

**Microfinance, Poverty Alleviation, and Improving Food Security: Implications for India**

by

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# **Microfinance, Poverty Alleviation, and Improving Food Security: Implications for India<sup>1</sup>**

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## **I. Introduction**

Analysts are becoming increasingly aware that microfinance can play multiple roles in reducing poverty and improving food security for poor people. This chapter discusses these roles and applies them to India. It begins by summarizing the changes in perceptions about poverty reduction that have occurred during the past couple of decades. Then there is a brief discussion of the relationship between finance and food security. The following section considers microfinance as a “win-win” proposition in the provision of financial services. This is followed by a discussion of microfinance in India, noting important strengths and weaknesses of current policies and programs. The concluding section outlines ways in which microfinance could be strengthened to improve its contribution to poverty alleviation and food security in India.

## **II. Changing Perceptions of Poverty and Finance**

Historically, poverty was viewed mostly as a problem of the poor earning too little income, consequently consuming too little to attain a socially acceptable standard of living, and possessing too few assets to protect themselves against unforeseen problems. Poverty alleviation strategies, therefore, included employment creation, skills development and, occasionally, redistribution of assets from the rich to the poor.

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<sup>1</sup> I acknowledge with appreciation the information and comments received on an earlier draft from Dale W Adams, Hema Bansal, Nimal Fernando, P.B. Ghate, Brigitte Klein, Geetha Nagarajan, V. Puhazhendhi, Shubhankar Sengupta, Girija Srinivasan, N.Srinivasan, Mather Titus, and Norman Uphoff. However, the conclusions and any remaining errors are my responsibility alone.

Technological change for small farmers has been a part of most rural poverty programs. Improving access to financial services, especially credit, has also been viewed as an important weapon in the arsenal to fight rural poverty. As shown in Table 1, granting production loans to small farmers was viewed as a means to augment food production under the now discredited “directed credit” approach to small farmer development pursued by many donors and governments in developing countries during the 1960s and 1970s.<sup>2</sup> These loans were expected to contribute to a virtuous cycle: credit would increase production and raise incomes, permit greater consumption and savings, and lead to further investment. The borrowing farm households would gain, and so would society because of greater food supplies. In this traditional view, finance was largely limited to the role of augmenting production through loans to producers, often at concessional interest rates.

[Table 1 about here]

During the past two decades, analysts concluded that this traditional view of poverty was too narrow and simplistic. A recent example of the expanded view of poverty is found in the World Bank's *World Development Report 2000/2001*. It notes that not only do the poor lack income; they lack adequate food, shelter, education and health. They are vulnerable to ill health, economic dislocation, and natural disasters. They are often exposed to ill treatment by the state and are powerless to influence decisions that affect their lives.

Paralleling this change in perceptions about poverty has been an evolution in understanding the role of finance in development. As noted in Table 1, financial services are recognized now as playing multiple roles in development so that improved access can have a far

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<sup>2</sup> The flaws in the “supply-led” approach to agricultural credit, which dominated thinking in the height of the Green Revolution, ultimately contributed to its demise. These flaws are summarized in studies such as Adams et al. (1984), Meyer and Larson (1997), and Meyer and Nagarajan (2000).

greater and more comprehensive impact on poor households than previously assumed. In addition to the virtuous production and investment cycle, financial services can smooth consumption and improve food security. Moreover, supplying financial services to women may be an especially important way to empower them to play more active economic and social roles in society. As the microfinance industry matures, many microfinance institutions (MFIs) are redesigning their financial products and services so they make a stronger contribution to these broader poverty impacts.

### **III. Financial Services and Food Security**

Critics of the directed credit approach frequently argue that an overemphasis on lending distracted attention from the fact that poor households need -- and increasingly demand -- a variety of financial services including savings and insurance. A recent statement of these arguments, emphasizing how financial services affect household food security, is found in a monograph from the International Food Policy Research Institute (Zeller et al., 1997).

The authors discuss three pathways or channels through which financial services affect food security. The first is through the familiar poverty-reducing path of improved income generation. The effects are expected to be twofold. First, there is the traditional argument that loans can temporarily enhance a household's productive human and physical capital. Second, savings and credit services can increase a household's risk-bearing potential, leading to the adoption of more risky but potentially more profitable income-generating activities. The profitability and mix of productive activities may change, leading to increased income that contributes to the virtuous production and investment cycle.

In the second pathway, finance contributes to poverty reduction by decreasing the rural household's cost of self-insurance. Improved access to credit, savings, and insurance services can induce changes in household assets and liabilities. For example, the holding of "precautionary savings" in the form of non-remunerative physical assets, such as cash, jewelry, staple foods and livestock, may decline. The emergency sale of productive assets at low prices may decrease, and the storage of crops for later sale at higher prices may rise. The importance of more expensive informal financial services may decline. Reductions in the cost of stabilizing consumption will release resources to finance more consumption and investment.

The third pathway, consumption credit, represents the greatest divergence from the narrow production and investment-oriented view of finance. Households attempt to smooth consumption over time by adjusting their disposable income. In the event of adverse shocks, such as bad weather, accidents and illness, rural households use traditional consumption-smoothing measures such as the emergency sale of assets, depletion of stocks and inventories, and grants and loans from family, relatives and the informal sector. Formal credit, savings and insurance services may help households smooth consumption so they use fewer traditional methods, which are often inefficient and bind households into unproductive social relationships that discourage savings and wealth accumulation.<sup>3</sup>

Financial policies will be more beneficial for the poor in developing countries if they pursue all three pathways rather than only expanding production credit. Poor households may use loans in immediately productive ways as envisioned in the narrow view so that incomes and food supplies rise, but they may also use loans to finance education or health expenses or to smooth consumption. Savings and insurance services must be emphasized, and savings programs for the

poor should be designed recognizing that liquidity and transaction-cost considerations may be more important than interest rates. Financial institutions that supply multiple financial services have a better chance of alleviating poverty along its multiple dimensions than those that focus exclusively on loans.

