

## **PROMOTING EQUITABLE MICROFINANCE**

### **DHAN INTERNATIONAL FOUNDATION**

#### ***Microfinance is Booming***

Ever more microfinance institutions report ever larger outreach figures and the sector is well serviced and financed by ever growing numbers of investors and supporters. In fact, the sector is gearing up to further exponential growth by way of integration into the formal banking sector, steady increase of efficiency through scale and application of IT innovations and broadening of services in line with widely adopted industry targets.

Across the board, customers are largely satisfied with the services they are being offered. Nearly all repay their loans in time, many safe with the institutions and most do not mind the stiff interest or service charged applied. Access to capital appears to be more important than the costs thereof. That at least is the overall message the industry is relaying: the systems are in place, the products are developed and the customers are ready to buy. The only thing left to do is bringing the system to the doorsteps of hundreds of millions more customers for which major fresh capital injections are required.

#### ***Microfinance and Poverty***

Yet, not all in microfinance is progressing equally well. A major concern is that the industry predominantly services low-income clients but has made little inroads in servicing the extreme poor. And whereas industry leaders recognize this shortcoming and formulate ambitious plans to reach out to the poorest, it is questionable if these will ever be successful. Mainstream microfinance is largely built on the strategy of downscaling and adjusting conventional banking practice to widen its scope of operations. It is doubtful if this strategy can be applied to work at the bottom of the poverty pyramid.

One out of every five citizen of this world lives in extreme poverty. Their poverty is not only a condition of low income and lack of assets, but also of lack of opportunities, vulnerability, exclusion and powerlessness. The hardcore poor rarely choose or control the conditions under which they earn their livelihoods. And, as a consequence, offering credit facilities is not going to change their lives unless it is done in conjunction with reducing vulnerability, creating opportunities, improving skills and capabilities and addressing issues of exclusion and powerlessness.

To many of these people - smallholders, landless wage labourers and sharecroppers, nomadic pastoralists, artisans, fisherman and women, indigenous peoples, ethnic minorities and members of scheduled castes - vulnerability is a *silent emergency* that is intimately linked to weak local governance. It is experienced as an inability to influence decisions affecting their lives, negotiate better terms of trade and barter, stop corruption, and make governmental and civil society organizations accountable to them. It is also about not being able to escape violence or earn enough to meet their basic needs. Powerlessness is clearly an effect of poverty; it is also one of its most important causes.

Long-term solutions to the problems of inadequate resources and social exclusion require connecting the poor to mainstream resources and services. While social capital among the poor is critical for daily survival and for making their voices heard to those in power, it is only by accessing increased resources that poor people will be able to come out of poverty. Communities are often endowed with land and water, natural capital, but they often do not

have the skills, human capital, and organisations, social capital, needed to turn the natural resources into wealth. If microfinance is to effectively work at the bottom of the pyramid, it therefore must be embedded in efforts to increase human and social capital.

### ***Towards Equitable Microfinance***

Unfortunately, mainstream microfinance is moving in an opposite direction. The mantra of financial self-sufficiency has effectively moved investors and supporters away from critical investments in the areas of building human and social capital. Rather it expects sustained commercialization of the industry to come forward with concepts to service the extreme poor. And if that would fail, the conclusion must be that microfinance cannot be expected to be of use to them; in fact never meant to, as illustrated in CGAP's *Principles of Microfinance*.

Our concern is that if the overriding purpose of microfinance is to establish sustainable financial systems, the extreme poor have very little to gain from it. We prefer a rights-based approach instead, and call that Equitable Microfinance: *the right for all to be serviced affordably, appropriately and accessibly*.

The right to be serviced implies a need for service providers to offer financial services to the extreme poor at terms they can handle. This does not only refer to the costs of service delivery, but also to building human and social capital as a precondition for ending poverty.

### ***The Dhan Experience: the Kalanjiam Self-Help Model***

In India an alternative approach to microfinance has gained prominence, generically known as the Self-Help Group approach. Dhan Foundation is a development NGO that has pioneered one of the largest pilots under this scheme: the Kalanjiam model. Currently close to 350,000 women, mostly living in extreme poverty, participate in this model, which is financially sustainable.

