VOL- VIII ISSUE- IX SEPTEMBER 2021 PEER REVIEW e-JOURNAL IMPACT FACTOR 7.149 ISSN 2349-638x

History of Microfinance

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Introduction:

Microfinance is a category of financial services targeting individuals and small businesses that lack access to conventional banking and related services. Microfinance includes microcredit, the provision of small loans to poor clients; savings and checking accounts; micro insurance; and payment systems, among other services. Microfinance services are designed to reach excluded customers, usually poorer population segments, possibly socially marginalized, or geographically more isolated, and to help them become self-sufficient.

Microfinance initially had a limited definition: the provision of microloans to poor entrepreneurs and small businesses lacking access to credit. The two main mechanisms for the delivery of financial services to such clients were: (1) relationship-based banking for individual entrepreneurs and small businesses; and (2) group-based models, where several entrepreneurs come together to apply for loans and other services as a group. Over time, microfinance has emerged as a larger movement whose object is: "a world in which as everyone, especially the poor and socially marginalized people and households have access to a wide range of affordable, high quality financial products and services, including not just credit but also savings, insurance, payment services, and fund transfers.

Proponents of microfinance often claim that such access will help poor people out of poverty, including participants in the Microcredit Summit Campaign. For many, microfinance is a way to promote economic development, employment and growth through the support of micro-entrepreneurs and small businesses; for others it is a way for the poor to manage their finances more effectively and take advantage of economic opportunities while managing the risks. Critics often point to some of the ills of micro-credit that can create indebtedness. Many studies have tried to assess its impacts.

New research in the area of microfinance call for better understanding of the microfinance ecosystem so that the microfinance institutions and other facilitators can formulate sustainable strategies that will help create social benefits through better service delivery to the low-income population.

Microfinance and Poverty:

In developing economics, and particularly in rural areas, many activities that would be classified in the developed world as financial are not monetized: that is, money is not used to carry them out. This is often the case when people need the services money can provide but do not have dispensable funds required for those services. This forces them to revert to other means of acquiring the funds. In their book, The Poor and Their Money, Stuart Rutherford and Sukhwinder Arora cite several types of needs:

1. *Lifecycle Needs: such as weddings, funerals, childbirth, education, home building, holidays, festivals, widowhood and old age*
2. *Personal Emergencies: such as sickness, injury, unemployment, theft, harassment or death*
3. *Disasters: such as wildfires, floods, cyclones and man-made events like war or bulldozing of dwellings*
4. *Investment Opportunities: expanding a business, buying land or equipment, improving housing, securing a job, etc.*

People find creative and often collaborative ways to meet these needs, primarily through creating and exchanging different forms of non-cash value. Common substitutes for cash vary from country to country, but typically include livestock, grains, jewelry and precious metals. As Marguerite S. Robinson describes in his book, The Micro Finance

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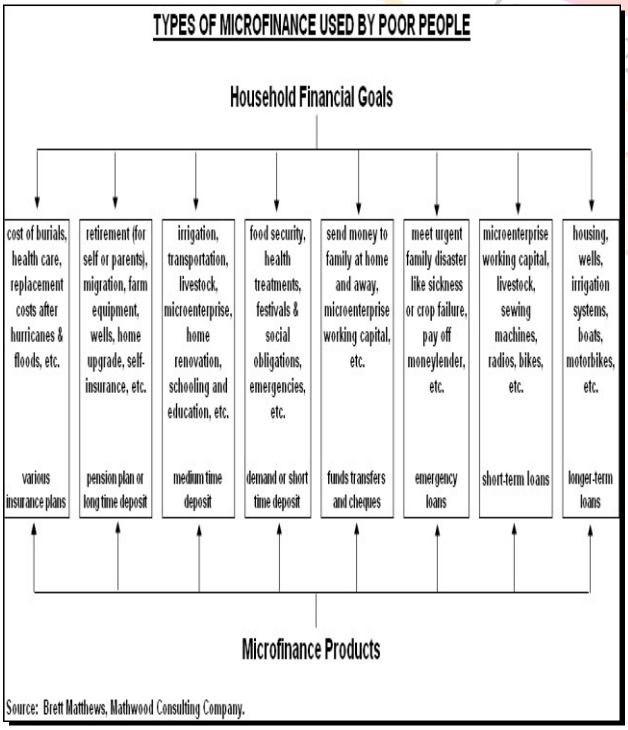
Revolution: Sustainable Finance for the Poor, the 1980s demonstrated that "micro finance could provide large-scale outreach profitably", and in the 1990s, "micro finance began to develop as an industry". In the 2000s, the microfinance industry's objective was to satisfy the unmet demand on a much larger scale, and to play a role in reducing poverty. While much progress has been made in developing a viable, commercial microfinance sector in the last few decades, several issues remain that need to be addressed before the industry will be able to satisfy massive worldwide demand. The obstacles or challenges in building a sound commercial microfinance industry include:

