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# MICRO FINANCE CREDIT MARKET STRUCTURE IN INDIA – AN OVERVIEW

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***Abstract***
*Microfinance is increasingly being considered as one of the most effective tools of reducing poverty. Microfinance has a significant role in bridging the gap between the formal financial institutions and the rural poor. The Micro Finance Institutions (MFIs) accesses financial resources from the Banks and other mainstream Financial Institutions and provide financial and support services to the poor. The purpose of this study is to know the significance, policy development and structure of microfinance. Various types of institutions offer microfinance: credit unions, commercial banks, NGOs (Non-governmental Organizations), cooperatives, and sectors of government banks. The emergence of "for-profit" MFIs is growing. In India , these 'for-profit' MFIs are referred to as Non-Banking Financial Companies (NBFC). NGOs mainly work in remote rural areas thereby providing financial services to the persons with no access to banking services.*

***Keywords: Microfinance, Poverty, NGOs, MFIs, NBFCs, Credit Unions etc.***

## Introduction

Poverty is the main cause of concern in improving the economic status of developing countries. A microfinance institution is an organization that offers financial services to low income populations. Almost all give loans to their members, and many offer insurance, deposit and other services.

A great scale of organizations is regarded as microfinance institutes. They are those that offer credits and other financial services to the representatives of poor strata of population (except for extremely poor strata).MFIs are the pivotal overseas organizations in each country that make individual microcredit loans directly to villagers, microentrepreneurs, impoverished women and poor families. An overseas MFI is like a small bank with the same challenges and capital needs confronting any expanding small venture but with the added responsibility of serving economically-marginalized populations. Many MFIs are creditworthy and well-run with proven records of success, many are operationally self-sufficient.

The term "transformation," or commercialization, of a microfinance institution (MFI) refers to a change in legal status from an unregulated nonprofit or non-governmental organization (NGO) into a regulated, for-profit institution. Regulated, transformed organizations differ from nonprofits in that they are held to performance and capital adequacy standards and are supervised by a financial authority, typically the central bank of the country where they are registered. A transformed MFI also attracts equity investors. The equity investors want to ensure that the values of their investments are maintained or enhanced and elect board members who share a common vision for the new for-profit institution. Among transformed MFIs, varying classifications of regulated institutions exist, the strictest being banks — rural banks and thrift banks — followed by non-bank financial institutions. Different countries have varied names for these regulated MFIs.

The microfinance sector consistently focuses on understanding the needs of the poor and on devising better ways of delivering services in line with their requirements, developing the most efficient and effective mechanisms to deliver finance to the poor. Continuous efforts towards automation of operations are steady improving in efficiency. The automated systems have also helped accelerate the growth rate of the microfinance sector.

## Significance of the credit market

There is a broad consensus, among both academics and policy makers, that a developed financial system spurs economic growth through a number of channels: (i) acquisition of information on firms; (ii) intensity with which creditors exert corporate control; (iii) provision of risk-reducing arrangements; (iv) pooling of capital; and (v) ease of making transactions. There are two mechanisms for mobilising savings and channeling them into investments, *viz.*, bank-based and market-based.
Credit institutions have the distinct advantage in information gathering and processing to monitor the efficiency and productivity of projects. In recent years the existence of banks, which are the major players in the credit market, is attributed more to their information gathering capacity arising out of the existence of asymmetric information and moral hazard problems, than to the classic explanation relating to their ability to mobilise savings and channeling them into investment. Savers usually have incomplete information on the affairs of companies, which makes it more difficult for companies to obtain direct financing from the market. Intermediation by banks mitigates such agency problems. The cost of acquiring information on a company by the providers of financial resources is high, the process of financing companies can be done more efficiently if the prospective investors are able to delegate the collection of such information to a specialised organisation (Diamond, 1984). The financial intermediation is justified on the grounds of information gathering and

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company-monitoring functions performed by banks. By reducing the costs of acquiring and processing information, financial institutions encourage mobilisation of savings and improve resource allocation. Banks can also versify risk among a number of companies.

Firms in developing countries generally tend to rely more on debt finance, including bank credit. The emphasis on credit rather than equity arises due to various reasons. The cost of equity in developing economies is often much higher than the cost of debt due to the existence of higher perceived risk premia than in developed countries. The existence of artificially repressed interest rates contributes further to the problem. The other reasons for the heavy reliance on debt in developing countries include the fragility of their equity markets, lack of suitable accounting practices and the absence of adequate corporate governance practices. The high dependence on bank credit and lack of substitutes for external finance, firms in developing economies are generally highly sensitive to changes in the cost and flow of credit.

Credit markets in developing countries plays an important role, apart from industry, agriculture is also an important segment of the economy. There are also a large number of small and medium enterprises in the industrial and service sectors, which are not able to access the capital market and have to depend on the credit market for their funding requirements. The importance of banks and other lending institutions in developing countries can hardly be overemphasised.

