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CONTENTS

Sr. No.	TITLE & NAME OF THE AUTHOR (S)	Page No.
1.	**FDI TRENDS IN INDIA: A MULTI-DIMENSIONAL ANALYSIS** *DR. K. R. PILLAI & DR. M. S. RAO*	1
2.	**BEHAVIORAL ANALYSIS OF THE FARMERS, AS END USERS, TOWARDS ORGANIC FERTILIZER: AN EMPIRICAL STUDY IN BANGLADESH** *MUJAHID MOHIUDDIN BABU*	6
3.	**ECONOMIC GROWTH NEXUS TO PERFORMANCE OF BANKING SECTOR IN PAKISTAN** *SHAHZAD GHAFOOR & UZAIR FAROOQ KHAN*	11
4.	**BANK CONSOLIDATION AND CREDIT AVAILABILITY TO SMALL AND MEDIUM ENTERPRISES: EVIDENCE FROM NIGERIA** *DR. AHMAD BELLO DOGARAWA*	19
5.	**STUDY OF LINKAGE OF DIVERSIFICATION STRATEGY AND CAPITAL STRUCTURE OF FIRMS: A SURVEY** *NEETA NAGAR*	26
6.	**A STUDY ON MONEY SUPPLY, INFLATION RATE AND GDP – AN EMPIRICAL EVIDENCE FROM INDIA** *UMANATH KUMARASAMY*	33
7.	**MICROFINANCE FOR SMEs: PROSPECTS, CHALLENGES & IMPLICATION** *GAURAV SEHGAL & DR. ASHOK AIMA*	37
8.	**TRADE ORIENTATION OF INDIAN INDUSTRIES** *NAGENDRA KUMAR MAURYA & J. V. VAISHAMPAYAN*	44
9.	**GLOBAL FINANCIAL CRISIS AND ITS IMPACT ON INDIAN INSURANCE INDUSTRY** *S. H. ASHRAF & DHANRAJ SHARMA*	49
10.	**FOOD INFLATION IN INDIA- WHERE ARE THE PRICES HEADING?** *DR. YASMEEN K. AOWTE*	57
11.	**SOCIAL ENTREPRENEURSHIP – STUDY OF KAUSHALYA FOUNDATION** *DR. SHILPA BENDALE & DR. ARVIND CHAUDHARI*	61
12.	**DYNAMISM OF INDIA'S FINANCIAL SECTOR DURING THE GLOBAL ECONOMIC RECESSION** *DR. B. KUBERUDU & DR. T. V.RAMANA*	64
13.	**MANAGING RELIGIOUS PHILANTHROPY FOR SOCIO-ECONOMIC DEVELOPMENT** *BEERAN MOIDIN B. M. & DR. FAISAL U.*	67
14.	**INVESTMENT PROCESS OF VENTURE CAPITAL: AN EXPLANATORY STUDY OF ANDHRA PRADESH INDUSTRIAL DEVELOPMENT CORPORATION VENTURE CAPITAL LIMITED (APIDC-VCL)** *DR. A. AMRUTH PRASAD REDDY & DR. S. RAGHUNATHA REDDY*	72
15.	**MICRO FINANCE LOANS – ENHANCING BUSINESS OR MEETING PERSONAL EXPENSES?** *ARADHANA CHOUKSEY & DR. YAMINI KARMARKAR*	78
16.	**INTERNATIONALIZATION OF INDIAN BUSINESS: DRIVERS AND CHALLANGES** *DR. VILAS M. KADROLKAR & SHREESHAIL G. BIDARKUNDI*	83
17.	**SMEs IN THE ECONOMIC GROWTH OF AGRA: OPPORTUNTIES AND CHALLENGES (WITH SPECIAL REFERENCE TO AGRA SHOE CLUSTER)** *SHAVETA SACHDEVA & LAXMI R.KULSHRESTHA*	90
18.	**SAFE MANAGEMENT OF HEALTH CARE WASTE** *DR. A. SHYAMALA*	94
19.	**POST MARITAL SEXUAL ANXIETY AMONG DOCTORS (A COMPARATIVE STUDY AMONG MALE AND FEMALE DOCTOTRS)** *VIJAYA U. PATIL, CHANDRAKANT JAMADAR & RUKMINI S.*	98
20.	**CLIENTS SATISFACTION TOWARDS PRIVATE LIFE INSURANCE COMPANIES** *DR. M. DHANABHAKYAM & M. KAVITHA*	101
21.	**RURAL ENTREPRENEURSHIP IN JAMMU AND KASHMIR: OPPORTUNITIES AND CHALLENGES** *DR. DARAKHSHAN ANJUM*	105
22.	**IMPACT OF DEMOGRAPHIC VARIABLES ON PERFORMANCE OF ENTREPRENEURS IN KERALA** *DR. R. JUBI*	111
23.	**MARKET ORIENTATION IN AGRICULTURE: CASE STUDIES OF DEVELOPMENT INTERVENTIONS IN INDIA** *NISHA BHARTI*	118
24.	**TRENDS AND PATTERNS OF FDI IN INDIA: AN ANALYSIS** *PRADEEP*	126
25.	**THE NEW CONSOLIDATED FDI POLICY 2011: WHETHER IGNORING SOMETHING IN ITS DRIVE TOWARDS BOOSTING INVESTOR CONFIDENCE?** *VAIBHAV CHOUDHARY & DEEKSHA CHAUDHARY*	131
	REQUEST FOR FEEDBACK	134