#### **IV. Microfinance: A “Win-Win” Proposition**

Microfinance refers to the provision of financial services, usually in the form of small-sized financial transactions, to people who usually fall outside the reach of formal finance. They tend to be the poorest members of all societies. Commercial banks usually ignore them to avoid high transaction costs of servicing small loans and savings deposits. Moreover, most of the poor do not possess assets normally demanded as collateral, and they are perceived as being too risky to be granted loans.

The microfinance sector has experienced considerable growth during the 1990s. The World Bank reported that 206 institutions surveyed in September 1995 held about US\$7 billion in loans outstanding made to more than 13 million individuals and groups (Paxton, 1996). This was an admittedly incomplete inventory, and the number of microfinance institutions and the volume of lending and savings mobilization have grown since then.

Bangladesh is one of the pioneer microfinance countries. It was estimated that by the end of 2000, more than 1,000 MFIs were operating in the country. As of December 2000, 585 MFIs reported loans outstanding to almost 8 million borrowers with a total amount of over US\$400 million (Credit and Development Forum, 2001). Most of these MFIs serve only rural areas. The growth in their lending has more than offset the fall in traditional agricultural lending of the

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<sup>3</sup> Townsend (1995) summarized the literature that reveals how traditional risk-sharing methods in developing countries are incomplete and inefficient, and why formal markets for credit and insurance services may improve

commercial and agricultural development banks. The MFIs have reached the scale where they may have an important influence on the country's rural poverty (Meyer and Nagarajan, 2000).

The microfinance industry consists of nongovernmental organizations (NGOs), village banks, credit unions, specialized banks for the poor, and commercial banks. It is difficult to generalize about such a heterogeneous group, but an important segment of the industry, especially in Latin America, operates on the so-called "win-win" proposition: when the poor can obtain financial services otherwise unavailable to them and benefit from these services, they are willing and able to pay high interest rates and fees that permit the MFIs to be sustainable (Morduch, 2000). Therefore, the MFIs that apply good banking principles are also expected to be those that alleviate the most poverty.

Although the industry is beginning to offer broader financial services, it is still dominated by MFIs that specialize in lending. They target the poor but, unlike the traditional small farmer lenders, they do not impose strict restrictions on the use of loan funds. They acknowledge the fungibility of money and recognize that borrowers will use funds to earn the highest economic return or meet their greatest needs, especially emergencies, consumption smoothing and medical expenses. Therefore, the MFIs educate clients to be prudent and to expect that they will have to repay their loans regardless of how the funds are spent.

Incentives such as interest rebates and automatic access to new larger loans encourage clients to repay on time. Many MFIs use some form of joint-liability, group-lending procedure so that group members screen out those who are less likely to repay and apply peer pressure on those delinquent in payments. The most successful MFIs recover most loans and experience loss rates of only 1 or 2 percent, a record far superior to most financial institutions under the directed agricultural credit paradigm.

MFIs are evaluated using three objectives. The first is outreach, to reach a large number of poor clients. The second is long-term sustainability, so the MFI can continue to provide financial services after any initial government or donor start-up funds have been exhausted. The third is impact on the clients served, improving incomes sustainably and alleviating poverty.

There are complementarities among these objectives. For example, MFIs that serve a large number of clients may achieve economies of scale that contribute to their sustainability. But there may also be trade-offs. If MFIs try to serve very poor clients, i.e., improve their depth of outreach and impact on the poor, average loans and savings deposits will be small and costs will be high, so sustainability may be difficult to achieve (Conning, 1999). This has prompted some analysts (e.g., Hulme and Mosley, 1996) to fear mission drift because MFIs that strive for sustainability may avoid serving poorer clients.

The objective of institutional sustainability is one of the most fundamental changes in the paradigm shift from directed agricultural credit to market-oriented microfinance. While this objective is difficult to achieve, there are a few highly successful “flagship” institutions. For example, the *unit desa* system of Bank Rakyat Indonesia (BRI) serves several millions of rural clients and has been so successful that each year the equivalent of millions of dollars in profits and surplus funds are transferred to bank headquarters to finance urban operations (Parhusip and Seibel, 2000). BancoSol in Bolivia is an example of an NGO that successfully converted itself into a specialized bank for the poor and currently manages a portfolio of over US\$75 million.

Nevertheless, less than one percent of all MFIs have reached the ability to cover all costs and mobilize funds on a commercial basis. That is one reason why some MFIs are beginning to mobilize voluntary savings aggressively rather than rely exclusively on donors or government funds. Some are experimenting with leasing, insurance and other financial services to attract

more clients and increase revenues. By offering more services desired by the poor, MFIs will also contribute more to poverty alleviation and food security.

## **V. Microfinance in India**

Unlike neighboring Bangladesh, India has not been a leading country in microfinance despite massive rural poverty. Until reforms were recently introduced, it was a prime example of a country that aggressively pursued the directed-credit strategy for rural and agricultural finance. Credit policies were designed to cater to the rural population, a major voting block for political parties (Meyer and Nagarajan, 2000). Poverty alleviation has been a major political appeal since the late 1970s, and the expansion of formal finance to serve the poor has been perceived as an important strategy to achieve it. The government has intervened in the banking sector with policies for setting up bank branches in rural areas, mandatory lending quotas and below-market interest rate loans for the priority sector, waivers of loan principal and/or interest (referred to as loan melas), and recapitalization and refinancing of loss-making financial institutions.

The bank branching policies contributed to the expansion of commercial banks in rural areas and loans to the rural population. The average population covered by each bank branch declined from 65,000 in 1969 to 15,000 in 1998. Agricultural cooperatives and regional rural banks were also created to help improve rural access to financial services. But directed credit, loan waivers, subsidies, and bailing out nonperforming institutions weakened the financial system and contributed to a breakdown in loan repayment discipline. By 1994, 196 regional rural banks had accumulated arrears of R. 13 billion (about U.S. \$0.5 billion) (Mosley, 1996). Overdue loans on some categories of rural loans were as high as 94 percent in 1997 (NABARD,

1997). The weak financial sector has not performed financial intermediation satisfactorily, nor has it contributed to efficient rural development (Vyas, 2001).

