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Research Paper

# MICROFINANCE - A TOOL IN SHGS INNOVATIVE BUSINESS STRATEGY FOR POVERTY ERADICATION

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***Abstract***
*Self-help groups play an important role in rural areas in reducing poverty. Microfinance and self-help groups assist the rural area people in their financial needs it is a type of banking service that ensure that unemployed a low-income level people get the better opportunity and they start to earn their livelihoods by themselves. The main aim of microfinance or self-help groups to empower women. Self-help groups need to focus on training program for the women's with the help of NGO's so they develop their skills and Talents.*

*Key Words:* ***Micro Finance, Rural Sector, Financial Services, Poverty Alleviation.***

## INTRODUCTION

In 2006, the Grameen Bank and its founder Muhammad Yunus were awarded the Nobel Peace Prize for their efforts to reduce poverty in Bangladesh. By providing small loans to the extremely poor, the Grameen Bank offers these recipients the chance to become entrepreneurs and earn sufficiently high income to break themselves free from the cycle of poverty. Yunus's pioneering efforts have brought renewed attention to the field of microfinance as a tool to eliminate poverty; and, since 1976 when he first lent $27 to 42 stool makers; the Grameen Bank has grown to include more than 5.5 million members with greater than $5.2 billion in dispersed loans. As microfinance institutions continue to grow and expand, in both the developing and developed world, social activists and financial investors alike have begun to take notice. This article seeks to explain the rise in microfinance since its inception in the early 1980s and the various mechanisms that make microfinance an effective tool in reducing poverty. Also address the current problems facing microfinance and areas for future growth.

## MICRO FINANCE – A CONCEPTUAL VIEW

Micro-finance refers to small savings, credit and insurance services extended to socially and economically disadvantaged segments of society. Indian context terms like "Small and Marginal Farmers", economically weaker sections have been used to broadly define micro-finance customer. Large part of micro finance activities is confined to credit.

Microfinance also refers to small scale financial services such as micro-saving, micro credit and micro-insurance to the people who operate micro enterprises which generate income and allowing them to meet financial needs and emergency. These short term loans are enough to start or expand business, weaving baskets, raising chicken or buying wholesale product to sell in the market. The aspect of microfinance has contributed to its success of its credit plus approach where focus has not only been on providing adequate timely credit to low income groups but to integrate it with other development activities such as community organizing and development, leadership, training, skill and entrepreneurship. The ultimate aim is to attain social and economic empowerment. The microfinance program has major impact on improving living standard of downtrodden people.

## MICROFINANCE VS MICROCREDIT

Although the terms microcredit and microfinance are often used interchangeably, it is important to recognize the distinction between the two. As mentioned before, microcredit refers to the act of providing the loan. Microfinance, on the other hand, is the act of providing these same borrowers with financial services, such as savings institutions and insurance policies. In short, microfinance encompasses the field of microcredit. Currently, it is estimated that anywhere from 1,000 to 2,500 microfinance institutions (MFIs) serve some 67.6 million clients in over 100 different countries. Many MFIs have a dual versatile to provide financial as well as social services, such as health care and educational services for the underprivileged. In this sense, they are not always perceived as profit-maximizing financial institutions. At the same time, the remarkable accomplishment of microfinance lies in the fact that some of the successful MFIs report high rates of repayment.

**SELF HELP GROUP (SHG) – MICRO CREDIT INSTITUTIONS (MCI) SYSTEM**

Typical SHG consist of 12 or 30 member. It is not only saving and loan association but serves as “affinity” group that provides platform for issues. SHG is system raises funds from individual and also from MCI. MCI arise fund from three sources: Capital, SHG saving and borrowing from outside.

Moreover MCI have regulatory restriction on assets, liabilities and interest rates. Some of the principles underlying for implementation,

- SHG use the sanctioned money from MCI almost 60% for lending to their members and rest for depositing.
- Joint liability of members is to serve as substitute for physical, collateral and saving are to come first.
- Interest rates on saving and credit for members are similar with market rates which are determined locally by participating institutions.
- All NGOs and SHGs will charge interest margin to cover their costs.
- SHGs may levy an extra charge on interest rate of internal fund generation which will force saving.