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MICROFINANCE FOR SMEs: PROSPECTS, CHALLENGES & IMPLICATION

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ABSTRACT

*Small and Medium Enterprises (SMEs) are a major contributor to the GDP of any country in general and developing countries in particular. SMEs are rather even larger contributor to exports and employment. Their role gets magnified in a developing country like India, where they are the catalyst of growth, with a significant contribution to the manufacturing and service sector. In developing countries, commercial banks mainly have provided loans to Small and Medium Enterprises (SMEs), wherein most of these loans are given to enterprises that have a relatively solid bottom line and sufficient financial data. On top of this, collateral is required for these loans in principal. Therefore, this type of loans is only available to some of the higher-performing SMEs. Whereas, there is another financial system: **"Microfinance."** Its targets are not only poor and low-income groups but also micro enterprises. Microfinance has such features as non-collateral loans and mutual guarantee by each group. Hence, there exists a "financial gap" that is not covered by two financial systems. The enterprises, which belong to this gap, have a potential to grow their businesses and create employment, even though they are small in size. Because of the lack of collateral and financial data, SMEs have difficulties in raising funds from commercial banks. Meanwhile, they face a dilemma in that microfinance loans are not enough to meet their capital demand. As a result, they are forced to raise funds from informal finance such as the loans shark or relatives borrowings. This paper aims to highlight the Prospects, Challenges and Implications of scaling up microfinance to SMEs with detailed analysis of the financial gap.*

KEYWORDS

Microfinance, SME, GDP, Employment.

INTRODUCTION

The advantage for a Micro Finance Institution (MFIs) is that it's committed to that particular segment - that the staff are trained up, they are used to dealing with borrowers who do not have financial information and records. Whereas, the disadvantage is that firstly the products are designed really for the alleviation of poverty and really for the micro and small entrepreneur just going into business. It's not for the formal business as such. Secondly, for the organizational structure, the financial structure is set and this makes it slightly difficult to expand its products and services. Small businesses need a variety of financial products whereas the Micro Financial Institutions (MFIs) are normally offering one or a few limited financial products. For example, small business may need to finance fixed investment which needs longer term maturity, it may need a gestation period before a project can generate cash flow, it may need different forms of services, not only working capital but letters of credit, it may need equity as well. These products are quite often produced by the Larger Financial Institutions (LFIs). But the problem with them is that they feel small business lending is risky and hence it incurs high cost to serve them.

For the Micro Finance Institutions (MFIs) to enter the segment of customization of small business segment, it's clear that one needs a new organization setup, whether it is a division or a department. Experience shows, including from the leading MFIs, that one can't just do that in the existing structure. It's better to produce a new structure of some kind so that there is a different financial structure. Also there is a need for long term financing. Apart from this there also is a need for an equity structure in a financing institution which could provide small business lending. Different skills are henceforth needed for these activities. Thus, one can also visualize to have a hybrid structure. It could be - at the lower level, just formal financing institution providing line of credit to a microfinancing institution or a joint venture. And many of these combinations have been tried and experienced in most of the developed countries.

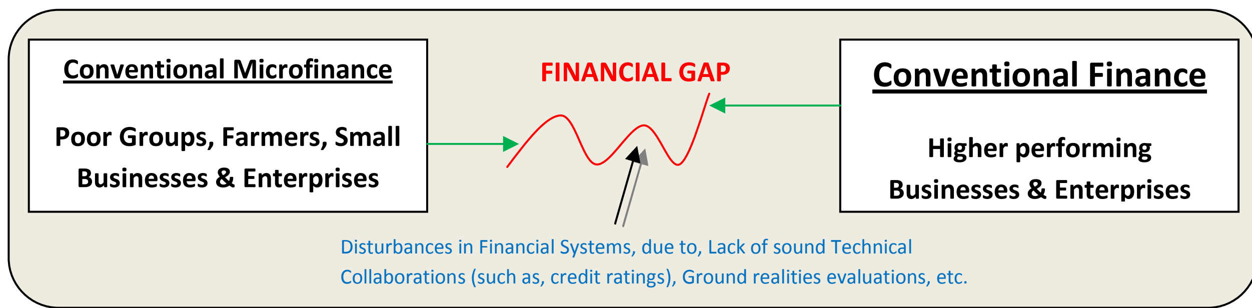
Thus, one can easily visualize a "financial gap" that is not covered by the above mentioned financial systems – Conventional Financial System for Loans Disbursement & Microfinance. Though both these systems work quite satisfactorily with Large Enterprises (LEs), but ironically most try to use the same techniques for SMEs as well, this is the main cause of underutilization of the resources for mobilizing the growth of SMEs. This area of the financial gap, have a potential to for those enterprises which have the lack of collateral and financial data, which makes them defunct in raising funds from commercial banks thus they are not able to grow / expand their businesses and create employment. Meanwhile, they face a dilemma in that microfinance loans are not enough to meet their capital demand. As a result, they are forced to raise funds from informal finance such as the loans shark or relatives borrowings.

Thus a new financing institutions needs to be set up for the purpose.

RECOGNIZING FINANCIAL GAP AS A PROBLEM

The model that has been proposed is one of the mixed finance model which is a combination of equity, quasi-equity and loan. The key to this proposed model is that there exist a number of financial instruments, not just a lending instrument and all is done in *synergy*. Along with the proposed model, technical assistance is also required which may prove to be a vital key for the filling-up of the financial gap. In order to cover the financial gap, the proposed model would prove to be an asset, especially in Indian concept, as it also takes into account the socio-political & socio-technical environments into consideration. Let us name this system as '**M- Microfinance'**.