In 1978, the government launched the Integrated Rural Development Program (IRDP) intended to alleviate poverty. It provided loans to the rural poor through the banking system at subsidized rates. In addition, a cash subsidy was paid to borrowers equal to 25 percent of the total cost for projects financed for small farmers, 33 percent for projects for agricultural laborers, and 50 percent for lower-caste persons. These subsidies were disbursed when the loans were disbursed. Loans made by commercial banks were subject to a nominal interest rate ceiling of 12 percent per year and were made for a maximum of three years. There are serious questions about its impact, however, and loan recovery had fallen to only 31 percent by 2000 (Vyas, et al., 2001). It was finally discontinued in 2000 and replaced by the Golden Jubilee Rural Self-employment Programme [SGSY]. Subsidies are now deposited with the lending bank and released only after the client repays the loan. The interest rate should not exceed the bank's prime lending rate.

In 1982, the government created the National Bank for Agricultural and Rural Development (NABARD) as an apex bank to provide credit for agricultural and rural development. Besides its role in refinancing loans made by financial institutions in rural areas, NABARD has emerged as a major institution to support institutional development, to regulate and supervise rural financial institutions, and to develop and implement programs for channeling credit, often at subsidized interest rates, into agricultural and rural activities.

In 1992, the government began to move away from directed credit, to liberalize the financial sector and to strengthen it by reorienting banks and other financial institutions toward a market-based financial system, by increasing competition and improving the quality of services.

Microfinance programs began on a large scale in the early 1990s, and they are considered essential for the provision of working capital and financing nonfarm activities for the rural poor.

Three major microfinance approaches have emerged in the country. First, some MFIs have emerged that specialize in serving the poor. They make retail loans directly to the poor and wholesale loans to NGOs that specialize in reaching the poor. Second, several apex organizations have been created that wholesale funds to NGOs and non-bank institutions that lend to the poor. These apex organizations also support institutional development through training and technical assistance. Third, the government has undertaken a massive program through NABARD to create and link self-help groups to banking institutions. A spinoff of this approach is that some banks have developed their own linkage programs with self-help groups.

NABARD began to support microfinance in February 1992 with a pilot project to test the self-help group (SHG) bank linkage approach, set up to cover 500 SHGs (Wright, 2000).<sup>4</sup> The intent was to utilize the existing large banking network rather than create special MFIs. A SHG is a small homogeneous group of rural poor coming together to save small amounts regularly and mutually contribute to a common fund to be lent to individual members per group decisions (Nanda, no date). Often some organization, usually an NGO, forms the group and links it with a bank as part of a broader package of activities implemented by the NGO in the village. Group formation may take six months to a year, and representatives selected by the group members are responsible for management. The NGOs can simply be facilitators in linking the groups with financial institutions or can act as financial intermediaries themselves.

Banks can lend to the NGOs or directly to the SHGs; increasingly they have chosen to lend to the SHGs using NGOs as facilitators. A few experiments are occurring with banks hiring

promotional agents to form groups. The banks are now authorized to count SHG loans against their required lending to priority sectors. Most loans are scheduled to be repaid over a two- or three-year period. NABARD refinances up to 100 percent of the loans made by banks to the groups at the interest rate of 6.5 percent (recently raised to 7 percent). On June 1, 1999, the rate that the banks charge the NGOs or the SHGs, the rates that NGOs charge the SHGs, and the rates the SHGs charge their members were completely deregulated (NABARD, 2000).<sup>5</sup> Still, many banks are reported to be skeptical of the SHG approach because of their past poor experience with lending in rural areas.

NABARD reported that as of March 31, 2001, over 260,000 SHGs involving over four million poor families had been linked to banks. Over 70 percent were concentrated in five of the wealthier states in the south. Over 85 percent of the groups were composed of women. Over 750 NGOs and 14,000 branches of 318 banks were associated with the program. Banks serving some 213,000 SHGs received refinancing from NABARD in a cumulative amount of Rs. 4.8 billion (US\$ 100 million). Almost 87 percent of the loan portfolio was financed by NABARD, but that percentage is expected to fall in the future as many banks have excess liquidity, a fact which calls into question the rationale for the refinance facility.<sup>6</sup> NABARD has set a target of reaching a million groups covering 100 million rural poor by 2008 (Nanda, 1998).<sup>7</sup>

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<sup>4</sup> The Asian and Pacific Regional Credit Association (APRACA) with financial support from the German technical assistance agency GTZ began a program in Asia in the late 1980s to promote SHGs as financial intermediaries (Kropp et al., 1989). Indonesia was the first country to begin large-scale field activities in the project.

<sup>5</sup> NABARD *Annual Report 1999-2000*, reported in <http://www.nabard.org/annr2000/chap6.htm>, April 29, 2001.

<sup>6</sup> To date, most of the banks that have granted loans are commercial state banks and Regional Rural Banks. The share of loans made by District Cooperative Central Banks has been increasing (Klein, 2001).

<sup>7</sup> Another increasingly important source of refinance for MFIs is the Small Industries Development Bank of India (SIDBI), which started a microcredit lending scheme in 1994 that evolved into a Foundation for Micro Credit in 1998. It provides loans to well-managed MFIs for on-lending to poor groups and individuals with an emphasis on women taking up micro-industrial activities. The MFIs may lend to smaller MFIs and NGOs or directly to SHGs and individuals. The minimum MFI loan is Rs. 1 million (about US\$ 24,000) and the maximum loan to a single borrower or SHG member must not exceed Rs. 25,000 (approximately US\$ 600). The nominal annual interest rate to the MFIs is 11 percent and they are to charge market rates. As of March 2001, the total cumulative disbursement to 169 MFIs exceeded Rs. 810 million (US\$17 million). It also supports training and capacity building of NGOs.

