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Combining Strengths: Synergies between Cluster Development and Microfinance

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Combining Strengths: Synergies between Cluster Development and Microfinance

by

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EXECUTIVE SUMMARY

For a variety of reasons, poor people lack access to formal credit and must therefore shoulder the high interest costs and dependence associated with informal credit markets. The negative implications on the development process have long been emphasised and microfinance, which includes microcredit but also other financial services such as savings facilities, insurance and payment services, has been identified as a viable solution to meeting the financial needs of the economically active poor. The UN has declared 2005 as the International Year of Microcredit to increase awareness of the fact that, when effectively delivered, microfinance can contribute to economic and human development and thus to achieving the Millennium Development Goals. Microfinance has the potential to stimulate the establishment of new businesses owned by the poor and to help existing microenterprises grow or diversify their activities. In addition, it can increase the standard of living of the economically active poor, improve their access to health care and education, reduce vulnerability and promote the empowerment of women and marginalised groups.

In India, the provision of microfinance is different from that in most countries due to the extensive bank branch network available. The most widely spread model of microfinance in India links so-called self-help groups (SHGs) with existing formal financial intermediaries rather than relying on the establishment of specialised microfinance institutions. This minimises set-up costs and ensures outreach. The main steps involved in the SHG-model include formation of self-help groups, accumulation of group savings, internal lending and on-lending of bank loans. In addition to improving access to financial services, the SHG-model also has significant social benefits. Nevertheless, like other types of microfinance programmes, it has its limitations.

It is now well over a decade that UNIDO has been implementing an innovative approach to assist micro-, small- and medium-scale enterprises (MSMEs) in the areas of network development. Its Cluster Development Programme assists MSME clusters, i.e. geographical concentrations of enterprises operating in the same or highly correlated activities, become more competitive by fostering inter-firm linkages and collaboration with local support institutions. The Programme helps MSMEs combine their strengths to jointly take advantage of market opportunities and to solve common problems.

In its activities in India, particularly those focusing on promoting clusters of microenterprises in the handicraft and agro-processing sectors, UNIDO's Programme repeatedly aimed at improving cooperation between cluster actors by creating and

strengthening existing, but non-operational, self-help groups. The fact that such revival of cooperation often calls for, or at least also involves, addressing deep-rooted financial problems suggests the existence of synergies between the Cluster Programme and credit institutions willing to provide microfinance to SHG members. Closer cooperation between UNIDO and microfinance providers can thus allow each organisation to focus on its own strengths and jointly offer a comprehensive package to promote enterprise and cluster development with a pro-poor bias. A variety of steps can be taken to create linkages between the SHGs and local financial institutions. These include exploring the financial needs of the cluster stakeholders, identifying suitable partner institutions, sensitising bankers to the needs and reality of the cluster, providing training for the economically active poor, and monitoring and evaluating the outcomes. With time, the Programme's efforts to link cluster actors with financial institutions can trigger positive externalities to enhance the contribution of cluster development to poverty reduction. The quality and accessibility of financial services may improve for all those living in the cluster, even those who are initially not involved in cluster-related activities.

Due to the specifics of the Indian financial context, it may be difficult to transfer the SHG-model of microfinance provision to UNIDO projects in other countries. Nevertheless, many features of the model remain relevant for countries beyond India and can be adapted to local circumstances.

Although the provision of financial services is a necessary condition for cluster development in any country, it is not a sufficient condition for *pro-poor* cluster development. Other constraints faced by the economically active poor must also be addressed.

In line with the objectives of the International Year of Microcredit, this paper draws attention to the importance of microfinance for human and private sector development and it explores innovative uses of microfinance. The first section is meant as little more than a simple overview of the very large and still growing literature on the rationale, benefits and limitations of microfinance. In section two, the Indian microfinance experience is described in greater detail. The third part, which is also the core of the paper, analyses the synergies between UNIDO's Cluster Development Programme and microfinance. The concluding section discusses the transferability of UNIDO's experience in India and it emphasises the importance of business development services in addition to financial services.

INTRODUCTION

Long before the term 'microcredit' was coined, governments and donors had devised schemes to reduce (rural) poverty through the provision of credit. Early schemes focused mainly on agricultural loans to small and marginal farmers. Credit for fertiliser and other farm inputs was intended to stimulate productivity and thus poverty reduction. However, past schemes to improve rural finance have mostly failed. The subsidised interest rates at which loans were provided were not economically viable and cheap credit was often captured by influential elites. Most loan programmes accumulated large losses and required frequent recapitalisation.

The failure of subsidised, directed credit programmes raised the need for market-based alternatives. The rise of microcredit in the 1980s and 1990s was partly advanced by the dominant development ideology of the time that emphasised market mechanisms, curtailing government intervention and the promotion of an entrepreneurial culture. Borrowers of microcredit programmes were no longer perceived as beneficiaries, but rather as clients. Over time, however, it became clear that savings products and other financial services were often of greater importance to the poor than access to credit. It was also recognised that the poor need financial services not only for productive purposes, but also to meet household needs.

The term 'microfinance' therefore refers to the provision of a variety of financial products (including credit, savings, insurance and payment services) adapted to the needs of low-income groups. Although precise definitions of microfinance differ, the main characteristics distinguishing microfinance services from those of conventional banks are the size (loans and amounts saved are micro, or very small, in size), the target users (microentrepreneurs and low-income households), the use of funds (for income generation, microenterprise development and possibly for consumption purposes) as well as the terms and conditions which are flexible, easy to understand and adapted to the needs of low-income groups. In India, for example, microfinance is typically defined as the provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards (NABARD, 2004).

The past two decades have shown that microfinance can considerably contribute to economic and human development. Microfinance can foster enterprise and productivity growth by allowing working capital needs to be met, by enabling investment in productive equipment and by facilitating the development of innovative production methods and new markets. In addition to promoting the establishment or growth of microenterprises, microfinance can increase the standard of living of the economically active poor, improve their access to health care and education, reduce vulnerability and promote the

empowerment of women and marginalized groups. To increase awareness about microfinance as a tool to meeting the Millennium Development Goals and to provide an opportunity for sharing innovative uses of microfinance, the UN has declared 2005 as the International Year of Microcredit.

In the UNIDO programme to improve the competitiveness of micro, small and medium enterprises operating in clusters (i.e. geographical agglomerations of enterprises engaged in similar or highly related economic activities), lack of access to formal financial services has repeatedly been identified as a major constraint to private sector development and as a factor perpetuating poverty. It restricts local processing capacities and strengthens dependence on middlemen.

The prime objective of this paper is to provide suggestions on how the provision of microfinance can be integrated into UNIDO's Cluster Development initiatives by guiding cluster development agents (CDAs) with limited background in finance on their role in improving poor cluster actors' access to financial services. Presently, such an objective appears as sufficiently ambitious; for this reason, the paper will not speculate directly on even bolder scenarios, such as the scope for microfinance institutions to become themselves providers of cluster development assistance. Based on a literature review and on the experience gained through UNIDO's activities in India, this paper identifies the most significant areas where microfinance can make an immediate contribution to cluster development and poverty reduction. Throughout the text, examples are given from UNIDO's projects in India in the handloom clusters of Chanderi and Kota and the agro-processing cluster of Sindhudurg. Since UNIDO cluster development projects have neither the resources nor the mandate to establish new institutions that provide microfinance, the paper starts from the premise that CDAs will work with existing financial institutions rather than attempting to provide microfinance itself.

Chapter I reviews existing evidence on microfinance and presents it as a viable solution to meeting the financial needs of the economically active poor. Due to lack of access to formal credit, the poor frequently turn to moneylenders. The provision of microcredit can alleviate the need to resort to informal financial sources and incur the high interest costs and dependency associated with them. Although discussions of microfinance tend to focus on microcredit, other financial services such as savings facilities, insurance products and payment services are frequently of greater importance to low-income groups. Considering the Cluster Development Programme's efforts of mainstreaming gender concerns into the projects in Chanderi and Sindhudurg, the role which microfinance can play in empowering women is also examined. An overview of the benefits and a discussion of the limits of microfinance conclude the section.

Chapter II describes the Indian microfinance experience. Due to the extensive bank branch network, the provision of microfinance in India is different from that in most other countries. The most wide-spread model of microfinance in India links so-called self-help groups with existing formal financial intermediaries rather than relying on the establishment of specialised microfinance institutions.

Chapter III gives a short overview of UNIDO's Cluster Development Programme (CDP)

with special emphasis on the activities in India. It identifies the areas of synergy between the CDP and microfinance providers and examines the role of UNIDO's cluster development agent in promoting the provision of financial services in a cluster. A variety of steps are described to link SHGs with institutions providing microfinance as efficiently as possible. It also briefly addresses what can be done to meet the financial needs of growing micro and small enterprises and non-poor cluster actors.

The concluding section shortly discusses the applicability of SHG-banking to other countries and emphasises that although the provision of financial services is a necessary condition for cluster development, it is by no means a sufficient one.

CHAPTER I:

Microfinance: An Overview

A. Microcredit

i) Lack of Formal Credit

There are over 500 million economically active poor people in the world operating microenterprises and small businesses, most of whom do not have access to adequate financial services (Ledgerwood, 1999)[1]. There are four main disincentives to lending to poor people[2]: (a) high administrative costs of small-scale lending; (b) high risk perception; (c) asymmetric information and (d) lack of collateral. It is very costly for banks to service a large number of poor borrowers who frequently need small loans. Since most of the administrative costs of lending (e.g. maintaining bank branches and cost of bank staff) are independent of the size of a loan, economies of scale arise so that the per unit costs of extending credit are lower the larger the loan. Moreover, administrative costs, such as information-gathering costs (visiting borrowers, analysing applications and monitoring loans) rise exponentially for poor borrowers, in rural areas in particular. In addition to the cost involved, formal lenders do not want to take on the risk of lending to the poor. Poor people are perceived as particularly risky since they often live at subsistence level, their incomes may be seasonal, they are vulnerable to unexpected events, they are often illiterate, they lack a credit record and they frequently operate in the informal economy. The risk of lending is increased by the fact that loan transactions are characterised by asymmetric information. Borrowers know more about the viability of their projects and their ability and willingness to repay than lenders. Since it is difficult for lenders to monitor borrowers, they either refuse to extend credit or demand collateral. Collateral acts as a screening device and reduces the risk of lending. By pledging his/her assets, a borrower signals the quality of his project and his/her intention to repay. However, the assets of the poor, e.g. livestock, jewellery, cooking utensils or TVs, are not deemed 'acceptable' collateral since they do not represent a safe store of value and are not easily sold in case of default. In those cases in which the poor own land or other forms of conventional collateral, deficiencies in the legal system or the fear of negative publicity may prevent banks from appropriating it in the case of loan default. Banks therefore typically prefer not to lend to the poor in the first place.

[1] Following Robinson (2001), the term 'economically active poor' is used here to refer to those among the poor who have some form of employment and who are not severely food-deficit or destitute. It is a heterogeneous group which includes households just living above extreme poverty to those close to lower-middle-income. This corresponds to the poor with whom UNIDO works in its Cluster Development Programme.

[2] The same apply to small and medium-enterprises but are exacerbated for the economically active poor.

ii) Informal Credit

Due to the problems involved in accessing formal loans, the poor often turn to informal lenders, such as local moneylenders, employers, landlords, pawnbrokers and commodity suppliers to finance consumption or working capital. Informal moneylenders provide important financial services to the poor and often function as social safety nets. For borrowers, the transaction costs of informal borrowing are low since moneylenders are conveniently located, loan procedures are minimal and cash is disbursed promptly. However, the interest rates charged are very high, with monthly effective interest rates ranging from less than 5% to more than 1000% (Robinson, 2001). The high variance of interest rates charged by moneylenders is explained by differences in type of loan, risk of lending and bargaining power of the borrower. High transaction costs of lending, low lending volumes, high opportunity costs of capital and absence of legal recourse for loan recovery are additional reasons for the high interest rates charged by moneylenders (Harper, 2003a). The fact that the poor pay extremely high rates of interest to local moneylenders suggests that stable and reliable access to credit is more important to them than the cost. Nevertheless, the high interest rates charged by informal lenders have significant economic and social costs. They inhibit the growth of borrowers' enterprises as retained earnings are reduced by interest payments. In extreme cases, interest rates are so high to force borrower default, leading to land seizures or debt bondage.

Informal credit is typically provided in the context of interlinked transactions, in which borrowers have some relation to lenders, e.g. being an employee or tenant (Robinson, 2001). The proximity between lender and borrower facilitates access to reliable information and increases the lender's control over the borrower. Collateral requirements thus tend to be low in informal credit markets. In those cases in which collateral is required - typically in the case of large loans - a wide range of assets, such as jewellery and household goods, is acceptable as collateral. The interlinked transactions between borrowers and lenders allow high interest rates to be replaced or accompanied by below-market wages or prices for borrowers' goods. Financing working capital needs through supplier credits or advances from employers or customers can also strengthen borrowers' dependence on the lender, as the example of Chanderi illustrates (see box 1.1).

Box 1.1 Credit Needs in the Handloom Cluster of Chanderi[3]

Without access to working capital, the weavers in Chanderi are unable to set-up and operate their looms. However, the majority of weavers are not able to borrow from formal channels. Historically, government credit schemes have been availed of mainly by Weaver Cooperative Societies and have benefited only a select few. Small weavers thus inevitably turn to master weavers and traders who provide advances and raw materials. Although middlemen do not charge interest on loans to weavers, such loans oblige weavers to undertake jobs on a subcontracting basis with their creditor and can reduce their independence in accepting orders from others. Wages paid may also be below the market level if a loan is outstanding.

Middlemen release the raw material required for weaving over an extended time period so that weavers are underemployed and take longer than necessary to weave one sari, which reduces their income stream. They may need to approach their trader for an additional loan to cover weekly expenses, suggesting that weavers' dependence on middlemen creates a vicious circle of poverty.

[3] UNIDO's projects in Chanderi and Sindhudurg are described in chapter 3.

Due to lack of funds, weavers also do not have the capacity to hold stock. More than 70% of weavers do not have enough money to support their families beyond ten days and between 30-40% of the weaving community are unable to save for the next day. They therefore sell their products to middlemen as soon as they are finished. Such distress sales significantly reduce the wages obtained by weavers. A participatory poverty assessment in Chanderi established that the poorest weavers are in a continuous debt cycle resulting from their low wages.

