Commercial Aspects of Self-Help Group Banking in India: a Study of Bank Transaction Costs [1]

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Abstract
Commercial Aspects of SHG Banking in India

There are **two outstanding aspects** to Nabard's *Linking Banks and Self-Help Groups*: with an outreach to 500,000 SHGs and a population of 40m rural poor, it is the largest non-directed microsavings & microcredit programme in the developing world; and its bank lending rates – fluctuating at market rates around 7% in real terms – are among the lowest. Is it a commercial proposition for the 17,000 participating bank branches, and perhaps for another 20,000 who might join the program to reach a population of 100m by 2008?

We are presenting a **methodology for the study of financial products**, applied to seven units of three banks in October 2002. The results are indicative only. We applied average cost analysis, attributing all costs duly to each product; and marginal cost analysis, in response to the advice of bank managers to ignore personnel costs of SHG banking because of existing idle capacities. Main performance indicators are non-performing loans, return on average assets, and operational self-sufficiency.

Non-performing loans to SHGs were 0%, testifying to the effectiveness of group lending to the very poor. In contrast, consolidated NPL ratios ranged from 2.6% to 18%; and of Cash Credit (CC) and Agricultural Term Loans (ATL) up to 55% and 62%, respectively.

Returns on average assets of SHG Banking ranged from 1.4% to 7.5% by average and 4.6% to 11.8% by marginal cost analysis, compared to –1.7% to 2.3% consolidated. The **operational self-sufficiency** of SHG banking ranged from 110% to 165% by average and 142% to 286% by marginal cost analysis, compared to 86% to 145% consolidated. In contrast, ROA of Cash Credit varied from –10.2% to –0.5% and of ATL from –6.3% to 0.2%; OSS ratios from 54% to 102%. SHG Banking was found to be a robust financial product, performing well in healthy and distressed financial institutions.

Self-reliance of SHGs based on internal savings and retained earnings was found to be rapidly growing, exceeding in older groups the volume of bank refinance by an increasing margin. In addition SHGs deposit substantial amounts of savings voluntarily in banks as a reserve for bad debts.

In addition to direct effects on bank profits, SHG Banking has **indirect commercial effects** on banks in terms of improved overall vibrancy in banking activities. **Indirect benefits** at village level include the spreading of thrift and financial self-reliance and of a credit culture among villagers, microentrepreneurial experience, growth of assets and incomes, the spreading of financial management skills, and the decline of private moneylending. **Intangible social benefits** are reportedly many: self-confidence and empowerment of women in civic affairs and local politics, improved school enrolment and women's literacy, better family planning and health, improved sanitation, reduction of drinking and smoking among men, and a decline in adherence to local extremism.

The future **sustainability of SHG Banking** hinges on five factors: (a) A sound self-supporting institutional framework is in place. (b) Despite exceptionally low interest rates, linkage banking was found to be viable and profit-making for all financial institutions and SHGs; however, many rural banks require restructuring. (c) SHGs have substantially increased their level of self-reliance and deposited reserves, while banks are constrained by high statutory liquidity requirements. (d) Given the low inflation rate, preservation of the value of resources is no major issue, except in distressed banks. (e) With continually increasing internal funds, effective supervision of SHGs through a delegated system, together with the enforcement of prudential norms in banks and cooperatives, emerges as a major challenge to the long-term sustainability of SHG banking and rural finance in India.

Among the **topics for further study** are: pricing of financial products in a random sample of rural financial institutions; extending SHG Banking to the middle poor; options of delegated supervision for SHGs and cooperatives; collateral for larger loans within SHGs; loan protection through life insurance; and options for individual performance incentives in banks and cooperatives.

Scepticism about the financial viability of microfinance is largely due to a lack of information on the profitability of microfinance programs and institutions in India, including the dominant self-help group model. (The World Bank, June 2001: 6)

1. Introduction

1.1 SHG Banking in India: is it viable?

Nabard's programme *Linking Banks and Self-Help Groups* aims at providing sustainable access to financial services to the rural poor, with a focus on those who had been considered unbankable. By using the existing rural financial infrastructure of 150,000 banking and cooperative retail outlets and linking them to savings and credit groups with joint liability, there are economies of scale and scope, resulting in substantially lower transaction costs. National implementation started in 1996, after four years of pilot-testing. Due to massive support from governmental and non-governmental agencies and the banking sector, the programme grew rapidly and, by March 2002, encompassed 461,000 self-help groups (now, in November, more than 500,000) with 8m members, covering 40m household members. Average loan sizes are Rs 22,240 ($463) per SHG and 1,300 ($27) per member.[2]

With its balanced emphasis on both savings and credit, it is the largest microfinance (and not just microcredit) programme in the developing world. By 2008, it is expected to cover a population of 100m, which is one-third of India's rural poor. 209 commercial banks, 191 regional rural banks and 44 commercial banks are involved as SHG Banking partners, with 17,085 participating branches. There can be no doubt about the programme's outreach to the poor; but is it viable for the banks? Is SHG Banking a poverty-lending program, which may be of immense benefit to the poor, but only thrives on subsidies; or is it a commercial proposition that can be recommended to all banks as an instrument of both outreach and institutional viability?

1.2 Nabard's bank refinancing: does it distort rural financial markets?

There has been a long-standing tradition of government owned agricultural development banks distorting financial markets with cheap credit and thereby, contrary to their good intentions, undermining rural finance and development as well as their own viability. It is also feared that easy money, even at market rates, discourages savings mobilization and thereby undermines self-financing and self-reliance of financial institutions and clients.

Nabard belongs to the new world of rural finance: it is profit-making;[3] and it actively promotes the viability of the rural banks under its supervision. As an investment in the SHG Banking infrastructure, it has established a microfinance development fund (MFDF) of Rs 1.06bn (US$22.1m), 43% of which is financed from Nabard's retained earnings.

Banks have cumulatively provided Rs 10.3bn ($214m) in loans to SHGs; estimated loans outstanding as of March 2002 amounted to Rs 6.9bn ($144m). 80% of cumulative bank loans have been refinanced by Nabard; from 2001 to 2002; Nabard's refinance has declined from 86% to 72% and is expected to continue declining. Nabard has provided its funds at interest

[2] Exchange rate: 1 USD = 48 Rupees.

[3] At zero percent non-performing assets, the return on average assets (ROA) of Rs 419bn = US$8.7bn for the fiscal year 2001-02 was 3.5%. This rate can be compared to that of agricultural development banks elsewhere, most of which are loss-making, but not directly to that of deposit banks, which have substantially higher costs of funds.

rates between 7% and 9.5%, depending on the prevailing market rates. During 2002, interest rates have been falling;[4] as of November, Nabard cut its small-loan interest rate down to 6.75%.

No compulsory deposit is required from the SHGs; but all SHGs have turned into grassroots financial intermediaries and mobilize savings vigorously. They use them mainly for internal lending, but also deposit substantial amounts as reserves in the bank.

There is no evidence thus, neither on theoretical nor on empirical grounds, that easy access to Nabard's liquidity has distorted rural financial markets; nor has it discouraged rural banks[5] and SHGs from mobilizing deposits, which have continued to grow substantially. However, given the existence of excess liquidity in the rural banking sector and the growth in savings mobilized, it is expected that Nabard's liquidity will continue to be fully available to new entrants, but its share of SHG financing in older partner banks might continue to decline.