NABARD also provides grants for strengthening NGOs and operates training programs for bankers, NGOs and SHGs.<sup>8</sup> It led a task force that in October 1999 recommended a series of measures to strengthen microfinance, including a regulatory framework for MFIs, and equity and start-up capital and capacity building funds for institutions engaged in microfinance. Much remains to be done to implement these recommendations.

The emphasis of microfinance in India has been to expand outreach and disbursements rather than to create sustainable institutions or improve impact on the clients. NABARD claims that the SHG linkage program has made a great impact on participating members, but few studies are available that evaluate how it operates in the field or its contribution to poverty alleviation and food security. A case study of NGO-bank linkages in one district in the state of Gujarat in 1997-98 found that at that time many NGOs and banks were not aware of the program (Bansal, 1998). That situation has probably changed in recent years due to the massive expansion of SHGs sponsored by NABARD and other organizations. The NGOs studied were engaged in a variety of village-level development activities. Some had organized savings groups, but there was little borrowing reported from banks. Some SHGs had started to lend their own funds and reported high recovery. Little information was provided on the sustainability of the operations.

Two NABARD studies attempted to evaluate impacts on the banks and households that participate in the SHG linkage program. In 1997, Puhazhendhi (2000) studied SHGs in Tamil Nadu where almost 80 percent of the 427 SHGs in the state were linked to just eight banks. Some banks had begun to organize groups on their own but most were organized by NGOs. The study focused on four NGOs responsible for over 90 percent of the groups. Seventy SHGs were sampled: 80 percent were women's groups; average group size was 19; and two-thirds of the

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<sup>8</sup> The NABARD annual report for 2000-2001 indicates that the cumulative grant support through March 2001 totaled Rs. 462,000 (US\$ 20,000) provided to 198 NGOs that supported almost 37,000 SHGs. The German aid

groups were 3 to 4 years old. About half of the group members were reported to be landless laborers with seasonal employment so they were considered to be among the poorest of the poor.

The total funds managed by the SHGs were composed of savings, donations from NGOs, and bank loans. Annual savings per group member rose from about Rs. 500 (U.S.\$12) in the groups of one to two years of age, to over Rs. 1,000 (U.S.\$24) for groups four years of age or older. The average size of loan granted per member rose over time from nearly Rs 1,000 in year one to almost Rs 4,000 (U.S.\$100) when groups were four years old or older; therefore, the multiple of loan size to savings grew from 1.64 to 3.75. Length of loans grew from two to four months to eight to 12 months over the same period, so members borrowed fewer loans per year as groups aged. Interest rates ranged from 3 to 5 percent per month initially but fell to 2 to 3 percent per month after about three years.

A study of the banks showed that for 1996-97, the average loan granted to a SHG was small at about Rs. 9,700 (U.S.\$ 230), or about Rs. 500 (U.S.\$ 12) per member for a group of 19 members. Almost two-thirds of the loans fell into the range of Rs. 5,000 to 10,000 (U.S.\$120-240). The repayment period was three years, but over 70 percent of the SHGs repaid early and received second and third loans with larger sizes. Interest rates charged by banks ranged between 12 and 14 percent annually, so SHGs earned a significant spread between their cost of funds and the rates charged to their members.<sup>9</sup>

Two important benefits were reported for the banks that made SHG loans compared to other types of loans. First, the recovery rate in 1996-97 for SHG loans was reported to be over 90 percent compared to a range of 37 to 68 percent for agricultural loans generally, and 31 to 43 percent for IRDP loans. Second, a study of one commercial bank revealed that the transaction

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agency GTZ is providing financial assistance for capacity building.

<sup>9</sup> No information was provided on the rates of interest that the SHGs pay on member savings.

costs of making the first SHG loan were only 60 percent as high as for making IRDP or general loans, while the costs for the second SHG loan were only 43 percent as expensive. No data were reported on average loan sizes, but if loan sizes were roughly comparable, the cost per rupee of making SHG loans would have been much lower and the probability of recovery much higher. However, the banks had made little progress in streamlining operations and SHG loans were treated much like other types of loans.

The economic and social impacts on SHG members were estimated. The average annual net family income was estimated at almost Rs. 4,440 (U.S.\$105), roughly double pre-linkage income of about Rs. 2,000 (U.S.\$47). Members who were agricultural laborers were able to undertake income-generating activities that increased family income. Income growth was correlated with the quality of group performance measured on a multi-variable scale. Groups that performed better had a higher growth of member income. However, no information was provided about how income growth was measured, nor was income growth reported from any comparative control group; therefore, the role of the SHGs in causing these income changes is open to question. Several positive social impacts were also noted, including greater consumption of wheat, rice and vegetables, and a better capacity to stock food for the lean season.

A more comprehensive impact evaluation was conducted by Puhazhendi and Satyasai (2000) of 223 SHGs sampled in 11 states. Two to three members were interviewed from each household for a total of 560 members. Roughly a third of the SHGs were drawn from each of the three models: a) groups developed by banks, b) groups with NGOs as only facilitators, and c) groups with NGOs as financial intermediaries. Impact was measured by comparing the members' pre-group situation (apparently established by member recall) compared with the post-linkage situation of 1999. Poverty lines were established using state government standards for

monthly consumption levels to evaluate if member households moved out of poverty during the time of membership.

The characteristics of the groups were similar to those found in the Tamil Nadu study. Average group size was 16 members, and agricultural laborers represented the largest number of members, followed by small farmers (2.5 to 5.0 acres), then marginal farmers (less than 2.5 acres). Almost 35 percent reported to be engaged in a mix of farm and non-farm activities, and 20 percent reported only non-farm activities. The groups formed by banks tended to be somewhat smaller than the other two types of groups, but even so they saved significantly larger amounts and received larger loans. The explanation may be that bank-organized groups are encouraged to emphasize financial services rather than other developmental activities, or perhaps persons more interested in obtaining financial services chose bank-promoted groups. When banks organize the groups and are able to monitor them more closely, they may be willing to lend more than to groups associated with NGOs.