**HDFC MECHANISMS FOR LOW INCOME GROUP BENEFICIARIES**

HDFC making sustained efforts to reach the lower income groups of society, especially the weaker section, thus enabling them to realize their dreams of possessing own house.

HDFC’s response to need for housing and living environment for poor, youth in rural and urban sectors materialized in collaboration with German Development Bank. It also ensures newly constructed houses within the affordability of beneficiaries and promotes the usage of innovative low cost technologies and locally available material for constructing house. To achieve the purpose of implementation of low cost having projects, HDFC collaborate with Government and Non-Government sectors.

Security for loan is mortgage of property being financed. Construction work is regularly monitored by coordinating agencies and HDFC. The loan is disbursed depending upon the stages of construction.

Microfinance operation experiences poor repay of their loans, saving and loan facilities. It also contributes to solve the problem of inadequate housing. It has not to contribute for this through building financial discipline but educating borrower about the repayment requirements.

**Is Microfinance a Desirable Alternative?**

The spread of microfinance and the success of MFIs in various countries around the world prompts a question is who served the poor before the micro credit revolution? It is well known that conventional banks, which act as creditors to most entrepreneurial activity in the modern world, have largely avoided lending to the poor. Instead, credit to the poor has been provided mostly by local moneylenders, often at usurious rates. Consequently, moneylenders are typically perceived as being exploitative, taking advantage of poor villagers who have no other recourse to loans. Therefore, it is not surprising that microfinance has been welcomed by most, as an alternative to the abusive practices of village moneylenders. By listing the difficulties that arise in lending to the poor, early studies believed that poor people often lack the resources needed to invest their borrowings to the most productive use. In short, the poor borrow mostly to finance consumption needs.

Even if loans could be earmarked for investment purposes, commercial banks would find it difficult to lend. Lack of credit histories and documented records on small entrepreneurs or farmers make it difficult for the bank to assess the creditworthiness of the borrower. Finally, there is the inability of the poor to post collateral on the loans. This reduces the bank’s recourse to a saleable asset once the borrower defaults on the loan. Therefore, it is not difficult to see why commercial banks have avoided lending to the poor.

The local moneylenders could mitigate the problems faced by outside banks in lending to the poor. Local moneylenders are arguably better informed of borrower quality and have more effective means of monitoring and enforcing contracts than outside banks. In short, because of their social ties, information, and location advantage, these moneylenders are in a unique position to lend to the poor. Some observers argue that usurious interest rates in these markets can be explained by this "monopoly" that the local moneylender's enjoyed.

**MICROFINANCE - A TOOL FOR POVERTY ALLEVIATION**

Microfinance started as a method to fight poverty, and although microfinance still fulfills this goal, several institutions have sought to make a distinction between the "marginally poor" and the "very poor." The broadest definition distinguishing these two groups comes from the Consultative Group to Assist the Poorest (CGAP), which defines the poor as individuals living below the poverty line and the poorest as the bottom - half of the poor.

The World Bank estimates that in 2001, some 1.1 billion people had consumption levels below $1 and another 2.7 billion lived on less than $2 per day. Micro finance continues to grow, questions have started to focus on who is the optimal client. Should microfinance target the marginally poor or the extremely poor? Morduch (1999) tries to answer this question by considering two representative microfinance clients, one from each poverty group described above. The first client belongs to a subsidized microfinance program and her income is only 50 percent of the poverty line. The second client belongs to a financially sustainable program that accordingly charges higher interest rates.

To ensure repayment of the loan at the higher rate, the second borrower is chosen to be marginally poor, that is, with an income of 90 percent of the poverty line. Using the widely used "squared poverty gap" (Foster, Greer, and Thorbecke, 1984) measure of poverty, Morduch suggests that a dollar increase in income for the very poor borrower has a five times greater impact than the same dollar for the marginally poor borrower. This simple example would suggest that, in terms of poverty alleviation, MFIs should focus on the poorest borrowers first, but this is not always the case.

**SOURCES OF MICROFINANCE IN INDIA**

**FORMAL SECTORS**

Formal Financial Institutions are concerned are Commercial Banks, Housing Finance Institution(HFI),NABARD, Rural Development Banks(RDB),Land Development Banks and Cooperative Banks(CBs).

