

Old and New Worlds of Microfinance in Europe and Asia
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1. Is microfinance a new solution for poor people in newly developing countries?

Microfinance is not a recent development. Every now developed country and some developing countries have a long history of microfinance. Yet, many associate microfinance with credit NGOs and recent origins in Bangladesh. We first take a look at the microfinance history of two European countries, Ireland and Germany, for several reasons: attributing the origin of microfinance to recent initiatives misses the historical depth and scale of microfinance, and the chance of learning from trial and error; (ii) self-help and informal finance were at the origin of microfinance in Europe; conducive policies created an environment in which informal beginnings evolved into networks of local financial institutions, now part of the banking system – presenting a vision to those thinking that microfinance might be a poor solution for poor countries, to be replaced by commercial banks as development takes off. Realizing how informal finance evolved into a major part of the banking system and contributed to poverty alleviation and development may induce policymakers, donors and researchers to take a fresh look at indigenous and informal finance in the developing world. Next we examine one segment of the variegated microfinance landscape in Indonesia: linkage banking, bridging the hiatus between formal and informal finance. Finally look at the long history of microfinance and indigenous banking in India, concluding with linkage banking, inspired by the Indonesian experience and adapted to a different environment.

2. Microfinance in Europe

The birth of microfinance in Europe dates back to tremendous increases in poverty since the sixteenth century. Microfinance in Europe evolved in response, from informal beginnings. From the onset, microfinance was powered by financial intermediation between microsavings and microcredit. Legal recognition, prudential regulation and effective supervision evolved in due course, leading to its mainstreaming as part of the formal sector.

The case of Ireland

The early history of microfinance in Ireland covers the period 1720 to 1950. It is the story of how self-help led to a financial innovation, legal backing and conducive regulation created a mass microfinance movement for the poor, and adverse regulation brought it down. The Irish loan funds emerged in the 1720s as charities, initially financed from donated resources and providing interest-free loans, but soon transformed into financial intermediaries. Loans were short-term and instalments weekly. Peer monitoring was used to enforce repayment. After a century of slow growth, a boom was initiated by two events: a special law in 1823, which authorized the funds to collect interest-bearing deposits and to charge interest on loans; and the establishment in 1836 of a Loan Fund Board for their regulation and supervision. By 1840, around 300 funds had emerged. The funds vigorously mobilized deposits, offering three times higher deposit rates than commercial banks, charging at the same time higher interest rates on loans. Financing their expansion from profits and deposits, their outreach eventually covered 20% of households in Ireland. Threatened by the competition, the commercial banks successfully lobbied for a law, passed in 1843, putting a cap on interest rates. The loan funds thus lost their competitive advantage, gradually declined during the second half of the nineteenth century, and finally disappeared in the 1950s.

The case of Germany

The story of microfinance in Germany, covering more than two centuries, is one of self-help, self-regulation and delegated supervision, which have created, relative to its population, the largest regulated microfinance sector of any country. It comprises two networks: community-owned savings funds, *Sparkassen*, and member-owned cooperatives. The community-owned financial institutions started during the second half of the 18th century. Having learned from the early Irish charities that charity is not sustainable and that there is a strong demand among the poor for safe deposit facilities, the first thrift society was established in Hamburg in 1778, followed by the first communal savings fund (*Sparkasse*) in 1801. As the movement spread, the influx of savings forced the savings funds to expand their credit business. The Prussian state responded with regulation, passing the first Prussian Savings Banks Decree in 1838. In 1884 they formed the German savings funds association.

The second microfinance movement started after the hunger year of 1846/47. Starvation was widespread; many peasants lost their farms to the moneylenders, and many small businesses went bankrupt. Two men are prominent among those who took action: Raiffeisen in rural areas, creating credit associations (*Darlehnskassen-Vereine*), later known as *Raiffeisenkassen*; and Schultze-Delitzsch in urban areas, establishing savings and credit cooperatives among small entrepreneurs, later turned into *Volksbanken*. In 1847, the movement had started with a charity established by Raiffeisen. He brought in grain from non-affected areas; and within a few months, this brought down the price of bread by 50 %. In 1850, Schultze-Delitzsch established the first urban credit association, insisting on self-help without charity from the beginning. Raiffeisen, realizing that charity did not lead to sustainable solutions, followed suit and established the first rural credit association in 1864. The initiatives gradually turned into a movement, but growth was slow, reaching about 245 rural cooperatives in the mid-1880s. The turn-around came in 1889, when a new law was passed for the credit associations, the Cooperative Act of the German Reich. Joint liability, which had kept back their growth, was replaced by limited liability. Until 1914, the number of cooperatives in Germany increased to more than 15,000 and spread to many other countries. In 1934 all financial institutions were brought under the banking law; but both networks adhered to their mission. Historically there have been three stages: informal beginnings with slow growth; regulation of MFIs as special financial institutions which led to rapid growth and worldwide dissemination; and consolidation under the banking law, turning them into universal banks. (Raiffeisen 1866; Seibel 2003; Steinwand 2001).