- Inappropriate donor subsidies
- Poor regulation and supervision of deposit-taking microfinance institutions (MFIs)
- Few MFIs that meet the needs for savings, remittances or insurance
- Limited management capacity in MFIs
- Institutional inefficiencies
- Need for more dissemination and adoption of rural, agricultural microfinance methodologies
- Members' lack of collateral to secure a loan

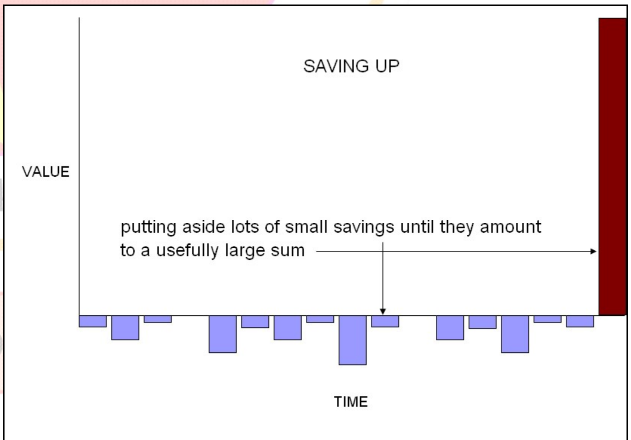
Microfinance is the proper tool to reduce income inequality, allowing citizens from lower socio-economical classes to participate in the economy. Moreover, its involvement has shown to lead to a downward trend in income inequality.



Source: Brett Matthews, Mathwood Consulting Company.

Ways in which poor people manage their money:

Rutherford argues that the basic problem that poor people face as money managers is to gather a "usefully large" amount of money. Building a new home may involve saving and protecting diverse building materials for years until enough are available to proceed with construction. Children's schooling may be funded by buying chickens and raising them for sale as needed for expenses, uniforms, bribes, etc. Because all the value is accumulated before it is needed, this money management strategy is referred to as "saving up". Often, people don't have enough money when they face a need, so they borrow. A poor family might borrow from relatives to buy land, from a moneylender to buy rice, or from a microfinance institution to buy a sewing machine. Since these loans must be repaid by saving after the cost is incurred, Rutherford calls this 'saving down'. Rutherford's point is that microcredit is addressing only half the problem, and arguably the less important half: poor people borrow to help them save and accumulate assets. Microcredit institutions should fund their loans through savings accounts that help poor people manage their myriad risks.



Source: Stuart Rutherford. The Poor and Their Money. Oxford University Press, Delhi, 2000.

The work of Rutherford, Wright and others has caused practitioners to reconsider a key aspect of the microcredit paradigm: that poor people get out of poverty by borrowing, building microenterprises and increasing their income. The new paradigm places more attention on the efforts of poor people to reduce their much vulnerability by keeping more of what they earn and building up their assets.