Lack of capital not only impacts adversely on the livelihoods of weavers, but also presents a constraint to cluster development. Weaver's financial vulnerability reduces their willingness to experiment with new designs or fabrics and due to low capital investment in the cluster, looms and technology are outdated.

Access to formal credit is thus crucial for the weavers of Chanderi to (a) obtain raw materials when needed, (b) reduce dependence on middlemen and thereby increase wages, (c) achieve increases in productivity by investing in new looms and technology, (d) improve their ability to innovate, (e) reduce vulnerability to unexpected events and (f) meet household consumption needs. Linking weavers with sustainable sources of finance is therefore an essential component of any poverty-reduction and cluster development strategy for Chanderi.

To avoid the high interest rates and dependence associated with informal commercial lenders, loans are also often taken from relatives, friends or neighbours. Although such loans are typically provided interest free, they tend to be restricted to emergencies and special occasions, rather than for financing working capital needs. Such loans may also involve social, economic or political commitments such as providing free labour, reciprocal future loans or rendering political support - obligations which represent a real cost for borrowers (Robinson, 2001).

Box 1.2 Credit Needs in the Agro-Processing Cluster of Sindhudurg

The agro-processing cluster of Sindhudurg encompasses a range of processors including individuals, self-help groups (SHGs), microenterprises (MEs) and small-scale industrial units (SSIs). Although precise credit needs differ considerably by type of enterprise, all depend crucially on the availability of credit for working capital. Failure to purchase large amounts of cashew apples and fruits results in a restricted processing capacity throughout the year. Access to credit can increase the ability of enterprises to purchase larger and thus cheaper quantities of raw materials as well as to enhance their storage ability. In addition to allowing working capital needs to be met, credit is needed to finance productive investments. The weak financial position of MEs has so far prevented many of them from purchasing good quality cashew cutters, which reduce the number of split cashews and thus result in higher income. The potential for value-added products has also largely remained untapped. Finally, access to credit can facilitate the start-up of microenterprises in areas other than food processing, which many unemployed youth resort to as a livelihoods strategy.

Despite the need for credit, many enterprises in Sindhudurg continue to lack linkages with credit institutions. This is largely because banks are reluctant to finance cashew enterprises due to their high past levels of indebtedness, because they perceive expected margins to be inadequate and because collateral requirements cannot be met.

iii) Benefits of Microcredit

In contrast to conventional bank clients, the economically active poor typically need smaller loans and for shorter durations. They are more sensitive to location, bureaucratic procedures, delays of credit provision and repayment schedules. Microcredit can be a viable alternative to informal financial sources for the economically active poor. It enables access to loans at a much lower price than informal sources, but maintains the ease of access, simple procedures, rapid transactions and flexible loan terms that characterise informal financial markets.

Microcredit programmes have become a favourite strategy of governments and donors to stimulate income-generation and employment creation for the poor. By improving poor people's access to working capital, enabling productive investments and allowing the poor to take advantage of business opportunities, microcredit has the potential to encourage the development of new businesses owned by the poor and to help existing microenterprises grow or diversify their activities. Microcredit can reduce the vulnerability of poor households by facilitating income diversification and allowing consumption smoothing or by enabling microenterprises to remain in business in times of crisis. It can increase the incomes of women and marginalized groups. All this can be achieved through financially self-sufficient institutions.

The private sector is also becoming aware of the benefits of microcredit. A growing number of commercial banks are developing microfinance activities as a new and profitable business segment. Whereas many international banks have funded microfinance activities as part of their corporate social responsibility agenda for several years now, they are increasingly realising that expanding operations to meet the vast number of low-income clients that lie at the "bottom of the pyramid" makes good business sense[4].

iv) Microcredit Delivery

There is significant debate over whether microcredit should be restricted to productive uses or whether consumption loans should also be provided. Proponents of the former argue that only investments in productive uses will entail sufficient returns to enable loan repayment. Advocates of consumption loans counter that loans for consumption purposes are often highly productive. By increasing household liquidity and helping to avoid the higher interest rates of moneylenders, consumption loans free enterprise revenue, which can be directed back into the business in the form of retained earnings. They enable a household to make important investments in education, nutrition and health which in turn strengthen income-generation capabilities, e.g. by allowing sick family members to return to work. Proponents of consumption loans also point to the fact that money is fungible and that it can never be determined with confidence what loans to a household are used for. Although households may claim to use loans for productive purposes, they may in fact use

[4] The "bottom of the pyramid" consists of the 4 billion people in the world earning less than $1,500 per year. Although their individual incomes are low, their combined purchasing power represents a vast, and largely unexplored, market for the private sector. Since the products and services available to the poor are typically substandard, targeting the "bottom of the pyramid" not only makes economic sense for the private sector, but also contributes to poverty alleviation by providing poor people with services and consumer products, increasing their choices and reducing prices (Commission on the Private Sector & Development, 2004).

their own savings for productive investments and divert the loan to non-productive uses. Finally, it is argued that access to credit exclusively for microenterprise development is likely to be less valued by poor households than credit which can also be accessed in times of emergency. Some microfinance providers have therefore developed special loan products for education, housing and other consumption purposes.

Most microcredit providers follow a group-based lending approach, which is modelled on informal lending and savings groups, such as *rotating savings and credit associations* (ROSCAs)[5]. In group lending schemes, borrowers are required to form groups with people of their own choosing, so-called solidarity or, in the Indian context, self-help groups. Loans are either extended to individual members of a group or (as in the Indian case) to the entire group, which then on-lends to individual members. In most schemes, if one or more members of a group fail to repay their loan, no other member of that group receives a loan until the defaulting borrower's debt is repaid. Conventional collateral is thus replaced by peer pressure and/or group guarantees, enabling poor people without assets to obtain credit. In addition to financial benefits, belonging to a self-help group has considerable social advantages. Groups represent a network of people to rely on in times of emergency and can thus function as social safety nets. Experience shows that they can facilitate skills development and the building of confidence and trust. Group membership can thus foster the creation of social capital.

The benefits of group-based lending may be even higher for microfinance providers than for group members. It was seen above that the costs involved in administering small loans, high risk, asymmetric information and lack of collateral are the main deterrents to small-scale lending. Group-based lending approaches address all these factors. By using self-selecting groups that are liable for one another's debts, microfinance providers can reduce risk and shift screening, monitoring and debt collection costs to the borrowers. Lenders' costs are further reduced by alleviating the need for loan officers to disburse loans and collect repayments from individual members. They can instead deal with the group leader. Asymmetric information is overcome since group members are typically from the same neighbourhood and have in-depth knowledge about each other. Peer pressure, group liability and compulsory savings have proven to be good substitutes for physical collateral. Group-based lending is thus cheaper and more effective for microfinance providers than providing loans to individual borrowers.

Although group-based lending is typically presented as the solution to overcoming the difficulties involved in the provision of financial services to the poor, it is not without problems. Firstly, for group members, participation in a self-help group represents significant costs in terms of time spent at meetings and risk of guaranteeing other members' loans[6]. For women in particular, microfinance may lead to an increased

[5] A ROSCA is a voluntary group in which all members contribute a predetermined amount at weekly or monthly meetings. Members then take turns to receive the full amount collected. This continues until all members have received funds, after which the ROSCA is dissolved or a new round is started. The order in which members receive funds is established by lottery, joint consensus or need. However, unlike group-based microfinance approaches, ROSCAs lack flexibility in that members cannot always receive a loan when they need it or for the amount required.

[6] The group discipline which is imposed, including compulsory attendance of meetings and small and fixed

workload because traditional responsibilities such as household chores and child rearing are not reduced while they become involved in time-consuming meetings and income-generating activities. Secondly, peer pressure may sometimes be excessive. There are incidents in which pressure exerted by peers (and sometimes bank workers) to ensure timely repayment has been so strong that borrowers have resorted to moneylenders to be able to repay the loans of microfinance providers, or in which peer pressure has led to emotional distress and even suicides. Thirdly, self-selection of groups often results in the exclusion of the poorest and most vulnerable. Fourthly, individual members and banks do not build a relationship over time and banks may need to incur group training costs. Fifthly, although repayment rates of group-based lending seem to be higher than those of individual lending in good years, the repayment rates may be worse in years with some type of crisis. If several group members are unable to repay, the entire group may collapse (Ledgerwood, 1999). Sixthly, group members have to share the details of their financial needs with others. In this sense, group-based microcredit schemes might be demanding something of the poor that those operating the schemes would not accept for themselves (Harper, 2003a). Finally, some borrowers may require loans that are too big for self-help groups to guarantee. For these borrowers, access to individual loans outside the group system is important.

Although microcredit is often associated with group-based lending approaches, this is not the only mechanism to administer it. There are several examples of institutions effectively providing microcredit to individuals, such as Bank Rakyat Indonesia or the Fédération des Caisses d'Epargne et de Credit Agricole Mutuel in Benin. In contrast to group-based schemes, individual lending is more similar to conventional banking. Lending decisions are based on client characteristics such as debt capacity, financial history, collateral or co-guarantees. However, collateral is typically defined more flexibly than by conventional lenders and more emphasis is placed on character references. Since individual lending requires that staff develop close relationships with clients, loan appraisal is more costly in an individual approach than in group-based lending[7]. Loans are therefore typically larger than in group-based approaches and tend to be suitable for production-oriented businesses. Due to the larger loan sizes and collateral requirements, microfinance providers extending individual loans thus typically do not reach as poor people as those using group-based approaches (Ledgerwood, 1999).

Some microfinance providers have recently begun to issue credit cards as a new form of administering microcredit on an individual basis, allowing clients to access a line of credit to make purchases or obtain cash up to a certain limit at their own discretion. Credit card schemes significantly reduce administrative and operating costs for both clients and lenders. The availability of an ongoing credit line allows borrowers to supplement their cash flow according to their needs and to smooth consumption during income shortfalls. However, for credit card schemes to be effective, the adequate infrastructure (i.e. cash dispensers and retailers or wholesalers able to accept credit cards) must be in place.

savings, are intended to deter richer people from participating. Richer people are likely to find the procedures involved in group lending too cumbersome and may be able to find cheaper loans elsewhere.

[7] However, individual lending models may be less labour-intensive to establish than group-based models since groups do not have to be created first.

The use of credit cards as a means of administering microcredit is still relatively recent. The Kisan Credit Card Scheme for farmers in India illustrates the main benefits of credit card schemes (see box 1.3).

Box 1.3 The Kisan Credit Card Scheme in India

With the introduction of the Kisan Credit Card (KCC) Scheme in 1998, the National Bank for Agriculture and Rural Development (NABARD) has pioneered an innovative credit delivery mechanism which ensures adequate and timely access to credit for participating farmers. Eligible farmers obtain a revolving cash credit facility which allows any number of withdrawals and repayments within a specified limit. The maximum period of repayment for each withdrawal is twelve months. Cards are valid for three years, subject to annual review. Credit limits may be increased as an incentive for good performance. In March 2002, 23.8 million KCCs had been issued by participating banks.

For farmers, the benefits of the scheme are significant. The credit cards enable farmers to purchase agricultural inputs such as seeds, fertilisers or pesticides, and to withdraw cash for production needs whenever required. Since participating farmers can obtain credit at any time, they no longer need to take out large loans at the beginning of a period and can thus significantly reduce their interest costs. Bureaucratic procedures are minimised and, depending on the bank, cash withdrawals are possible at branches other than the issuing branch. KCC holders are also eligible for a personal accident insurance scheme, which covers them against death or permanent disability resulting from accident.

Participating banks also benefit from the scheme. Transaction costs are reduced since repeat appraisal and processing of loan applications can be avoided and paper work is minimised. The recycling of funds is facilitated and banker-client relations may improve.

Source: NABARD (2004)

v) Risks of Microcredit

Despite the obvious benefits of microcredit for the poor, there is a need to be aware of the unintended consequences it may have. The other side of microcredit is 'microdebt'. The economically active poor do not always have business opportunities to exploit and due to lack of skills or information, bad decisions or events beyond their control, they are not always able to repay their loans (Hulme, 2000). Business failure and the resulting inability to repay loans do not only have adverse economic effects on the poor, but can also result in a further loss of self-confidence from an already low level. In some cases, intrahousehold tensions may also rise because households experience difficulties in repaying loans or because husbands do not approve of their wife's participation in microcredit schemes. Nevertheless, most impact assessments of microfinance programmes report positive or neutral findings (Simanowitz & Walter, 2002).

Although discussions on microfinance tend to focus on microcredit, other financial services such as savings facilities, insurance and payment services are at least of equal importance to the economically active poor.

B. Microsavings

Contrary to common belief, the economically active poor can and do save. They often have no choice but to save because they know that in times of emergency, their options are limited. They typically do not have health or life insurance, they experience significant income losses if they are ill, job security tends to be limited and they do not have pension schemes (Harper, 2003a). However, since commercial banks are often unwilling to incur the costs involved in handling the small deposits of poor people, deposit facilities are seldom available to the economically active poor.

Without access to formal savings services, the poor typically save at home, in informal savings associations or by using the services of deposit collectors. They save by keeping cash in the household or in kind, e.g. by investing in land, grain, livestock, raw materials and jewellery. However, cash savings are often unsafe since other household members may take them and there is danger of theft or accidental destruction. Investing in nondivisible assets makes savings illiquid and carries the risk of losing value (e.g. animals may die and raw materials may deteriorate). Many poor people save in rotating savings and credit associations (ROSCAs) or in accumulating savings and credit associations (ASCAs)[8]. However, particularly the former have fairly rigid procedures and timing. Moreover, the size of funds may not necessarily coincide with financial needs. In absence of a reliable place to store their money, the poor often pay deposit collectors and accept a negative interest rate for their savings.

Box 1.4 Rotating Savings and Credit Associations in Chanderi

Chit funds are the South Indian form of rotating savings and credit associations and serve as substitutes for formal financial institutions. At each meeting, the 'winner' is determined through a random draw. The person who wins is immediately given the entire amount collected but must continue to contribute in subsequent meetings until all members have received the fund once. If there is a delay in payment, a fee (e.g. in Chanderi, Rs 20 or USD 0.45 per day) is to be paid.

Since banks and other financial institutions are inaccessible to weavers in Chanderi and relatives rarely have the capacity to help them, weavers feel they have no other option but to approach shopkeepers and/or traders or to participate in a chit fund. Almost one third of weaver families, in particular Muslims, regularly contribute around Rs 100 (USD 2.20) to a chit fund in the hope of winning a lump sum. However, when this happens, the amount is spent on urgent needs rather than invested in income-generating activities. People play in the hope of being able to repay debts, purchase durable goods or marry their daughters with the money 'won'.