Commercial banks, given their preeminent position in the regulated financial sector, dominate the credit market. The quantity of loans created by the banking system is generally a function of both the willingness and ability of banks to lend. In an economy with ceilings on lending rates, banks face a higher credit demand than they can effectively supply, necessitating reliance on a credit rationing mechanism. In a non-repressed financial system, the borrowers are, in principle, differentiated along the lines of risk characteristics and riskier borrowers are charged higher interest rates to account for default probabilities. The riskier projects bring higher returns, banks, out of sustainability consideration, need to optimise the risk of their portfolio.

Another important factor influencing the supply of credit is the amount of reserves available from the central bank to the banking system. A large pre-emption of central bank money by the Government may constrain reserve supply to the banking system, affecting their capacity for credit creation. Credit expansion could also be an endogenous process, *i.e.*, it is the demand for credit that may drive the banking system's ability to create credit in the economy.

Development of the credit market plays an important role in the monetary transmission mechanism. The traditional interest rate channel, represented by the 'money view', mainly focuses on the liability side as banks create money through chequable deposits. The asset side is not emphasised as firms' financial structure is believed to be neutral to borrowings through loans from banks or through issuance of securities. This is based on the assumption that different financial assets such as bonds and bank loans are perfect substitutes. In terms of 'credit view', bonds and bank loans are not seen as perfect substitudes primarily because of information asymmetries. Firms facing informational problems find it more expensive to borrow through bonds than availing loans from banks. Developed financial intermediation system facilitates growth, policy makers tend to liberalise the system to facilitate financial development. The literature suggests that authorities should take adequate caution in adopting a liberalised policy frameworks intended to develop the financial sector.

**Institutional structure of the credit market in India**

The credit market structure in India has evolved over the years. A wide range of financial institutions exist in the country to provide credit to various sectors of the economy. These include commercial banks, regional rural banks (RRBs), cooperatives [comprising urban cooperative banks (UCBs), State co-operative banks (STCBs), district central co-operative banks (DCCBs), primary agricultural credit societies (PACS), state co-operative and agricultural rural development banks (SCARDBs) and primary co-operative and agricultural rural development banks (PCARDBs)], financial institutions (FI) (term-lending institutions, both at the Centre and State level, and refinance institutions) and non-banking financial companies (NBFCs).

Scheduled commercial banks constitute the predominant segment of the credit market in India. The co-operative banking system, with two broad segments of urban and rural co-operatives, forms an integral part of the Indian financial system. Urban cooperative banks, also referred to as primary cooperative banks, play an important role in meeting the growing credit needs of urban and semi-urban areas of the country. The UCBs, which grew rapidly in the early 1990s, showed certain weaknesses arising out of lack of sound corporate governance, unethical lending, comparatively high levels of non-performing loans and their inability to operate in a liberalised environment.

The rural co-operative credit institutions have played an important role in providing institutional credit to the agricultural and rural sectors. These credit institutions, based on the nature of their lending operations, have typically been pided into two distinct segments, commonly known as the short-term cooperative credit structure (STCCS) and the long-term co-operative credit structure (LTCCS). The STCCS, comprising PACS at the village level, DCCBs at the intermediate level, and the STCBs at the apex level, provide crop and other working capital loans to farmers and rural artisans primarily for short-term purposes. The LTCCS, comprising SCARDBs at the State level and PCARDBs at the district or block level, provide typically medium and long-term loans for making investments in agriculture, rural industries and housing.

Financial institutions owed their origin to the objective of state driven planned economic development. The capital markets were relatively underdeveloped and judged to be incapable of meeting adequately the long-term requirements of the economy. A wide range of FIs, mostly Government owned, came into existence to cater to the medium to long-term financing requirements of different sectors of the economy. FIs played a key role in extending development finance in India and for this purpose they were given access to concessional finance in the form of Government guaranteed bonds and Long-Term Operations (LTO) Fund of the Reserve Bank.

NBFCs encompass a heterogeneous group of intermediaries and provide a whole range of financial services. It can be broadly classified into three categories, *viz.*, asset finance companies (such as equipment leasing and hire purchase), loan companies and investment companies.

**The Credit Channel of Monetary Policy**

The impact of monetary policy on the real economy operates through various channels. Under the conventional approach, referred to as the ‘money view’, monetary policy influences the economy *via* the interest rate.

There are two channels through which credit conditions are expected to affect monetary transmission. First, the ‘bank lending’ channel, that operates through modulation of bank reserves, is affected by monetary policy. Contractionary/ expansionary policy limits or enhances the ability of banks to lend and thereby reduces/increases investment and output. The second, the ‘balance sheet’ channel works through net worth of the borrowers.

**Policy developments in the credit market in India**

The credit market, with commercial banks as its predominant segment, has been the major source for meeting the finance requirements in the economy, both for the private sector and the Central and State Government enterprises. The issue of allocation of bank resources among various sectors was addressed through mechanisms such as SLR, credit authorisation scheme (CAS), fixation of maximum permissible bank finance (MPBF) and selective credit controls. This regulated environment set in complacency in the manner in which credit institutions operated and responded to the customer needs. The interest rate played a very limited role as the equilibrating mechanism between demand and supply of resources.