This has resulted in a financial sector dominated by these former microfinance institutions, which have continued serving households and small businesses. In 1997 the two networks comprised 39,000 branches, 75 million customers, 64% of all financial intermediation and 51.4% of all banking assets. Compared to the four big commercial banks, *small and local* is profitable. In 2002 pre-tax return on equity was 8.2% among savings banks, 9.2% among cooperative banks and -3.1% among the four big commercial banks.

Lessons to be learned in microfinance

Three centuries of microfinance in Europe have taught a number of lessons: Informal local initiatives based on self-help have a tremendous potential. Savings are their foundation and the essence of self-reliance, both of the household or small enterprise and of local financial organizations. The viability and sustainability of small enterprises (farm or non-farm) and of local financial institutions are intertwined: they rise and fall together. Continual access to financial services, particularly savings and credit, over long periods of time are crucial in poverty alleviation and economic development, which are both interrelated. Small local financial institutions have proven their ability of providing such services for generation after generation.

Three factors have been crucial: an appropriate legal framework, effective delegated supervision, and institutional self-reliance without government interference – there is no ministry of cooperatives! Beyond this, we have to be careful with generalizations: different European countries have taken different paths in microfinance. Germany has stuck to a multitude of local financial institutions; in Italy, they have established nation-wide branch networks; the Netherlands have created a centralized institution, Rabobank; France has its centralized *Crédit Agricole*; and Sweden has merged its savings and cooperative banks into a single national banking institution. There is no single *best practice* model.

Presenting experience from Europe is not meant as a proposal to replicate European models. Mechanical replication of success stories is bound to failure. Similarly, the replication of Raiffeisen banking has failed in many developing countries when usurped and perverted by the state. The history of errors, which are easier to replicate than successes, is yet to be written. Two such errors may be mentioned here, of interest to believers in *appropriate* interest rates and group lending, respectively: interest ceilings imposed in Ireland in 1843 undermined the competitiveness of the Irish Funds and eventually led to their extinction; joint and several liability was an effective collateral substitute in early credit associations in Germany, but proved an impediment to the further growth of loan sizes and the spread of institutions until in 1889.

3. Microfinance in Indonesia: the case of linkage banking

Origins of linkage banking

Microfinance has a much longer history in Asia than in Europe, though little is documented about the early history of indigenous institutions like *arisan* in Indonesia, *hui* in China, *chits* in India, or *paluwagan* in the Philippines, to name but a few (Seibel and Damachi 1982). Self-reliance, viability and sustainability have been identified as core institutional principles. Such informal institutions are still exceedingly widespread, but have generally failed to evolve as they did in Europe. Since the early 1900s when Westermann (1934) discovered the *sodyodyo*, a rotating savings and credit association in Togo, many have argued to build a modern financial system on indigenous foundations. At the time this found little interest. This began to change in the 1970s when commercial and development banks as well as cooperatives used as credit channels turned out to have failed delivering to the rural and urban masses. Assuming that poor people were too poor to save, credit NGOs ushered in what came to be known as the *microcredit revolution*; Grameen Banking, the delivery of credit through newly established small groups and standardized delivery schedules, became a model. Development banks and credit NGOs both had in common ignoring savings and financial intermediation, relying instead on capital transfer from abroad: *undermining rural development with cheap credit* (Adams et al. 1984) and *easy money* (Seibel 1994). As a result they lacked self-reliance and institutional sustainability; many still do.

In the early 1980s the poor performance of development finance created a climate of openness for innovations and a paradigm shift. As SHGs as informal financial intermediaries were still found to be ubiquitous, Seibel (University of Cologne) argued for their upgrading; Kropp (GTZ) and Mittendorf (FAO) pointed out they could only work with governmental and formal sector partners. The result was a hybrid model: *linking* formal and informal finance. This was to include *upgrading* of informal, and *downgrading* (*downscaling*) of formal financial institutions (Seibel 1985, 1996, 1997).

In Indonesia Bongartz (1989) had found up to 60 SHGs in a single village – indigenous, self-, government- or NGO-induced (see Holloh 1998: 37-45 for a more differentiated picture). Hence, there was no need to establish new groups. SHGs as local financial intermediaries of various types and sizes were to be brought into business relationships with banks as refinancing agencies. Terms and conditions, including interest rates, were to be determined by the business partners. Technical assistance was to set the process into motion. Capacity-

building services were to be provided by NGOs. No capital was to be transferred from abroad; there was enough liquidity in the banking sector.