During a participatory poverty assessment in Chanderi, it was established that the total value of chit funds in the surrounding area was about Rs 111,000 (USD 2,450) per week, with 800-900 members (approximately 500 families) contributing. This represents a circulation of more than Rs 5 million per year (USD 110,000) and an average contribution of over Rs 10,000 (USD 220) per family per year.

[8] In ROSCAs all members are both savers and borrowers and the capital of the fund does not grow during its lifecycle since a new fund is formed and depleted during each meeting. In ASCAs, by contrast, all members are savers but not necessarily borrowers. The fund is lent to members and grows with the interest charged. ASCAs offer more flexibility than ROSCAs in terms of loan sizes and timing.

In contrast to informal savings, deposit facilities with microfinance providers ensure security, liquidity, convenience, divisibility of savings, confidentiality, access to loans and returns[9] (Robinson, 2001). They allow the poor to accumulate the lump sums required for life cycle events such as births, marriages or funerals, for religious obligations and for school fees. Savings also play an important role in reducing vulnerability. They represent a fall-back option for the poor in times of emergencies and enable them to meet unforeseen expenses such as those arising from illness or death of a relative. They help smooth consumption by making it possible to resort to past income during lean periods. By alleviating the need to resort to informal financial sources, access to savings services can help wean away the poor from moneylenders. Microentrepreneurs can benefit from access to savings services to facilitate self-financing of working capital needs, accumulating funds for investments in productive equipment and/or taking advantage of unexpected business opportunities.

The availability of both savings and credit products can be particularly beneficial for microfinance clients. Such a combination of financial products improves microentrepreneurs' ability to manage working capital needs by borrowing and saving when required. Business profits can be deposited and savings can be used to purchase assets which in turn can serve as collateral for larger loans. Offering a combination of deposit mobilization and credit facilities in rural areas has an additional economic benefit: it helps keep savings in rural areas and thus stimulates regional economic growth. This in turn may have second-order effects on reducing poverty.

The provision of deposit facilities not only benefits the clients, but also the providers of microfinance. A savings component increases the funds available for on-lending without needing to resort to external sources. If savings serve as a guarantee, they can reduce a lender's risk. The provision of saving services by a microfinance provider may enhance clients' perception of ownership and thus potentially their commitment to loan repayment (Ledgerwood, 1999). Finally, the likelihood of loans being used for consumption purposes is reduced if savings facilities are available.

Many microfinance providers, even those not providing voluntary savings facilities, require compulsory savings before loans can be accessed. It is claimed that compulsory savings test clients' ability to make periodic contributions and to manage cash flows, which is of importance for loan repayment. They help borrowers to build up an asset base and thus demonstrate the value of regular savings. There is, however, considerable debate about the usefulness and desirability of compulsory savings. Opponents maintain that the poor know how to save and do not need to learn financial discipline. For clients, compulsory savings represent an additional cost of accessing credit since the opportunity costs of not investing the funds in the borrower's business may be significant. If compulsory savings cannot be easily withdrawn, borrowers may be taking out loans for amounts that are less than their accumulated savings.

[9] However, returns are typically of least importance to poor savers with limited access to savings services.

Wage workers in Sindhudurg would benefit significantly from the availability of savings products to reduce the hardship of seasonal unemployment. Workers - women in particular - are typically not hired on a permanent basis. Work in cashew microenterprises is normally only available during three to four months per year and agricultural daily wage labourers usually only find employment for five to six days a month. Access to savings products may facilitate consumption smoothing and alleviate the need to sell productive assets in times of limited income.

C. Microinsurance

Due to their low income and asset levels, the poor are particularly vulnerable to adverse shocks. Like savings, insurance services (such as life, accident, health or property insurance) can help the poor cope with unexpected events or emergencies and prevent them from sliding further into poverty. Unlike savings, however, insurance products allow clients to obtain more funds than they paid in - if the event that was insured occurs. Yet, the poor are typically not insured against the risks they face daily. They often do not know about insurance, they may not be able to afford it or insurance companies do not offer suitable insurance products for the poor (Harper, 2003a). There are still few microfinance providers offering insurance products, although the number is rapidly increasing.

Most microfinance institutions do not have the skills and financial strength to provide viable insurance services. However, they do not necessarily need to offer microinsurance themselves but can act as intermediaries between insurance companies and their clients. Partnerships between microfinance providers and insurance companies provide benefits for all involved. The poor benefit from greater insurance coverage at lower cost than if the microfinance provider offered insurance coverage on its own (Brown, 2001). Insurance companies gain access to a new market segment while incurring minimal transaction costs. Microfinance providers can earn commissions from insurance companies and reduce the risk of non-wilful default if borrowers are insured against adverse events which can affect loan repayment (Harper, 2003a). Nevertheless, in most partnerships - particularly where insurance companies have little experience with low-income clients - insurance coverage continues to be restricted to basic life insurance, which is the least complex form of insurance. Whereas the poor could benefit from a variety of insurance products, poor households do not necessarily want to be insured against all risks. Brown (2001) reports that while microcredit clients in Cambodia valued health insurance, they were not interested in insuring themselves against death of livestock.

Some microfinance providers have incorporated a form of insurance into their group lending activities. In the Grameen Bank, for example, each member contributes 1% of the loan amount to a risk fund. In the event of a client's death, the fund is used to repay the loan and to provide his/her family with money to pay for the funeral.

Box 1.5 Insurance Scheme in Chanderi

In Chanderi, UNIDO staff help weavers avail of a government insurance scheme. The Government of India (GOI), in cooperation with the Life Insurance Company of India, offers a welfare scheme for weavers under which weavers can insure themselves against accidents leading to injuries (minor and major) and against death. In Chanderi, 129 weavers are benefiting from the scheme. To obtain insurance coverage of up to Rs 20,000 (USD 440) in case of natural death and up to Rs 50,000 (USD 1,100) in case of accident, weavers must pay an annual fee of Rs 130 (USD 2.85).

As a part of the scheme, GOI and State Governments offer an educational scholarship to encourage weavers' children to attend secondary schools. Per family, a maximum of two children attending grades nine through twelve are eligible to receive the scholarship of Rs 100 (USD 2.20).

The poor are often unaware of the existence of insurance. In many cases, introducing an insurance scheme in a cluster therefore needs to be preceded by education on what insurance is, why it is useful, what procedures must be followed to receive insurance and how to file a claim. In Chanderi, UNIDO has been instrumental in making weavers aware of the scheme's existence and has played the role of facilitator. UNIDO staff helped weavers fill out insurance forms and collected the annual fees.

D. Payment Services

Payment services include check writing and check cashing rights as well as the transfer and remittance of funds from a place to another. Payment services are important to facilitate the procurement of raw materials and the sale of goods as well as to receive remittances from relatives that have migrated, be it to urban centres or abroad. Transfer services may be of particular importance to the economically active poor. Without them, entrepreneurs need to carry cash for all financial transactions. Since the risk of theft may force entrepreneurs to carry less cash, they may incur higher prices on purchases, lower prices on sales and higher costs due to more frequent trips (Hatch, Levine & Penn, 2002).

To be able to provide payment services, a microfinance provider must have an extensive branch network or relationships with at least one bank. Therefore, few are currently offering payment services despite their obvious importance to clients (Ledgerwood, 1999).

E. Gender Aspects of Microfinance

In contrast to conventional financial institutions which have traditionally focused on men, microfinance providers tend to have a majority of female clients. There are three main reasons for targeting women in microfinance programmes: (a) to facilitate the provision of microfinance; (b) to maximise the positive externalities of microfinance and (c) to promote women's empowerment.

For many microfinance providers, the reason for focusing on female clients is mainly of a practical nature. Repayment rates are typically higher for women than for men, partly because women tend to have fewer alternative sources of finance and are easier to reach. Women are also seen as more compliant and reliable. They are perceived to have a higher

sense of responsibility and to be more affected by social pressure than men (Harper, 2003a; Ledgerwood, 1999; Simanowitz & Walter, 2002).

Another reason for targeting women is that the positive externalities of microfinance seem to be greatest when it is provided to women. Improvements in women's economic and social status appear to have a greater impact on the health, nutritional and educational levels of other household members than those of men since women seem to spend more of their income on the household.

Many microfinance providers have the explicit goal of empowering women by providing them with greater financial security and increasing their economic position in society[10]. By enabling them to make important economic contributions to their households, microfinance often improves women's status within the household. This in turn strengthens their decision-making power. Evidence from various countries shows that participation in microfinance programmes frequently has a positive effect on women's influence in the areas of family planning, children's marriage, sending daughters to school and buying and selling of property. Most female microfinance clients also report improved relationships with their husbands and families as well as a decrease in domestic violence (Cheston & Kuhn, 2002). The fact that even illiterate women can receive and handle banking services can provide an important boost to self-confidence and can prove to the wider community that women are capable of managing their own businesses.

Although the economic improvements associated with microfinance are probably the most important factor contributing to women's empowerment, other aspects of microfinance programmes, such as group membership and training, also play a role. For example, leadership and public speaking skills learned in groups often help women be more confident and increase their ability to interact with others in their households and communities. Several accounts exist where people in villages turned to self-help groups rather than to traditional leaders to help them solve problems. Finally, the respect that microfinance clients receive from bank staff can in itself be empowering.

Women in Sindhudurg, feel that enterprises started jointly with other members of their self-help group have enhanced their control over their lives. Activities such as selling vegetables or the preparation and marketing of snacks have increased their disposable income. This has been used not only to take care of their personal needs, but also to help each other with small amounts of credit in times of crisis (see section 2). Access to credit and savings can thus have significant non-pecuniary benefits.

Despite the arguments suggesting a positive impact of microfinance on women's empowerment, there is reason for caution. Access to financial services for women will not automatically lead to increased welfare or gender equality. Although many women worldwide are already contributing to household income, their status within the household continues to be low. In Chanderi, for example, women reported that despite earning a

[10] The term 'empowerment' is seldom precisely defined, but typically refers to women's increased ability to take decisions within the household and the wider community and their ability to have access and control over resources. This process is accompanied by changes in social attitudes towards women.

living for the family, they have little control over the household's finances or even over their own earnings. The men in the family continue to decide on expenditures. As long as women continue to lack social resources such as access to education, they will only be able to make limited use of the financial resources they have obtained. As Cheston and Kuhn (2002, p.178) observe: "The ability of a woman to transform her life through access to financial services depends on many factors – some of them linked to her individual situation and abilities, and others dependent upon her environment and the status of women as a group".

There is some empirical evidence which questions the positive effects of microfinance on women. In a study of microcredit provision to women in Bangladesh, Goetz and Sen Gupta (1996) find that only in 37% of cases, women retained full or significant control over loans, while 63% of cases fell into the categories of partial, very limited and no control over loans[11]. Particularly when women are not generating cash income themselves and have to ask their husbands for funds to meet their regular loan repayments, dependency can be reinforced and new sources of tension may arise. However, control over loans is by itself not a good indicator of empowerment. 37% of loan retention may already be a significant achievement in a gendered society such as Bangladesh. In societies in which women are precluded from access to markets, male relatives remain important mediators. Indeed, cooperation between men and women may already be a form of empowerment. It can also be considered an improvement if women and men take joint decisions on business investments since husbands would previously have taken the decisions by themselves (Cheston & Kuhn, 2002). Finally, handing over loans to male relatives may increase women's bargaining power or may be a survival strategy (e.g. to preserve a marriage or to guarantee food supply). For example, Rahman (1986, quoted in Goetz & Sen Gupta, 1996) found that female Grameen Bank borrowers who had transferred their entire loan to a male relative had a higher nutritional status and more money spent on clothing and medical needs than wives of male borrowers. Nevertheless, as long as women borrowers bear the liability for loans invested by their male relatives, loan retention remains an important variable.

F. Benefits of Microfinance

The preceding discussion has shown that microfinance can lead to increased income, consumption and human capital accumulation. It can reduce vulnerability and may improve women's economic and social status. As Ledgerwood (1999, p.1) notes: "[m]icrofinance is not simply banking, it is a development tool". Box 1.6 summarises the benefits of microfinance for the economically active poor.

[11] It was found that women were more likely to retain full control when they were widowed, separated or divorced, when loans were invested in traditional women's work such as livestock rearing, when loans were small and when resources were provided in kind.

Box 1.6 Benefits of Microfinance

Microfinance can:

- **Promote microenterprise development** by facilitating access to working and investment capital as well as enabling bulk purchases of inputs, which entail cost reductions
- **Improve household income and reduce poverty** by promoting microenterprise development and facilitating income diversification
- **Promote economic independence of the poor and marginalised and decrease exploitation by local elites**.
- **Stimulate employment creation** for household members and others.
- **Enable consumption smoothing** by reducing seasonal fluctuations in income.
- **Help avoid recourse to moneylenders** as well as the dependence and high interest rates associated with informal credit.
- **Act as a social safety net and reduce vulnerability** by helping to protect against risk ahead of time and to manage losses following an adverse shock. Microfinance clients may also be more able and likely to seek outside support and demand the services they may be entitled to.
- **Increase physical asset accumulation** (both for business and household purposes) either through direct loan use or through profits re-investment. Existing assets can also be improved and protected, e.g. by having funds to repair equipment or avoiding the sale of productive assets in the event of a crisis.
- **Improve women's economic and social status** and thus have an empowering effect on women.
- **Increase clients' self-confidence**.
- **Alleviate the need for child labour.** However, child labour may initially rise as children are relied upon to ease women's increased work burden.
- **Increase human capital**, by improving nutrition as well as access to health care and education.
- **Allow provisions for old age**, which could in the long-term affect fertility rates.
- **Allow improvements in housing**.

Source: Robinson (2001); Simanowitz & Walter (2002).

G. Limits of Microfinance

Despite the significant benefits of microfinance, it is not a panacea for the elimination of poverty. It has its limits, including that (a) by itself microfinance is often insufficient to alleviate poverty, (b) microfinance typically does not reach the 'poorest of the poor', (c) not all economically active poor want to become microentrepreneurs and thus can benefit from microcredit, (d) microfinance may lead to the displacement of entrepreneurs without access of microfinance, (e) there might be cultural or religious reasons against accessing microfinance products and (f) many microfinance programmes have simply failed.