1.3 Methodology

Case study approach: Our study is not statistically representative; we did not draw a random sample. Instead, we are presenting seven indicative case studies of the profitability of SHG banking during Fiscal Year 2001-2002:

- ✓ The Gudur branch of Andhra Bank, a national commercial bank
- ✓ Kakathiya Grameena Bank, a regional rural bank (RRB) in Warangal, and two branches in Parkal and Palakurthy
- ✓ The District Cooperative Central Bank in Bidar, its Bhosga branch and an associated primary cooperative society, the PACS of Ladwanthi.[6]

In the RRB, we also include profitability data for 1999-2000 and 2000-01. In three of the branches, we compare the profitability of SHG banking to that of other financial products: Agricultural Term Loans and Cash Credit. The field work was carried out in October 2002.

The conclusions and recommendations are indicative and cannot be generalized. SHG Banking is not a standardized approach in India, all stakeholders in the various states and districts being free to do it their own way without rigid rules of targeting, loan terms, loan purposes, or interest rate determination. This would have made it difficult to directly embark on a profitability study with a rigorous representative survey. We have tried to avoid a bias in favor of well-performing banks, which might do well with any financial product. There is a good and a medium bank among the three banks; one is technically bankrupt.

Developing a methodology: The main value of the study is therefore methodological: we have tested an instrument, which anyone may use to examine the financial feasibility of SHG linkage banking at the level of bank branches, banks or districts. Our approach is innovative in the sense that it provides the banks with an instrument for measuring the profitability of any of its financial products, which we have seen none of the banks doing.

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[4] Average three-month fixed deposit rates: 6.0%; average bank rate as of 15 Nov.: 6.25%).

[5] Liquidity requirements for rural banks are considerable: there is a statutory liquidity ratio of 25% for all banks, plus a cash reserve ratio of 5.5% in 2002 (down from 10.5% in 1999) for commercial banks and 3% for regional rural and cooperative banks.

[6] The study was preceded by a qualitative study by the first author, as IFAD Rural Finance Adviser, in February 2001. See H. D. Seibel & S. Khadka, SHG Banking: A Financial Technology for Very Poor Microentrepreneurs. NABARD's Program of Promoting Local Financial Intermediaries Owned and Managed by the Rural Poor in India. *IFAD Rural Finance Working Paper* No. A9, 2001; also published in: *Savings and Development* (Milan) 26/2 (2002): 133-149.

Average vs. marginal cost calculation: Our estimates of general head office and branch cost attributions have been on the conservative side. We have therefore used average, rather than marginal, cost calculations, treating SHG Banking as a normal product which shares in all costs. However, as some branch managers have pointed out that they have ample free capacities, combine visits to SHGs with other trips due to villages, and therefore incur no additional personnel costs, we have also calculated marginal costs in those case studies where it appeared appropriate.

How to deal with the basic costs of social mobilization, such as group formation, group maintenance, and training? Is this part of building a rural infrastructure, like roads and bridges, or are these product costs to be factored in? In cases where they were clearly externalized in NGOs or government agencies, we excluded them. They were included when borne by the banks or SHGs.

Introducing vs. mainstreaming SHG Banking: Here we have to distinguish between the early phase of introducing, and the mature phase of mainstreaming, SHG Banking. In the latter, we found that compensation of non-bank field personnel stationed in the villages such as assistant supervisors and volunteers was variously borne, without outside subsidy, by banks, cooperatives or SHGs; and was accounted for in our cost calculations when borne by the banks. Training expenses incurred by the banks were included, but posed an additional problem: should they be considered as current expenses; or as an investment in human and social capital to be spread over a period of time? Here we offer alternative calculations.[7]

The performance indicators (expressed in percent) used in the study are given below; of these, we have mainly used NPL, ROA and OSS, based on monthly averages. Administrative costs were attributed to the respective financial products on the basis of their proportion of the total number of accounts. As SHG Banking has both a savings and a credit component and loan accounts are more labour-intensive, the savings accounts were given a weight of 30% and loan accounts of 70%.[8] In the branches, income from SHG savings deposited in the head office and the cost of SHG loan funds are based on the transfer price mechanism adopted by the respective banks.

Non-performing loans (NPL):[9]	Amount overdue >180 days from end of quarter /Portfolio outstanding
Return on average assets (ROA):[10]	Net income/Average assets
Return on average loans (ROL):	Net income on loans/Average loans
Operational self-sufficiency (OSS):[11]	Operating income/Operating expenses incl. cost of funds
Self-sufficiency in funds:	Deposits/Loans outstanding

[7] Balance sheets, profit & and loss accounts, loan recovery data and performance ratios are given in the annexes in Excel; the files, with detailed footnotes, will be provided upon request by nabmcid@vsnl.com. .

[8] We arrived at this calculation after lengthy discussions with the bank managers, discarding two options: the volume of deposits and loans outstanding; and the number of vouchers of savings and loan transactions.

[9] Loan loss provisions were included on an actual basis as prescribed by RBI. In bank branches, retained earnings or losses are transferred to the head office balance sheet and not included in branch balance sheets.

[10] Return on equity (ROE) is not used in this study, as equity is only assigned to a bank as a whole and not to branches or products.

[11] Mainly used in the microfinance community and by the donor consultancy group CGAP. Operating expenses comprise interest expenses, personnel expenses, loan loss provision, and other operational costs. Some authors erroneously exclude interest expenses from total operating expenses and thereby arrive at inordinately high OSS ratios, which may be well above 100% in loss-making institutions. We are not using the (CGAP) financial self-sufficiency ratio (FSS) here, which indicates the extent to which an institution covers its operational costs and preserves the value of its resources by accounting for subsidies and the effects of inflation:

Operating income/(financial costs + operating costs + loan loss provision + imputed cost of capital).

2. Case studies of rural banks

2.1 Kakathiya Grameena Bank, a Regional Rural Bank in Warangal District, AP

Warangal in Andhra Pradesh is an agricultural district with 3.2m inhabitants in 1,080 villages. 50% of arable land is irrigated, largely by tanks (*water reservoirs*). Land holdings are small and fragmented. Of the 620,000 families, about 100,000 are agricultural labourers and 50,000 are microentrepreneurs. There are 18 banks in the district with 210 bank branches, 167 of them with a rural service area, plus 180 cooperatives. In the district, 23,000 SHGs have been formed, 19,000 of which are operational, 13,000 of them with loans outstanding. The district is considered a vanguard in higher education and in extremism.

The **Kakathia Grameena Bank** (KGB), a regional rural bank (RRB), was established in 1982 and has been in losses for the first 17 years of its existence, made profits for two years and went again into the red during the last year due to the court-ordered payment of salary arrears for a ten-year period. Recoveries were around 25%-30% and increased to around 50% - with a peak of 62% - during the last five years. Annual loss ratios are estimated at 7-8%. The bank has a negative networth; this is not shown in the balance sheet, as accumulated losses are hidden under "other assets." Between 1988 and 2002, KGB's business has gone up substantially: from 62m to 1.4bn in deposits and from 89m to 1.03bn in loans, while the number of staff has changed little: from 163 to 181. Its market share in the district is 9.0. KGB is considered as an RRB of average standing.

KGB started SHG Banking in 1997 in cooperation with the District Rural Development Agency (DRDA) as the agency of social mobilization; which has made large capacity-building efforts through its Technology Training and Development Center and is now self-managed and nearly self-financing. KGB now works with 6,589 groups, 3,350 of them with loans outstanding. The basic data are summarized below; further details are given in the annexes.

KGB basic data (31/3/2002)	*Bank*	*Parkal branch*	*Palakurthy branch*
Number of branches	40	1	1
Number of units with SHG Banking	37	1	1
Start of SHG Banking	1997	1998	1997
Total number of loan accounts	84,244	2672	2404
SHGs loan accounts (with outstanding)	3,350	235	126
Total number of deposit accounts	123,484	4022	4112
SHGs deposit accounts	6,589	565	275
Number of SHG members (estimated)	98,835	8,475	4,125
Interest rates on loans:			
Non-SHG loans	13%-17%		
SHG loans	12.5%-13%		

SHGs account for 6.0% of the bank's loan portfolio and 1.4% of total deposits:
In Parkal, SHGs account for 9.7% of total loans and 3.5 of total deposits;
In Palakurthy, SHGs account for 6.2% of loans and 4.3% of deposits.