The model deviates from conventional financial delivery approaches as it is profoundly demand instead of supply based. Key features of this self-reliance approach are the following;

- Member owned, controlled and managed as opposed to be serviced by an external party.
- Savings-driven as opposed to credit-driven.
- Focus on internal instead of external capacity building; it is not the service provider that benefits from capacity building but the self-help group.
- Decentralized instead of a centralized set-up and design to allow for members' buy-in; it is their program, not somebody else's.
- Poverty instead of financial focus; the overall objective is to end poverty as opposed to building financial institutions of third parties.
- It is cost-effective and does not lead to high transaction costs.
- Flexibility as regards local design of financial products that meet actual requirements in the field as opposed to one-size fits all products and services.

### ***Key Operational Considerations***

The model works on the basis of four key operational considerations. First it enables communities to build their own *nested institutions*. As the microfinance program will be theirs, they have to build and control the institutions that run it. This takes the form of nucleus mutual structures (self-help groups in the case of India) that cluster and federate at higher levels: the Kalanjiam Foundation.

Second, the program exclusively *reaches out to the poorest*, particularly poorest women. Often microfinance is considered unable to focus on the poorest in a sustainable manner. This is a myth. It is a matter of sequencing of priorities rather: first comes the client; only then financial sustainability. Scale of operations, rigorous cost control and high portfolio quality will bring self-sufficiency within reach. To achieve high portfolio quality, however, it is essential to design financial products in line with client preference and handling capacity and to reach low costs levels it is necessary that the clients' organization are actively involved in the management of the program.

A third consideration that worked well in the Kalanjiam program is the *arresting of leakages*. Many poor experience negative cash flows: earnings are structurally lower than cash outflows, resulting in perpetual indebtedness, poverty and misery. This vicious circle can be broken by rescheduling old debt with moneylenders and other credit providers at manageable terms and linking repayment of rescheduled loans to actual savings capacity.

The fourth consideration is an obvious one, though rarely practiced in mainstream microfinance: *moving beyond financial services* and addressing social development. Over-emphasis on financial returns and commercialization has made microfinance drift away from its original purpose: ending poverty through social development. This requires not only making available financial products for social purposes such as marriage, education, health, de-addiction and social obligations, but also working on drinking water, sanitation, business development and creating an educational and health infrastructure in rural areas. The Kalanjiam experience shows that the social and human capital built around financial service delivery in rural areas can be quite effectively applied for working on other developmental issues.

#### ***Achievements of the Kalanjiam Program***

The Kalanjiam model is based on group formation at village level. Up to 20 women form a primary group which is self-managed and self-governed. Up to 20 groups from nearby villages form a local cluster association to attend to local development issues and at the same time 150-200 groups form a district level federation. The financial program is based on wholesale borrowing from the formal banking sector. Primary groups can directly borrow from a bank in their vicinity, but also clusters and federations can borrow and on-lend to groups; all depending on group preference as well as the banking sector's ability to disburse credit. All groups, clusters and federations are formalized and registered and, hence, have a legal ability to borrow.

This community banking system is supported by Dhan Foundation in various ways. It helps with group formation and building management and governance skills, it can link groups to potentially interested wholesale loan providers, it works with the groups to install portfolio management capacities and it supports the groups in addressing non-financial development issues.

The program started in 1990 and by September 2006 total membership had reached 347,955 women in 6605 villages and urban slums in eight Indian states. By that time EUR 13 million in savings was brought together by the members. Primary groups had negotiated loans from 32 commercial and public banks to a volume of EUR 23.5 million whereas at federated level another loan inflow of EUR 4.2 million had been secured. At the same time Dhan managed to provide nearly 200,000 women and 50,000 spouses with microinsurance coverage.