Access to microfinance is by itself insufficient to reduce poverty. The economically active poor need skills, adequate technology, profitable investment opportunities and access to markets to make their business ventures profitable. Frequently, limited demand, low quality products, unavailability of inputs, scarce public infrastructure and lack of education and health care facilities is an even greater obstacle to enterprise growth and poverty reduction than lack of capital. The fact that credit on its own fails to address many of the constraints faced by the economically active poor is supported by evidence suggesting that - although microfinance can play an important role in enabling enterprises

to survive in times of crisis - there appears to be a ceiling on the growth that is stimulated by improved access to credit (Dawson & Jeans, 1997).

There has been considerable debate over whether microfinance can and should reach the 'poorest of the poor'. Microcredit in particular, seems to help mostly those on the upper edge of poverty. People near the poverty line are typically more likely to have business opportunities and thus more able to make productive use of microcredit than the 'poorest of the poor'[12]. The poorest, by contrast, will channel any available money into meeting basic needs. Although the poorest may have a need for credit, their debt capacity, i.e. their ability of taking on debt without running the risk of inadequate cash flow and subsequent loan default, is likely to be insufficient. Encouraging these people to take on debt will serve neither the borrower nor the lender. As Robinson (2001, p.73) emphasises: "commercial microfinance is a complement to, not a substitute for, government and donor poverty alleviation and employment generation programs for the extremely poor". Some microfinance institutions, such as BRAC in Bangladesh, have therefore developed special programmes for the poorest, in which they provide grants or food for a fixed period of time. This is intended to stabilize clients' income so that, over time, they will be able to graduate into the institution's mainstream credit programme. Despite the limited usefulness of microcredit for the poorest, other microfinance products such as savings facilities and insurance are likely to assist them in managing their livelihoods.

Not all poor want to invest and be entrepreneurs. Entrepreneurship requires a certain degree of skills and owning and managing a business carries a risk that not everyone is able and willing to assume. Self-employment is therefore often a last resort and many poor people would prefer stable wage employment. Nevertheless, whereas poor wage labourers may not benefit directly from microcredit, they typically do gain from access to reliable savings and insurance services and may benefit indirectly if they find employment in an enterprise that was created or expanded with microcredit. There is evidence that daily wage labour rates of the poorest increased in Bangladesh as a result of microfinance interventions (Wright & Dondo, 2001).

A loom in Chanderi costs between Rs 5,000 and Rs 8,000 (US$ 110–176). This represents over one third of an unskilled weaver's annual salary. Only very skilled weavers can accumulate enough capital to become independent weavers. For poor weavers, it is less risky to work as labourers than to be independent. In these cases, the provision of microcredit to buy a loom could be counterproductive and result in a debt trap - unless it is accompanied by skills training, which provides weavers the opportunity to increase their incomes.

Microfinance may displace some economically active poor without access to credit through competition with microfinance clients. Particularly in saturated markets characterised by low entry barriers, low skill levels and lack of innovation, the growth of

[12] Some authors (e.g. Simowitz & Walters, 2002) challenge the belief that very poor people cannot productively use credit by arguing that inadequate financial products are typically the problem. There are some microfinance institutions that attempt to serve only the very poor. These institutions are, however, mostly dependent on subsidies.

enterprises with access to microfinance may take place at the cost of displacing those unable to obtain credit. Thus, microfinance targeted only at a subgroup of the population can entail significant displacement rather than the creation of employment (Dawson & Jeans, 1997).

For cultural or religious reasons, some people may be reluctant to take out microcredit or to deposit their savings in financial institutions. Most devout Muslims accept the interpretation of the Koran that all "riba," i.e. a fixed rate of interest on loans or deposits, is forbidden. Islamic banks may therefore neither charge or pay interest, nor can they require specific provisions for inflation. Instead, they earn their money by charging fees and by sharing the risk and profits with entrepreneurs. For Muslims it is forbidden to give money to financial institutions and to collect interest at the end of a certain period. They may therefore not have regular savings accounts and any interest which accrues must be given to charity.

Finally, not all microfinance programmes have done well. The success of microfinance programmes crucially depends on an enabling macroeconomic, political, legal and regulatory environment. There is some evidence (e.g. Yaqub, 1995) suggesting that the low default rates of many microfinance institutions may not be sustainable in the long run. Through larger repeat loans and the resulting increase in income and assets, clients obtain access to alternative sources of finance and are less dependent on microfinance providers. They may therefore be more likely to default.

CHAPTER II:

Microfinance in India

A. Background

Since independence, a variety of government schemes have been initiated in India to improve access to credit for the rural poor. In particular, the introduction of special credit programmes and the expansion of the banking sector were intended to make the financial system responsive to the needs of small and marginal farmers, landless labourers, rural artisans and other economically active poor. From 1977 until financial liberalisation in 1990, the Indian banking network saw a rapid expansion under the initiative of the central bank, the Reserve Bank of India (RBI). The RBI had mandated that commercial banks could only open a branch in developed areas if four branches were opened in locations with no bank branches. The bank expansion programme resulted in an extensive branch network, which is unparalleled in other countries. The Indian rural and semi-urban banking network today is made up of about 33,000 branches of scheduled commercial banks, 14,500 branches of regional rural banks (RRBs), over 12,000 branches of district level cooperative banks and 92,000 primary agricultural cooperative societies. Semi-formal and formal financial services are available within less than 5 km for about 99% of the Indian population (Kropp & Suran, 2002). The provision of credit to the poor is further promoted by the requirement that commercial banks must direct at least 40% of their credit portfolio to priority sectors (including agriculture and allied activities as well as small, cottage and village industries). Moreover, 10% of their loan portfolio must be provided to weaker sections of society, including scheduled castes and tribes, small and marginal farmers, agricultural labourers or rural artisans (NABARD, 2004).

Despite the unique outreach of the Indian banking network and the existence of a variety of credit schemes, the financial needs of the rural poor remained largely unmet by the formal financial system. Since the bulk of bank lending was for agricultural purposes, landless labourers, artisans and the assetless poor were still largely neglected by the formal financial sector and small loans for business purposes were often not available. Some schemes were predetermined and could not be modified to the needs of borrowers. As in many other developing countries, the subsidised loans provided resulted in significant losses. Low interest rate margins forced banks to cut down on appraisal and monitoring costs (NABARD, 2004). Loan recovery of regional rural banks was 56% of amounts due in March 1996 (Robinson, 2001). Although RRBs have been successful in mobilizing savings, these deposits were often on-lent to larger borrowers in urban areas, shifting liquidity from rural to urban areas. In the early 1990s, it was estimated that between 35% and 40% of rural households in India continued to depend on informal sources of credit (NABARD, 2004). The failure of government credit programmes raised a need to find more viable mechanisms for administering small loans to the rural poor.

Today, three main models of microfinance can be identified in India: (a) the Grameen model, which is based on the methodology pioneered by the Grameen Bank in Bangladesh; (b) the cooperative model, in which cooperative societies provide credit and savings services to their members and (c) the SHG model (L.B. Prakash, 2004). The SHG model consists of linking so-called self-help groups (SHGs), comprising between ten and twenty poor members, to existing financial institutions. The strength of the model is that it uses the existing network of banks which are legally allowed to mobilise savings rather than having to rely on newly established specialised microfinance institutions which are slow and costly to develop and whose capability and financial strength is not guaranteed. With its equal emphasis on credit and savings, the SHG model has evolved into the main microfinance model in India. Due to its importance to the Indian context and the potential synergies with UNIDO's pilot cluster projects in India (see section 3C), the SHG model will be the form of microfinance provision focused on in this paper[13].

B. The SHG-Bank Linkage Programme

Following an action research project by the National Bank for Agricultural and Rural Development (NABARD) and the NGO Myrada in 1987 and a pilot phase in 1992, the SHG-Bank Linkage Programme was mainstreamed as a normal banking activity in India in 1996. The programme was supported by the Reserve Bank of India. RBI allowed savings accounts of informal groups to be opened by the formal banking system, gave appropriate guidelines to banks to take up the programme and classified SHG-lending as priority sector lending for commercial banks, RRBs and cooperative banks.

NABARD's vision in 1998 was to provide access to finance for one third of the rural poor through the SHG-Bank Linkage Programme by linking 1 million SHGs by 2008. This goal was met ahead of schedule. By March 2004, banks had cumulatively lent Rs 39.04 billion (USD 860 million) to 1,079,091 SHGs[14], providing about 16.7 million poor households with access to the formal banking system. Today, the SHG-bank linkage model is one of the world's largest microfinance initiative in terms of outreach (Kropp & Suran, 2002).

NABARD is the pioneering agency of the SHG-Bank Linkage Model. It partly finances the cost of SHG promotion, provides 100% refinancing to participating banks and offers revolving fund assistance on a selective basis to NGOs, SHG Federations, credit unions and other organisations providing microfinance for on-lending. NABARD also provides capacity building support to bank officials, NGO staff, government officials and SHG members. In addition to NABARD, several other apex bodies or wholesalers provide loans to financial intermediaries for on-lending to SHGs. These include the Small Industries Development Bank of India (SIDBI), Rashtriya Mahila Kosh (RMK), Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC) and Friends of Women's World Banking (FWWB). Some donors and banks (e.g. Rabobank) also provide grants and loans to microfinance institutions for on-lending to SHGs and SHG federations (Tankha, 2002).

[13] In Sindhudurg, UNIDO has also been working to strengthen cooperative societies.
[14] Nearly 90% of SHGs are women-only groups (NABARD, 2004).

C. Functioning of SHG-Bank Linkage

The main steps involved in the SHG model include group formation, accumulation of group savings, internal lending and on-lending of bank loans.

i) Group Formation

SHG formation is typically promoted by external facilitators such as NGOs, banks, government agencies or volunteers[15]. Once the poor have become convinced of the benefits, they form affinity groups of about ten to twenty members. A similar socio-economic background of members ensures that they feel at ease and fosters equal participation of members. Since joint savings and internal lending of these savings are important components of the SHG model, the affinity between members is fundamental and it is crucial that members feel they can trust and work with each other.

In a Cluster Development Project in the handloom cluster of Kota (Rajasthan), SHG members emphasised the importance of knowing other members well. However, they pointed out that being related too closely would present problems for peer pressure. In their opinion, they would not be able to do anything if their brothers took the money and did not repay.

During initial meetings, SHG members set rules for the group. It is important that these rules evolve through consensus, that members are aware of the rules and ensure that rules are implemented. Meetings take place regularly at predetermined intervals, e.g. weekly, fortnightly or monthly. Regular meetings foster confidence building among members and improve knowledge of group members.

Members should not join as a condition for receiving a benefit (e.g. access to credit or external assistance), but because they see membership as a means to improve their situation through their own efforts. It is important that groups have a fixed membership and a name to ensure that the group is not a place where people can walk in and out at will[16]. SHGs can be registered or unregistered. Experience from Bangladesh (Yaqub, 1995) suggests that group formation and cohesiveness of groups has a positive effect on repayment rates at later stages. Special emphasis must therefore be put on group development during the formation stage.

ii) Accumulation of Group Savings

Soon after the formation of the group, a savings account should be opened in the group's name. The SHG authorises three members to operate the account. During each meeting, savings are collected from all members. The group decides on the frequency and amount

[15] For more detailed information on forming SHGs, see NABARD's *Handbook on Forming Self-Help Groups*, available at http://www.nabard.org/roles/mcid/formingshgs.pdf.

[16] A group's name often gives an indication of members' expectations of the SHG. In Sindhudurg and Chanderi, the names of SHGs included "Moral Support", "Inspiration", "Freedom Fighter" and "Constitution".

of savings (or thrift). Monthly amounts saved tend to be small, between Rs 20 and Rs 100 (USD 0.45 – 2.20) per person and are entered into individual passbooks and the group passbook. Regular savings are intended to encourage financial discipline, to provide members with a safe place to save and to build up an internal resource base for the group.

iii) Internal Lending

After about two to three months, the pooled savings are used to make small interest-bearing loans to members[17]. Savings and internal lending allow members to meet consumption and production needs and provide training for future larger external loans. Evidence from Myrada (2000) suggests that in the first year after SHG formation, between 40% and 50% of internal loans are provided for consumption purposes and to release members from moneylenders. At later stages, asset loans become more common. For members, the advantages of borrowing from their group is that loans received can be significantly higher than individual accumulated savings, the amounts required can be negotiated rather than having to accept a pre-determined package, there are no bureaucratic procedures involved, no official guarantors are necessary, and credit is available when needed (Myrada, 1986). The fact that members are simultaneously borrowers and lenders serves as an incentive for repayment. The trust developed through collective savings and internal lending is a crucial component for future joint activities in other areas, such as common production.

Loan proposals, repayment schedules and interest rates are decided upon by the group during meetings and recorded in the minutes book. Good SHGs not only approve loans but also reject some for valid reasons (Myrada, n.d.a). Due to their knowledge of the group members and the environment in which they operate, SHG members are good judges of which business projects are viable.

Experience from UNIDO projects has shown that internal lending is used for both consumption and production purposes. In Kota, internal loans have been used to deal with emergencies and to pay off previous debts. For example, one SHG-member obtained a loan from her group to pay for her husband's operation who had had an accident. In another group, a woman borrowed the entire group fund of Rs 20,000 (USD 440) in order to pay off a mortgage. She realised that with the savings on interest rates, she would be able to install a loom and increase her income. The group negotiated that her land titles be used as collateral.

In Sindhudurg, three members of an SHG took a joint loan from their group to produce goods to be sold during the Ganesh Festival and for agricultural production. A member from another SHG took out a loan to buy a rickshaw for her husband. Another member used her loan to set up a grocery stall for her husband. In a third group, a member took out a loan to pay for her son's wedding. Other activities financed through internal loans included trading in cashews, poultry rearing, setting up shops, the purchase of a sewing machine and housing improvements. SHG members said that if the loans could not be repaid, they would seize the defaulting borrower's goats.

[17] SHGs are thus a form of Accumulating Saving and Credit Association (ASCA).

iv) On-Lending of Bank Loans

After about six months, bank staff visit groups and grade them on their performance. SHG assessment differs considerably from that of individuals. Whereas individuals are evaluated on the quality of their projects or their ability to provide collateral, SHGs are assessed on group dynamics and group performance. Grading criteria include frequency and attendance of group meetings, enforcement of rules, maintenance of books, regularity of savings and utilisation of savings for internal loans. If found to be satisfactory, groups can obtain loans or overdraft facilities from financial institutions - typically up to four times the group's common fund[18]. Loans are made to the group, not to individual members. All members are jointly liable for loans provided to the group, which are used to supplement the group's internal funds for on-lending to members. For most SHG members, this is the first time in their lives that they have access to formal loans.