Three models of institutional links were proposed, in a loose sequence: *Model 1 Indirect Linkages* while banks lacked confidence in informal SHGs: Banks–NGOs–SHGs–Members; *Model 2 Direct Linkages*: Banks–SHGs–Members, including NGOs as capacity-builders; *Model 3 Direct Access*: Banks–Individual clients. Avoiding a bank wagon effect, SHGs were to deposit savings in banks as partial collateral and to obtain repeat loans at an increasing ratio. SHGs would lend to their members on their own terms. All partners involved would cover their costs from the interest rate margin and generate a surplus. Group savings were to be the main source of loanable funds. However, as the SHGs were pre-existing, project emphasis was on access to bank credit, while internal savings were neither promoted nor monitored. (APRACA 1986; Kropp et al. 1989; Seibel and Parhusip 1990).

The development of linkage banking in Indonesia

In Asia linkage banking was taken up by APRACA, an association of agricultural and central banks, as of 1986 and disseminated among its members. Indonesia was first starting a pilot, 1988-91, serving as an experimental field station visited by member countries. The Philippines, Thailand and India followed with own projects. The project was guided by a task force of Bank Indonesia (BI), the central bank; Bank Rakyat Indonesia, a government-owned agricultural development bank; and Bina Swadaya, a leading NGO. Technical assistance was provided by GTZ, 1988-99. (Seibel 1996: 62-71)

Initial linkages were mostly mediated through NGOs, on-lending to the groups. Charging a margin of 5-10%, this greatly increased transaction costs. During the pilot phase, a growing number of banks and SHGs discovered that direct linkages, and direct selection of groups by banks, was more beneficial. As PHBK progressed, the number of NGOs involved greatly increased, while their direct involvement as lenders declined. There is a qualifier: with the passing of the BPR law, PHBK recommended to its NGO partners eager to maintain their own microfinance activities to convert into BPR-type banks, which Bina Swadaya and several others did, carrying out linkages under their new institutional roof.

GTZ-ProFI (2007) reports that since its inception PHBK facilitated linkages of 351 commercial bank branches and 998 People's Credit Banks (BPR) with 6,582 SHGs and 31,636 channelling groups who received 74,111 loans; 240 NGOs were involved. These are cumulative data; data at four points in time, between 1992 and 2003, are given in Table 1.

Table 1: Linkage banking in Indonesia, 1992-2003

	3/1992	3/1997	3/1999	6/2003
Commercial bank branches	33	211	218	111
People's Credit Banks (BPR)	11	225	667	552
NGOs	23	130	131	53
Savings & credit groups (SHGs)	698	2,016	1,312	647
Channelling groups	-	3,065	12,137	10,599
Group savings in banks (Rp bn)	0.3	3.7	10.8	20
Group savings in banks (US\$ mn)	0.15	1.54	1.23	2.42
Group loans outstanding (Rp bn)	1.9	24.3	71.7	70.5
Group loan outstanding (US\$ mn)	0.95	10.1	8.2	8.5
Bank savings to loans ratio	0.16	0.15	0.15	0.28
Long-term loss ratio (in percent)	6	4	3	2

Source: GTZ-ProFI 2007

During the pilot phase, the size of SHGs varied from 10 to 200, averaging around 45, but declined with a shift to channelling groups. Around 30,000 group members were involved as of 1992, and probably less than 400,000 as of 1999 (a fraction of the outreach of BRI's 4,000

BRI village units). Some BPR reportedly embraced linkage banking wholeheartedly. Eg, in Yogyakarta Province, as of Dec. 2005, 18 BPR served 1,051 SHGs with loans outstanding of US\$ 1.05m; 8 BPR, with an NPL ratio of 2%, accounted for 90% of the loan balance. Yet, as banks consider linkages their private business and are neither compelled nor particularly motivated to engage in voluntary reporting, actual outreach is likely to be greater. Moreover, transitions to Model 3, direct access of members to banking services, have not been monitored.

Critical perspectives

Several factors have to take into account when assessing PHBK. First, the program benefited from a conducive policy environment, starting with interest rate deregulation in 1983; the passing of a legal framework for microbanks (BPR) as regulated financial institutions in 1988, later the main partners in PHBK; banking deregulation in 1992 which facilitated branching; and the phasing-out of 30 out of 34 subsidized credit programs in 1990 (Seibel 1996: 17-23). Second, given the dismal performance of cooperatives (KUD), groups have suffered from the lack of an appropriate legal framework and remained informal; the draft microfinance law of 2001 seemed to offer a solution, but has been put on hold by the Ministry of Finance. Third, the Asian Financial Crisis affected the mandate of BI, the champion of PHBK, of engaging in activities other than monetary policy.