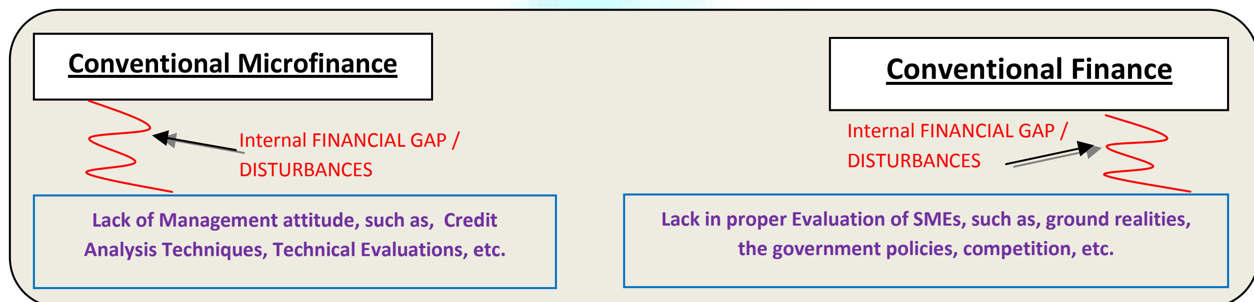
Most developing countries in general and India in particular un-doughtily foster that SMEs are essential to realize sustainable economic growth. In this context, the proposed model '*M-Microfinance*' could be a powerful tool for achieving this aim.



Why hasn't SME finance been conducted widely before in developing counties? Although there are various reasons, the most common is the lack of credit analysis techniques for SMEs as well as misunderstanding the concept for different requirements for LEs & SMEs. This and many other reasons shall be elaborated further in this paper.

DISTURBANCES IN CONVENTIONAL MICROFINANCE & SMES FINANCING

Generally, we're thinking in terms of SME Financing or more generally in terms of ***SME Development Strategy***.



(A.1) THE SCALING UP/DOWN CONCEPT AS A DISTURBANCE REMOVAL STRATEGY

The very question that poses into the mind is that whether SME financing is merely a scaled up activity or not. And when we talk of scaling up MFI financing into SME financing, obviously one has in mind whatever is happening in the MFI experience in terms of scaling up which largely amounts to increasing the size of loans to its borrowers, other than few other elements in it also. Whether that's what we really mean, venturing into basically scaling up into aggressive SMEs. Is that all to SME financing or not?

Then there's the second question, can SME financing be meaningfully continued in the existing manner? Can it be provided without provisioning of non-financial services? Then what really is SMEs? That is, how can one conceptualize the ideas about SMEs since there are historical perceptions about what SMEs are, there are legal definitions of what SMEs are. So how can one clearly identify what really we mean by SMEs when we talk about scaling up, or scaling down of the operations of the commercial banks into addressing SME sectors. What is the right delivery mechanism to address these SMEs?

Now, one could pose it as scaling up of MFI operations into addressing SMEs. Alternatively, one could see it as commercial banks scaling down their operations and trying to reach out the smaller segment in the market with smaller sized loans with some additional supervision and other advisory services attached to that kind of financing.

Historically in the seventies, sixties even, the developed countries had experience with development FIs on trying to channel finance to develop the industrial sector which largely is acknowledged to have failed. But in the meantime there even have been successful stories over the two decades or more with MFI lending. And increasingly most economists are now talking about scaling up of MFIs. Several rationales which economists normally associate with arguments for scaling up is nominal value of loan size increase with inflation.

The rationale of scaling up can be better understood if one goes back into the conventional notion of what tends to associate with scaling up. Obviously this whole issue of scaling up, the rationale did never actually address the issue of addressing the SME sector for justifying why MFI sector has to scale up its size of loans and the other activities. And if one looks into the historical perspective in terms of what went wrong, it is worthwhile to mention here the development financial institutions dealing with large scale lending to industries which largely had failed.

Thus, if one moves into SME units for scaling up, and if one uses that term "scaling up" what it involves is two aspects. One is on scaling up does address different groups of clients who obviously have different kinds of demand for loan services, and for different reasons. So often one have to associate those things with different kinds of non-financial packages. At the same time, on the supply side, the management-staff who are acquainted with dealing with small sized loans and those who deal with large sized loans differ in skill.

So, on both sides, there are reasons for packaging different things for addressing different sizes of loan. And one can't just say that within the same program, by just merely scaling up, we can achieve what we want to in terms of addressing the SMEs. So scaling up seems to be a bit of a misnomer if one uses it in the context of SME financing.

Thus, one ought to recognize that historically on one hand; commercial banks can come up with innovations to address groups who require smaller size loans with supervision. And on the other hand, there is a requirement of moving up from micro credits to micro enterprise and then to SME units.

One possibly ought to recognize that these two trends, up-scaling and down-scaling are in progress and one has to choose these somewhere in between. And depending on the specific experience of a country, one ought to pick up which side it should be tilted. Should it borrow more from the institutional arrangements and experiences of the MFIs or should it borrow more from the larger corporate banking or commercial banking sector. This is possibly something where no straitjacket solution can be given. It should depend on each individual country's own experience and the state of institutional development that the country is in.

As a case for a micro based approach, the core elements of a successful micro lending program can be applied to SME lending operations because underlying problems in such a case is that of lack of reliable information, lack of collateral and difficulty of inputs in contracts. But choice between a bottom-up approach, upgrading an NGO into a formal financial institution and a top-down approach, which is downscaling operations of commercial banks, seems to be a solution.

The second part within the context of SMEs is, that of the MFIs which have gone beyond lending operations. Lending itself is an enterprise activity which has enabled the MFIs to develop the managerial capacity at a very micro level. At even the smaller administrative level, you have local MFIs who have that capacity now. And for their own sustenance, many of these MFIs have engaged in commercial activities which are, in many contexts, linked up with the welfare of the clients they deal with. Either in terms of the marketing of their products or bringing in things from outside to provide or to create the extension services.

Now that has given them an edge in certain areas over an individually run private sector enterprise. It is possibly time to think whether we start acknowledging that some of these microfinancing institutions are effectively SMEs who also deserve to be supported in terms of bank financing.