KGB selected balance sheet data, 31/3/2002	*Consolidated*	*SHG*	
(Amounts in Rs '000)		*Amount*	*% of bank*
Total assets	2065600	81580	3.9
Net loans outstanding	9,88000	59750	6.0
Other assets (incl. accumulated losses)	1,34700	0	0
Total liabilities	19,61800	79320	4.0
Deposits	13,56600	19570	1.4

Viability of SHG Banking comes early: Profitability of SHG Banking has come early for KGB. Data were not available for a profitability analysis during the first two years of SHG Banking; but during the third and fourth year, it was already substantially profitable, with a ROA *(at fiscal year-end)* of 1.7% [bank : 1.0 %] in 1999-2000 and 1.66 % [bank : 0.9 %] in 2000-01. . Needless to say, at a higher interest rate, the bank would have reached profitability quicker. During 2001-02, the ROA of SHG Banking went up to 2.5%, while the bank was heavily into losses (bank ROA: –1.7%). Using marginal instead of average cost calculation, its ROA would have been 4.7 %, 3.6% and 4.7%, respectively for the three years. Its operational self-sufficiency ratio in 2001-02, using the CGAP formula which indicates the extent to which a bank covers its total operational costs including costs of funds, was 126% according to average, or 163% according to marginal cost calculation.

Selected profit & loss account data, 31/3/2002		
(Amounts in Rs Million)	*Consolidated*	*SHG*
Total operational income	194.90	7260
Total operational expenses	226.86	5800
Interest expenses	152.80	3811
Personnel expenses	36.80	1293
Direct SHG social mobilisation costs	0.27	270
Loan loss provision	24.21	60
Other operational costs	3.40	150
Net profit/loss	-31.96	1523
Adjusted profit (marginal cost calculation)		2816

The commercial performance of SHG Banking is astonishing, given the fact that interest rates to SHGs are at the low end of the bank's interest rate structure. This performance is largely due to a zero rate of non-performing loans, compared to 10% in the bank as a whole (2001/02).

Performance data, 31/3/2002		
(in percent)	*Consolidated*	*SHG*
Non-performing loans [in % to total]	10.0	0
Return on assets (ROA)	-1.7	2.5
Adjusted (marginal cost calculation)		4.7
Operational self-sufficiency (CGAP)	86	127
Adjusted (marginal cost calculation)		163
Self-reliance (bank deposits/bank loans)	137	33

The savings performance of SHGs has surpassed most expectations; but this is difficult to present in detail as only bank deposits are being monitored. Bank deposits by SHGs have increased substantially over the years, representing 33% of loans outstanding as of March 2002. The deposits-to-liabilities ratios in the bank and the two branches are given below, indicating that at branch level SHG deposits account for about half the liabilities.

Deposit-to-liability ratios, 31/3/2002		
	Consolidated	SHGs
KGB	69%	25%
Parkal branch	82%	50%
Palakurthy branch	83%	100%

SHGs are required to first build up their own internal lending business, which is entirely based on internally mobilized resources. As resource mobilization continues from savings and substantial earnings from a margin of 12%, the larger share of is kept in the groups and recycled among the members in the form of loans. In Warangal District, there are reportedly some 500 SHGs with own resources of more than Rs 100,000 ($2,000), of which 250 have more than Rs 200,000 ($4,000).

How does SHG Banking compare to other products? In the branches of Parkal and Palakurthy, we extended our study to include profitability analyses of the two financial products: cash credit (CC) and agricultural term loans (ATL). Parkal works with 328 SHGs, of which 235 have loans outstanding; Palakurthy with 275 SHGs, of which 126 have loans outstanding. In both branches, SHG Banking is profitable at ROAs around 1% by average cost calculation and around 5% by marginal cost calculation.

Parkal is a loss-making branch, with 18% of its portfolio in arrears and NPA of 16%. SHG Banking outperforms CC and ATL by a wide margin, which have high arrears ratios (55% and 62%, respectively) and negative ROAs (-8.7% and –6.2%, respectively).

Parkal branch *(31/3/2002)*	*SHG*	*Cash credit*	*ATL*	*Branch*
Total assets	*3,406*	*1,856*	*2,531*	*69,636*
Net loans outstanding (in Rs '000) Average loans outstanding	*3,406* *3,022*	*1,856*	*2,531*	*35,187* *64400*
Portfolio in arrears	0.0%	55%	62%	18%
Return on (av.) assets (ROA) Adjusted (marginal cost calculation)	1.4% 4.6%	-10.2%	-6.3%	-0.4%
Operational self-sufficiency (CGAP) Adjusted (marginal cost calculation)	110% 142%	54%	70%	98%

In contrast, Palakurthy is a profitable branch, with arrears of 6.5% and a ROA of 1.0%. At 19%, both CC and ATL have substantially higher arrears than SHG Banking at 1%. With average cost calculation, SHG Banking and CC are almost identical in profitability, while ATL is incurring a moderate loss at –0.7% of assets.

Palakurthy branch *(31/3/2002)*	*SHG*	*Cash credit*	*ATL*	*Branch*
Total assets	*1,950*	*1,645*	*3,228*	*54,241*
Net loans outstanding (in Rs '000) Average loan outstanding (in Rs.'000)	*1,561* *1455*	*1,645*	*3,228*	*25,277* *47667*
Portfolio in arrears	0%	19.3%	18.8%	6.5%
Return on (av.) assets (ROA) Adjusted (marginal cost calculation)	3.9% 6.1%	-0.5%	-1.3%	1.1%
Operational self-sufficiency (CGAP) Adjusted (marginal cost calculation)	129% 154%	97%	91%	107%

Indirect effects of SHG Banking, include:

- an increase in the bank's overall repayment rate, due to the influence of the SHG women members
- increased overall vibrancy in branch business, due to the economic activities of SHGs in the villages, very much welcomed by the branches where "large underutilized capacities" exist
- substantial decrease in the reliance on moneylenders, many of whom have reportedly gone out of business, while the remaining ones have tended to lowered their interest rate (from 5% to 3% on the declining balance).

Intangible or social effects are reportedly many, which are attributed to a significant degree to the vibrancy of the SHGs, but are difficult to quantify. In a district where SHGs first appeared in1993, a study by the DRDA in Warangal claims that there an impact on the following:

- Women's literacy, which increased from 14% in 1981 to 28% in 1991, but jumped to 49% between 1991 and 2001
- Population growth, which declined due to improved family planning from 23% during 1971-81 und 24% during 1981-91 to 14.6% during 1991-2002
- School enrolment, which is 92% among the children of SHG members
- Vaccination of children
- Access to drinking water
- Sanitation
- Political empowerment of women, who gained 34% of seats in local self-government institutions (against a stipulation of 30%) and now take an active influence on local politics
- Local extremism (*naxalites*), which has declined due to improved earning opportunities, increased school enrolment and direct action by women.

2.2 District Cooperative Central Bank (DCCB) in Bidar District, Karnataka

Bidar, with a population of 1.4m in 600 villages and 300 hamlets, is a remote and backward district in Karnataka State; only 10% of cultivated land is irrigated. 52% of the 280,000 families are below poverty; 30% belong to scheduled castes and tribes.

The **DCCB** in Bidar, established in 1922, is considered among the best of 356 cooperative banks in India, consistently earning profits for the last ten years. It functions as a central cooperative bank in the region, which delivers its services through two channels: 43 branches, which are profit centers, and 171 primary agricultural cooperative societies (PACS), which are autonomous local financial institutions. This applies also to SHG Banking, which is financed by the bank through its branches and through PACS. There are 37 different loan products with different interest rates: some of them a relic of supply-led directed lending to agriculture; diversification into the rural non-farm sector started during the late 1980s.