SHGs can be considered financial intermediaries that reduce costs for both borrowers and lenders. It is the SHG which decides on whether a member's loan application should be accepted and sets the interest rate. Some groups charge lower interest rates for loans aimed to cope with emergencies than for loans for income generation. The purpose of the loan does not need to be specified to the bank. Group liability, peer pressure and group savings are used as substitutes for traditional collateral. In general, interest on loans from SHGs tends to be lower than those of moneylenders, but higher than those of banks[19]. Members are willing to pay these higher rates because they know that the interest will flow into their common fund. Loan monitoring is also undertaken by the SHG and not by bank staff. If repayment problems arise, SHGs decide how to deal with defaulters and repayment flexibility is therefore granted if necessary. Within SHGs, peer pressure is thus complemented by 'peer sympathy' which facilitates rescheduling of loans in case of crisis (NABARD, 2004).

Loans from banks tend to be short- to medium- term, i.e. up to three years. Well-performing SHGs have the option to receive increased repeat loans. In 2002, average loan sizes per SHG were Rs 22,240 (USD 490) and Rs 1,300 (USD 30) per member (Seibel & Dave, 2002). Some SHGs also give loans to non-members and thus channel the resources obtained through SHG-linkage to the wider community. However, the efficacy of peer pressure may be reduced in these cases.

[18] Some SHGs choose to remain pure thrift groups which do not access credit.

[19] In 2001-2002, NABARD refinanced banks engaged in SHG lending at 7% p.a., interest rates on bank loans to SHGs ranged between 9.75% and 16% p.a. and SHGs on-lent to their members at about 2% per month or 24% p.a.. The SHG-Bank Linkage Programme thus represents one of the microfinance programmes with the lowest interest rates worldwide (Seibel & Dave, 2002). In areas with vibrant SHGs, substantial decreases in the reliance on moneylenders and lower informal interest rates have been reported.

Box 2.1 Characteristics of Well-Functioning SHGs

SHGs should:
- Be homogeneous in socio-economic terms.
- Have between 10 and 20 members.
- Have members who are residents of the same area and who have an affinity to each other.
- Have written rules, which regulate aspects related to membership, frequency and time of meetings, savings, credit, etc.
- Hold regular meetings (e.g. weekly, fortnightly or monthly) to strengthen intragroup relations. Dates and times of meetings should be fixed.
- Maintain records including minutes book, attendance register, members savings ledgers, a group passbook, etc. to ensure transparency.
- Take decisions collectively.
- Elect leaders democratically and rotate leadership to give all members the chance to develop leadership skills and to avoid group capture by one or two dominant members.
- Avoid terms such as 'president', 'chairman' or 'group leader' which are associated with positions of power. Use neutral terms such as 'representative'.
- Ensure that loan requests and loan approval as well as payments (i.e. loan disbursement, repayments and savings) take place during group meetings to ensure transparency.
- Levy fines, e.g. in the event of coming late, failing to attend meetings without an adequate excuse or late payments of savings and/or loan instalments.
- Exclude members who deliberately break the rules.
- Encourage members who want to save more than the required amount to set up an individual savings account at a bank, to avoid complication in bookkeeping and dominance in decision-making by some members[20].
- Discuss and try to find solutions to family or community problems during meetings.

v) SHG Federations

In recent years, SHG Federations have been created to improve access to finance as well as to improve service provision to SHGs. They are formal institutions, typically registered under the Societies Registration Act. SHG Federations allow the resources of individual groups to be pooled and thus to channel resources from surplus groups to resource-deficit SHGs. Some federations also act as financial intermediaries between financial institutions and SHGs. A number of federations perform no direct financial function, but instead provide services such as training, marketing, legal advice, advocacy as well as SHG promotion (Harper, 2002).

[20] However, some banks may be reluctant to open individual savings accounts for SHG members, because the main benefit of SHG-banking for them, i.e. the reduction of transaction costs, is thereby partly diminished.

Box 2.2 SHG Federations in Two Indian Clusters

In Sindhudurg, 16 SHGs have formed a network for food processing. The SHGs pooled their savings as a common fund for the network and each SHG contributed an additional Rs 300 (USD 6.60) as an annual fee. The network applied for a common loan and received Rs 50,000 (USD 1100), which was used to purchase the equipment necessary to process kokum and enabled the groups to attend a trade fair. It is particularly remarkable that a bank sanctioned a loan to attend a fair, i.e. for promotional purposes. The loan was repaid and since it was in the form of cash credit, it became available to the network again. One member SHG has now obtained a loan from the network for goat farming and another for the production of traditional products.

In Chanderi, one of the main strategies to improve the income of weavers is to link them directly with buyers, thereby reducing their dependency on intermediaries. To achieve this, seven self-help groups have been formed into an apex organization, registered as an NGO. The need for such an organization arose from the recognition that a group of 10 weavers could not attain the critical mass and variety of products required by buyers. Furthermore, quality control and marketing efforts were believed to be more effective within a larger group.

D. Beyond Financial Intermediation

Self-help groups not only facilitate access to financial services for their members, but also serve as a tool for social development. Social effects attributed to SHGs include significant increases in standards of living, women's literacy, school enrolment, vaccination of children, access to drinking water and sanitation, improved family planning and political empowerment of women (Seibel & Dave, 2002). A number of groups have also set rules pertaining to the prohibition of child marriage or child labour. Some SHGs have developed a common fund to be able to meet emergency situations or to undertake community development activities, such as providing meals or scholarships for school children, water conservation and irrigation projects and construction of village infrastructure. According to Myrada (1997), the well-off in villages respect SHGs, because they have been able to improve their livelihoods as well as to initiate programmes for the public good and to settle long outstanding disputes. SHG members report that they have become more confident and are willing to share their experience with others and to give advice. Women giving advice may be an important indicator of empowerment since this implies sharing one's knowledge to help others and, above all, having enough self-confidence to do so (Cheston & Kuhn, 2002).

SHGs can contribute to the development of social capital within a community and can promote a democratic culture. Bargaining power both towards local authorities and elites may be increased through group membership. Government schemes are easier to access through SHGs, political parties are known to have visited SHGs and some members have even entered politics. Due to their stable membership, SHGs offer a unique forum to development practitioners to spread information and to conduct sequenced activities in areas such as health education, agricultural development or skills training.In Sindhudurg, SHG members perceived the main benefits of belonging to an SHG to be:

Box 2.3 Benefits of SHG membership in Sindhudurg

- Access to loans;
- Employment;
- Increases in income;
- Joint income-generation activities;
- Learning and gaining experience, e.g. in marketing;
- Training;
- Satisfaction of working together;
- Security, especially for widowed members;
- Husbands are happy;
- Increased influence over household decisions, i.e. members are discussing decisions with husbands that before were taken only by the husband;
- Increased status in the community. People in the village are turning to the SHG for help and SHG members feel they can now even influence local decisions, e.g. where a road should be built;
- Exposure visits.

Female SHG members in Sindhudurg report that their husbands' attitude towards SHG membership has significantly changed. Whereas husbands initially opposed the fact that their wives attended group meetings, they have come to see the economic benefits of group membership. They now encourage their wives and let them go on exposure visits to far-away places. Husbands sometimes even participate in group meetings since these take place at all members' houses on a rotational basis. However, some women also noted that their husbands become angry if they do not receive a loan.

E. Limits of SHG Banking

Despite the benefits associated with SHG-banking, there are some problems involved. SHGs may find it difficult to access the credit amounts needed, particularly in the initial growth stages. In the early stages of bank-linkage, loan amounts are restricted to four times the group fund. However, this amount is often insufficient to cover the rapidly growing capital needs of the groups. So far, SHGs linked to banks do not appear to be able to easily graduate to (larger) individual loans under banks' normal lending programmes.

Although outreach of the SHG-Bank Linkage Programme is significant, there is a strong geographical concentration of SHG-banking in Southern India. In 2002, just two states, Andhra Pradesh and Tamil Nadu, accounted for more than 66% of SHGs linked to banks (Tankha, 2002). The non-availability of NGOs capable of promoting SHG formation has hindered the spread of the SHG-Bank Linkage Programme into states such as Bihar, Madhya Pradesh, Rajasthan, Uttar Pradesh and Orissa (Kropp & Suran, 2002). Many bank branches and cooperative societies continue to be unwilling to adopt the SHG-linkage model or lack financial soundness and/or adequate infrastructure.

Quality and stability of SHGs may pose a problem for the long-term sustainability of the SHG model. Little seems to be known about the sustainability of SHGs, in particular how long they last and how they change over time (Harper, 2002)[21]. Tankha (2002) notes that even best practice NGOs generally place only about 50% of groups in the highest category of performance, with 10-20% failing to take off. Although many initiatives exist to form SHGs, there are few to strengthen them. For example, group leaders often do not receive specific training, which could then be disseminated to the entire group.

As with other models of microfinance, it is unclear to which extent the poorest benefit from SHG-bank linkage. Although SHG members tend to be poor, they are typically not as poor as those benefiting from Grameen-type microfinance. The distribution of benefits within SHGs is also an area of contention. Some SHG members have never taken out loans, either because they had no profitable investment opportunities or were anxious about obtaining credit. These members thus mainly provide their savings as free collateral to back the loans of other, possibly less poor, members (Harper, 2002).

[21] A bank manager in Sindhudurg remarked that women-only SHGs tend to stay together longer than mixed or male SHGs, in which political or other conflicts arise more easily.

CHAPTER III:

UNIDO's Cluster Development Programme and Microfinance

A. UNIDO's Approach to Cluster Development

Micro-, small and medium enterprises (MSMEs) are increasingly recognised as important players in the fight against poverty. They are a key source of productive employment and income for the poorest segments of the population and are major suppliers of basic goods consumed by poor people. However, due to their small size and isolation, MSMEs' growth and employment-creation potential can be significantly curtailed. MSMEs have difficulties in achieving economies of scale and thus face higher unit costs than their larger competitors. They are often unable to capture market opportunities because their production quantities are insufficient and they cannot guarantee regular supply. Their small size can hinder MSMEs from internalising functions such as training, market intelligence and logistics and can prevent an internal division of labour that fosters improvements in productive capabilities and innovation. By operating in clusters, MSMEs can overcome these obstacles.

Clusters are geographical agglomerations of enterprises which are engaged in similar or highly related economic activities and therefore face common challenges and opportunities. In the best performing clusters, MSMEs derive a clear competitive advantage from the proximity to sources of raw material inputs, the availability of suitably customised business development services, the abundance of clients attracted by the cluster tradition in that industry, the presence of a skilled labour force and the vibrant competition among the cluster entrepreneurs, which spurs innovation and increases efficiency. In addition, clustering can potentially help firms, especially smaller ones, overcome constraints associated with size, promote technological development and productivity increases, and enhance their ability to compete in local and global markets. Geographical agglomeration also throws up possibilities of local joint action, between firms and through local institutions. Finally, well-performing clusters can make an important contribution to poverty reduction, as they promote sustainability in employment and incomes and thus serve to improve the situation for the working poor.

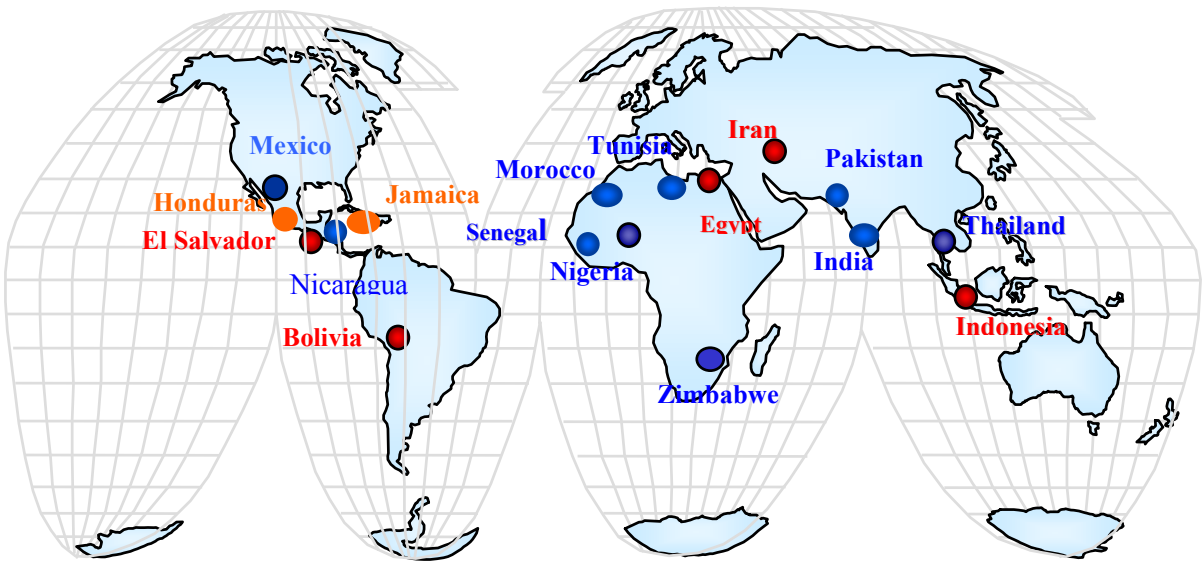
Mere concentration of enterprises operating in the same sector is, however, no guarantee of success. The advantages associated with clustering do not always emerge automatically. Agglomerations of MSMEs are a widespread phenomenon in many developing countries. In most cases, however, cooperation among firms is accidental or non-existent. Although

entrepreneurs work - and frequently even live - in close proximity, they typically do not share business information, discuss their common problems, or organise themselves to implement self-help actions for fear of revealing business secrets. MSMEs often have only occasional relationships with providers of business development services (BDS) and are not accustomed to presenting articulated calls for action to local policy makers. These underperforming clusters are characterised by low levels of trust, latent conflicts, and cut-throat competition among firms. As an outcome, they are locked in a vicious cycle of stagnation and poverty. In such cases, external technical assistance can be beneficial to help trigger a process in which local actors organise themselves and capture common opportunities.

The UNIDO's Cluster Development Programme (CDP) assists micro-, small and medium enterprises become more competitive by fostering inter-firm linkages as well as collaborative relations with local support institutions. The Programme aims at helping MSMEs combine their strengths and jointly take advantage of market opportunities or to solve common problems with a combined effort.

Over the last twelve years, UNIDO has worked intensively in the field of MSME cluster and network development in over a dozen countries in Africa, Latin America and Asia (see figure 3.1)[22]. In all these countries, UNIDO's key objective has not been to create new clusters but rather to provide effective assistance so that underperforming clusters could not only overcome their problems but also exploit the opportunities provided by the opening of markets and by innovation.