The formal sector banking institution in India have been serving only the needs of commercial sector and providing loans for middle and upper income groups. For housing the ***HFIs*** primarily perceived risk of lending to this sector.

Risks generally perceived by formal sector financial Institutions are credit risk, High transaction and services cost, Irregular flow of income due to seasonality, Lack of tangible proof of assessment of income, Absence of land tenure of financing housing.

The government has taken several initiatives to strengthen the institution rural credit system. The rural branch network of commercial banks have been expanded and certain policy prescriptions imposed, in order to ensure great flow of credit to agriculture and other preferred sectors. The commercial banks are required to ensure that 40% of total credit is provided to priority sectors out of which 18% in the form of direct finance to agriculture and 25% to priority sector in favor of weaker sections besides maintaining a credit deposit ratio of 60% in rural and semi urban branches. Further IRDP introduction in 1979 ensure supply of credit and subsidies to weaker section beneficiaries.

**INFORMAL SECTORS**

Informal sectors generally include funds available from family sources or local money lender. Local money lenders charge exorbitant rates, generally ranging from 36% to 60% interest due to their monopoly in the absences of any other source of credit for non-conventional needs.

NGOs engaged in activities related to community mobilization for their socio-economic development have initiated saving and credit program for their target groups. Community based financial system (CBFS) can be categorized into two models. Group base financial intermediary and NGO linked financial intermediary.

NGOs like SHARAN in Delhi, FEDERATION of THRIFT AND CREDIT ASSOCIATION (FICA) or SPARC have adopted first model where they initiate groups and provide necessary management support SEWA pertain to second model.

## CHALLENGES OF MICROFINANCE IN POVERTY ERADICATION

The importance of microfinance in the process of poverty eradication is realized, it faces multiple problems. Offering financial services to poor individual and in itself leads to various challenges. Challenges are divided into challenges faced by Micro Entrepreneurs and challenges faced by Microfinance Providers.

### I. Challenges to Micro Entrepreneurs

1. **Inability to offer marketable collateral for loans:** They are either small businesses or poor individual who have few assets and low income. These clients have cannot offer any collateral for loans. Due to this microfinance providers may raise their interest rate or turn down hundreds of application.

2. **Poor institutional viability of micro enterprises:** Business ideas with a lack of consideration of demand and cost render the micro venture unsustainable and microfinance may incorrectly get blame for it. For instance, In the case of micro crop farming farmer often fail to account for their personal consumption between the sowing and harvesting periods and realize they face shortage of more. Due to this they often end up using the micro loan for personal matter and problem arises when its time to pay back the loan, farmer are forced to take another loan.

3. **Knowledge regarding sources of microfinance is lack:** Many micro entrepreneurs live in remote villages, so they have no access to microfinance service offered by MFIs.

4. **Misallocation or shortage of finance:** Lack of fund, which can solve if MFIs build up their capital base by accessing various sources of funds without fund micro ventures, cannot grow.

5. **Inability to exploit growth opportunities:** Shortage of finance is a contributor to this problem, because lack of access to funds means micro entrepreneurs cannot inject money into their business to grow. They may have little information pertaining to their market such as customer needs and competitor strengths and weakness, this may result May critics.

6. **Lack of organizational resources and governance:** They may have limited skill, qualification and exposure to handling business. They need to be trained through capacity building initiative by MFIs; many micro entrepreneurs may not grow because of this problem.

7. **Low bargaining power:** Micro entrepreneurs operates in competitive markets, their individual bargaining power is diminished. There still isn't any respite because micro entrepreneurs deal with MFIs on individual basis, which also erode their bargaining power.

Most problems faced by micro entrepreneurs are caused by small size, improper skill, and location. When venture secures loan and begins to grow these problems will eventually.

### II. Challenges to microfinance providers.

The importance of microfinance in the process of process of poverty eradication is realized, it faces multiple problems. The challenges to microfinance providers are

1. **High risk of micro entrepreneurship and small business**: Micro entrepreneur usually no collateral to offer microfinance providers, no alternate source of income. Micro entrepreneurs are considered high risk ventures and micro finance providers are forced to compensate for this by changing interest rate.