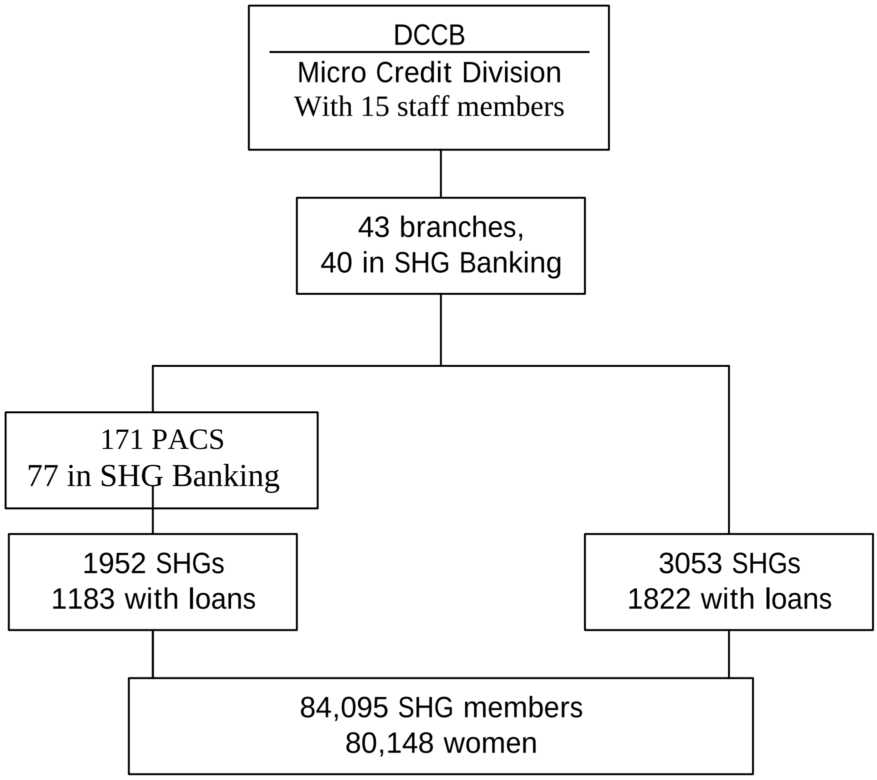
DCCB basic data (31/3/2002)	*Bank*	*Bhosga branch*	*Ladwanthi PACS*
Number of branches	43	1	1
Number of units with SHG Banking	42	6	
Start of SHG Banking	1996	1999	1999
Total number of loan accounts	3,958		
SHGs loan accounts (with outstanding):*	3,005		
Through branches:	1,822		
Through PACS:	1,183		
Total number of deposit accounts	49,191		
SHGs deposit accounts*	7028		
Number of SHG members	84,095		
Interest rates on loans:			
Non-SHG loans	13%-17%		
SHG loans**	13%		

* There are some incongruencies in the data, as the bank originally financed SHGs only through its branches; and as of 2000 started to encourage PACS to finance SHGs.
** As of 1/4/2002: 12.5% on loans up to Rs 25,000.

Total assets of the bank amount to Rs 4.44bn, loans outstanding to Rs 3.43bn, deposits to Rs 0.56bn. Its Return on Assets is 0.8%.

DCCB Bidar *(31/3/2002)*	*SHG*	*Bank*
Total assets (***in Rs. Million***)	45.0	4,438.4
Net loans outstanding (in Rs million)	44.9	3,425.0
Deposits	12.1	561.5
Non-performing loans (in %)	0.0	2.7
Return on (av.) assets (ROA)	0.1%	0.8%
ROA adjusted (training amortized over 5 years)	2.1%	
Operational self-sufficiency (CGAP)	101%	108%
OSS adjusted (training amortized over 5 years)	118%	

DCCB SHG Banking Programme



SHG Banking: DCCB started SHG Banking in 1996. By March 2002, a total of 6900 SHGs had been established in Bidar District, comprising about 100,000 members from poor families. 5005 SHGs had opened savings accounts with DCCB; and 3,005 had been credit-linked: 1,183 financed by societies and 1,822 financed by the branches. Of 3,117 SHGs ever financed by DCCB, 3,005 (96%) have loans outstanding. Among the SHG promoting agencies, NGOs are the most active organizers of SHGs in the district; primary cooperatives are second in importance; the government's women development programme, Stree Shakti, is third.

SHGs linked to DCCB by self-help promoting agency (SHPI), 31/3/2002				
SHPI	*SHGs with savings accounts*		*SHGs with loan accounts*	
	Number	%	Number	%
PACS	1866	37	1123	36
NGOs	2374	47	1345	43
Women's org. (Stree Shakti)	765	15	649	21
Total	*5005*	*99%*	*3117*	*100*

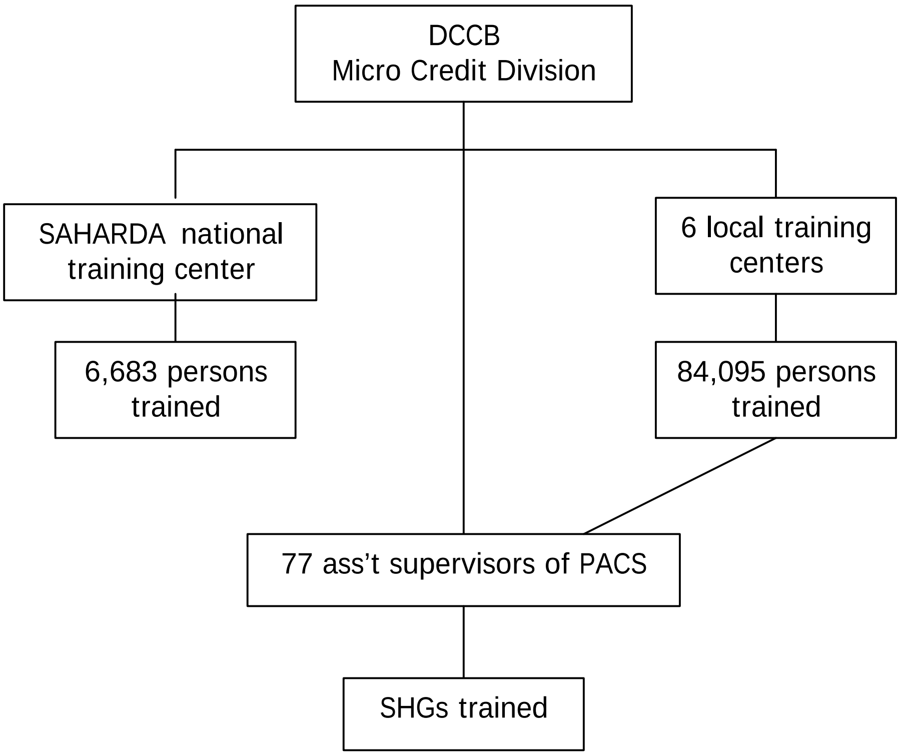
Profitability of SHG banking: Due to its heavy expenditure on SHG promotion through training and the establishment of a Micro Credit Division, SHG Banking in DCCB is just breaking even, with a the return on assets of 0.1% and an OSS is 101%. However, if we assume that training expenditures are long-term investments in human capital and should be amortized over five years, the ROA surges to 2.1% and the OSS to 118%.