Figure 3.1 UNIDO's Cluster Development Programme



[22] In Honduras and Jamaica, assistance has been completed. Projects are presently being discussed in Bolivia, Egypt, El Salvador, Indonesia and Iran. In the remaining countries, UNIDO is currently implementing one or more projects.

Box 3.1 UNIDO's Approach to Cluster Development

In terms of implementation strategy, UNIDO's cluster development approach calls for a multistage participatory approach entailing the following phases:

- **Diagnostic study**: Understanding what lies at the core of cluster underperformance is crucial for the success of a cluster development initiative. Information about the cluster is gathered in a participatory manner with a specific emphasis on the constraints faced by the stakeholders, the untapped potential, the features of local as well as global linkages and the viability of support mechanisms.
- **Trust building**: Establishing an atmosphere of trust within a cluster is an essential prerequisite to obtain support from those involved in the cluster. The cluster development agent must first develop "bilateral" trust with individual stakeholders and then use it to create or enhance trust among them. This starts with informal interactions and later takes the route of trust building through participation in joint activities.
- **Identification of an action plan**: This list of activities, which is necessarily more than the sum total of demand from the different cluster stakeholders, starts with inputs from the diagnostic study. It is a roadmap that helps foster relationships among the stakeholders while delivering visible results. It is also an attempt to embody a vision for the cluster as a whole in a set of activities that can be implemented through stakeholder collaboration.
- **Implementation activities**: Turning the action plan into actual activities does not only entail the realisation of the objectives agreed. First and foremost, it involves a radical change in the way the cluster actors interact with each other and conduct activities. The responsibility for implementation lies initially with the cluster development agent but it is progressively shifted to the stakeholders, particularly those in the private sector, with support from local institutions. In the implementation of the action plan the stakeholders discover the advantages of closer cooperation. Joint activities with intermediaries enhance capacity and strengthen governance structure of the cluster.
- **Monitoring and evaluation**: Monitoring of the quantifiable and qualitative outcomes of implementation helps to disseminate good practices and strengthen trust among stakeholders. It also allows the identification of emerging changes in the relationships among cluster stakeholders and the adaptation of cluster activities and governance structures to these.

B. The CDP's Experience in India

India is a country extremely rich in clusters of small-scale enterprises and one of the earliest cases of a developing country that has embarked upon cluster support as a strategy for SME development. With a contribution of 40% to the country's industrial output and 35% to direct exports, the small-scale sector has achieved significant milestones for the industrial development of India. Furthermore, small-scale enterprises, provide a viable employment and income opportunity for millions of underprivileged households on the way out of poverty. Within the sector, an important role is played by the numerous clusters that have been in existence for decades and sometimes even for centuries. There are around 400 industrial clusters and approximately 2,000 rural and artisan ones in the country. It is estimated that clusters contribute 60% of Indian manufactured exports.
Despite these achievements, the majority of the Indian clusters share significant constraints

such as technological obsolescence, relatively poor product quality, information deficiencies, poor market linkages and inadequate management systems. Moreover, with the Indian economy on the path of liberalisation, all clusters (even the best performing ones) are increasingly feeling competitive pressures from international markets. Under such conditions, achieving greater competitiveness in global markets has become a matter of concern for Indian policy makers.

Traditionally, UNIDO's cluster development methodology has focused on assisting firms in underperforming clusters to exploit the opportunities provided by the opening of markets and by rapid technological change. The CDP attempts to enhance the competitiveness of a cluster by fostering export promotion, introducing technological innovations within the cluster, stimulating human resource development, improving marketing techniques and facilitating access to information. The majority of clusters supported so far have been industrial clusters and the CDP has mainly worked with well-established cluster actors, in particular exporters and vibrant small-scale units. Past interventions have, however, shown that whereas strengthening a cluster's competitiveness is a necessary condition for poverty reduction, it is by no means a sufficient condition.

To develop a deeper understanding of the impact of cluster development on poverty reduction, UNIDO, with funding from the Swiss Development Cooperation (SDC), launched an action research project in 2002. A central component of the project are pilot activities in India aimed at developing methodologies, tools and best practices to maximise the contribution of cluster development to the fight against poverty. The two pilot projects in India - Chanderi and Sindhudurg - have been chosen taking into consideration that the bulk of the deprived and marginalised population in India is concentrated outside the major metropolitan areas and that the livelihoods of most poor people in developing countries continue to depend on the growth of the agro-related industry.

The handloom cluster of Chanderi, Madhya Pradesh, is a small rural town of about 30,000 inhabitants. Weaving and related industries, such as dyeing and trading, are the main source of income for more than half of Chanderi's population. The relevance of caste and religious communities continues to be very strong in Chanderi. Whereas the affluent traders are mostly Jains, weavers mainly belong to the Muslim (70%) and Hindu (30%) communities and largely live at subsistence level. A participatory poverty assessment found that almost 90% of weaver households live in poverty and most suffer from bad health, poor working conditions and dependency on middlemen. Although women perform a considerable part of the weaving, they are typically unpaid and not recognised as weavers.

To address the problems faced by weavers in Chanderi, UNIDO assists them in forming self-help groups and to engage in collective production and marketing. UNIDO has also encouraged the establishment of a federation of SHGs, registered as an NGO, to ensure sustainable backward and forward linkages for the groups. Moreover, weavers receive training in areas such as dyeing, product costing, pricing, accounting, marketing and product diversification. UNIDO attempts to improve women's social and economic status through the creation of women-only networks, exposure and sales visits, literacy classes

and health camps. In order to mitigate the resistance of traders and master weavers to pro-poor activities, UNIDO assists them in targeting new niche and export markets. Finally, awareness creation activities about the need to improve physical infrastructure and public services are organized for local and district authorities.

The district of Sindhudurg in Southern Maharashtra is, on the other hand, an agro-processing cluster for cashews, mangoes, kokum and jackfruits. It covers an area of 1,200 km^2. Food processing activities are spread all over the district and are carried out by about 3,000 workers in more than 70 self-help groups and approximately 100 micro- and small enterprises. The participatory poverty assessment in Sindhudurg determined that poverty was particularly severe among small and marginal farmers, microentrepreneurs and workers of small-scale industry. These groups have difficulties in sustaining their livelihoods and, in most cases, suffer from poor health.

In Sindhudurg, UNIDO has promoted networks of microenterprises and works with NGOs to improve the services provided to self-help groups. It organises exposure visits for SHGs and microenterprises on new technologies and the production of value-added goods. Business development services providers are introduced to assist in upgrading production technology and marketing as well as to promote improvements in product quality, packaging and hygiene. Sensitisation activities on gender issues and health of workers take place. Lastly, capacity building activities in the field of cluster development are organised for local government officials.

In the pilot activities carried out in India, lack of access to formal financial services has repeatedly been identified as a major constraint to cluster development and as a factor perpetuating poverty. In Chanderi, limited access to formal credit and the resulting recourse to advances from middlemen has strengthened weavers' dependency on traders and master weavers. In Sindhudurg, scarcity of working capital is one of the greatest constraints to the expansion of local processing capacities. In light of what has emerged in the previous section, it seems that microfinance can make an important contribution towards cluster development. Moreover, by benefiting particularly the poorer strata of the cluster, microfinance can enhance the pro-poor effects of cluster development.

C. Areas of Synergy between UNIDO and Microfinance Providers

UNIDO's cluster development methodology focuses on strengthening inter-firm networks as a key component to enhancing the performance of micro-, small and medium enterprises. In the pilot activities in India aimed at determining the impact of cluster development on poverty reduction, UNIDO has promoted cooperation between poor weavers (in Chanderi) and small agro-processing units (in Sindhudurg). One of the main mechanisms to improve such cooperation has been the creation of SHGs and the strengthening of existing, but non-operational, groups. SHGs have proved to be an important tool to reach the poorer sections of both clusters and to promote economic and human development within them. By working together in SHGs, poor cluster actors in both Chanderi and Sindhudurg have been able to decrease input costs through bulk purchases, increase quantity and quality of output, develop new markets and obtain higher wages. After participation in UNIDO-organised exposure visits, skills training and health camps, group representatives disseminated the knowledge gained during group meetings.

The fact that UNIDO's activities involve working with SHGs, whose performance is often constrained by lack of credit, suggests the existence of synergies between UNIDO's Cluster Development Programme and financial institutions willing to provide microfinance to SHG members.

Both microfinance providers and UNIDO aim to reduce poverty by assisting the poor in creating and expanding their enterprises. Whereas microfinance providers address financial constraints, UNIDO seeks to improve business performance by fostering inter-firm cooperation and providing linkages to support agencies. A partnership between UNIDO's CDP and microfinance providers, in which each organisation focuses on its comparative advantage and expertise, can promote the provision of sustainable and profitable financial services to the economically active poor and contribute to pro-poor cluster development.

Although the use of self-help groups as financial intermediaries reduces the costs of providing credit and savings facilities, microfinance providers must nevertheless reach a minimum scale to reach profitability. Cooperation with the CDP facilitates reaching this minimum scale. Through its projects, the CDP has gained experience in creating and strengthening networks. It thus has the expertise to build the institutional capacity of self-help groups needed for financial intermediation. Banks cooperating with the CDP can therefore access strong SHGs with viable business propositions while avoiding the high up-front costs of group formation.

Microfinance provision by itself is often insufficient to improve business performance since clients need information, skills, adequate technology as well as backward and forward linkages to be able to use the financial resources obtained effectively. To maximise the benefits of financial service provision, many microfinance providers therefore attempt to provide support services to their clients. However, experience has shown that this often exceeds the capacity and resources of these institutions. The result is the provision of suboptimal services and/or exessive costs which cannot be recovered through normal credit operations. Sustainability and outreach of microfinance provision is therefore jeopardized. As part of its regular cluster development activities, UNIDO links cluster actors with business development services (BDS) providers and other support institutions, which provide marketing assistance, business management training and technology development support. The linkages created by the Cluster Programme enhance the technological capacity of cluster actors, their ability to innovate, the quality and value of their products and their capacity to respond to changing market conditions. This in turn improves enterprise performance and increases the probability of productive use of a loan as well as borrowers' repayment capacity. Cooperation between cluster development projects and microfinance providers thus allows each organisation to focus on its respective strengths while offering a comprehensive package to promote enterprise and cluster development.

Many economically active poor work in low-return activities and microcredit is often used to simply expand activities rather than to invest in technological upgrading, to improve productivity or to enter higher value markets. This eventually leads to market saturation

(Dawson & Jeans, 1997). Bankers may therefore fear that SHG members are unable to sell the goods their loans enabled them to make and may thus have problems in repaying their loans. In clusters supported by the CDP, however, this concern is likely to be irrelevant. The CDP aims at improving product quality, meeting training needs and creating market linkages. This makes the cluster as a whole more competitive and secures viable business opportunities for SHGs receiving credit. The risk for bankers is therefore minimised.

In sum, clusters can facilitate access to new clients for microfinance providers. For banks and specialised microfinance institutions, clusters promoted by the CDP represent a concentration of potential clients with concrete needs for financial services to fund their viable business activities. By operating in a cluster that has been suitably dynamised, microfinance providers can therefore significantly reduce the costs involved in reaching a new and profitable clientele.

For UNIDO's CDP, cooperating with microfinance institutions is a strategy to ensure that cluster actors are no longer constrained from realising their viable business propositions by lack of finance and that efforts to stimulate cluster development will have a pro-poor bias[23]. By integrating microfinance into cluster development activities, the impact on the "bottom of the pyramid" can be enhanced. Access to financial services enables producers in artisan and agro-processing clusters to improve the quality of their products, to ensure regular supply and possibly to reduce prices through improvements in production technology and productivity. This in turn benefits local consumers who will be able to obtain better quality products at a lower price.

With time, integration of microfinance into cluster development activities can have benefits beyond the development of individual enterprises and can profit the cluster as a whole. Experience from Sindhudurg has shown that SHG members already use microfinance for common production. As trust between SHGs and microfinance providers as well as among individual group members grows stronger, there may even be scope for using microfinance to fund joint investments, such as the common purchase of equipment. Finally, microfinance may also be instrumental in addressing cluster-wide problems such as the need for infrastructure, which is frequently a constraint for the competitiveness of rural clusters in particular. Whereas the CDP's efforts to link cluster stakeholders with regional and local government institutions have, for example, contributed to improving roads, some infrastructure problems, in particular lack of a reliable supply of electricity, continue to exist. Such issues could possibly be addressed by SHG members with linkages to microfinance providers, e.g. through the joint purchase of power generators - provided, however, that a significant level of trust exists among members.

D. Role of the CDA

A distinguishing feature of the UNIDO approach to cluster development is its reliance on a cluster development agent (CDA) - also referred to as broker, cluster change agent, intermediary agent or system integrator by other institutions - whose task is to facilitate implementation of the cluster development initiatives. The CDA, who should be

[23] This can be achieved without reverting back to large, inefficient organisations attempting to deliver a wide range of services simultaneously, as was the case in the 1970s (Dawson & Jeans, 1997).

specifically trained in the fields of enterprise and cluster diagnostics, conflict management and resolution, network building, project management and project evaluation, operates on a full-time basis within the cluster and enjoys a good degree of autonomy in providing the technical, financial and human resources required for the development of the cluster.

The cluster development agent (CDA) can play a crucial role in improving cluster actors' access to financial services. In view of the discussion above and keeping in mind the objective of this paper, namely to enhance the synergy between microfinance and cluster development, the remainder of the chapter describes the steps for the CDA to follow in order to create linkages between the SHGs with which s/he works and local financial institutions[24]. Many of these will need to be addressed simultaneously[25].

i) Exploring the Financial Needs of Cluster Actors

The sector in which enterprises are active is a crucial determinant of the financial products and services required. The financial needs of cluster actors are likely to differ considerably between industrial clusters (i.e. the clusters which have traditionally been the focus of the Cluster Development Programme) and artisan and agro-processing clusters (i.e. the clusters which are now at the centre of the action research determining the impact of cluster development on poverty reduction). In these latter clusters, credit needs will be lower. This is partly due to the nature of the economic activity that is less capital-intensive, and partly due to the lower debt-servicing capacity of the economically active poor who represent an important group of cluster actors in artisan and agro-processing clusters. Since microenterprises in artisanal and agro-processing clusters tend to be home-based and are an integral part of households' livelihoods strategies, it will not always be possible to make a clear distinction between the financial services required by households and those required by microenterprises. This is not the case in industrial clusters.

