Enabling Urban Microfinance

At the outset, let me congratulate Additional Secretary for the theme of this conference 'Énabling Urban Microfinance' which is truly appropriate as it chooses to bring to centre stage issues of urban poverty. The scale of urban poverty in India is staggering. Current estimates suggest that 100 million poor people live in urban settlements comprising 40% of the urban poor. These numbers are expected to rise. The prediction is that the total urban population of India will increase from 26% of total population to over 36%-50% over the next twenty-five years. The number of urban poor would increase to 200-300 million. Until and unless cities are able to meet the growing needs of the expanding population, any advantages that economic opportunities might present the urban poor are likely to be outweighed by these factors for policy makers. Therefore it means that the characteristics of urban development must be understood and included in initiatives to reduce overall poverty in India. The general consensus is that poverty can be most effectively addressed through economic development for which rapid urban development is a key driver. The National Institute of Urban Affairs estimates that urban India currently contributes more than 50% of the country's GDP whilst accommodating less than a third of its population and this contribution is likely to increase to 60%. The manufacturing and services sectors that are the most dynamic constituents of the Indian economy are predominantly urban. In addition, with agriculture exempt from Income Tax, the fiscal base of the economy is also disproportionately reliant on the urban economy as the proportion of people thronging urban areas continues to rise. The opportunities for poorer people to tap this growing economic base are enormous. In the wake of the often unplanned and unregulated urbanization, the urban poor face physical, environmental, social and psychological problems. These impose a heavy burden of disease and inequity on the urban poor. They are compelled to live in squalid and untenable settlements and suffer the consequence of environmental degradation, resulting in ill-health, disability and loss of earnings. As cities grow, the pressure on existing services and associated infrastructure increases with resultant increase in the number of people without access to these services. The poor and therefore the most vulnerable are excluded and end up paying higher prices for lower quality products via the informal sector. Ironically, it is the poor who provide the essential services which keep cities functioning. The problem of service provision for the poor is compounded by the fact that decision makers do not necessarily know their needs or recognize their civic rights. Employment opportunities are severely restricted in urban areas. The main asset of the poor is the capacity to sell their labour. They have few other assets to build on. Their home may be rented or unfit for habitation, they may not own land or capital or cattle in towns and the social networks built by households over generations in the village are less strong in a dynamic urban context where people come and go. There is always lack of employment opportunities; the poor are not necessarily equipped with the skills and training to take advantage of newer opportunities in modern industry and in the nascent services sector. The formal wage sector has been unable to absorb the expanding labour force. As a result, there has been a massive growth in the informal sector and in the casualization of employment, wages are forced downward, working conditions are not protected and unregulated access to opportunities is mediated by the capacity of individuals. A way of strengthening the bargaining power of the poor in urban contexts is through the formation of neighbourhood groups federated as Community Development Societies at the state level in addition to engaging in self-help schemes, as micro planning credit extension or directly operating and maintaining infrastructure. The CDS can create the infrastructure for receiving benefits of Government programs like the SJSRY. Access to financial services is a critical aspect of both, social development and social protection measures for the poor. These services create an opportunity for access to low interest credit which can be used for skill enhancement or micro enterprise growth. This also creates an opportunity to use savings and loans as a buffer against crisis. The poorer the household, the greater the desire to save financial services provide a critical safety net as well as a spring-board to advancement.

We need financial inclusion for the urban areas to link people to mainstream financial service providers so that they can access the entire suite of financial products and services from the mainstream financial institutions. Till this happens, I do see an important role for microfinance. Conventional wisdom has it that access to microfinance services can enable the poor to smoothen their consumption, manage their risks better, build their assets, develop their microenterprises, enhance their income-earning capacity and enjoy an improved quality of life. The primary clientele of MFIs consists, almost by definition, of those who face severe barriers to access financial products from conventional financial institutions. These barriers comprise mainly high operational costs and risk factors. MFI clientele in urban areas may possess few negotiable assets and live in hostile environments where enforcement of property rights and other contracts is expensive and uncertain. MFIs can help in providing handholding support and markets typically for encouraging small service enterprises and cottage and small industries. Cottage industries have traditionally played an important role in the Indian economy. The bustling urban enclave of Dharavi is a case in point. It generates large volume employment and provides subsidiary services. The cottage and small industry's need for capital is not very large and they help in ensuring equitable income distribution. There are several artisan based clusters in India, these are skill-based and use simple manufacturing processes and technology. These clusters consist of unorganized sector, tiny units, with little access to market information. If credit and the entire range of banking products and services from mainstream financial institutions is made available, it will enable the small units to scale up and grow. The problems of urban poverty can only be addressed by encouraging the small scale service/manufacturing enterprises which generate employment. Much has been written about the benefits and positive externalities of agglomeration. The cluster based approach to lending is intended to provide a full-service approach to cater to the diverse needs of the MSE sector. This can easily be achieved through extending banking services to recognized MSE clusters. A cluster based approach is beneficial (a) in dealing with well-defined and recognized groups (b) in ensuring the availability of appropriate information for risk assessment (c) in monitoring by the lending institutions and (d) achieving reduction in costs.