Then the third element is, to avoid the issue of choice of delivery mechanism but a public investment in certain areas is critical. One thing is to ensure that the markets developed by developing the providers of the non financial services. But beyond that, there has to be some public investment in certain areas like information infrastructure, the financial infrastructure also and that has to be take care of.

Lastly, interest rate has been a thorny issue in the area of MFIs. And if one has to address the SMEs, it is very likely that the operational cost will increase by some proportion. It'll be more than what it is under the MFI sector. What that means is in order to recoup that, you ought to raise the interest rate that you charged your clients. But at the same time we have a situation where SMEs may need equity funding where it's a long term financing which normally one is encouraged to engage in if the interest rate is low. I mean there are rationales for that.

So there is a dilemma here. One possible area which can resolve this is to include that part of the cost in the project cost rather than try to recover that from the interest rate.

(a.2) Sustainability Concept (or Removal of Ground Realities / Limiting Factors) as a Disturbance Removal Strategy

The key issues that limit the expansion of the existent financial service particularly in developing countries like India is that there is still low financial intermediation in general and in rural areas of India in particular? Main reason is that in such areas of India, there exists manifest structural problems of market failures and absence of markets as well as low attention to research and innovation to alleviate problems discussed in above paragraphs. So the following paragraphs will highlight on these ever-present challenges in expanding financial services, as they apply in developing countries in general and India in particular.

1. ***Market Failure:*** According to basic economic theory, credit can be traded through competitive markets where supply and demand forces interact like any other tradable goods. In the absence of externalities, and if these markets are left to operate freely, competitive markets tend to reach a state of equilibrium (Garson, 1999, p.26). But credit is a special good because it requires repayment, and repayment is not always made by borrowers. There always exist asymmetric information between lenders and borrowers which creates problems of adverse selection and moral hazard – the classic principal-agent problem (Yaron, 2005). However, when loans are relatively sizable, borrowers can usually offer traditional collateral that can conveniently be repossessed in a case of default. Also, when individuals' credit history can be easily and cheaply presented and the legal, judicial and enforcement function effectively, as is the case in most developed countries, the problem of the asymmetric information on the volume and cost of financial intermediation can be effectively mitigated. In contrast, in many developing countries in general, and in poorer ones in particular, most of the instruments that can mitigate asymmetric information do not exist or perform poorly.
2. ***Absence of Markets:*** Yet, in rural areas of developing countries in general and India in particular, the "market failure" paradigm simply cannot be applied because in many areas there is no (formal) market at all: supply and demand cannot meet. Supply is weak or missing - very few banks and other financial providers operate. There is little lending activity and no savings mobilization, mainly due to the high transaction cost involved. For many other reasons e.g. accessibility - hence transaction cost for the other party, cultural specificities, etc., there is little or no explicit demand for financial services (from formal markets). All sorts of financial transactions are concluded at the village level. Money is borrowed or lent by individuals and households, hoarded or saved at home, in Rotating Savings and Credit Associations, Social Insurance Systems, etc, or the Individual Money Lender.

The problem is further exacerbated in India because of low attention accorded to innovation in new methodologies. Such innovation in new methodologies and information, is fundamentally a public-good, in the sense that it is non-rival in consumption and non-excludable. Such goods are undersupplied in a competitive equilibrium. Thus, financial intermediaries in India, on top of their weak capacity, have low incentive for investing on such innovations since while they will bear all the costs on such efforts, it is often difficult to prevent others who will NOT share the research cost from adopting the new technology once it has proven successful. Absence of alternative methodologies further limit outreach financial services.

[*The logic behind the government role in innovations on new financial methodologies with a view to sustainably expanding outreach to the poor (Fernando, 2006) is presented in the ANNEXTURE-I*].

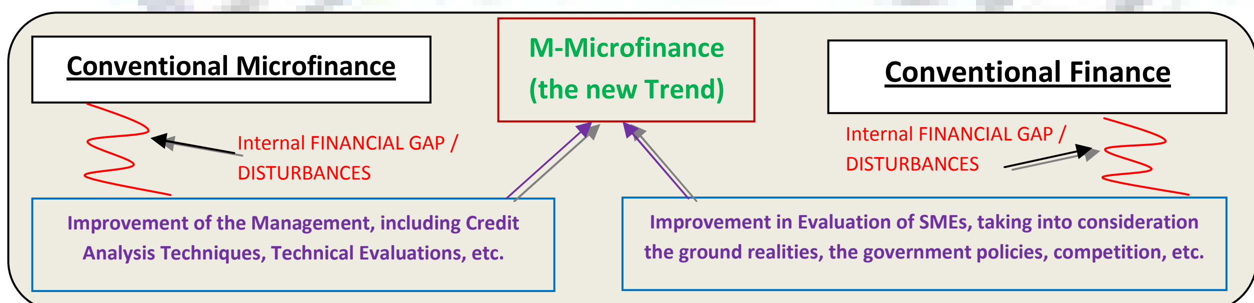
A micro-financial program, whether formal or informal, is said to be sustainable if it can pursue its activities and provide the required services in a "continuous" and objective oriented manner (Garson, 1999). Sustainability is therefore a primary issue for successful micro finance services. In seeking to achieve sustainability in financial intermediation and financial market development, consideration has to be given to the sustainability of the lender, the intermediate institution, the depositor, the borrower and the sector as a whole. If borrowers become chronically indebted, nothing else can be sustained. If savings cannot be mobilized on a consistent and continuing basis, there will not be resources to lend. If the lenders do not recover all the money they lend, they will soon cease to exist. If a financial intermediary cannot fully recover the cost of mobilizing recourses (money cost - interest paid to depositors, plus administrative costs of intermediation), the institution will soon have to shut its doors.