The costs of Dhan support were traditionally covered from grants mobilized from various philanthropic organizations but are increasingly paid for by groups, clusters and federations out of their savings and newly built assets. In the Indian market groups have access to relatively low cost banking loans which are distributed amongst group members at a considerable mark-up, decided by the groups. This differential interest rate allows for provisioning for bad debt within the groups but also creates a surplus in the form of community assets, which are usually invested in community development projects. So whereas members pay fairly high interest rates, a substantial part thereof stays within the community and does not flow out of the system to outside investors and shareholders.

In terms of human and social capital formation, the program has trained 70,000 women in performing their current leadership roles at group, cluster and federation level. In addition, the program now employs well over 5000 people, the vast majority of which are younger women sourced from primary groups. Together they represent a EUR 1 million pay role, largely financed by the groups.

The programme has demonstrated the success of the community banking concept on scale in rural, urban, coastal and tribal contexts. Though the basic principles and guiding philosophy were the same, each context has offered unique lessons and operation modalities to make microfinance relevant for the poor. Even in the most remote tribal areas financial services can be offered sustainably overtime, but it requires commitment, stamina and a longer term horizon to get to that point. Most microfinance institutions shy away from that perspective; at Dhan we made it part of our core business.

### ***Next Steps***

The Kalanjiam program is planned to grow to a volume of one million clients in the coming years through a process of horizontal expansion and vertical deepening: geographical spread and saturation as well as offering new financial and non-financial services. This process of expansion will increasingly be driven by graduates from early day primary groups, clusters and federations. This means that Dhan Foundation is gradually handing over the better part of its enabling functions to the Kalanjiam Foundation and will concentrate more on business development support activities to add value to the products of primary group members. In addition Dhan Foundation is working towards increasing insurance coverage of all Kalanjiam members by pioneering new insurance products.

Given our success to date in servicing the lower brackets of the microfinance markets, Dhan is increasingly requested to help or support other NGOs and microfinance institutions to install similar capacity in their respective regions. Initially these requests came from India, but today from various parts of the world. As it is difficult for us to lift our senior staff out of their current duties and responsibilities, we decided to entertain such requests on a professional footing.

### ***Dhan International Foundation***

Dhan International has been registered as a foundation under Dutch law in the Netherlands, to allow for maximum international operational flexibility, but operates from Madurai, Tamil Nadu, India. Dhan International is devoted to promoting community based microfinance and development programs.

Community based banking has a tradition in many developing countries, in an informal format as well as in a formalized form such as primary cooperatives or associations. The

current practice of most community banking systems, however, has two limitations to fully utilizing all potential. Member-based systems often face problems attracting outside capital meaning that little leverage capacity is developed and mobilized capacity often is used for a single purpose only. Our Kalanjiam experience has shown that such systems can be upgraded to serve many more extreme poor with a greater diversity of services and products. The objective of Dhan International is to work with community-based organizations to unlock that potential.

### ***Community-Based Pilot Partnerships***

The way we do so is by establishing tri-partite partnerships between primary groups, an enabling community development organization and a formal financial institution willing to come in with wholesale loans.

These partnerships will design a pilot program relevant for the primary groups and work with these for a considerable period of time on the basis of the same components applied in the Kalanjiam program: building or strengthening of nested institutions, exclusive focus on the poorest, particularly poor women, arresting leakages in the system and moving beyond financial services.

In cases where no sufficiently experienced development organization is operational, Dhan International can second qualified staff from Dhan Foundation for a limited period of time whilst working with local actors to form such a qualified organization. Likewise, if no local capital provider can be found prepared to come in with affordable wholesale loans, Dhan International can play an active role in providing access.

Dhan International will also play a coordinating role in securing the financial resources of such partnerships and will work with domestic and international agencies and institutions for that purpose.

### ***Effectuating Pilot Partnerships***

Interested parties can contact Dhan International Foundation through its India office for exploring the possibilities for establishing a community based tri-partite partnership. As a first step a common survey will be undertaken, after which the partnership model will be detailed and activity and human resource plans, monitoring and evaluation schemes and budgets will be designed. A financing strategy will be agreed upon to secure proper resource allocation to the program.

All pilots will be intensively monitored and supported with appropriate research and documentation capacity to disseminate the progress of the pilots and prepare for scaling up in a second phase.

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