The total size of the loan portfolios grew with the age of the groups, and the share of income-generating to non-income-generating loans rose over time. However, because of the fungibility of money, it is impossible to know for certain how loans were actually used. These data may simply reflect reporting bias if income-generating loans are considered by the banks and NGOs to be more desirable. Annual interest rates tended to fall in the range of 12 to 24 percent, and the term of most loans was 6 to 12 months. The repayment rate for loans received from all sources rose from about 84 to 94 percent, with the most dramatic increase noted for bank loans.

This evaluation concluded that the SHG linkage program had significant economic and social impacts on members. For example, member households were reported to experience more

than a 70 percent increase in assets, more than a tripling of annual savings, and almost a doubling of annual borrowing. Average net household income reportedly rose by a third compared to pre-SHG levels, and the greatest increase was observed for the groups with NGOs as facilitators. Perhaps the assistance provided by NGOs in the form of services other than finance contributed to this difference.

The proportion of members below the poverty line before joining the SHG (42 percent) fell to half that level at the time of the survey. The proportion of members that rose out of poverty was higher if they engaged in off-farm activities, had smaller families and had higher levels of income before joining. Estimated household monthly consumption levels rose by 24 percent. Total food expenditures rose, but following Engel's law, more slowly than did other categories such as expenditures for health and clothing. The social impacts included: improved feelings of confidence and self-worth, a reduction in social problems such as wife beating, and better access to improved health and sanitary services. Surprisingly, less than a quarter of the members reported receiving training, and that proportion was higher for both NGO models compared to the bank model.

Although promising, these results must be interpreted with caution. The evaluation did not address possible problems of self-selection bias, measurement errors in using recall data, and the lack of a control group to help determine if the changes reported for the members should be attributed to the SHGs rather than to other factors.

Other studies in India have focused on alternative microfinance models and the operational performance and sustainability of MFIs. One study concluded that few Indian MFIs had achieved great success in their microfinance operations. Quiñones (1997) evaluated ten

NGOs considered among the best in outreach and sustainability. However, few could cover their operating costs, and none could operate completely free of subsidies.

One of the largest MFIs in the study was SEWA, the Self-Employed Women's Association, composed of self-employed women that began in 1972 as a trade union.<sup>10</sup> It currently has about 320,000 members with a trend toward attracting more rural members in recent years. SEWA organized a cooperative bank for members in 1974, which makes loans, mobilizes savings, and utilizes mobile vans and field agents for the daily collection of loan payments and savings deposits. It emphasizes savings and considers making a loan only after observing a member's saving behavior. About 70 percent of the Bank's members are now urban. It also provides financial services to savings and credit groups in Gujarat state. As of March 1999, there were 298 groups with over 8,500 members that had collected over Rs. 2.5 million (U.S.\$60,000) in savings and had Rs. 1.1 million (U.S.\$26,000) in loans outstanding (Chen and Snodgrass, 2001). The bank currently reports 130,000 depositors and shows profits, but Quiñones found that in 1997 it covered operational but not financial costs. In addition, SEWA organizes rural women into savings groups and teaches them how to manage these funds. SEWA has also initiated various types of life, accident, health and other insurance products for its members to reduce their vulnerability and increase their ability to withstand negative shocks. Several of these products are offered in conjunction with established insurance companies.

One of the most rapidly growing MFIs included in the Quiñones study was SHARE (Society for Helping, Awakening Rural Poverty through Education) that provides credit and savings services in over 500 villages in the state of Andhra Pradesh. During the year 2000, its active borrowers grew from 29,000 to 59,000 while the number of savers climbed from 37,000 to

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<sup>10</sup> The information reported here was obtained from the SEWA web site at the end of April 2001. For more on SEWA, see Rose (1992) and Chen and Snodgrass (2001).

72,000. By September 2001, the number of savers reached 104,000 and the borrowers totaled almost 70,000. It had about US\$5.8 million in outstanding loans at the end of September 2001. Although it aggressively mobilizes savings, the savings balance was just over US\$2.9 million, reflecting the organization's continuous dependence on outside resources.<sup>11</sup>

SHARE follows the Grameen Bank methodology of group lending in which borrowers, mostly rural women, are organized into five-person groups, and seven groups are organized into centers. The centers meet weekly to discuss matters related to loan approval, disbursement, and repayment structure. Loans are granted on a graduated scale starting with a maximum of Rs. 4,000 (US\$95) for the first loan to a maximum of Rs. 8,000 (US\$190) in the fifth year. Additional seasonal loans are available, which range from Rs. 3,000 to Rs. 6,000 (US\$70-140) in the fifth year. Clients are eligible for a housing loan of Rs. 12,000 (US\$285) after the second year. All loans are to be repaid in 50 equal installments. Clients are required to deposit Rs. 5 (US\$0.12) per week in a compulsory savings program, and 5 percent of the loan amount is retained in a group fund. The members were generally poorer than non-members in the villages, suggesting that it has good depth of outreach (Sharma et al., 2000).<sup>12</sup>

Recent results reported by an organization that has rated some of the best MFIs in South Asia revealed a pattern of financial weakness. The results were heavily influenced by India because of the 53 MFIs rated, 44 MFIs were in India, four in Nepal, and three in Bangladesh (M-CRIL, 2001). They had been operating for an average of 5.9 years and employed different

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<sup>11</sup> These data are reported in the newsletter *Credit for the Poor*, April 2001 and October 2001. The dependency on external funds is reflected in the information included in the December 2000 issue of the newsletter. It reported that SHARE was going to receive a soft loan as part of US\$1.2 million raised by the Grameen Foundation-USA for expanding Grameen-type programs in India. It also reported on a meeting held with Steven C. Rockefeller to discuss mobilizing foreign funds to expand microlending rapidly in India, with 70 percent of the on-lending funds to come from commercial banks in India at market interest rates.

<sup>12</sup> A preliminary report of an impact study conducted of SHARE clients was summarized in *Credit for the Poor*, Vol. 30, April 2001. It reported that 38 percent of the SHARE clients moved out of poverty after three or four years

lending methodologies with the largest number, 31, using self-help groups. Ten employed the Grameen model and ten used individual lending.