This, paper will try to explore factors affecting institutional sustainability focusing on microcredit interest rate, which not only plays a pivotal role in determining institutional sustainability, but also reflects on other dimensions of institutional efficiency. The key issue is that while there is a general consensus on the 'components' that should go into the computation of interest rate to be charged by a micro-credit service provider, the 'level' under each component is left to be fixed by each actor. This gives rise to various applications, which often is a cause for high level controversies. Clarity and 'consensus' around this very issue will help practitioners, supervisors, government, donors, NGOs, and other stakeholders to identify those practitioners which are on the right truck in pursuing this desirable objective, galvanize support towards them, as well as monitor and evaluate their progress.

THE PROPOSED MODEL (M – MICROFINANCE)

The recognition of the "financial gap" described above, has now been globally recognized and many agencies are presently customizing their activities of SME Micro-financing, depending upon the ground realities. This concept has been possible because the related agencies are now able to evaluate their actions & policies by taking into account the following points:

- ✓ That recently, there has been a new trend, called "commercialization" in microfinance.
- ✓ That, the goal of is to create a new style of microfinance that can raise funds from the financial market, and operate sustainably on its profits; in other words, to build a new style of microfinance on a commercial base.
- ✓ That, the Financial Institutions (FIs) are required to enhance fiscal soundness, transparency and governance. In terms of financing, they are required to set appropriate loan interest rates so that a profit can be obtained, to select customers capable of paying the interest, and to conduct exacting credit analysis.



In fact, similar trend can be observed in current scenarios in Japan, which requires the banks to improve their "keen eyes for SMEs." This says that banks in Japan should provide loans to MSEs, which have had difficulty in raising funds until now, by getting rid of collateral dependent loans, and by evaluating the SMEs precisely through managers' personality and ability.

CRITICAL ANALYSIS OF PROPOSED MODEL (M – MICROFINANCE)

Therefore, the new style as discussed in the above paragraphs for 'microfinance', turns its focus toward the "financial gap." In other words, by conducting appropriate credit analysis, microfinance tries to extend loans to SMEs, which are operating their businesses actively even though they don't have enough assets for collateral and sufficient financial data. Thus, we may say that the area of the "financial gap" seems to be drawn attention from both the financial systems, that is, Microfinance and Conventional SME Finance.

As outlined in the above paragraphs of this paper, sustainability is a primary issue for successful microfinance services. Establishing a system of sustained provision of modern financial services has, however, been challenging and most controversial. The sustainability of financial intermediation obviously depend on the operational locations, the infrastructure, the economic conditions, the technology level, the credit culture of the society, the efficiency of the Institution, etc. These all are reflected in the amount of interest that need to be charged from credit clients as well as the one that can be paid to depositors. Now let us assesses the different factors that go into setting the 'desirable' level of microcredit interest that can sustain the provision financial services in desired rural areas thereby lessening the financial gap and provide sustainability to the microfinance services.

Any lender has costs comprising four basic components which (should) determine the interest rate charged:

1. ***Cost of funds*** – The cost of funds is usually a composite figure as any lender is likely to be utilizing funds from a variety of sources that have been obtained at different rates. For example, many NGO-MFIs will have donor capital that has been provided in the form of a grant. They will also, hopefully, have built up some surplus income or equity from their own operations. Whilst there is no interest as such to be charged on these two sources of equity, account should be taken of the rate of inflation in order to maintain its 'real' value. In some cases an MFI will have funds from a foundation or trust which has provided 'patient capital'. Finally there will be loans from lending institutions, notably the commercial banks. The average cost of funds depends therefore both on what proportion of an MFI's resources come from all these different sources, and also what rates of interest are being paid (or should be charged) on each source.
2. ***Operating or Processing costs*** – Operating costs are relatively straightforward, and represent an important portion in the cost structure of the microfinance service. According to a recent study of 1003 MFIs in 84 countries by the Microfinance Information Exchange, Inc in 2006,

operating expenses (both personnel and administrative) represented 62 percent of charges to borrowers, financial expenses 23 percent, profits 10 percent, and losses from defaults 5 percent (Gonzalez, 2007). They include the costs of: staff identifying clients, checking their creditworthiness, processing loan applications, disbursing loans, monitoring and collecting repayments, and following up non-repayments. In addition there are also all the overheads in running any operation: the costs of the space occupied, communications, transport, support staff, auditors, etc, etc. However, the percentage cost of lending will vary enormously depending on a number of factors, notably:

- ✓ the size of the actual loans;
- ✓ pay structure, notably of the loan officers;
- ✓ the efficiency of the organization, the number of borrowers/loan officer often being taken as a good indicator; and
- ✓ it's scale of operations.

The loan size is the primary reason why the processing costs of micro-loans to poor customers are so much higher than the costs of much larger loans made by commercial banks to their business clients. Delivering low value financial transactions (credit & savings) entail relatively high fixed cost per Rupee value outstanding of credit or savings. This is the most common reason why so many observers of the microfinance sector cannot understand why MFIs have to charge a higher rate of interest than commercial banks.

3. ***Cost of risk or loan losses*** – The cost of risk or loan losses may also vary considerably. Almost all lending institutions make a standard provision for loan losses at the time of disbursement – it is usually 2% of disbursements. This goes into the loan loss reserve and at regular intervals the actual loan losses, and whatever proportion of poor-performing loans are judged to be irrecoverable, are written off against this reserve. A well managed institution which carefully selects and then closely monitors repayments by its customers will have to write off only a small proportion of its loans, say 1-2%. One which is poorly managed and/or lending to customers who either do not have the resources to repay their loans, or who refuse to do so, possibly for political reasons, will suffer much higher loan losses, say 10-30% p.a.
4. ***Net income, surplus or profit*** – Finally, there is the net income or surplus, often misunderstood, especially if the word 'profit' is used. Generating some surplus income is essential for a number of reasons.