2.**High costs for Micro Lending:** Small micro enterprises increase the transaction cost for MFIs, because they cannot process micro loan in bulk. In study conducted by Asian Development Bank, Microfinance providers change interest rate ranging from 30 to 70% per year.

3.**Fund shortage:** There are plenty of financial options available for MFIs there is an emerging shortage of money. This is due to lack of awareness of funding source by MFI managers.

4.**Difficulty in measuring the social performance of MFIs:** Micro finance is delivering the economic returns its proponents promised but there are only a handful of tools available that measure the social return of microfinance.

5.**Mixing of charity with business**: If microfinance providers fail to protect themselves against loan delinquency, they will in effect, prioritize social at expenses of financial sustainability. Improper delinquency management is result of inadequate implementation of corporate governance principle. As result loses control over microfinance deals will lead to higher default rates.

6.**Lack of solution for poor:** Targeting of poor households by microfinance programs is common problem because MFIs fail to understand the various needs of micro entrepreneurs. MFI must spend time to develop microfinance tools for each micro entrepreneur.

7.**Lack of microfinance training for MFIs:** Micro finance sector is different when compare to traditional financial sector, microfinance providers need special training to ensure they avoid problem such as under-serving clients..

**III. Challenges to Women**

Micro-finance has been successful in supplying production loans to women; these initiatives may produce negative results

1. The workload may lead to poor health, exhaustion and overwork.
2. The problem of male influence is one of the most difficult challenges related with women as micro-finance clients.
3. They turn the money to their husband, rather than using for business.
4. Even after the disbursement of loan they don’t know how to use it.

**A KEY TO WOMEN EMPOWERMENT AND EDUCATION**

Any review of microfinance is incomplete without a discussion of its impact on women. The Microcredit Summit Campaign Report (2000) lists over a thousand programs in which 75 percent of the clients were women. Yunus (2003) recounts the initial difficulties overcoming the social mores in rural Bangladesh and lending to women in this predominantly Islamic nation. However, his efforts were rewarded and 95 percent of the Grameen Bank’s current clients are women. This focus on women follows largely from Yunus’s conviction that lending to women has a stronger impact on the welfare of the household than lending to men. This has been confirmed by a large volume of research on microfinance.

In countries where microfinance is predominant, country-level data reveal signs of a social transformation in terms of lower fertility rates and higher literacy rates for women. Loans to women have a positive impact on outcomes such as children's education, contraceptive use, and the value of women's non-land assets. It finds that borrowing by a woman has a greater impact on per capita household expenditure on both food and non-food items. Among other things, this also improves nutrition, health care, and educational opportunities for children in these households. Microfinance institutions that also offer health services with institutions that offer only credit. Notes that, “in both countries, health bank participation significantly raises subsequent health care over credit-only participation.” In particular, that participation in MFIs that offer health services reduces the tendency to switch to bottle feeding as incomes rise. Breast-feeding children under age two is a key health-enhancing behavior. A pro-female bias in lending works well for the MFIs. Practitioners believe that women tend to be more risk averse in their choice of investment projects, more fearful of social sanctions, and less mobile (and therefore easier to monitor) than men—making it easier for MFIs to ensure a higher rate of repayment..

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**CONCLUSION**

Micro finance is a poverty-alleviation tool that has proven to be both effective and adaptable. Muhammad Yunus's vision of extending credit to the poor has reached a global level. Through innovations in group lending and dynamic incentives, MFIs have been able to successfully lend to those traditionally ignored by commercial banks, because of their lack of collateral and credit scores. The poor have responded kindly, by repaying their loans with significant repayment rates. As MFIs have grown and reached new clients, they have continued to innovate by offering individual loans, savings options, and life insurance and seeking new forms of capital in domestic and international markets. The problems can broadly fall into either financial or operational in nature, they should not be impossible to solve as microfinance sector move towards its optimal performance level in next several years. Microfinance can also contribute to solve the problem of inadequate housing and urban service as an integral part of poverty alleviation programs. The micro-finance also proved it to the success of women empowerment. In the recent year's micro-finance have confined themselves in distribution of loan to women, the receipt and utilization of loan helps in improving their economic status.

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