Institutionalizing SHG Banking: DCCB has institutionalized SHG Banking, fully bearing its costs, through four channels:

- ✓ a microcredit division
- ✓ six local training centers for SHG and other training within the district
- ✓ a national training center for banks and other institutions from throughout India
- ✓ SHG supervisors at PACS level:

The bank has established a separate Micro Credit Division functioning as an SHPI, with 15 officers. The division has trained all branch and PACS staff and has developed PACS as SHPI as the bank's own direct instrument of sustainable SHG promotion at the grassroots level. The bank provides training in SHG Banking through its local training centers, located on the second floor of block branches and staffed by personnel from the block branches. All costs of the Micro Credit Division and the local training centers are included in the profitability analyses at the respective institutional levels. In addition, the bank trains SHG supervisors as PACS staff, whose costs are transferred to the PACS over a three year period; the bank bears 75% of the costs during the first year, 50% during the second year and 25% during the third year. The bank has also developed a network of NGOs as facilitators, receiving a 1% margin from the SHGs. Saharda, a national training center established by the bank, does not serve the district. As a subsidiary of the bank, it is fully self-supporting and does not enter into our calculations.

DCCB's SHG training programme



The branch of Bhosga : Of the bank's 43 branches, 40 participate in SHG Banking.We studied the branch of Bhosga, which acts as an intermediary for 6 PACS, where 129 SHGs hold their accounts.Most of the the outstanding SHG portfolio is covered by SHG deposits. There are no non-performing SHG loans, compared to an overall NPL ratio of 2.6% of the branch. The branch earned 2.3% on its total average assets, equivalent to an OSS of 121%, and 4.2% on SHG Banking, equivalent to an OSS of 157%.

DCCB branch Bhosga (31/3/2002)	*SHG/PACS*	*Branch*
Total assets (***in Rs. '000***)	1,650	39,233
Net loans outstanding (in Rs '000)	1,607	34,654
Deposits	1,500	10,472
Non-performing loans	0%	2.6%
Return on (av.) assets (ROA)	4.2%	2.3%
Adjusted (marginal cost calculation)	7.7%	
Operational self-sufficiency (CGAP)	157%	121%
Adjusted (marginal cost calculation)	286%	

The PACS of Ladwanthi: Of 171 PACS in the district, 77 participate in SHG Banking; it is planned that eventually all PACS will participate. Until about 2001, the PACS served as a mere credit channel and received a commission of 1.5% from the bank branches, with the risk borne by the branch. At present, the bank's policy concerning the role of PACS in SHG Banking is contradictory: the PACS are not permitted to determine their own interest rate; they receive a fixed margin of 1.5%, but bear the full risk. The PACS in the district are slow recovering from poor performance in the past due to non-performing loans and a low level of business activities. This is now changing; and this change is largely attributed to the vigor of the SHG business.

The PACS of Ladwanthi has 1,065 regular members, 135 women; 664 members have loans outstanding. Most of the members are land owners; but anyone can become a member. Only land owners can borrow, unless two land-owning members provide guarantees. SHGs are nominal, non-voting members. Admitting SHG members, who are mostly poor women, as regular members on a broad scale – some are already members – would totally alter the composition of membership.

The PACS provides financial services to 69 SHGs; 43 of them have loans outstanding. SHG deposits account for 38% of outstandings, which is identical to the share of overall deposits in overall outstandings. Non-performing loans in the PACS are coming down, but are still high at 3.6%. In contrast, NPLs are zero in the cooperative's lending to SHGs. The PACS earns 1.5% on its total assets and 2.0% on its SHG assets. The PACS attributes much of the change over the last three years to its participation in SHG linkage banking and its indirect effects on cooperative members: an increase in deposits from Rs 1.3m to Rs 3.5m; an increase in loans outstanding from Rs 4.1m to Rs 9.1m; and increase in the recovery from 91% to 94%. There is new, almost forgotten, awareness that the society accepts deposits; 12 out of 113 fixed deposit holders are SHG members.

PACS, Ladwanthi (31/3/2002)	*SHG*	*PACS*
Total assets (***in Rs. '000***)	1,320	12,503
Net loans outstanding (in Rs '000)	1,262	9,131
Deposits	481	3,524
Non-performing loans	0%	3.6%
Return on average assets (!) (ROA)	2.0%	1.5%
Operational self-sufficiency (CGAP)	116%	113%

Profitability of SHG Banking: SHG Banking is breaking even (with a slight positive margin) at bank level, where the overhead costs for the Microcredit Division are borne, while the bulk of the profit-making SHG business is shifted to the branches and PACS. At bank level, marginal cost calculation is therefore not appropriate. At branch and PACS level, SHG Banking is highly profitable: above the profitability of the respective units.

Profitability of SHG Banking, 31/3/2002		
Unit	*ROA*	*Adjusted ROA*
DCCB Training amortized	0.1% 2.1 %	-
Branch of Bhosga	4.2%	7.7%
PACS of Ladwanthi	2.5%	

Impact on SHG savings, retained earnings and borrowings: There is a strong impact of SHG membership on savings behavior; in many SHGs, the amount of individual weekly savings has quadrupled from Rs 5 to Rs 20, which has substantially increased the volume of loanable funds and retained earnings. As of August 2002, SHGs in the district had total savings of Rs 120m and retained earnings of Rs 90m (*common fund*), totaling internal resources of Rs 210m, which is nearly five times the amount of bank loans of Rs 45 m. Total working capital is thus Rs 255m ($5.26m). The annual total turnover of SHGs is reportedly Rs 500m. The repayment rate is 98%; non-performing loans are zero.

Resources of SHGs in Bidar District, 8/2002	*Amounts*		*Percent*
	Million Rs.	*Million $*	
Savings	120	2.50	47
Retained earnings	90	1.88	35
Total internal resources	*210*	*4.33*	
Bank loans	45	0.93	18
Total resources	*255*	*5.26*	*100*

The proportion of SHG deposits in terms of loans outstanding in the three entities studied is as follows:

Bidar DCCB consolidated : 27%
Branch of Bhosga : 93%
PACS of Ladwanthi : 38%

Indirect benefits of SHG Banking in the district are pronounced. 38% of the families in the district, and 72% of poor families are SHG members with access to financial services. SHG Banking is considered the main factor in the turn-around of primary cooperatives from sleepy, loss-making entities, open for a couple of hours per week, into increasing active member-societies, with frequent opening hours. At the same time, it has added vibrancy to the bank branches. DCCB has provided data for estimating indirect benefits, comparing data for 1998 and 2002, but attribution is virtually impossible, except in the case of passbook savings in PACS, where the SHG portion has amounted to 93% in 2002:[12]

[12] M. Shripathy Rao (Director of Saharda) & B.S. Kudre (Senior Adviser): SHG Movement in Bidar District: Indirect Benefits. DCCB Bidar, November 2002.

- ✓ Total deposits in 43 bank branches increased from Rs 0.75bn to Rs 2.5bn (233%)
- ✓ Total deposits in 171 PACS increased from Rs 26.6m to Rs 136.7m (414%)
- ✓ SHG deposits in the form of passbook savings in bank branches increased from Rs 0.7m to Rs 12.1m (1648%)
- ✓ SHG deposits in the form of passbook savings in PACs increased from Rs 0.3m to Rs 17.4m (5275%)
- ✓ The recovery rate of the branches has increased from 70% to 89%
- ✓ The recovery rate of the PACS, where the impact of SHG members in stronger, has increased from 72% to 95%
- ✓ The number of profit-making PACS has increased from 93 to 131
- ✓ Many moneylenders have gone out of business; the remaining ones have reduced their interest rates due to competition by SHGs.

Intangible benefits: The DCCB paper lists the following intangible effects, which are directly attributed to the SHG social movement:

- ✓ Self-confidence and self-discipline among women, resulting in a more active personal and family life
- ✓ Empowerment of women, who are increasingly involved in community development programs and local politics
- ✓ Exposure of bad habits of family members harassment of women, resulting changing male attitudes and behavior
- ✓ Exposure of social evils such as child marriage, child labour and dowry.