First, all financial organizations must have some reserves against unforeseen contingencies and demands (which is why banking laws always specify a minimum capital adequacy ratio for any regulated financial institution). In similar manner, every NGO-MFI must be looking to generate a surplus in order to cover itself against various contingencies: natural disasters when customers in the affected area lose all their assets and therefore ability to repay; opening up a new line of credit for existing or new customers which is very unlikely to be wholly funded by donors, loans from banks, etc; unforeseen high loan losses not covered by the loan loss reserve; and losses which occur through internal fraud, embezzlement, etc.

Second, many NGO-MFIs may want to finance, at least in part, their social programmes, notably health and primary education. If sufficient net surplus can be generated from their microfinance operations, then this reduces their dependency on donor or government funds which has obvious benefits. Indeed many NGOs have initiated microfinance operations as a later activity, precisely in order to help fund their social programmes.

Third, it should also be noted, however, that in those countries which have introduced legislation for MFI banks, there is another powerful reason for such MFIs to build up their equity base through retained earnings. This strengthens their capacity both to leverage that equity with bank loans and also, if the return on the equity is good, to attract additional equity. In both cases, the MFI can then expand its activities and serve a greater number of clients.

Fourth, when an MFI is looking to expand or improve its systems in pursuit of providing sustainable services as is often the case, then these costs have to be met from somewhere. Unless these costs are covered by a donor, or a grant, they have to be met from the accumulated surplus that an MFI has built up from the total interest rate paid by customers net of the costs. Expanding outreach to those who are still unreached, as well as sustaining the service for future-generation poor is most desirable social objective. Indeed, more recent arguments on the contribution of microfinance on enhancing social welfare, focuses on the net increase in total 'social welfare' over and above the 'benefit to (private) customer' that result from consumption of financial services. The net social benefit is determined by the 'depth', 'breadth', and 'length' of outreach. Depth of outreach matters because society places greater value on helping the poor people than the better-off; breadth of outreach matters because society values helping more people than fewer people; finally, length of outreach matters, because society cares about the poor both now and in the future. Other things remaining equal, the greater the depth, breadth, and length of outreach, the greater the net social benefit (Woller and Schreiner, 2004).

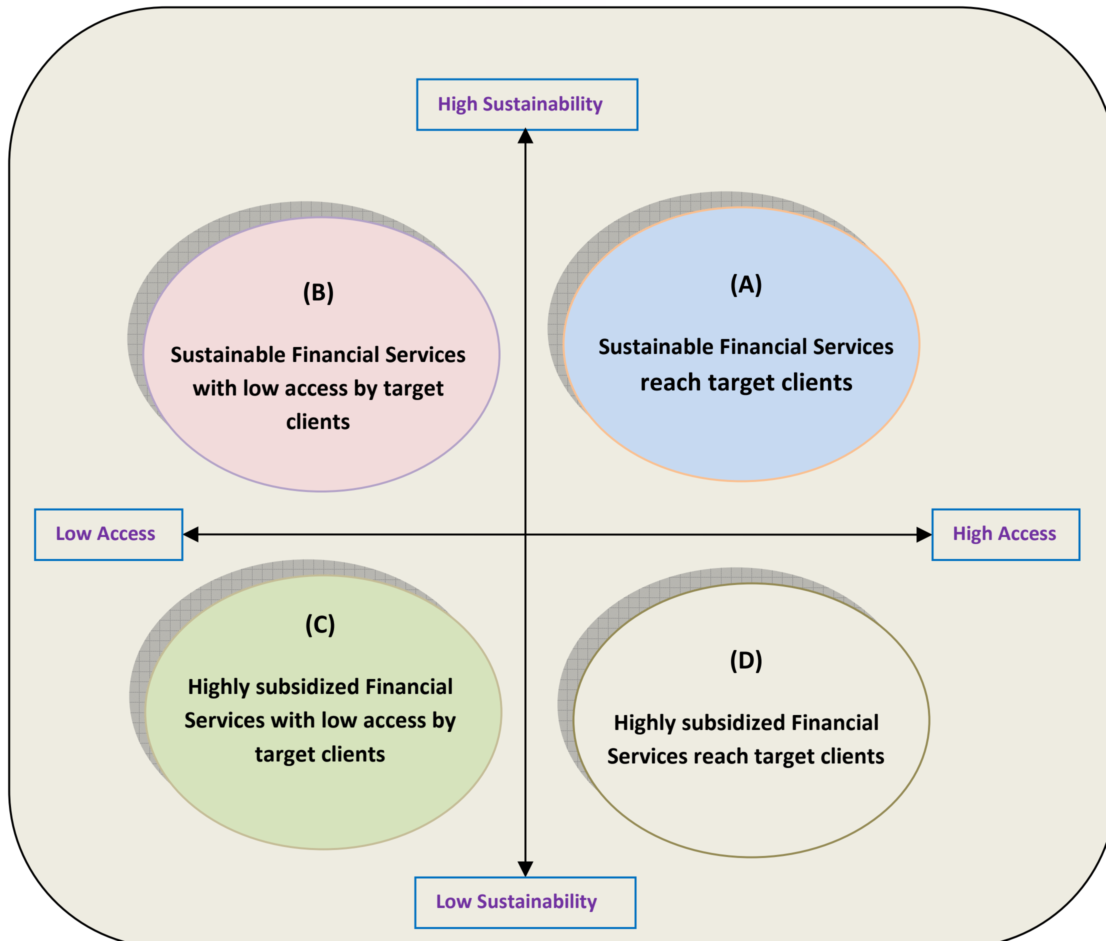
Thus, the ability to survive without looking for donations or other subsidies matter for sustainability – first, for the poor to get out of poverty, they require sustained microenterprise services like credit; second, the bulk of the poor people who are still out of the reach of any modern financial services need to be reached; and finally, the 'future poor' need to be taken account of in any policy decision on (current) resource allocation. Thus the length of outreach matters very much. This requires ensuring both full repayment and profitability. The latter – profitability – is perhaps the most controversial issue in the industry. While there is a general consensus on the 'components' that should go into the computation of interest rate to be charged by a micro-credit service provider, the 'level' under each component - hence the level of institutional 'profitability'- is left to be fixed by each actor. In particular, given the few choices for alternative sources of finance for the rural areas, and their weak bargaining power, there is a growing consensus that there should be a checking mechanism to monitor how service providers, working in diverse geographic and economic circumstances, are setting their microcredit interest.