1. Priority sector comprises agriculture (both direct and indirect), small scale industries, small roads and water transport operators, small business, retail trade, professional and self-employed persons, state sponsored organisations for Scheduled Castes/Scheduled Tribes, education, housing (both direct and indirect), consumption loans, micro-credit, loans to software, and food and agro-processing sector.
2. Under Section 18 of the Banking Regulation Act, 1949, all scheduled banks are required to maintain SLR, *i.e.*, a certain proportion of their demand and time liabilities (DTL) as on the last Friday of the second preceeding fortnight as liquid assets (cash, gold valued at a price not exceeding the current market price or unencumbered approved securities valued at a price as specified by the Reserve Bank from time to time).

**Annex IV.1: Menu of Policy Options in Responding to Rapid Credit Growth**

Policy Options

- Macroeconomic Policy Measures
  - Fiscal measures
    - Fiscal tightening
    - Avoiding fiscal/ cuasi- fiscal incentives that may encourage certain lending
  - Monetary measures
    - Interest rate tightening
    - Reserve requirements
    - Liquid asset requirements
    - Sterilisation operations
  - Exchange rate policy response
    - Increase exchange rate flexibility
    - In general maintain a consistent mix of a monetary and exchange rate policy
- Prudential Measures
  - Higher differentiated capital requirements
  - Tighter/ differentiated loan classification and provisioning rules
  - Tighter eligibility criteria for certain loans
  - Dynamic provisioning
  - Tighter collateral rules
  - Rules on credit concentration
  - Tightening net open foreign exchange position limits
  - Maturity mismatch regulations and guidance to avoid excessive reliance on short-term borrowing
- Supervisory/ Monitoring Measures
  - Increasing disclosure requirements for banks on risk management and internal control policies and practices
  - Closer onsite/ off-site inspections/ surveillance of potentially problem banks
  - Periodic stress testing
  - Periodic monitoring/ survey of banks and customers exposure
  - Increasing supervisory coordination of banks and non-bank financial institutions
  - Improved dialogue and exchange of information between domestic and home supervisors of foreign banks
- Market Development Measures
  - Encouraging development of hedging instruments to manage risk requirements
  - Developing asset management instruments to deal with distressed assets
  - Developing securities markets to reduce dependence on bank credit and improve diversification of banks' credit risks
  - Improving credit culture (establishment of credit bureaus, credit registry, stronger legal system, creditors rights, etc.)
  - Improving banks' and corporations' accounting standards
- Administrative Measures
  - Overall or bank-by bank credit limits
  - Controls on capital flows e.g.
  - control on foreign borrowing by banks and/or bank customers
  - different reserve requirements on domestic and foreign currency
  - taxes on financial intermediation
- Promotion of Better Understanding of Risks
  - Strengthening banks' ability to monitor assess and manage
  - Public risk awareness campaigns press statements, etc.
  - Discussions/ meetings with banks ("moral suasion") to warn or persuade banks to slow down credit extension

**Source:** Hilbers, *et al*, 2005.

**Credit Information Bureaus**

Credit bureaus (or credit reference agencies) are useful as they help lenders to assess credit worthiness of individual borrowers and their ability to pay back a loan. As credit bureaus collect and collate personal financial data on individuals from financial institutions, a form of price discrimination can be modelled taking into account credit rating and past behaviour of borrowers. The information is generally aggregated and made available on request to contributing companies for the purposes of credit assessment and credit scoring.

The CIBIL provides a vital service, which allows its members to make informed, objective and faster credit decisions. CIBIL's aim is to fulfil the need of credit granting institutions for comprehensive credit information by collecting, collating

and disseminating credit information pertaining to both commercial and consumer borrowers, to a closed user group of members. Banks, financial institutions, non-banking financial companies, housing finance companies and credit card companies use CIBIL’s services.

**Conclusion**

The credit market is the most significant segment of the financial market structure in India. The credit market in India has witnessed significant transformation in the last 15 years in terms of type of borrowers/type of instruments and price of credit. With the conversion of two DFIs into banks and reduction in the business operations of NBFCs, the predominance of banking institutions in the credit market has increased. Enhanced freedom for business operations and increased presence of private and foreign banks and non-bank credit institutions, the credit market has become highly competitive as new banks are making every effort to increase their share in the credit market. The credit market has also persified in terms of borrowing entities and the purposes for which credit is extended.

A proper functioning of the credit market depends on adequate competition. In a competitive environment, the more efficient institutions capture the market share at the expense of less efficient ones, which improves the overall efficiency of the system. This benefits both the credit institutions and their clients. While gains to credit institutions occur in the form of higher profits, to consumers they occur in the form of lower cost of the services. The process of consolidation and restructuring that is underway in the credit market in India may result in weeding out the inefficient players and the credit market may become more efficient in future.

Robust economic growth has increased the demand for credit. Proper functioning of credit institutions in general and banks in particular is key to sustained economic growth. In the current situation of high credit expansion, banks have been unwinding their surplus investments in SLR securities, over and above the prescribed minimum. This unwinding would soon reach a limit. Therefore, banks need to make sustained efforts for mobilising stable retail deposits by extending banking facilities and wide-spreading their deposit base. In particular, banks would need to devise imaginative ways to mop up the resources in rural areas to balance their deposit mobilisation and credit expansion.

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