The most important factor, however, was internal: a change in policy from SHGs as self-reliant financial intermediaries to channelling groups as an outreach strategy of banks. In the eyes of this author, who is partial as he designed and implemented the original approach, this almost meant a return to a government program (BIMAS) of the 1970s. The new channelling approach differs from the old in some essential respects – the emphasis on market rates of interest, and the commercial interest of banks in group linkages; but it is similar in others – the neglect of savings mobilization and financial intermediation by the groups. Project documents say there were good reasons for the change: a declining interest of SHGs in bank linkages after a couple of cycles. I only doubt that the program would have been started by APRACA and the Indonesian task force in the 1980s as a channelling approach.

Crunching the numbers of data collected by PHBK during 1989-93, Holloh (1998) examined the internal dynamics of groups. He concluded: (1) Savings-driven groups outperform all other groups; when there is an unmet demand of members for credit, there are lasting effects of access to bank credit on the growth of these groups, also in terms of additional savings mobilization. (2) Equity-driven groups, funded through initial and compulsory regular savings, are substantially smaller, their growth is slow; benefits from access to bank credit are only temporary. (3) Groups without a solid equity or savings base either benefit little, or are even damaged, by bank credit.

Maurer (1998:223) offers a more general explanation of inconsistencies – correctly so, in my view –, pointing to an inherent conflict of objectives: between impact on target groups through credit disbursement, and institution building of SHGs as financial intermediaries. Indeed, one may either aim at a “linkage product... designed in a way that would attract banks... successful in facilitating finance to low-income-microentrepreneurs” (Steinwand 1997:63-64); or at strengthening SHGs as financial institutions in a systems perspective (Seibel 1996). In the original APRACA/GTZ design document, the two perspectives are reduced to a question of practicality: “It is the ultimate and long-range objective of such linkages to make the individual small enterprise bankable. In this case the individual may eventually gain direct access to a formal financial institution.” (Kropp et al., 1989:55).

Through dissemination, the Indonesian linkage banking pilot has entered the history of rural microfinance in a number of countries. It achieved its greatest depth and breadth of outreach in India.

4. Microfinance in India

Origins and early developments

The case of India shows that the origins of microfinance predate those reported above in Europe by two or three millennia. There are at least three strands of indigenous finance of historical depth in India: moneylenders, rotating chits and merchant bankers. The following may serve as an inducement to embark on historical research from a microfinance perspective.

Moneylenders, providing loans from their own resources, date back to prehistoric times. There was probably a long period of transition from gift-exchange, reciprocal lending and trading-cum-lending to specialized lending before the first millennium B.C. Moneylending became an organized and regulated profession in India 1700-2200 years ago. Moneylending is still widespread today, and remnants of its historical precedents are still in existence, re-emerging time and again according to demand. Many moneylenders have turned into merchant bankers, other into organizers of informal or formal chits.

Chits (chit funds, chitty, kuri or *cowry*) are widespread institutions of ancient origin in India; but the time of their origin is unknown. A number of people join together and regularly contribute equal amounts, allocated to one member at a time; a cycle ends when each participant had his turn. Conventionally allocation is either by lot, demonstrated need or in an agreed-upon sequence. Alternatively, as business opportunities increase, the allocation may be by auction to the lowest bidder, the balance being returned to the members. As chits grew and fraudulent pyramid schemes came up, the regulator stepped in. Starting with the Travancore Chit Act of 1945, they eventually came under the federal Chit Funds Act in 1982, regulating minimum capital, ceilings on aggregate chit amounts, and procedures of dispute settlement. This has greatly contributed to the growth of licensed chits. Yet large numbers of smaller, unregulated chits have remained, particularly in southern India.

Merchant banking evolved in India during the first millennium B.C. Merchant guilds, dealing in goods and money, appeared already in the Vedic scripts. Between 200 B.C. and 300 A.D. a differentiation took place between the guilds of moneylenders and traders, followed by the emergence of a guild of merchant bankers. Eventually they turned into hereditary castes; banking became a sub-caste of the traders' caste (*vaisya*). Regulation evolved during the first two centuries A.D. when a law code, *dharmashastras*, was written regulating loan deeds, law courts and debt procedures. Moneylending and banking became licensed and tax-paying professions. Usury became an issue of religious disputation, documented in *Manu*, an ancient text. "Reasonable" interest rates were agreed upon, such as 15% p.a. on secured loans. Interest rates on unsecured loans ranged from 2% p.m. on loans to a priest (*Brahman*) to 5% p.m. to a cultivator (*shudra*), supposedly reflecting different assessments of risk by caste. Payments in kind carried a substantially higher charge. Overdue loans were written off after 10 years. Social banking also existed, in the form of interest-free loans to the deserving. (Bhargava 1934; Schrader 1997)