In addition to variations across clusters, there are differences in financial needs among diverse cluster actors within a cluster. The financial services demanded will not be the same for individuals engaged in income-generating activities, microenterprises and small and medium enterprises. Within these categories, there will again be differences between start-ups and existing enterprises. The financial needs of growing micro and small enterprises and of non-poor cluster actors will briefly be discussed in section (vii) below.

A genuine demand for financial services must be ascertained but also that access to credit will positively impact on poor cluster actors. Frequently, lower input costs or access to markets for existing products are seen as more important than access to credit. Even when cluster actors perceive a need for credit, their true problems may lie elsewhere, e.g. in a lack of skills, quality products or market information. Providing credit in these cases could

[24] What follows represents a first step in uncovering the potential synergy between cluster development and microfinance. In principles, there might be broader and more ambitious agenda such as, for example, microfinance institutions becoming providers of funding for cluster development initiatives. Such discussion appears premature at this stage, when the actual scope for operational rather than strategic synergy is yet to be ascertained.

[25] The steps involved in forming and strengthening SHGs are not described. Interested readers may refer to NABARD's *Handbook on Forming Self-Help Groups*, available at http://www.nabard.org/roles/mcid/formingshgs.pdf.

be counterproductive. To identify truly unserved or underserved cluster actors, it needs to be determined which financial services are currently being provided and to establish whether poor cluster actors are resorting to informal financial sources.
It should also be identified at what point in time poor cluster actors will benefit most from access to financial services. Trust only evolves slowly within SHGs and they need to be given sufficient time for bank linkage. If credit is available too early, e.g. before groups are prepared for the non-financial aspects of credit taking such as the capacity to use peer pressure, the ability of groups to ensure repayment - and thus to access financial services in the future - can be compromised. If credit is provided too late, however, enterprise performance can critically be harmed. The timing of credit delivery is thus crucial.

ii) Identifying Suitable Partner Institutions

After the financial needs of cluster actors have been determined and if it has been found that there is demand for microfinance, potential partner institutions must be identified. It therefore needs to be established which local institutions are able and willing to provide microfinance to poor cluster actors. In India, a variety of public and private sector institutions provide microfinance. These include commercial banks, regional rural banks, cooperative banks, non-banking financial companies (NBFCs), NGOs, cooperative societies and SHG Federations. It is estimated that about 800 microfinance institutions which are not part of the formal banking system exist in India. However, only ten of them reach more than 100,000 clients and most are concentrated in southern India. With the exception of NBFCs, private microfinance institutions in India are still unregulated and are evolving (NABARD, 2004). Development financial institutions such as NABARD and SIDBI support Indian microfinance providers for on-lending and capacity building.

For cluster actors, *permanent* access to financial services is crucial. Since cluster actors must be able to rely on the established linkages to financial institutions also once UNIDO has withdrawn, the partner institutions chosen must be well-placed to provide microfinance services in a sustainable manner. They must therefore be financially sound and have adapted their credit and savings methodologies to low-income clients. Although there is no one right microfinance model, some good practices can be identified regarding the provision of microcredit and microsavings as well as concerning administrative issues. Box 3.2 summarises basic good practices in microfinance provision, which may assist in identifying a suitable partner institution.

It is neither necessary nor desirable to focus solely on one partner institution. The larger the number of financial institutions able and willing to work with SHGs, the greater the options of financial services for groups to choose from. In Sindhudurg, for example, the CDP works with a cooperative society as well as a variety of banks, including Sindhudurg District Central Cooperative Bank, Ratnagiri Sindhudurg Gramin Bank, Bank of India, ICICI Bank, NABARD and SIDBI.

Box 3.2 Good Practices in Microfinance Provision

Microcredit:

- **No stringent requirements on loan use.** Although investment in productive uses will increase income and thus the likelihood of repayment, clients will typically need to meet consumption needs before money can be invested productively.
- **Rapid disbursement of loans.** Delays in obtaining credit can have detrimental effects on the economically active poor. Credit should thus be disbursed within one week for new borrowers and within a few days for repeat borrowers.
- **Flexible collateral requirements.** Peer pressure, group guarantees and/or savings substitute for conventional collateral.
- **Loan terms compatible with enterprise needs.** Loan packages, although partly standardised to reduce administrative costs, should retain enough flexibility to meet borrowers' needs in terms of maturities and loan sizes. A variety of loan maturities should be available to meet short-term working capital needs and longer-term investment capital needs. Loans that do not match the income streams of an entrepreneur's business activity can do more harm than good. In general, loans provided to microentrepreneurs will need to be of shorter duration than those provided to larger enterprises and average loan sizes will be considerably smaller.
- **High frequency of repayment collection.** Weekly, fortnightly or monthly instalments facilitate loan repayment for the poor who may find it easier to repay small amounts regularly than a large lump sum after a long period. However, if a loan is used to finance a seasonal activity, a lump sum repayment may be more adequate.
- **Incentives for timely repayment.** These include the promise of (larger) repeat loans, appropriate loan products, flexible repayment schedules, low transaction costs and the use of joint liability groups. Bank Rakyat Indonesia, which administers one of the world's largest microfinance programmes, provides interest rebates if loans are repaid on time.
- **Repeat loans.** In addition to providing borrowers with an incentive to repay, repeat loans with increasing loan sizes also reduce lenders' initial risk. Repeat loans should not be extended automatically once a loan has been repaid and loan sizes should not routinely be increased since good business opportunities are not always available. Instead, amounts and maturities should only be increased with need and performance.
- **Defaults are controlled rigorously.** The existing credit culture depends crucially on how a lender deals with default. Immediate follow-up, threat of legal action and, in extreme cases, seizing of assets such as TVs have shown to impact significantly on repayment rates.
- **Rescheduling or Refinancing of loans only under extreme circumstances.** Write-offs should be avoided.

Microsavings:

- **Availability of voluntary savings facilities,** also for non borrowers. Savings services should not be tied to credit uptake.
- **Low opening and minimum balances.**
- **Availability of a variety of savings products.** Clients value the availability of liquid savings products, semi-liquid savings products and fixed-term deposits and are likely to use a combination of them.
- **Flexible interest rates.** Interest rates should increase with the size of the savings account to provide an incentive for saving. Savings account balances below a certain minimum should be interest-free to partly compensate for the high administrative costs of small accounts.
- **Savings accounts are kept confidential.**

- **Regulation and Supervision.** To protect small savers from losing their life-savings, microfinance providers mobilizing voluntary savings must be adequately regulated and supervised. Only institutions that have the institutional capacity to comply with prudential regulations should therefore consider deposit taking.

Administrative issues:

- **Clients are treated with respect.** Bank staff often treat poor clients rudely. Treating clients with respect is fundamental from a moral and business point of view and can have an important empowering effect on the poor.
- **Unit costs are minimised for both the microfinance provider and clients.** This can be achieved by standardising the lending procedure, i.e. making loan applications simple and approvable on the basis of easily verifiable criteria. Decreasing transaction costs for the microfinance provider should not lead to undue increases in transaction costs for borrowers. Some microfinance providers (such as Swayam Krishi Sangam of Andhra Pradesh, India) reduced the transaction costs of lending through the introduction of so-called smart cards, which contain information about a client's loan on a memory chip.
- **Interest rates and fees are calculated to cover costs.** Because the costs of frequently providing small, short-term loans to the economically active poor are much higher than conventional bank loans, financially viable microfinance providers must charge higher than commercial bank rates. However, in contrast to what many bankers believe, the poor are able to repay credit at commercial rates and do not require subsidised loans. Interest rates that are too low to cover costs not only make lending to the poor unprofitable and thus decrease the amount of loans available, they also reduce the rates lenders can offer on savings, encourage slow repayment and may result in elite capture and corruption.

Source: Harper (2003a); Hatch, Levine & Penn, 2002; Ledgerwood (1999); Robinson (2001)

iii) Sensitisation of Bankers

Once potential partner institutions have been identified, they must become interested in the project and willing to interact with cluster actors. Although the institutional framework for SHG-bank linkage exists in India, there is no obligation for bank branches and the ultimate decision to participate still remains with the branch manager. Whether financial services will be provided to poor cluster actors thus crucially hinges on the motivation of bankers. This makes sensitisation of branch managers one of the most important tasks in linking SHGs. For commercial banks more sensitisation is likely to be necessary than for cooperative societies or specialised microfinance institutions.

In addition to the traditional deterrents for small-scale lending (see section 1Ai), there are several reasons why bankers may be reluctant to work with SHGs. Bankers sometimes think that they cannot compete successfully with moneylenders since these are believed to have better information about borrowers than banks could obtain cost-effectively (Robinson, 2001). They may fear that unregistered SHGs will cease to exist and that loans extended to groups cannot be recovered. Bank staff may also be reluctant to deal with poor borrowers and to visit groups which often meet at odd hours. They may perceive microfinance provision as a social activity, which should be undertaken by NGOs rather than by business-oriented financial institutions. Above all, many bankers - particularly in rural areas - have had bad experiences with past government programmes to improve credit extension to the rural poor. They are therefore likely to be sceptical of SHG-banking and to perceive it as simply another government scheme. To ensure branch manager's cooperation, bankers must thus be convinced that SHG-banking is viable and can be profitable. In some cases, exposure visits for bankers may be necessary. Box 3.3. outlines

the benefits of SHG-banking for financial institutions.

Box 3.3 Benefits of SHG-Banking for Financial Institutions

- **Development of new business activities.** By actively targeting the "bottom of the pyramid" market rather than simply attempting to meet priority-sector lending targets, financial institutions can develop a new profitable business segment and thus diversify their activities.
- **Achieving economies of scale**. By working with SHGs, banks can reach a larger client base while only marginally increasing operating costs. Banks only have to maintain one account for the entire group, there is no need for individual loan appraisal, and loan monitoring as well as loan recovery are undertaken by group members. The SHG-Bank Linkage Model thus significantly reduces the high transaction costs involved in providing a large number of small loans at frequent intervals to poor people.
- **Reduction of asymmetric information**. Members of a community typically know who is credit-worthy and who is not. Group liability and self-selection of group members ensure that only reliable people will participate in SHGs.
- **Reduction of moral hazard.** Group monitoring and peer pressure increase members' commitment.
- **Reduction of risk.** The reduction of asymmetric information and moral hazard reduces the risk for financial institutions.
- **High repayment rates.** Repayment rates of SHGs range between 95% and 100% and are higher than those of individuals.
- **A profitable loan portfolio.** The combination of high repayment rates and low transaction costs makes SHG-lending a profitable business segment for financial institutions.
- **Increased savings mobilization.** SHGs have proven to be reliable and regular savers that can significantly increase the deposit base of financial institutions.
- **Absorption of underutilised capacities.** Some bank branches may have excess capacities. SHG-banking offers the opportunity to obtain additional savings and credit business to absorb fixed costs.
- **Availability of refinance.** Refinance, at a concessional rate, is available from NABARD, SIDBI and other apex organizations.
- **Classification as priority-sector lending.** SHG-banking is recognised by the Reserve Bank of India and is classified as priority sector lending. SHG-banking thus provides a good opportunity for banks to meet their targets through low risk and profitable loans to SHGs.
- **Increase in banks' overall repayment rates.** There is evidence of spill-over effects on the repayment behaviour of non-members due to the influence of SHGs on their communities. Several financial institutions report that recovery rates of outstanding loans have improved.
- **Improvements in overall performance.** Cooperative societies participating in SHG-banking have reported significant improvements in performance which they attribute to their SHG business. Some have turned from loss-making institutions into profitable entities (Seibel & Dave, 2002).
- **Improvement of public image.** In addition to being lucrative, providing financial services to self-help groups of the poor offers financial institutions the opportunity to improve their public image.
- **Increased job satisfaction.** Bankers participating in the SHG-Bank Linkage Programme have reported a new dimension of job satisfaction resulting from the increasing amount of loans disbursed, the good loan performance and the socio-economic achievements of their groups (Kropp & Suran, 2002).

In addition to becoming aware of the benefits of SHG-banking, bankers must learn about cluster activities. Bank staff must have at least a limited understanding of the activities undertaken in the cluster and of the financial needs of cluster actors to ensure that adequate financial services are provided. In Sindhudurg, UNIDO's CDA organised several visits for bankers to the cluster to increase awareness on credit needs. Involving bankers from the start of CDP intervention in meetings and workshops is a good strategy to improve bankers' knowledge of the cluster programme and of cluster actors. It also influences cluster actors' perception of bankers and can increase their trust in the bank. In fact, a borrower's perception of a lender crucially influences his willingness to repay.

A regional rural bank in Sindhudurg has been working with SHGs since 2002. In total, the 15 branches in the district served 586 SHGs, of which 348 were below poverty line groups. In autumn 2004, 173 groups had outstanding loans for a total of Rs 5.8 million (USD 127,600). Total savings of SHGs amounted to Rs 17.6 million (USD 387,200). Initially, the bank promoted the SHGs themselves but has now contracted an NGO to do so. The NGO receives a NABARD subsidy per SHG formed.

The branch manager perceived the main benefits of SHG-banking for his bank to be the margin between deposits on group savings (3%) and loans to groups (9%). The recovery rate for all branches in the district was about 94% despite the fact that many of the loans were used for consumption purposes. According to the branch manager, "only once the poor have filled their stomachs will they start economic activities".

Women in particular may be reluctant to approach banks because the employees are typically men and are perceived to be 'women unfriendly'. Bank staff may therefore need to be sensitised to gender issues. Their behaviour towards women can be an important determinant of whether gender inequalities in the community are challenged or reinforced.

iv) Sensitisation of Cluster Actors

In addition to bankers and microfinance practitioners, poor cluster actors must also be sensitised on the SHG-Bank Linkage Programme and its benefits. To overcome prejudices, the CDA may have an important role to play as intermediary between poor cluster actors and bankers. There is often mutual distrust between bankers and the poor. Whereas bankers perceive the poor to be 'wilful defaulters', the poor often view banks as institutions for the rich and perceive the banks' services to be inaccessible to them.

Men and women in Chanderi agreed that, despite their need for credit, banks are not accessible to the poor. Not only did most women not know how banks function, but the majority of them could not describe what the local bank looked like. They explained that they had no reason to know since they seldom had reason to go there. The widely held view among men weavers was that the bank was a non-performing, corrupt institution. It was judged to be poorly managed and non-responsive to their needs. Nevertheless, there was awareness among men weavers that banks are important for capital needs, to start a business and to grow independently of middlemen.