Total outreach and coverage was almost 700,000 persons of which the SHGs served about 50 percent. About 300,000 were borrowers, but the total volume of lending was only about US\$23.5 million, less than one-third of the portfolio of BancoSol in Bolivia and much smaller than just one of the large MFIs in Bangladesh. Savings mobilization, including amounts generated by SHGs but not deposited with MFIs, totaled only US\$12.3 million, in spite of the supposed emphasis on savings and self-help. Moreover, nonbank finance companies and other MFIs face constraints in being denied authorization to mobilize voluntary savings. Obligatory savings are permitted because they can be interpreted as ownership shares and can only be withdrawn when the savers' loans have been repaid. The total savings represented 34 percent of the amount lent to clients reflecting the great dependency on non-member sources of funds for lending.

Low levels of productivity were also evident as the SHG programs averaged only 50 clients per staff member compared to 94 clients for Grameen programs and over 100 for the individual lenders. This was due to the heavy staff input required during the start-up phase of some SHGs and the social rather than business orientation of many SHGs in India. The sample average of 15 percent of the portfolio at risk (defined as 60 days overdue) was a cause for concern, and the SHGs averaged a much larger 29 percent of portfolio at risk. The average operating cost ratio of 23 percent exceeded the average portfolio yield of 17 percent, so this means that most MFIs are not able to cover their costs. The average return on assets was a

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in the program. Another 22 percent reported no change in status however. No details were presented on the methodology used in the study in order to evaluate the robustness of the results.

negative 4.8 percent showing how far they are from commercial viability.<sup>13</sup> The report concluded that the microfinance sector in South Asia has, generally speaking, a long way to go before it can achieve any form of commercial viability and can become a dynamic and sustainable component of the region's poverty reduction efforts.

A new Indian MFI, BASIX, is taking a different approach to microfinance. It was organized in 1996 as a group of financial services and technical assistance companies, one of which is a nonbanking finance company.<sup>14</sup> Recently it established a Local Area Bank with a license from the Reserve Bank of India to offer full-fledged banking services. It is pursuing a more commercially oriented strategy than most MFIs, but faces challenges from the subsidized credit provided by the formal financial sector. Rather than specifically targeting the poor, BASIX believes that making larger loans to the nonpoor in rural areas will create employment for the poor. By the middle of 2000, it had over 12,000 borrowers with over US\$2.5 million in loans outstanding with an average loan size of over US\$200.

BASIX operates in the states of Andhra Pradesh and Karnataka and offers a variety of group and individual loan products granted through self-help groups, intermediaries such as trader organizations and agroprocessing firms, and NGOs. About half the loans are for agricultural activities. Interest rates range from 15 to 24 percent and vary in term from one to five years. Most loans require monthly payment schedules. Almost 90 percent of the assets are financed from commercial sources of funds.<sup>15</sup> This, plus rapid growth and competition, have prevented the organization from making rapid progress in achieving operational and financial

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<sup>13</sup> The report noted that many of these performance measures are similar to the average results shown for the MFIs included in *The MicroBanking Bulletin*, but the peer group of large Asian MFIs reported in that source have more positive results than were shown for these 51 MFIs.

<sup>14</sup> Bhartiya Samruddhi Finance Limited.

<sup>15</sup> The finance company received loans from the holding company and from several banking sources including SIDBI. The holding company has obtained funding from external sources including the Ford Foundation and the Swiss Agency for Development Co-operation.

self-sufficiency. Interest rates on some products have been reduced due to competition. There is pressure to improve efficiency by increasing the client load per loan officer, and to improve on-time loan recovery. Commercial banks, subsidized NGOs and government programs are increasingly attracting self-help groups by providing loans at cheaper rates (Nagarajan, 2000).

Although most Indian MFIs seek cheap foreign or government funds, in part to cover start-up and institution building costs, there is not a serious shortage of loanable funds for MFIs that meet the standards established by apex institutions. A total of four apex institutions, including NABARD, now provide funds to MFIs. Yet in spite of such support, the country has not yet succeeded in achieving large outreach or in creating vibrant and sustainable MFIs. Most are far from reaching the stage where they can operate on a commercial basis. No single “flagship” institution has emerged to demonstrate how to achieve large-scale outreach and sustainability. Microfinance is not yet making much of an aggregate impact in the country and is far from reaching its potential in contributing to poverty reduction and food security.<sup>16</sup>

## **VI. Improving Microfinance in India**

India is attempting to expand microfinance and it is logical that the country would look to its large bank network as the primary way to supply microfinance services. That approach, however, continues the country’s long tradition of a top-down, non-market strategy of mandates, quotas, and refinance funding to expand access to financial services for priority sectors.

The microfinance strategy also continues the strong bias toward emphasizing targets for achievements, i.e., outreach, rather than stressing financial efficiency and self-sustainability.

Many policymakers are encumbered by the outdated view that the poor cannot save and need

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<sup>16</sup> For an assessment of eight schemes, including SEWA and SHARE, and their contribution to poverty alleviation, see Sinha et al. (2000).

subsidized loans so lending is often emphasized relative to savings mobilization and other financial services. Recent government poverty initiatives threaten to undermine commercial microfinance by providing more subsidies for the poor. Although some liberalization has occurred, the financial system is still highly constrained by governmental regulations. State-owned or controlled banks and cooperatives thwart the development of nonbank financial institutions and other types of MFIs that attempt to operate on a commercial basis (Mahajan, 2000). The following changes should be considered in India's microfinance strategy to achieve three major objectives: increase outreach and coverage, both total numbers of poor served as well as the depth of poverty of the clients; enhance the sustainability of MFIs and reduce dependency on subsidies; and improve impact on clients.

#### **A. Adjust interest rates and the use of subsidies**

The interest rates charged on most microloans are too low to cover lending costs and risks, as shown by the M-CRIL analysis (2001) of MFIs and by experience in other countries. Low interest rates undermine financial institutions, destroy institutional sustainability, discourage MFIs from trying to serve the poorest of the poor, and constrain the emergence of market-oriented MFIs and the innovations that arise from increased competition. Many banks do not need NABARD funding and might be induced to invest some of their excess liquidity in microfinance if the rates of return were more attractive.