2.3 The Gudur Branch in Warangal District of Andhra Bank, a national commercial bank

Andhra Bank is a government-owned national commercial bank, with its head office in Hyderabad. It has 1031 branches throughout India, 37% rural and 28% peri-urban. Its total assets as of 31/3/2002 amounted to US$4.29bn, its loans outstanding to $1.98bn and its deposits to $3.79bn. Its net non-performing assets were 1.1%; its return on assets was 1.0%.

With a total number 55,000 SHGs financed (27,349 during 2001-02), Andhra Bank is among the top bank performers in SHG Banking in India. We studied one branch, not the bank as a whole. The following basic information on the bank as a whole is taken from the annual report for 2001/02:

Andhra Bank, 31/3/2002	Rs billion	US$ million
Total assets	209.4	4,290.4
Loans outstanding	96.8	1,983.1
Loans outstanding to SHGs	1.0	21.0
Deposits	184.9	3,789.1
Total profit	2.0	41.5
Net NPA	1.1%	
ROA	0.97%	
No. of SHGs financed	54,908	

The Gudur branch of Andhra Bank in Warangal District comprises a branch office and, as a result of a merger in 2000-01, a satellite branch It has 2,714 loan accounts, 12% of them SHGs; and 7,447 deposit accounts, 8% of them are SHG accounts. It covers 26 villages with

100,000 inhabitants, at a distance of 5-20km. Large parts of the area are under forests and have sizeable tribal populations.

Gudur branch, Andhra Bank(31/3/2002)	*Bank*
Start of SHG Banking (savings) Start of credit linkage Best Banker Award	1997-98 1999-2000 2001-02
Total number of loan accounts SHGs loan accounts (with outstanding)	2,714 324
Total number of deposit accounts SHGs deposit accounts	7,447 632
Number of SHG members (estimated)	9,480
Interest rates on loans: Prime lending rate Non-SHG loans SHG loans (average)*	 12 11%-16% 11.25%

The branch has been consistently profit-making since 1998. In 2001-02, its non-performing loans stood at 5.6% of average assets; its ROA was an impressive 2.3%, its operational self-sufficiency ratio 145%.
The comparative performance of the SHG product vis-à-vis Agricultural Term Loans and the aggregate branch performance for the year 2001-02 is given below :

Gudur branch selected balance sheet data (*31/3/2002) (in Rs '000)*	*SHG*	*ATL*	*Branch*
Total assets Average total assets	4,154 2,533	4,938 3,893	79,247 82,808
Net loans outstanding (in Rs '000)	4,154	4,938	34,323
Deposits	943		51,154
Non-performing loans	0.0%	21.3%	5.6%
Return on average assets (ROA) Adjusted (marginal cost calculation)	7.5% 11.8%	0.2%	2.3%
Operational self-sufficiency (CGAP) Adjusted (marginal cost calculation)	165% 264%	102%	145%

SHG Banking was introduced upon the initiative of the District Rural Development Agency (DRDA), which established the first 68 groups through its officers in 1997; initial disbursements were made through the District Collector. Subsequently, the DRDA organized and trained village volunteers, who were paid by each SHG Rs 15 per month for guidance and bookkeeping services. The success of the early groups and the initiatives taken by the groups and the volunteers led to a rapid increase of SHGs in the branch's service area.

At the Gudur branch, SHG Banking initially met with skepticism and therefore took a slow start. Up to 1999, there were only few savings and credit activities of the branch with SHGs. The rapid spread of the movement and the excellent repayment performance of the SHGs, with zero percent non-performing assets, turned the branch manager around. Within three years, the number of SHGs with deposit accounts rose to 632; and the number of SHGs with loans outstanding to 324.

Only SHGs collect savings at village level and deposit them in the branch on market days, at near-zero saver transaction costs. The branch has responded to the extra demand for services and on market days keeps its counters open until evening.

Profitability of the branch, SHG Banking and Agricultural Term Loans: SHGs banking performs exceedingly well in the Gudur branch:

- ✓ Non-performing loans to SHGs are zero, compared to 5.6% at branch level and 21.3% of ATL
- ✓ ROA of SHG Banking is 7.5%, compared to 2.3% of the branch and 0.2% of ATL
- ✓ OSS is 165% for SHG Banking, compared to 145% for the bank and 102% for ATL.

According to the branch manager, the branch is underemployed and carries out SHG Banking at no additional administrative costs. All mobilization and maintenance costs are externalized and borne by the DRDA or SHGs, respectively. It is therefore appropriate to recalculate the profitability of SHG Banking, using marginal cost analysis, with the following extraordinary results for the SHG Banking product:

- ✓ ROA-marginal: 11.8%
- ✓ OSS marginal: 264%.

Interest rate: One of the main determinants of profitability is the interest rate. The branch lends to SHGs at 11%, which is the lowest interest rate of any of its loan products. This makes the profitability of SHG Banking all the more astonishing and is indirect evidence of the efficiency of the branch and the linkage partners.

Direct impact: According to the branch manager, SHG Banking has the following direct effects:

- ✓ The spreading of thrift among members and non-members
- ✓ Excellent credit culture, with SHG members fully observing their loan obligations.
- ✓ Higher economic activities and family income of SHG members
- ✓ Asset creation, such as cows, agricultural implements and land among SHG members
- ✓ Access to credit by non-members (at 3% interest per month, compared to 2% to members and 5% charged by moneylenders).

Indirect effects reportedly include the following:

- ✓ Higher savings volume mobilized from the village
- ✓ Spill-over effect on repayment behavior of poor and non-poor farmers
- ✓ Extremists (*naxalites*), as a result of interaction, accept and encourage SHGs and leave participating bank branches unharmed.

Intangible effects reportedly include improved adult literacy, drastic increase in school enrolment, better health, family planning, support for government programmes, and a decline in adherence to the extremist movement.

3. Summary and conclusions[13]

3.1 Interest rates and flow of funds

Funds flow in two directions: credit from Nabard through banks to SHGs and their members; savings and repayments in the opposite direction. Interest rates, a major determinant of profitability, are deregulated and fluctuate according to the market. During 2001-02, the following lending rates prevailed:

- **Nabard**, a profit-making apex development bank, refinances banks engaged in SHG Banking at **7%** (real: 2.3%); its share of finance has declined from 86% to 72% and continues to decline. There is no evidence of distorting effects on rural finance.
- **Banks** have refinanced SHGs at rates between 9.75% and 16% since the beginning of the program; and during 2001-02, at around **12%** of interest effective p.a. (real: 7.3%), which is at the low end of their interest rate spectrum and far below interest rates of comparable financial products in other countries.[14]
- **SHGs** mostly lend at effective rates of 2% per month or **24%** (real: 19.3%) per annum.