United Nations Industrial Development Organisation (UNIDO) has identified 388 clusters spread over 21 states across various parts of the country. The Ministry of Micro, Small and Medium Enterprises has also approved a list of clusters under the Scheme of Fund for Regeneration of Traditional Industries (SFURTI) and the Micro and Small Enterprises Cluster Development Program (MSE-CDP) located in 121 Minority Concentration Districts. Accordingly, banks have been advised to take appropriate measures to improve the credit flow to the identified clusters of micro and small entrepreneurs from the minority communities residing in the minority concentrated districts of the country.

The RBI has advised banks to open more MSE focused branch offices at different MSE clusters which can also act as counselling centres for MSEs. Each lead bank of the district may adopt at least one cluster.

A Microfinance model which has been relatively successful is the SHG Bank linkage model which leverages the penetrative reach of the NGOs and civil society organizations and the financial strength and managerial expertise of the commercial banks. Starting from a modest scale as a pilot in the year 1992, the SHG-Bank linkage program linked 79.60 lakh savings-linked Self Help Groups (SHGs) covering over 10.3 crore poor households as on 31 March 2012. As per the NABARD Annual Report, however, the concentration of the SHG Bank linkage model continues to be to the southern states and is not evenly spread over the BIMARU (Bihar, Madhya Pradesh Rajasthan and Uttar Pradesh) states. The second model is that of the registered NBFCs. These work as profit companies and extend loans to the entrepreneurial poor at the middle of the pyramid. This is an important distinction which I want to emphasize as this brings into salience the continuing need and relevance of this model. There is an important role which both models of microfinance fulfill in the critical areas of training and capacity building of the poor. This enables them to graduate to larger loans and to setting up sustainable, scalable, self-sustaining enterprises and income-generating projects which **pay for themselves**. The most serious limitation of microfinance is that it does not address all needs holistically. There is a problem of scaling up, and in this lies the promise of inclusive finance which links the poor to the formal financial system. There is a clear comparative competitive advantage which commercial banks enjoy in extending microfinance. As financial inclusion and basic bank deposit accounts are in place, banks should now move to the next step of crafting products and services for the poor. The advantages of banks over MFIs stem from their being regulated institutions fulfilling the necessary preconditions of ownership, financial disclosure and capital adequacy that help ensure prudent management. They have the physical infrastructure, large networked branches on CBS from which to expand access and reach out to a substantial number of poorer clients. They have well established internal controls and administrative and accounting systems to keep track of a large number of high volume, small value transactions. As they are well capitalized, they are not dependent on scarce and volatile donor resources unlike NGOs and MFIs. Banks offer savings, remittance, loans and other financial products that are prima facie attractive to the hitherto unserved micro finance clients. On the downside, however, banks lack key ingredients, most of all, the financial methodologies to reach the low income population. There are several issues trammeling banks. The issue of commitment is fairly significant. The commitment of commercial banks (particularly the larger banks) to micro enterprise lending is often fragile and generally vests on the direction provided by one or two Board Members rather than it being rooted in their institutional mandate. Secondly, they are hampered by their organizational structures. Programs for the poor or microfinance programs need to be inserted into the larger bank structure while retaining flexibility, operational independence and autonomy. Banks need an appropriate financial methodology to work with efficiency. For gains in the penny economy, they need suitable financial methodology to service the micro enterprise sector and financial innovations that enable cost effective analysis of credit worthiness, the monitoring of relatively poor clients and acceptance of effective collateral substitutes. Human Resources also need attention given that microfinance programs differ so radically from traditional banking. Banks need to recruit and retain specialized staff to manage these programs. Issues of recruitment, training and performance linked incentives for bank personnel need special consideration. Cost effectiveness is a critical issue. Micro finance programs are costly to administer given the overheads of banks. Despite these apparent disabilities, if banks work on this, they are ideally suited to microfinance provision. The targeted interventions of the Swarn Jayanti Shahri Rozgar Yojana and the District Industries centres which are designed to impart vocational training to the target group of this program as also the Prime Minister Rozgar Yojana have enjoyed only limited success ratios attributable not so much to infirmities in policy design issues as to faulty implementation and poor targeting, lack of pre-disbursement credit assessment, coupled with poor post-disbursement credit supervision and no space for capacity building and handholding in between. The clear winner is financial inclusion. Savings credit extended to the urban poor by the banks can help grow the micro enterprises and power economic growth. Let me begin with a simple example. Micro enterprises like the ubiquitous street-corner paan wallah who runs a small self-sustaining enterprise, if extended credit by banks, can expand his business, can employ two other helpers. Such micro enterprises have tremendous potential to create employment and put in place virtuous cycles of economic growth. How do we enable micro finance in the urban areas well to be facile? It is not an easy task. First, we need to build a suitable framework. The framework will need