Examples:

The microfinance project of "saving up" is exemplified in the slums of the south-eastern city of Vijayawada, India. This microfinance project functions as an unofficial banking system where Jyothi, a "deposit collector", collects money from slum dwellers, mostly women, in order for them to accumulate savings. Jyothi does her rounds throughout the city, collecting Rs5 a day from people in the slums for 220 days, however not always 220 days in a row since these women do not always have the funds available to put them into savings. They ultimately end up with Rs1000 at the end of the process. However, there are some issues with this microfinance saving program. One of the issues is that while saving, clients are actually losing part of their savings. Jyothi takes interest from each client—about 20 out of every 220 payments, or Rs100 out of 1,100 or 8%. When these slum dwellers find someone they trust, they are willing to pay up to 30% to someone to safely collect and keep their savings. There is also the risk of entrusting their savings to unlicensed, informal, peripatetic collectors. However, the slum dwellers are willing to accept this risk because they are unable to save at home, and unable to use the remote and unfriendly banks in their country. This microfinance project also has many benefits, such as empowering women and giving parents the ability to save money for their children's education. This specific microfinance project is an example of the benefits and limitations of the "saving up" project.

The microfinance project of "saving through" is shown in Nairobi, Kenya which includes a Rotating Savings and Credit Associations or ROSCAs initiative. This is a small scale example, however Rutherford (2009) describes a woman he met in Nairobi and studied her ROSCA. Everyday 15 women would save 100 shillings so there would be a lump sum of 1,500 shillings and everyday 1 of the 15 women would receive that lump sum. This would continue for 15 days and another woman within this group would receive the lump sum. At the end of the 15 days a new cycle would start. This ROSCA initiative is different from the "saving up" example above because there are no interest rates affiliated with the ROSCA, additionally everyone receives back what they put forth. This initiative requires trust and social capital networks in order to work, so often these ROSCAs include people who know each other and have reciprocity. The ROSCA allows for marginalized groups to receive a lump sum at one time in order to pay or save for specific needs they have.

Use of loans:

Practitioners and donors from the charitable side of microfinance frequently argue for restricting microcredit to loans for productive purposes—such as to start or expand a microenterprise. Those from the private-sector side respond that, because money is fungible, such a restriction is impossible to enforce, and that in any case it should not be up to rich people to determine how poor people use their money.

Microfinance standards and principles:

Poor people borrow from informal moneylenders and save with informal collectors. They receive loans and grants from charities. They buy insurance from state-owned companies. They receive funds transfers through formal or informal remittance networks. It is not easy to distinguish microfinance from similar activities. It could be claimed that a government that orders state banks to open deposit accounts for poor consumers, or a moneylender that engages in usury, or a charity that runs a heifer pool are engaged in microfinance. Ensuring financial services to poor people is best done by expanding the number of financial institutions available to them, as well as by strengthening the capacity of those institutions. In recent years there has also been increasing emphasis on expanding the diversity of institutions, since different institutions serve different needs.

Some principles that summarize a century and a half of development practice were encapsulated in 2004 by CGAP and endorsed by the Group of Eight leaders at the G8 Summit on 10 June 2004:

1. Poor people need not just loans but also savings, insurance and money services.
2. Microfinance must be useful to poor households: helping them raise income, build up assets and/or cushion themselves against external shocks.
3. "Microfinance can pay for itself". Subsidies from donors and government are scarce and

uncertain and so, to reach large numbers of poor people, microfinance must pay for itself.

4. Microfinance means building permanent local institutions.
5. Microfinance also means integrating the financial needs of poor people into a country's mainstream financial system.
6. "The job of government is to enable financial services, not to provide them".
7. "Donor funds should complement private capital, not compete with it".
8. "The key bottleneck is the shortage of strong institutions and managers". Donors should focus on capacity building.
9. Interest rate ceilings hurt poor people by preventing microfinance institutions from covering their costs, which chokes off the supply of credit.
10. Microfinance institutions should measure and disclose their performance – both financially and socially.

Microfinance is considered a tool for socio-economic development, and can be clearly distinguished from charity. Families who are destitute, or so poor they are unlikely to be able to generate the cash flow required to repay a loan, should be recipients of charity. Others are best served by financial institutions.

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