The remaining regulatory and social barriers to charging cost-covering interest rates need to be removed, and MFIs should utilize the flexibility they already have to set realistic rates. It is interesting that rural people often set high rates for loans made from savings they mobilize themselves, as found in the study of Tamil Nadu SHGs. They understand the need to

compensate savers and to ration credit use through proper pricing.<sup>17</sup> In the long run, interest rates will fall as MFIs expand, become more efficient, and reach economies of scale. Market forces will eventually determine the level of rates appropriate for the poorest segment of the market.

Governments have an obvious interest in providing subsidies to aid the poor. But alternatives other than financial institutions should be used as channels for such subsidies to avoid confusing the poor about the difference between grants and loans. Subsidies for MFIs would be better used to cover start-up costs rather than being passed on directly to clients in the SHGs. Financial discipline within the SHGs could be damaged if this subsidy issue is not handled with care (Sheokand, No date).

## **B. Broaden the scope of financial services**

The poor need and demand financial services other than just loans. The poor, as well as the rich, value savings, insurance and other financial services. Loans are useful for those with good investment alternatives, but secure savings services are valued by everyone regardless of their investment opportunities. Flexible access to voluntary savings is especially important to the poor so they can smooth household consumption in emergencies. With its large network of regulated financial institutions, India should be a leader rather than a laggard among low-income countries in savings mobilization and in offering secure savings outlets for the poor. Postal offices also offer a vast untapped network to mobilize savings. Unfortunately, government policies continue to emphasize lending, and treat obligatory savings largely as a way to screen

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<sup>17</sup> In a program to introduce participatory irrigation management through farmer organizations in Sri Lanka, when farmers set up their own savings and credit scheme, they decided on a loan interest rate of 16 percent per month. This sounds usurious, but farmers paid about 25 percent per month to informal moneylenders and wanted to build up their capital quickly so they could displace the latter (Uphoff, 1996).

potential borrowers and reduce lending risks, rather than viewing savings instruments as important in themselves.

There is a logical tendency in group-based financial services for all members to be offered the same product: loans of the same size and maturity, and a fixed requirement for obligatory savings. There are advantages for MFIs in offering only a few highly standardized products in terms of lower costs and simplicity in internal control. But the Bangladesh experience has shown that standardization can contribute to client dissatisfaction and high rates of drop-out (Meyer, 2002). Moreover, peer pressure to repay loans seems to wane after several loan cycles. These observations support the argument favoring more flexibility in the products offered to the poor (Wright, 2000). Some MFIs in Bangladesh and elsewhere have begun to add individual loan products and have completely discontinued making group loans. This leads to a fundamental question: should group-based financial services be viewed as just an intermediate step in the long-term process of developing sustainable individual financial services for the poor?

### **C. Evaluate the long-term strengths and weaknesses of SHGs**

The APRACA-GTZ financial linkage concept<sup>18</sup> was based on the idea that indigenous self-help groups could be strengthened by becoming formally linked with formal sector financial institutions, perhaps with the assistance of NGOs (Kropp et al., 1989). The Indian approach is more oriented toward creating and linking self-help groups of a uniform size rather than formalizing existing indigenous groups. It represents a hybrid model with characteristics borrowed from models that link indigenous groups to banks, from models that create self-governed village banks, and from models that create joint-liability borrowing groups.

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<sup>18</sup> See footnote 4.

The concept of providing financial services through groups offers some advantages, one of the most important being the potential to reduce transaction cost for MFIs as noted in the Tamil Nadu study. Once SHGs are formed, they can serve as efficient mechanisms through which to provide training and other services. Undoubtedly, many NGOs find the linkage model attractive for this reason. NGOs have their own objectives, however, which may conflict with those of banks.<sup>19</sup> Some NGOs may object to standardized loans that treat all borrowers the same and may even ally with borrowers against the banks when they face difficulties in making loan payments.

Group-based microfinance systems have demonstrated major limitations. As noted above, the effectiveness of peer pressure as a contract-enforcement mechanism for group lending may decline after several loan cycles. All member-owned institutions face serious governance challenges as the poor performance of many Indian cooperatives amply demonstrates. Local elites may eventually dominate the groups and monopolize access to loans at the expense of weaker members. The poorest may be systematically excluded from groups because wealthier members fear that they will not fulfill their loan contracts. Women take on huge additional burdens in order to receive financial services through SHGs, and the potential negative aspects do not seem to be as well appreciated in India as they are in Bangladesh (e.g., Kabeer, 2001).

Reaching the poorest who are most food insecure may require more complex programs such as the combined food aid and credit approach being tested in Bangladesh (Hashemi, 2001).

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<sup>19</sup> Reid (no date) describes a case where the objectives and perceptions of an NGO diverged from those of financial institutions. The case describes the evolution in the relationships between the NGO Youth Charitable Organisation (YCO) in Andhra Pradesh and the banks. At first, YCO was enthusiastic when its women's groups were successfully linked with local banks. With the assistance of NABARD, the groups mobilized savings, deposited them with banks, and received loans. The relationship soured, however, when the groups became disenchanted with what they believed were excessively bureaucratic bank regulations, lack of access to their savings, and the small interest margin the NGO was permitted to earn relative to the margins permitted for the banks. Eventually, YCO bypassed the financial system and borrowed from the National Women's Fund of the government. YCO is now promoting a mutually aided cooperative society with the hope it can eventually become a bank.

Groups face inherent instabilities because financial interests of group members may diverge over time. The most successful members may decide to drop out and seek larger individual loans, which presumably would be the preference of banks. It will be a huge and expensive task for the banks and NGOs to create, strengthen, and effectively monitor and supervise the performance of hundreds of thousands of small groups to minimize potential governance and other problems, and preserve the financial integrity of the SHGs. Huge costs are involved in reaching the targeted numbers of SHGs and no system is yet in place to cover these costs (Sheokand). Perhaps these resources would be better utilized if they were directly invested to meet a long-term goal of sustainable individual lending.