Medieval India, from the mid-thirteenth century to the beginning of British rule during the eighteenth century, with its highly monetized economy was the heyday of indigenous banking. With domestic and international trade, merchant banking grew enormously, held by individual, joint family and partnership firms – all within the same *baniya* caste, differentiated into numerous sub-castes. Customers included European merchants and trading companies as well as artisans to produced goods on order. Some commercial interest rates on secured loans during the seventeenth century ranged from 0.5% to 1.25% p.m.; risky commercial credit fetched a flat rate of 40-60% per trade venture. The basic principle of merchant banking were mutual trust and benefit: in contrast to simultaneous rural finance.

Rural finance spread under the Delhi sultanate with the introduction of a system of land revenue, housing tax and cattle tax to be paid in cash. Land was abundant; but the payment of taxes in cash was difficult, forcing the peasants to produce for the market. This resulted in the overall commercialization of the rural economy and the expansion of trade. At the same time it created a new market for rural moneylenders advancing land revenue payments to peasants and merchant bankers financing trade. Indigenous banking in Mughal India, from the sixteenth to the eighteenth century, is described in detail by Schrader 1997. The urban population paid a mere 5% of their income in taxes, while land assessments in rural areas varied from one third to one half of the produce. Assessments of actual production were soon replaced by average pre-assessments, causing severe hardship during bad years. This created a class of rent-seekers, comprising tax collectors, moneylenders, landlords and unsalaried officials with rights to collect revenues; they kept about one quarter and transferred between one quarter and one third of the revenue to the government. Moneylending became part of everyday life in Indian villages. As rural indebtedness and the loss of land to moneylenders surged, rural finance turned into *usurious moneylending* of the worst kind. Peasants became serfs; they could not be displaced as long as the revenue was paid, but, if not, were punished by expropriation, bonded labor, enslavement or death. This led to a land reform-in-reverse: dispossessing the peasants and converting their rights of occupancy into alienable rights of tax collectors (*zamindari*).

In British India, microfinance and banking changed substantially, starting in 1757. The imposition of trade restrictions and the exclusion of Indian merchants from long-distance maritime trade led to a decline of indigenous trading and merchant banking. Interventionist policies such as the preferential importation of cloth from England dealt a death-blow to Indian textile manufacturing and the ancient commercial structure. However, this was followed by a rise in domestic trade and a shift to Bombay as the main centre of indigenous industry and banking. European finance confined itself largely to European enterprise. In rural areas, new legislation on land revenue collection, private property and land mortgaging and the transformation of subsistence agriculture into cash-crop production created new opportunities for moneylender, who could now enforce their claims in court. During the first half of the 20th century, rural indebtedness first increased, then was reigned in by legislation on moneylending, usury and tenancy; but this failed to prevent the rise of new types of lenders eager to acquire the land of their debtors. In the small and medium business sphere indigenous-style banking continued; the bankers' castes rose to new heights. In the sphere of big business they adopted Western banking by pooling their capital, establishing joint-stock companies or buying shares of banks.

Independent India: searching for new approaches to reach the rural poor

Upon independence India faced an underdeveloped rural economy and high levels of indebtedness. Since the 1950s the lack of rural development has been attributed to a lack of access to credit. Private banks were absent from rural areas; and informal finance was inadequate. 80% of the population lived in rural areas; 40% of GDP was contributed by agriculture; but only 2.2% of total credit went to agriculture, mostly to big farmers. No attempts were made to build on indigenous informal finance, despite the fact that, according to Reserve Bank of India findings, informal credit accounted for 90% of rural indebtedness in 1951 and 70% in 1971. The Union Government introduced three remedies in 1969: nationalizing 14 private banks (another six in 1980); the requirement to open two rural branches for every urban branch; and a mandatory system of priority sector lending.

A stocktaking in 1975 revealed that 10,882 rural and semi-urban branches had been opened; yet the poor still lacked access to credit. Rural branches of large commercial banks, be they private or public, apparently were no solution. Hence, the government introduced a new network of government-owned Regional Rural Banks (RRBs), with a minimum capital of \$250,000. More than 10,000 rural branches were established. Yet, according to the All-India Debt and Investment Survey in 1981, the problem persisted. After years of massive branch

expansion, policies of directing credit to the rural areas, massive self-employment programs, and large numbers of donor credit lines, among them over \$1 billion from the World Bank with the requirement to disburse at least 60% to small farmers, some 250 million of the rural poor still had no access to formal finance. The National Bank for Agriculture and Rural Development (NABARD), carved out of the central bank in 1982, analysed the reasons behind the failure of reaching the rural poor: a sole emphasis on production loans, prohibitive transaction costs for lenders and borrowers, failure to mobilize savings, and overly complicated procedures. The contradiction between a highly diversified rural financial infrastructure and lack of access of the rural masses to formal finance is paralleled by another contradiction: between an emphasis on institutional diversity and a lack of emphasis on institutional viability.