CHALLENGES TO ESTABLISH THE PROPOSED MODEL

In countries like India there are three key challenges to establishing the proposed M-Microfinance System, which are,

- ✓ related to the incentive problem in organizations;
- ✓ charity-oriented credit programmes; and
- ✓ the problem of (Mis)Targeting

The reality is that the poor people do not necessarily lack business skills and are not looking only for charity hand-outs, as is often assumed. They are not passive recipients of money transferred from other segments of the economy in a top-down approach. Rather, they need to be empowered to create their own jobs and enhance private income and, in fact, they are too proud to look for charity! They only lack the opportunity for income generation and employment. Such service providers may be troubled by taking money from current clients to help 'future' clients. But such approaches based on higher subsidies can exhaust resources (which are in scarce supply) on current projects and the current poor, and lack sustainability as shown on Quadrant C and D of the Chart below. [*The detailed reference Johnson, Suzan, Markku Malkamaki, and Kuria Wanjau (2005) for the presented chart is presented in ANNEXURE-II*].



The micro-credit industry has sought to resolve the tensions between a focus on (current) poverty and a commitment to sustainability by integrating them within a matrix defined by two axes, or outreach (or access) and financial sustainability. The formal financial sector (e.g. commercial banks) may achieve financial sustainability, but has little outreach to poor clients (Quadrant B). Traditional efforts by nongovernmental organizations (NGOs) may reach poor clients, but are often unsustainable (Quadrant D and C). Good microfinance practice, on the other hand, combines both outreach and sustainability in the virtuous Quadrant A.

CONCLUSION

It is of utmost requirement that such a trend shall prove to be a success only if:

- ✓ It supports well-defined credit analysis techniques and those too supporting SMEs for a long time.
- ✓ It should not focus on only financial figures, but instead should understand actual conditions of SMEs by a careful look at each customer, and deal with their operations systematically & efficiently.

The need for sustainable financial services is very clear. How to realize this desirable objective is a bit controversial. As we have seen, the first option would be to let the market decide on such items like the microcredit interest rate and the clients to judge for themselves. One may even argue that it is better if the poor can access finance even if they pay higher interest rate – i.e., if the alternative is NOT having the access at all''. Since the poor are fully repaying and coming back for repeated loans, this means that, under the given circumstances, they 'value' the service and have the real demand. However, borrowers should not have to pay high interest rates to cover a program's inefficiencies. Because most microenterprise credit programmes operate in an environment with little direct competition, and in circumstances where poor clients are not organized to voice out issues affecting them, first of all such programmes must challenge themselves to control their costs, provide efficient services, and become self-sufficient. This, however, is not often happening and therefore calls for a new approach to certification for microfinance service providers. Mechanisms should be in place to check that the MFI is working at the "desirable", that is, what is the benchmark? level of efficiency.

Lastly, to conclude with it is very important on the part of the Government to provide a conducive environment for a sustainable microfinance. And these roles can be summarized as:

- ✓ Monitoring market distortions, capacity development to MFIs;
- ✓ Rural infrastructure;
- ✓ Expand Credit Analysis Service; and
- ✓ Support Innovation in Financial Services