to be localized, customized and contextualized to suit the differing needs of different localities, and addressing issues such as the development of an overarching macro policy environment, long-term financial sustainability of microfinance institutions, increasing outreach by capacity building and effective governance, and broad-based research and monitoring/evaluation. Its linking top other developmental priorities, particularly those related to environmental issues at the local level will be an important justification in its adoption. There is need to recognize the importance of bringing people from the margins to the mainstream of economic activity as producers of goods and services. The challenge of financial exclusion is widespread in metropolitan areas, especially among the disadvantaged and low-income groups. To facilitate doorstep banking to the excluded segment of the urban poor and provide an institutional mechanism for co-ordination between the government and banks, lead bank responsibility has been assigned to 16 districts in metropolitan areas, thus bringing the entire country under the fold of the lead bank scheme and covering a total of 659 districts under the lead bank scheme. The Peruvian economist Hernando de Soto showcased the unreported unrecorded activity of a vibrant informal sector whose participants remained at the margins. It successfully created many small entrepreneurs but could not secure credit from mainstream financial institutions as they lacked legal ownership of their property, making it difficult for them not only to obtain credit, but sell the business, or expand. They cannot seek legal remedies to business conflicts in court, since they do not have legal ownership. Lack of information on income prevents governments from collecting taxes and acting for the public welfare. "The existence of such massive exclusion generates two parallel economies, legal and extra-legal. An elite minority enjoys the economic benefits of the mainstream financial institutions, law and globalization, while the majority of entrepreneurs are stuck in poverty." He terms them extra-legal. To survive, to protect their assets, and to do as much business as possible, the extra-legal create their own rules. But because these local arrangements are full of shortcomings and are not easily enforceable, the extra-legal also create their own social, political and economic problems that affect the society at large. It is essential that these issues are given due attention of policy makers to encourage and promote the growth of micro enterprises. The Prime Minister's task force (TKA Nair 2010) laid emphasis on the micro enterprise sector which generates opportunities for self-employment and stipulated that 60 per cent of MSE advances should go to the micro enterprises. MSMEs make a significant contribution in the country's GDP, manufacturing output, exports and employment generation. MSMEs contribute 8 per cent of the country's GDP, 45 per cent of the manufactured output and 40 per cent of our exports. The labour and capital ratio in MSMEs and the overall growth in the MSMEs is much higher than in the larger industries. MSMEs are better dispersed. In view of these factors, MSMEs are important for achieving national objectives of growth with equity and inclusion. As per the quick estimates of 4th All-India Census of MSMEs, the number of enterprises is estimated to be about 26 million and these provide employment to an estimated 60 million persons. Of the 26 million MSMEs, only 1.5 million are in the registered segment while the remaining 24.5 million (94%) are in the unregistered segment. The state-wise distribution of MSMEs shows that more than 55% of these enterprises are in 6 states, namely, Uttar Pradesh, Maharashtra, Tamil Nadu, West Bengal, Andhra Pradesh and Karnataka. Fewer MSMEs are owned by women, the unorganized sector, in which enterprises are typically established through own funds or funds obtained through non-institutional sources, they lack managerial bandwidth, do not have established channels for marketing and are centred around a single traditional technology. More than 94 per cent of MSMEs are unregistered, with a large number established in the informal or unorganized sector. The National Commission for Enterprises in the Unorganised Sector (NCEUS) defines unorganized sector as enterprise employing less than 10 workers. It has estimated such enterprises at 58 million with employment generated of 104 million persons. Shortage of capital, particularly working capital, is the major problem faced by the enterprises in the unorganized sector. Further, the field studies undertaken by NCEUS indicate that seasonality of markets is another hassle. In addition to the growth potential of the sector and its critical role in the manufacturing and value chains, the heterogeneity and the unorganized nature of the Indian MSMEs are important aspects that need to be factored into policy making and program implementation. The policies and programs for the micro and small enterprises in the unorganized sector would need to address their survival strategies and should be in the direction of providing livelihood alternatives such as social security, skill formation and credit. On the other hand, policies/programs for the larger sized MSMEs need to address issues relating to growth marketing, access to raw material, credit, skill development and technology upgradation.

Credit to Micro and Small Enterprises by SCBs

As on last Friday of March	Outstanding Credit to MSE sector		MSE credit as percent of ANBC
	Number of accounts (in million)	Amount outstanding (₹ billion)	
1	2	3	4
2012	9.86	5,276.85	16.5
	(6.0)	(10.3)	
2013*	11.23	6,847.97	14.7
	(13.9)	(29.8)	

*:As on March 31, 2013.

Note:1.Data for 2013 are provisional.
2.Figures in parentheses indicate y-o-y change in per cent.

The millenium development goal is halving poverty by 2015. If this is to be attained, it is central to address the concerns around urban poverty through strategies of increasing income to make basic needs more affordable. If our cities are not to become centres of squalor and crime, these issues will require urgent redress.

Thank You for patient listening. I wish the deliberations all success.