In Sindhudurg, it was believed that banks are 'poor people unfriendly' and that their procedures are too complicated and time-consuming.

Although it is important to motivate cluster actors and make them aware of the benefits of formal credit, it is also necessary to caution them of its limits. Expectations of the usefulness of credit may in some cases be excessive. It must therefore be ensured that cluster actors understand the responsibilities associated with taking credit and do not confuse bank loans with government grants, which do not have to be repaid. It should also be emphasised that money does not necessarily need to come from external sources and that their own savings and retained earnings can go a long way.

v) Training for Poor Cluster Actors

In order for SHGs to maximise the benefits of bank linkage, groups must obtain information and training on a variety of issues. In addition to being familiarised with the concept of the SHG-Bank Linkage Programme, cluster actors must be trained on issues such as rules and rationale for internal lending, responsibilities of group leaders, bank procedures and administrative requirements. They will also need to be made aware of the different financial services available so that they can make an informed decision. Since experience has shown that the quality of groups is a crucial determinant of SHG sustainability and later repayment rates, group cohesion should be stimulated whenever possible - particularly in the early stages of SHG formation.

In a UNIDO project in Kota, Rajasthan, SHG members were initially reluctant to save jointly. Trust levels were low and since only three members had signing authority for the account, the others feared that they would secretly take the money. The CDA therefore had to spend considerable time in explaining the functioning of banks and that all transactions are recorded. Eventually, the members recognised the advantages of saving in a bank: they were less tempted to draw on their savings than if they were hidden at home and family members could not simply take them.

From the beginning, it should be ensured that groups are aware of and do well on those issues on which they will be graded for bank linkage. All SHG members ought to know why the individual criteria are important for their functioning and why bankers put emphasis on them.

The fact that many SHG members are illiterate can hamper the quality and regularity of book keeping. The unreliability of SHGs' books endangers the survival of SHGs and may thus contribute to banks' reluctance to serve SHGs. It must therefore be ensured that bankers' concerns in this area are mitigated, e.g. by identifying someone who can assist SHG members in book-keeping or by providing the necessary training. Initially, groups may rely on the CDA's team to help with book-keeping. Long-term reliance on UNIDO should, however, be discouraged. Some SHGs have asked their literate children to help with book-keeping or have hired skilled locals such as retired government officials to assist them.

In addition to book-keeping, group members may require training in accounting and record-keeping to help manage their businesses. Experience in Chanderi has shown that many poor cluster actors do not have a complete overview over the cost of their products.

With proper training, SHG members can learn how to prepare simple financial statements, which will help significantly in managing their economic activities and in long-term business planning. This will also improve their capacity to manage financial services.

During workshops or training sessions, the importance of maintaining separate accounts for households and businesses may also need to be emphasised. In many microenterprises, the finances of the business and the household are interwoven. Owner-operators tend to extract funds for personal or household use from the business, sometimes without having an adequate overview of the accounts and therefore taking more than the business can bear. This interconnection of household and business funds implies that funds may not be available to meet operating costs or to build up reserves to finance future growth.
Finally, cluster actors should be advised to start with as little capital as possible in order to reduce risk. Initially, it is safer to use a loan to lease equipment or rent premises rather than to invest in their purchase. Only after a business is well established should such investments be undertaken.

vi) Monitoring and Evaluation

Sooner or later, the impact of microfinance on cluster actors and on cluster development will need to be assessed. Any observed changes should therefore be noted from the beginning. It is crucial not only to consider the effect of microfinance on productive activities and income. Its impact on reducing other dimensions of poverty, such as health and educational status, is of equal importance and is likely to lead to productivity increases in the mid to long term. Changes may be observed at three main levels, namely the economic, socio-political or cultural, and personal or psychological (Ledgerwood, 1999)[26]. Box 3.4 provides a list of indicators, which can be used to assess impact.

Box 3.4 Impact Indicators

Economic:
- At the cluster level: Is the cluster becoming more vibrant and competitive? Is it growing?
- At the individual enterprise level: Has profitability increased? Has output expanded? Were costs reduced? Have sales risen? Has employment increased? Has asset accumulation increased? Have new technologies been introduced? Has quality improved?
- At the household level: Has income risen? Have savings increased? Has asset accumulation increased? Has child labour decreased?

Sociopolitical or Cultural:
- Has the bargaining power of previously disadvantaged groups (e.g. lower castes, ethnic minorities, low-income groups) within the cluster increased?
- Are there signs of women's empowerment, such as increased decision-making within the household?

Personal or Psychological:
- Has consumption (of food and non-food items) increased? Has health and nutrition improved Has access to education improved? Has housing improved?
- Has self-confidence of disadvantaged cluster actors increased?

[26] As in all partnerships, it will be difficult to determine whether changes are attributable to the provision of microfinance services or to cluster development activities in general.

vii) Assisting Non-Poor Cluster Actors and Growing Enterprises to Meet their Financial Needs

A key component of UNIDO's projects in Chanderi and Sindhudurg is the fact that the CDA also devotes a significant amount of time to non-poor cluster actors in order to minimise the potential for conflict. Master weavers and traders in Chanderi or owners of SMEs in Sindhudurg are by no means poor. However, their cooperation is necessary for sustainable poverty reduction. They can ensure improvements in workers' income and health and can outsource production to SHGs.

The financial needs of larger firms or growing microenterprises are unlikely to be met by microfinance. Precisely because relatively large loans can only be accessed after several loan cycles, microfinance is often unsuited for vibrant micro- and small enterprises, which may need larger loans at an early point of time. However, due to insufficient collateral, they may also have difficulties in obtaining the credit they require from commercial banks (see box below).

Box 3.5 Credit Needs of a Rapidly Growing Microenterprise in Sindhudurg

The main reason why cashew and fruit-processing microenterprises in Sindhudurg require access to credit is to finance their working capital needs, in particular to enable procurement of raw materials. For S. Gawande, the owner of a rapidly growing microenterprise in Sindhudurg, to be able to process 200kg of raw cashews per day, he needs about Rs 240,000 (USD 5,280) per month. Although he has previously received bank loans, they were too small to allow him to purchase the amounts of raw cashews he would have needed to be able to process throughout the year. His first loan had been for Rs 200,000 (USD 4,400). To obtain the second loan of Rs 400,000 (USD 8,800), he had to deposit Rs 100,000 (USD 2,200) with the lending bank, mortgage his land worth Rs 1.6 million (USD 35,200) and find two guarantors for the loan amount. He knows that he could profitably extend his processing capacity in the next year if he could obtain a larger loan. However, this would require that he increases his deposit with the bank and provides additional collateral. He is confident that he may obtain a loan of Rs 600,000 (USD 13,200) in the following year, because he has begun to build a storage facility for cashews on his land, which has increased the value. Nevertheless, even a loan of Rs 600,000 is insufficient to enable him to exhaust his processing capacity. He estimates that to keep his factory running from the end of the cashew season until the new season begins, he would require about Rs 2.1 million (USD 46,200). He has so far used his savings to invest in the factory (e.g. to purchase cashew cutters and a boiler) and is planning to purchase a vacuum packaging machine in the future.

Meeting the financial needs of the economically active poor and microentrepreneurs will have a more direct impact on poverty reduction than meeting the financial needs of growing and larger firms within the cluster. Nevertheless, the indirect contribution of finance for these firms on poverty reduction (e.g. increased employment or job stability achieved through firm growth) is also likely to be significant. Through past interaction with bankers, the CDA may be in a position to link non-poor cluster actors to financial institutions at little additional cost. A case can therefore be made for assisting non-poor cluster actors in meeting their financial needs.

The Cluster Development Programme's experience in other Indian clusters has shown that mutual guarantee associations (MGAs) are an effective way to assist enterprises whose credit needs exceed those of microfinance clients but are unable to meet the collateral requirements of banks. This is likely to be the case for growing micro- and small-scale enterprises. MGAs are solidarity groups formed by small firms without access to credit due to insufficient collateral. MGAs evaluate their members, recommend them to the lender, provide guarantees and pursue defaulting borrowers for loss recovery. They do not, however, extend credit directly to their members. Guarantees are backed by the capital of the MGA, which is based on the share capital provided by all members and by a risk fund. Hence, each member accepts a commitment for part of the guarantee. Since guarantees are only extended to members, the borrower himself is also liable. Shares can only be sold if the owner's liabilities have been extinguished. Since their contribution is at stake, members have an incentive to ensure that only credible borrowers receive loans. As not all members require a loan at the same time and only a small percentage of borrowers is likely to default, members' contributions can have a significant leverage effect.

MGAs have extensive knowledge of the operating sector of a member and are thus aware of factors such as competition within the sector, market trends or production techniques. Additionally, they assess the viability of an applicant's project by taking the entrepreneur's background, business performance and reputation into account. MGAs are therefore often able to make better-informed decisions than banks.

The decisive characteristic of MGAs is that, like SHGs, they are based on social capital in addition to financial capital. However, in contrast to SHG members, members of MGAs are typically not poor and their credit needs exceed those of SHG members. UNIDO, in cooperation with SIDBI, has successfully introduced the Mutual Credit Guarantee Fund Scheme (MCGFS) in the Indian clusters of Jaipur and Ambur[27].

An alternative to MGAs are state credit guarantee schemes. The Government of India, in association with SIDBI, introduced a Credit Guarantee Fund Scheme in 2000. The scheme aims to assist new and existing industrial units in the SSI sector to obtain collateral-free credit by guaranteeing loans up to Rs 1 million (USD 22,000) extended by scheduled commercial banks and selected RRBs. To operationalise the guarantee scheme, a Credit Guarantee Fund Trust For Small Industries has been set up by Government and SIDBI. Of the credit facilities extended by eligible institutions, the Fund guarantees, in case of default by the borrower, up to 75% of the defaulted principal amount. However, as with the SHG-Bank Linkage Programme, bankers' willingness to participate is fundamental. In Sindhudurg, for example, banks have so far been reluctant to implement either the MCGFS or the state guarantee scheme.

E. A Note of Caution

Linking cluster actors with financial institutions is a time-intensive task. It is important to work with small groups at a time and not to attempt to link the entire cluster at once. In addition, it is not useful to encourage everyone to take out a loan. If other inputs are

[27] See Technical Working Paper no. 10, *Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth?,* available at <http://www.unido.org/en/doc/18252>

missing, borrowing can lead to a debt trap. Access to savings facilities and skills training are likely to be more appropriate in these cases.

Finally, it cannot be emphasised enough that access to finance is only one - and frequently not the most important - constraint for cluster actors. Thus, while sufficient and timely attention to improving access to financial services is crucial, it should not come at the expense of equally important activities, such as training or linkage with support institutions.

CHAPTER IV:

Conclusion

This paper has stressed that the poor are 'bankable'. By adapting conventional banking practices, microfinance providers can offer commercially viable financial services while meeting the financial needs of the poor. Access to microcredit can help the economically active poor enhance the performance of their microenterprises, improve their living conditions and reduce vulnerability. However, microfinance is not only about microcredit. Access to savings facilities, insurance products and payment services may be of equal or even greater importance to the poor than microcredit and can reduce the likelihood of falling into a debt trap. The SHG-Bank Linkage Model is an innovative form of microfinance provision, which is particularly well-suited to the Indian context.

The International Year of Microcredit provides an opportunity to share new uses of microfinance schemes. It was seen throughout this paper that limited access to formal financial services can be a significant constraint to cluster development. This suggests possible synergies between the SHG model and UNIDO's Cluster Development Programme. By linking SHGs and banks, the CDP can contribute towards building inclusive financial sectors for the economically active poor while at the same time promoting human and economic development and stimulating the creation of an environment in which a self-help rather than a grant mentality exists. Equally, microfinance providers can benefit from linkages with cluster stakeholders by developing a new clientele with profitable business ventures.

The CDP's efforts to link cluster actors and financial institutions may have positive externalities, which enhance the contribution of cluster development to poverty reduction. In its projects, the CDP works primarily with the "integrated poor", i.e. those poor people whose economic activities are directly related to the cluster and affect its production. However, in the mid- to long-term, the CDP's efforts to improve access to financial services for integrated poor cluster actors are also likely to have spill-over effects for the non-integrated poor, i.e. the poor living in the same geographical area, but whose income-generating activities are not related to cluster activities. Once a few SHGs have been created, a dynamic may emerge which stimulates the self-multiplication of groups as SHG members encourage friends, relatives and neighbours to create their own groups. With time, a number of SHGs may come forward, which have not been promoted by the CDP, but have evolved from their own initiative after observing the functioning of existing groups. These groups may be able to create their own linkages with financial institutions. Once banks or other microfinance providers have become convinced of the concept of

microfinance and have gained experience in working with SHGs, the marginal cost of serving groups of the non-integrated poor are low.

Despite the benefits of the SHG-Bank Linkage Model, there may be some problems of integrating it into UNIDO projects in countries other than India. In India, SHG-banking is facilitated by the extensive bank branch network which extends far into rural areas and by the existence of national regulations governing SHG-banking. SHGs are a well-known concept and clear rules exist for lending to them. The SHG model can therefore not simply be transferred to UNIDO projects in other countries where these conditions are not met. Nevertheless, many features of the model remain relevant for countries beyond India and can be adapted to local circumstances.

Although the size and composition of joint liability groups tends to differ by country and scheme, the general concept of group-based lending has proved to be effective in meeting the financial needs of the economically active poor in countries around the world. In its projects worldwide, UNIDO works with networks of cluster actors to promote cluster development. With proper training, these networks can function similarly to Indian self-help groups and can also be linked to microfinance providers. However, unlike in India, CDAs in other countries may not be able to work with commercial banks due to limited branch networks and lack of regulations which foster linkages between groups of the poor and formal financial institutions. In these countries other possible partner institutions will need to be identified, such as specialised microfinance institutions, savings and loan cooperatives or possibly even postal banks which provide much needed deposit facilities and payment services.

Due to the constraints on enterprise growth, innovation and access to markets arising from limited access to finance, improving the provision of financial services is a necessary condition for achieving cluster development in any country. In addition to promoting the development of clusters directly by improving enterprise performance, microfinance also has an indirect effect on cluster development through its impact on nutrition, health and education, which in turn increases productivity. Nevertheless, stimulating the provision of microfinance is not a sufficient condition for pro-poor cluster development. Besides financial constraints, the economically active poor face a number of challenges, including lack of skills, information, quality products and markets that require urgent attention if cluster development is to make a significant contribution to poverty reduction.

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