Other unresolved issues include who should bear the cost of NGOs and banks in forming and nurturing groups, the role and sustainability of federations of SHGs, the ability of SHGs to effectively engage in self-regulation and promotion, and the potential for other subsidized enterprise development and poverty alleviation activities to undermine the self-help philosophy introduced in the linkage model.<sup>20</sup> Apex institutions and federations of SHGs are expanding but their sustainability is uncertain and their future role in promoting and strengthening the system is unclear.

#### **D. Strengthen alternative institutional forms**

The SHG linkage strategy is complex and represents huge principal-agent challenges. To succeed, the staff of NABARD, the banks, the NGOs, and the members of the SHGs themselves must all perform their respective tasks effectively if SHG members are to receive efficient financial services. This complexity offers many opportunities for failures, inefficiencies, and

unproductive rent-seeking behavior. The financial layering involved means that the costs of several institutions must be covered in order for the entire system to be financially sustainable. Considering the enormity of the task and limited resources, the target of one million SHGs by 2008 seems unrealistic, if they are to achieve efficiency and sustainability. Moreover, banks and other types of formal financial institutions have not been the most innovative MFIs in most countries. Generally NGOs, foundations, and non-bank financial institutions have been more dynamic, and banks have become interested only after profitable models have been created, tested and proven. This pattern seems to be evident regarding SHG linkages.

Competition between competing models and approaches has proven to be beneficial for the entire microfinance industry. The examples of SEWA, SHARE, and BASIX suggest this will likely be the case in India as well, but the current strategy is heavily biased in favor of formal banks. Competitive conditions need to be improved and a more level playing field created so that multiple forms of financial institutions can emerge and seek solutions to the challenge of increasing access, achieving sustainability, and enhancing impact. Regulations need to be changed so that non-bank financial institutions can more easily mobilize savings for rural and micro lending (Mahajan, 2000).

Natural disasters are frequent in India, and MFIs face challenges in servicing affected clients. An appropriate role for NABARD would be to monitor the sector and assure that all market participants implement prudent policies so they can survive these challenges. NABARD might explore the development of a safety-net mechanism in the form of a lender of last resort mechanism to support MFIs most affected by disasters.

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<sup>20</sup> Fukaya et al. (2001) report on a study made of MFIs in which self-regulation was proposed by many of the participants in response to the threats and opportunities represented by the explosion of organizations and resources

## **E. Expand the analysis of microfinance problems and performance**

Many countries have benefited from an active program of analysis of microfinance problems and performance. In these countries, baseline data are collected from clients so that their progress over time can be more accurately monitored; marketing studies are conducted to evaluate how MFIs can offer more attractive products and services. Investments are made in good management information systems so that MFI managers have the information necessary to make timely decisions; a few carefully designed impact studies are done so that the effects and limitations of expanded financial services for the poor can be better understood. Although fiercely competitive, some MFIs have found ways to exchange ideas about common problems and the identity of their delinquent borrowers.

The relatively little information that is available publicly on microcredit operations suggests that India is underinvesting in microfinance research and analysis. More information is needed about what is actually happening on the ground so that policy makers can assess how the microfinance industry is evolving, both in terms of performance and problems. Good analysis is needed of the level of interest rates required for MFI sustainability, of the problems and constraints as observed by all agents in the system, of client perceptions about changes needed in products and services, and of the dynamics of SHG operations.

## **VII. Conclusion**

Microfinance can contribute to poverty alleviation and food security. It does this through supplying loans, savings and other financial services that enhance investment, reduce the cost of self-insurance, and contribute to consumption smoothing. India has expanded microfinance, but it has not yet developed a strong system capable of serving massive numbers of poor in a

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devoted to microfinance in the country.

sustainable fashion. Undoubtedly the legacy of directed credit with its top-down approach to lending and the prevalence of highly subsidized state and national poverty projects and programs retard the development of true market-oriented rural microfinance. The policy of supporting SHG linkages with banks has merit in a country with a large bank network, but it should not be the only model encouraged. Additional efforts are needed to create and nurture competitive MFIs willing to experiment with other models.

Policy-makers face a dilemma in channeling microfinance funds through the rural banking system. On the one hand, it represents a fairly quick way to expand outreach. On the other hand, the country faces the serious challenge of repairing the damage done to the rural financial system by years of political involvement. The current system of unviable and proliferated rural cooperatives and banks needs to be restructured and rationalized. This will involve closing unprofitable branches, merging and privatizing some institutions, and building institutional capacity to provide quality services to rural clients. Considering the poor performance of much of the rural financial system, providing it with access to the SHG linkage refinance window may complicate rather than simplify the reform process.

**Table 1. Changing Perceptions of Poverty and Finance**

<u>Poverty</u>	<u>Finance</u>	<u>Expected Results of Finance</u>
<p><b>Narrow view:</b></p> <p>Income/consumption</p> <p>Assets</p>	<p><b>Single role:</b></p> <p>Small production loans for food production</p>	<p><b>Production and investment:</b></p> <p>Virtuous circle of investment, production, income, consumption, savings, and investment</p>
<p><b>Broad view:</b></p> <p>Income/consumption</p> <p>Assets</p> <p>Vulnerability</p> <p>Health</p> <p>Education</p> <p>Voicelessness</p> <p>Powerlessness</p> <p>Food insecurity</p>	<p><b>Multiple roles:</b></p> <p>Loans for wider uses, leasing, savings, insurance, payment/money transfer, and financial intermediation</p>	<p><b>Multiple results:</b></p> <p>Virtuous circle of investment, production, income, consumption, savings, and investment</p> <p>Consumption smoothing (food security)</p> <p>Capacity to bear risk</p> <p>Empowerment</p> <p>Education</p> <p>Health</p> <p>Nutrition</p> <p>Contraceptive use and other social impacts</p>

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