Lending rates of banks/PACS in %, 2001-02	*SHG Banking*	*Other products*
Kakathiya Grameena Bank, Warangal	12.5-13.0	13-17
Andhra Bank Gudur branch, Warangal	10.75-11.75	11-16
District Coop Central Bank, Bidar, to branches DCCB to PACS	13 10.5	13-17
PACS, Bidar	12	15-16

3.2 Profitability

Profitability has been measured in terms of *Return on Average Assets (ROA),* a standard performance measure in the banking industry, and *Operational Self-Sufficiency (OSS),* which is widely used in the non-banking microfinance community. Two methods of analysis have been used: (i) average cost analysis, in which all costs including personnel expenses are duly attributed to SHG Banking;[15] and (ii) marginal cost analysis, based on the assumption, where appropriate, that excess capacities exist and SHG Banking causes no extra personnel costs to banking units. In terms of all measures used,

- the profitability of the SHG Banking product is **positive** throughout all units studied, despite the very low interest rates charged by banks, with *Returns on Assets* ranging from 1.4% to 7.5% and *Operational Self-Sufficiency* ratios from 110% to 165%;
- it **significantly** exceeds the profitability of the respective units: bank, branch or cooperative society, using average cost analysis;

[13] All figures are for the fiscal year 2001-2002 ending 31/3/2002 unless otherwise stated.
[14] At an average inflation rate of 4.7% during 2001-2002, real interest rates are: Nabard 2.3%; banks 7.3%; SHGs 19.3%. By comparison, the rural microbanking units of Bank Rakyat Indonesia, considered a benchmark AgDB, before the Asian financial crisis lent directly to clients at nominal rates of 44% minus 11% rebate for timely repayment = 33% effective p.a., equivalent to a real interest rate of about 24%. In the Philippines, bank and non-bank Grameen replicators charge annual effective rates of. 40-60% (real: 35-55%) and above.
[15] Administrative expenses are attributed to the SHG Banking product on the basis of the number of loan accounts with a weight of 75% and savings accounts with a weight of 25%. Using loans and savings balances or the number of vouchers results in somewhat different figures, but does not alter the overall picture.

- using marginal cost analysis,[16] SHG banking exceeds the profitability of the respective units **by a wide margin**, with ROAs ranging from 4.6% to 11.8% (compared to –1.7% to 2.3% for the respective units) and OSS ratios from 142% to 286% (compared to 86% to 145% for the respective units).

Profitability of SHG Banking vs inst. unit by average and marginal cost analysis (%)	*Average cost analysis*				*Marginal cost analysis*			
	ROA		*OSS*		*ROA*		*OSS*	
	SHG	*Unit*	*SHG*	*Unit*	*SHG*	*Unit*	*SHG*	*Unit*
Kakathiya Grameena Bank	2.5	-1.7	127	86	4.7	-	163	-
Parkal branch	1.4	-0.4	110	98	4.6	-	142	-
Palakurthy branch	3.9	1.1	129	107	6.1	-	154	-
District Coop Central Bank	0.1	0.9	101	107	-	-	-	-
adjusted f. training amortization	2.1	-	118	-	-	-	-	-
Bhosga branch	4.2	2.3	157	121	7.7		286	
PACS Ladwanthi	2.5	1.5	116	113	-	-	-	-
Andhra Bank Gudur branch	7.5	2.3	165	145	11.8	-	264	-

Amortizing training expenditure: Training expenditures are long-term investments in human capital and should not be fully accounted for in the year of accrual. The effect on profitability (and taxes) can be considerable. A considerable amount of such expenses occurred in DCCB at head office level. When amortized over five years, the ROA for 2001-2002 surges from 0.1% to 2.1%; the OSS from 101% to 118%.

Profits of SHG Banking account for around **one-tenth of total profits** of the unit studied. In the KGB branch of Palakurthy and the Andhra Bank branch in Gudur, its profit share is 11% and 10%, respectively; in the DCCB branch 6.2%; in the PACS 7%. In KGB as a whole and the KGB branch in Parkal, it reduces losses by 5% and 18%, respectively. Only in DCCB with its emphasis on the promotion of branches and PACS and its heavy investment in SHG promotion, the share of SHG Banking in total profits is negligible.

Growth of profits was studied only in KGB. Over a three-year period, profits of the SHG Banking product **grew eightfold** from Rs 190,000 to Rs. 1.5m, while the bank went from profits to losses.

Are interest rates to SHGs adequate? The interest rate margin is a major determinant of profitability. If cost of funds and portfolio quality remain constant, profits correlate directly with the interest rate. In several SHGs visited, we raised the question whether an increase of the interest rate fromaround 12% to 15% would create a problem; no objection was voiced against such a potential increase. None of the bankers, however, appeared interested in a raise of the interest rate, despite the fact that there might be no other country with such low market rates of interest to SHGs. To the contrary, in the present situation of generally falling interest and under the pressure of competition, the banks have been lowering the interest rate. Yet, the adequacy of interest rates to SHGs is a wider issue to be discussed in the community of bankers. The following arguments speak in favour of an increase in interest rates to SHGs:

- Building up reserves to withstand downturns
- Financing the expansion of SHG banking
- Financing an SHG banking division with additional staff

[16] Not applicable in DCCB at bank level, where a new microcredit division has been established; and at PACS level, where additional staff has been recruited.

- Covering the social mobilization costs of SHGs, providing training, guidance and monitoring services
- Taking the bank to the people and providing collection services in villages, thereby lowering client transaction costs
- Expanding services to remote villages through mobile services
- Facilitating microenterprise promotion
- Increasing the overall direct interaction of banks with SHGs, which is on a low level.

Profitability of SHG Banking vs. other products: Profitability analysis can be applied to any financial product and should guide a bank in the decision which products to offer, or to improve. Between the three branches studied, there is a definite ranking: The Andhra Bank branch, were only SHG Banking and ATL were studied, performed consistently best, the KGB branch in Parkal worst, incurring heavy losses on CC and ATL.Comparing the three products, **SHG Banking outperforms the other products** by a wide margin. It is only in the Andhra Bank where ATL breaks barely even; in the other two bank branches, both CC and ATL produce losses. The discrepancy between the three products is even wider when taking the interest rate into account: in KGB, the interest rate on SHG Banking is 13%; on CC and ATL, it is 15%-17%, depending on loan size.

ROA of SHG Banking vs. CC and ATL (in %)	*SHG Banking*		*Cash Credit*	*Agric. Term Loans*
	Average cost calc.	*Marginal cost calc.*	*Average cost calc.*	*Average cost calc.*
KGB Parkal	1.4	4.6	-10.2	-6.3
KGB Palakurthy	3.9	6.1	-0.5	-1.3
Andhra Bank Gudur	7.5	11.8	-	0.2

OSS of SHG Banking vs. CC and ATL (in %)	*SHG Banking*		*Cash Credit*	*Agric. Term Loans*
	Average cost calc.	*Marginal cost calc.*	*Average cost calc.*	*Average cost calc.*
KGB Parkal	110	142	54	70
KGB Palakurthy	129	154	97	91
Andra Bank Gudur	165	264	-	102

The results of this comparison, as tentative as they may be, raise a number of *issues:*
- The performance of different financial products clearly requires further study on a broad scale;
- Such a study may provide an entry point to the reform of rural banks;
- Tied products of savings-cum-credit hold great promise in improving the self-financing capacity as well as credit discipline of clients;
- The stark differences in performance of the financial products raise the question of how the methodology of SHG Banking could be applied to other financial products

3.3 Self-reliance

Internal resources mobilized through savings and retained earnings are at the core of self-reliance, self-help and self-financing. At the start of the SHG banking program, it was assumed that the poor have a demand for credit far beyond their savings capacity. SHGs were therefore perceived, in a long-term perspective, as net borrowers. However, by requesting groups to first build up internal lending activities with own resources as an eligibility criterion for bank credit, the foundation was laid for the establishment of groups functioning as local financial intermediaries: they mobilize savings, lend to members, and generate substantial earnings which in turn contribute to the growth of internal loan funds. This has resulted in the following:

- Large numbers of SHGs are thrift groups, which have not availed of credit
- Internal funds have grown substantially over time through savings and retained earnings, exceeding in many cases the amount of bank refinance
- SHGs, which fully bear the credit risk, have deposited substantial amounts of savings in bank branches or cooperatives, mainly as a reserve for arrears and bad debts.

The amounts of voluntary savings deposited by SHGs in banks as a proportion of loans outstanding vary in the seven case studies from 23% to 125%:

Kakathiya	33%
Parkal	50%
Palakurthy	125%
DCCB	27%
Bhosga	93%
PACCS	38%
Andhra Bank Gudur	23%

Increasing self-reliance at village level, predominantly of poor women, is an outstanding direct effect of SHG banking.