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ANNEXURES

ANNEXTURE - I

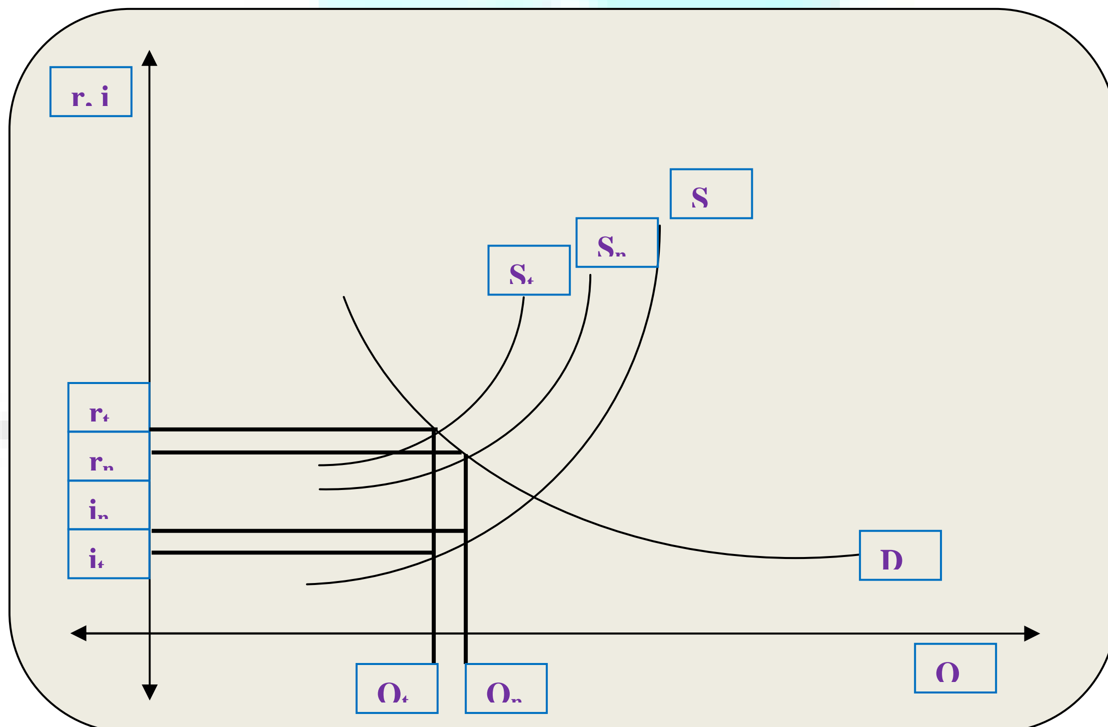

Figure : Impact of Operating Costs on the Supply of and Demand for Microcredit

Source: *Fernando, A. Nimal* (2006): Understanding and Dealing with High Interest Rates on Microcredit, A Note to Policy Makers in the Asia and Pacific Regions, Asian Development Bank

KEY

Horizontal axis: measures the quantity of lending or borrowing per unit of time.
Vertical axis: measures the interest rate (**r**) borrowers pay and gross return (**i**) lenders receive.
D: is the demand curve that measures the economy's demand for microcredit.
S: is the supply curve that measures the industry's supply of microcredit, if there were no lender operating cost.
S_t: is the industry's supply of curve of microcredit with operating costs.

- At this initial level of operating costs, borrowers pay an interest rate of r_t
- And the lenders' gross return after deducting operating cost is it
- The quantity borrowed (lent) is Q_t.
- Now assume that lender operating costs are reduced through some innovations and improvements in financial infrastructure. And this shifts the supply curve to S_n.
- Now the amount of microcredit lent (the amount of microcredit borrowed) increases from Q_t to Q_n and the gross return to lenders increases from it to i_n.
- And the interest rate to borrowers declines from r_t to r_n.

ANNEXTURE - II

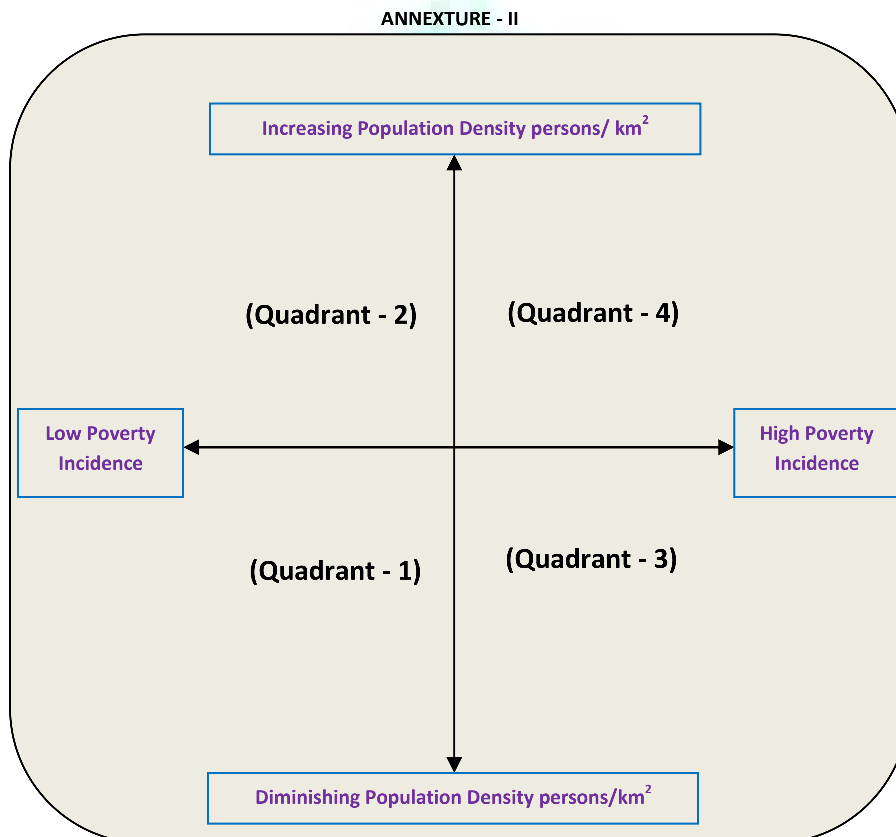

Figure : Defining Factors of Microfinance Credit Services Delivery

[**Source:** *Johnson, Suzan, Markku Malkamaki, and Kuria Wanjau* (2005): Tackling the 'frontiers' of Microfinance in Kenya: the role for decentralized services. Decentralized Financial Services, Nairobi, Kenya.]

In order to consider where the frontier of sustainable Microfinance Credit Service delivery currently lies, this paper uses two dimensions to guide the coverage: ***Population Density*** **and** ***Poverty Incidence***. *Lower population density relates to high transactions costs on both the supply and demand sides. Higher poverty incidence implies smaller transaction sizes on the demand side.*

Quadrant – 1: present the most promising environments for the purposes of sustainable financial service delivery, with high population density areas with low poverty incidence

Quadrant – 2: offers high population density and higher poverty incidence, so that transactions costs related to distances are lower, but providers are likely to encounter lower transactions sizes and the weaker economic environment in such areas is also likely to make productive investments more risky.

Quadrant – 3: reflects areas of low population density but low poverty incidence: the service delivery problem here is also less severe if transactions sizes are high enough and risks sufficiently diversified, that is, through investments in a range of sectors including manufacturing, trade and services and not solely agriculture.

Quadrant – 4: reflects the most extreme cases of high poverty incidence and low population density and hence the most challenging environment for service delivery.

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