There are 97 commercial banks with 57,772 branches, 32,244 of them (56%) in rural areas, among them 27 state banks holding more than 80% of commercial banking assets. There are 196 RRBs with 11,944 rural outlets; and 115,000 rural cooperative outlets. The total number of rural outlets of the formal sector is thus around 160,000. The commercial banking sector has been the first to be reformed, followed by the regional rural banks which is still ongoing. Yet, according to a rural finance access survey conducted in 2003, over 70% of small farmers and landless have no deposit account; 87% have no access to formal credit.

Turning from the old to a new world of rural finance during the second half of the 1980s, NABARD argued that programs with the poor have to be savings-led and not credit-driven; and that the poor have to have a say in their design. In the years to come they looked for new partners, new delivery systems and new financial products. One of these new partners was MYRADA, one of now 700 credit NGOs, whose action research into *credit management groups* during 1985-88 was funded by NABARD. The study was based on a new paradigm: savings first. Three options were discussed, all hinging on prior savings by the groups: matching grants, matching interest-free loans, or loans with interest. In search for a sustainable solution, NABARD opted for the latter. (Seibel 2005)

Cooperative finance: replication gone astray

The financial cooperative sector is a major part of rural finance in India which dates back to 1892 when the Government of Madras Presidency felt inspired by the German Raiffeisen movement and recommended replication in India. In 1901 the Government of India accepted the proposal and in 1904 enacted the Co-operative Credit Societies Act, followed by the more comprehensive Co-operative Societies Act in 1912. This was to serve as a framework for promoting self-help among farmers and artisans. By the early 1930s some 50,000 savings and credit cooperatives had emerged: originally a self-help movement. In 1919, authority over cooperatives was transferred to the provinces. Impressed by the success of the cooperatives, the state stepped in; self-help and self-reliance were eventually replaced by well-meaning state interventions.

After independence, following the recommendations of the All India Rural Credit Committee in 1954 and the Committee of Co-operative Law in 1955, the states introduced "state partnership" in their cooperative laws, placing the cooperative sector under government control. The resulting laws were encumbered by the ideology of a planned economy, giving the state a dominant role in all institutions including cooperatives. Regulatory power was conferred to state governments in matters such as appointment of chief executives, suspension of elected boards of directors, compulsory fusion or fission of co-operative banks, amendment of bylaws, vetoing of bank decisions, issuing of directives, and supervision. The state cooperative administration was put in charge of registration, licensing, statutory inspections and audit of the cooperative banks. The states participate also in the ownership of cooperative institutions all levels down to primary societies. Bureaucracy, government intervention and loan channelling have replaced self-management and self-reliance.

The cooperative sector with short-term financial services now comprises 98,247 primary credit cooperatives with 100 million members; and 368 district cooperative banks with 12,652 branches, acting as federations of the primaries and providing wholesale and retail finance. Long-term finance is provided by 768 primary cooperative agricultural and rural development banks with 1,091 district branches and 13 million members; and 20 state banks with 887 branches. 30 state cooperative banks act as apex banks to the district banks and provide both short- and long-term finance. In addition there are 2,015 urban cooperative banks. Accounting for 69% of all rural retail outlets, the sector mobilizes 31% of rural savings and provides 57% of agricultural and 29% of investment credit. Yet, while outreach is large, efficiency is low. Loan recovery rates of district cooperative banks and primary societies are around 67% and substantially lower among the two providers of long-term credit (46% and 55%, respectively); the rates of loss-making institutions are 20% among state cooperative banks, 30% among district banks, 43% among primary societies, and 75% and 55%, respectively, among the two providers of term finance: primary and state cooperative banks. Following the reforms of the commercial and regional rural banking sectors, steps are now taken to reform the cooperative sector. (Hannover and Haberberger 2004) However, the plan of covering up to 90% of bad debts from government resources may be a recipe for disaster.