3.4 Indirect effects of SHG Banking

Our profitability analysis has focused on SHG Banking as a financial product of banks. There are multiple other benefits which are difficult to quantify and have not been included in the profitability analysis; yet they deserve mentioning. There are claims that some of the indirect and intangible effects may be more important than the direct effects.

Indirect commercial benefits for banks and PACS include spill-over effects, resulting in:

- ✓ Increased overall vibrancy in branches where large underutilized capacities exist, resulting in higher overall volumes of deposits and loans
- ✓ Improved loan recovery due to the influence of SHG members on other villagers
- ✓ Substantially invigorated business in primary cooperatives
- ✓ Better service extended to all clients; decline of *Gheda* banking[17]
- ✓ Expected future growth of business with SHGs and individual members.

Indirect commercial benefits at village level reportedly include the following:

- ✓ The spreading of thrift among members and non-members, resulting in improvement in self-reliance and self-financing
- ✓ Excellent credit culture, with SHG members fully observing their loan obligations and spill-over effects on other villagers
- ✓ Income-generating activities of SHG members, with growth of assets and incomes
- ✓ Incipient commercialization of production, eg, in the dairy sector
- ✓ Propagation of financial management skills at village level
- ✓ Gaining entrepreneurial experience
- ✓ Preparing the ground for direct microenterprise promotion
- ✓ Decline of moneylenders, who have gone out of business or lowered their interest rate.

[17] Gheda banks (a Panjabi term) are those which require many visits.

Intangible social benefits are reportedly many, attributed to a significant degree to the vibrancy of the SHG movement and its supporters:

- ✓ Self-confidence and self-discipline among women, resulting in a more active life
- ✓ Empowerment of women in community development programmes, civic affairs and local politics
- ➢ Improved women's literacy
- ➢ Drastic increase in school enrolment
- ➢ Population growth, which declined due to improved family planning from 23% during 1971-81 und 24% during 1981-91 to 14.6% during 1991-2002
- ➢ Vaccination of children and better health
- ➢ Improved sanitation and access to drinking water
- ✓ Changing male attitudes and behavior, reduction in drinking and smoking
- ✓ Voicing of objections against child marriage, child labour and dowry.
- ➢ Decline in adherence to local extremist groups.

3.5 Sustainability

The sustainability of any financial scheme including SHG Banking hinges on five factors:

- ✓ the overall institutional framework;
- ✓ the viability of institutions in terms of profitability at all relevant levels;
- ✓ self-reliance in terms of resources;
- ✓ the maintenance of the value of all resources under inflation;
- ✓ regulation and effective supervision.

This study of the commercial aspects of SHG Banking can only partially and indicatively answer to the question of sustainability, but it can point to strong and weak parts of the system:

(a) **Institutional framework:** A sound overall institutional framework is in place. Its foundation are the SHGs, which have emerged as local financial intermediaries; its pillars are federations of SHGs registered as Mutually Aided Cooperative Societies (MACS), banks with their branches and primary cooperatives; supporting walls are governmental and non-governmental agencies; the roof is provided by Nabard.

(b) **Viability:** Linkage banking was found to be viable and inherently profit-making for all participating financial institutions and the SHGs; despite unusually low interest rates of loans to SHGs, the profitability of SHG Banking is high for banks. Nabard, itself a profit-making institution, will continue to lend its support at market rates of interest. The costs of governmental and non-governmental support agencies are externalized and financed from other sources. Some banks have internalized the costs of institution-building and training and still make a profit; at higher interest rates, virtually all banks could internalize these costs and bear all its costs. However, the viability of the rural banking sector as a whole is a critical wider issue, which in many cases requires major restructuring, reorientation, and revamping of financial technologies; much can be learned here from SHG banking.

(c) **Self-reliance:** SHGs have substantially increased their level of self-reliance through savings and retained earnings. In addition, they have contributed to the resources of banks by depositing significant amounts as reserves. Many banks are strong in liquidity, but constrained by high statutory liquidity reserve requirements. Further improvements are contingent upon a lowering of reserve requirements and internal reforms of rural banks.

(d) **Preservation of the value of resources:** Inflation rates are low in India. Average deposit rates are above the level of inflation and thus positive in real terms; passbook savings, however, are slightly below. Erosion of the value of savings is therefore no serious problem. Retained earnings of SHGs are very high in real terms and offset the effects of inflation by a wide margin. This differs among banks: the profits of well-performing banks from SHG banking are sufficient to offset the effects of inflation and generate profits in real terms. However, the financial self-sufficiency of poorly performing banks – their equity eroded by accumulated losses – needs to be addressed in the framework of bank restructuring; they would have to charge substantially higher interest rates to account for the effects of inflation and rebuild their capital base; however, increasing the interest rate would not suffice to solve their problems.

(e) **Regulation and effective supervision:** Appropriate regulation of rural financial institutions is in place; but major efforts are still required to enable them to cope with the effects of liberalization and fully utilize market opportunities.

(i) Banks are adequately supervised; but action to close non-performing banks has rarely been taken in the past.

(ii) Cooperatives are under the dual supervision of Nabard and state governments; little effort has been made in the past to enforce prudential norms.

(iii) The deposits of SHGs in weak institutions, their continued access to credit and confidence in their banking partner are at risk. Effective internal and external controls and the enforcement of prudential norms are greatly in need of improvement throughout the rural financial sector.

(iv) Federations are registered as MACS and face the same challenges of prudential regulation and effective supervision as the whole cooperative sector. As their financial operations increase, action will be urgently requirement for damage control.

(v) (v-1) SHG Banking is not a rigidly reglemented programme; and SHGs as small local institutions owned and managed by their members are therefore not regulated. In fact, the flexibility of the approach has been a source of innovation and dynamic growth. With their growth in business, the question of legal status and regulation may eventually arise; among some of the older groups, it might already have arisen and require further study. (v-2) While most SHGs may not need to be regulated, they do need effective supervision: not to enforce prudential norms, which do not exist for the time being, but to have their books examined and fraud prevented. Tentative first steps have been taken in this direction by appointing assistant supervisors (Bidar) and village volunteers (Warangal), but not as part as a regular system of supervision; nor are they always adequately trained. Neither the banks nor any other institution is formally given the task of organizing supervision. With the continual growth of SHGs as local financial intermediaries, a *delegated system of supervision*[18] will eventually be indispensable.

[18] In a delegated system, supervision is delegated by a central authority to organs at lower tiers, such as auditing apexes of networks of SHGs, cooperatives or types of banks.

3.6 Follow-up studies

As a main follow-up, we propose to carry out studies of:

- Pricing of financial products

This study may include an analysis of elements of the SHG Banking products and their incorporation in other financial products, such joint liability for small loans through in solidarity or self-help groups and credit appraisal by groups for larger individual loans without joint liability. The studies may be variously organized by the Indian Banks Association, State-Level Bankers Committees, District Consultative Committees, Sponsor Banks, Lead Banks, or Nabard; and carried out by appointed research teams or by research institutions. The results would be shared in the banking community. They may be used as a major element in the reform of rural financial institutions.

Other topics which have emerged from this study as deserving further attention include:

- How to extend SHG Banking to better-off market segments ("the middle poor")
- Effective supervision: Options of delegated supervision for SHGs, federations and cooperatives (MACS, PACS)
- Collateral substitutes: the feasibility of informal collateral taken by SHGs from group members with larger loans
- Loan protection through life insurance (with banks, PACS or federations acting as agents)
- From targets to incentives: Options and legal implications of financial incentives for individual performance in banks and cooperatives

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