in physical monitoring of this vast sector remains an issue in this regard.

Transparency of Interest Rates

As it has been observed that, MFIs are employing different patterns of charging interest rates and a few are also charging additional charges and interest free deposits (a part of the loan amount is kept as deposit on which no interest is paid). All this make the pricing very confusing and hence the borrower feels incompetent in terms of bargaining power. So a common practice for charging interest should be followed by all MFIs so that it makes the sector more competitive and the beneficiary gets the freedom to compare different financial products before buying.

Conclusion

Although micro-finance industry has grown rapidly in India in recent years, the supply of micro-finance has failed to match with the needs and demand for it in India. There is an urgent need for a formal institutionalization of micro-finance sector under independent department under Reserve Bank of India (RBI) to assess the demand for micro-finance in India and take effective steps for meeting such demand on time. To boost micro-finance sector in India, there is a coordinated action of various agencies such as government, financials, NGOs etc. It is necessary to recognize that we in India have to focus on extending financial services to both rural and urban areas to ensure the financial inclusion of all segments of the population. As most of the population are living in rural areas and illiterate and have low awareness about micro-finance services therefore, a special campaign should be started to familiarize the poor about micro-finance services.At the same time one should avoid the temptation of creating one set of banking and financial institutions to cater to the poor or the unrecognized, and another for the rest.

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