Linking formal and non-formal finance: a financial innovation

Reform of the regional rural and cooperative financial sectors is not seen as a solution for reaching some 250-300 million rural poor, impoverished by centuries of exploitation and dispossession. The trigger in a new search for rural financial innovations to reach the poor was an external event: the APRACA regional workshop in Nanjing, China, in May 1986, where GTZ presented the model of linking formal and nonformal finance, or banks and SHGs (Chapter 3). NABARD, one of the participants, coordinated a field study of SHGs in 1987, carried out by NGOs. SHGs without any link to an NGO, including the ubiquitous chits, were not included. Almost all the groups identified were of recent origin, emphasized self-help, were largely homogeneous in terms of caste and activity, built a common fund from very small regular savings and interest income, and lent to their members for periods of 1-3 months at 2-3% interest per month. Recovery of these loans was excellent, and an impact, however small, was felt, reaching from emergency assistance to release from bonded labor. While the groups preferred to remain informal, they shared basic features of formal bodies in terms of bookkeeping and management. Access to formal credit was virtually nonexistent. NABARD reported that NGOs had “played a commendable role in organising the rural poor into self-help groups and thereafter promoting their proper functioning.” Given the very low resource base of internally generated savings on the one hand and some notable exceptions of “effectively developed credit links between the target groups and banks”, the team thought it “desirable to consider development of flexible models of linkages appropriate for various situations” and asked “what types of pilot or action-research projects need to be developed for evolving appropriate linkage models.” (NABARD 1989: 53-58)

Meanwhile, PHBK had taken off in Indonesia, APRACA’s and GTZ’s first experimental station for linkage banking in Asia. Y.C. Nanda, general manager and later chairman of NABARD, visited the project several times, learning that the central bank had authorized its public and private banks to accept informal groups as customers and lend to them without physical collateral. Monitored and reported upon at APRACA meetings and international conventions, linkage banking attracted widespread attention: “Informal financial institutions have proved able to serve the household, agricultural, and microenterprise sectors on a sustained basis. Measures that link informal institutions to the formal financial system will improve that service and ensure a competitive environment.” (World Bank 1989; iv, 119) APRACA member institutions, including NABARD, were impressed.

Reviewing the situation of rural finance in India again in 1989, it was observed that most of the 196 Regional Rural Banks (RRBs) were loss-making and thus did not present a viable

solution. This led to a discussion in parliament about the feasibility of a Grameen Bank, following the model of Bangladesh, as a new national banking structure. On the basis of its own studies and exposure visits, NABARD instead argued for a different approach: using the existing infrastructure of banks and social organizations; being savings-driven rather than credit-led; using bank rather than donor resources in the provision of credit.

Between 1989 and 1991, NABARD (1991) entered into a policy dialogue with RBI to make preparations for a pilot project linking informal groups to banks. On 24 July 1991 RBI issued a circular to commercial banks (RPCD.No.Plan.BC.13/PL-09-22/90-91), advising them to actively participate in a non-mandatory pilot project, refinanced by NABARD. The groups were required to have been in existence for at least six months and to have actively promoted savings.

The pilot phase covered the period 1992-96. The banks noted a contradiction between a directive of the RBI of 27 December 1985, restricting the opening of savings accounts, and the circulars of RBI and NABARD authorizing bank linkages of informal groups: did the SHG banking circulars allow for savings accounts or just credit? This was decided in a circular (DBOD.No.BC.63/13:01:08/92-93) by RBI on January 4, 1993: "... such Self-Help Groups, registered or unregistered, may be allowed to open Savings Bank Accounts with banks." At mid-term, March 1994, 637 SHGs (80% women's groups) with 11,000 members had opened savings accounts and were credit-linked to 16 commercial and 12 regional rural bank branches. 34 NGOs were involved as facilitators. Large numbers of officers of NABARD were sent to MYRADA and other NGOs for exposure training. By March 1996, 4,757 SHGs with 80,000 members had been mobilized by 127 NGOs and were credit-linked to 95 bank branches. Wilson (2002: 220) describes "how the new microfinance works:"

"Promoters—field staff of NGOs, bank staff, or volunteers (often group members themselves)—reach out to women, gather them into groups of twenty or fewer—and encourage women to save weekly or monthly. Sometimes they save as little as five rupees (US\$0.10) per month. Promoters show groups how to lend their collective savings for a variety of purposes, ranging from loans to buy a few chickens, pay school fees, or finance emergency medical care of a child. Promoters also instruct groups to properly record saving and lending transactions. After groups stabilize and are able to perform a variety of group management activities, promoters link them to local banks, where they may receive a group loan."

NABARD evaluated the project and found that the program was highly suitable for poor and very poor women particularly in marginal, resource-poor areas; membership had come mostly from the poorest section of the society; women frequently need credit, but at irregular intervals; they used the loans for productive and non-productive purposes, with a trend towards productive investments; incomes have gone up; even the poorest saved, and their savings increased with their income; transaction costs of banks and SHG members went down (confirmed by Seibel and Dave 2002, Karduck and Seibel 2007); repayment rates were close to 100%, in contrast to 50-60% in agricultural credit. In comparison to the Grameen Bank model, NABARD found that "the SHG linkage model appears more sustainable and appropriate in the Indian conditions where (India has) in place a vast network of rural bank branches... (and) SHGs which are functioning on their own and waiting to be linked to the banking system." (Nanda 1995)

Nationwide mainstreaming started in 1996 after clarifying two issues by circular: (i) SHG members who had earlier defaulted on bank loans and were therefore not bankable could obtain loans from the groups' own internal funds if so decided; (ii) informal groups were limited to 20 members, beyond which they would be required to legally register. To implement mainstreaming, NABARD (i) provided refinancing to participating banks; (ii) declared SHG banking the dominant, but non-mandatory approach of lending to the poor; (iii) propagated its *grand vision of one million SHGs* to be credit-linked by the year 2008, subsequently articulated by union government in all budget speeches; (iv) created a Micro

Credit Innovations Department (MCID) as the program steering unit, with representations in all states; (v) set up a special fund to finance capacity-building measures as the motor of expansion; (vi) assisted the establishment and maintenance of SHGs through numerous NGOs and GOs; (vii) finally allowed for initiatives to organize SHGs in cooperative federations under new state laws.

Backed by the joint political will of Union Government, state governments, Reserve Bank of India and NABARD, program dissemination and capacity building expanded rapidly. The number of SHGs credit-linked to banks grew from 33,000 in 1999 to 2.9 million as of 31 March 2007, with 42.4 million members, covering a population of 212 million (*cumulative data*). The majority of members (90%) are women: by choice, not program design.

Table 2: SHG-bank linkages in India, 1999-2007, cumulative figures (March 31)

Year	No of SHGs credit-linked	No of members (in mn)	Disbursements of banks to SHGs (in mn US\$) *)	NABARD re-finance to banks (in mn US\$) *)	Percent refinanced
1999	32,995	0.56	13.4	12.3	91
2000	114,775	1.9	44.2	34.4	78
2001	263,825	4.5	103.1	85.9	83
2002	461,478	7.8	209.9	163.0	78
2003	717,360	11.6	430	297.8	69
2004	1,079,091	16.7	884.8	481.6	54
2005	1,618,456	24	1575.4	705.5	45
2006	2,238,565	33.2	2554.5	932.3	37
2007	2,858,042	42.4	3823.9	1255.2	33

*) Exchange rates as of 31 March

Source: NABARD

GTZ (2006) calculated current data as of 31 March 2005: 1.4m SHGs had US\$ 935m in bank loans outstanding; 2.6m SHGs had bank savings accounts, with an aggregate deposit balance of \$531m. Adding internal savings and retained earnings of the SHGs (Karduck and Seibel 2006), bank loans outstanding are matched by total savings and retained earnings of about the same magnitude. Over 3,000 NGOs and government organizations have been involved as self-help promoting institutions in credit linkages to some 42,000 banking and cooperative units.

As transaction costs are low and recovery rates reportedly around 98%, SHG banking is highly profitable to the banks, despite lending rates, which are deregulated, from banks to SHGs between 10% and 13% (Seibel and Dave 2002). Thus, bankers have increasingly gained confidence in SHG banking as a market segment and substantially stepped up the use of own resources, bringing the share of NABARD's refinancing down from 91% in 1999 to 33% in 2005. At low transaction costs of SHGs and at on-lending rates to members around 24%, internal resources grew rapidly, increasing the financial self-reliance of the groups (Karduck and Seibel 2006).

Growth continues, and impact is deeply felt by the members: on employment, income, self-confidence, children's education and, last but not least, moneylenders; many have reportedly gone out of business where SHGs are active. Challenges remain, particularly in terms of expansion into underserved areas, effective supervision and sustainability. In Andhra Pradesh (AP), where the movement originated, SHGs are now responding to the challenge of sustainability by organizing in federations at village, sub-district and district level, licensed as Mutually Aided Cooperative Societies, a new legal status since 1995. Out of 30,000 federations in AP, some 10,000 are licensed, but as yet unsupervised. There is an enormous potential of SHG expansion into underserved rural and urban areas; SHG federations as licensed financial intermediaries; appropriate regulation and effective (delegated) supervision; international exposure training; and adjusting and disseminating the approach.

4. Conclusion

Digging into the history of microfinance in Europe, Africa and Asia generates a wealth of insights. This calls for further analysis of what propels, or keeps back, the growth in outreach and viability of informal, micro and rural finance and their linkages. We are calling for a coordinated effort at microfinance history in developed and developing countries.

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