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Does History Matter?
The Old and the New World of Microfinance in Europe and Asia

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Abstract

In a number of European countries microfinance evolved from informal beginnings during the eighteenth and nineteenth centuries as a type of banking of the poor, juxtaposed to the commercial and private banking sector. Almost from the onset, microfinance meant financial intermediation between microsavings and microcredit, and was powered by intermediation. Legal recognition, regulation and mandatory supervision evolved in due course and led to a process of mainstreaming during the twentieth century when microfinance became part of the formal banking sector. In Germany, the former microfinance institutions now account for around 50% of banking assets; outreach is to around 90% of the population.

Microfinance in Asia presumably has a much longer history, though little seems to be known about the early history of the *hui* in China, the *chit funds* in India, the *arisan* in Indonesia or the *paluwagan* in the Philippines, to name but a few. Financial institutions of indigenous origin, most of them informal, are still exceedingly widespread but have been largely ignored in financial sector development. There are exceptions on a limited scale, as in India where chit funds are regulated and in Indonesia with its highly diversified rural and microfinance sector where various forms of informal financial institutions have been registered and eventually regulated throughout the twentieth century. Not a single country has made indigenous forms of microfinance a pillar of its modern financial system.

As neither commercial nor development banks nor state-dominated but unsupervised cooperatives delivered to the rural and urban masses, credit NGOs, during the 1970s, ushered in what came to be known as the *microcredit revolution*. Powered by donor support and international publicity, Grameen Banking became the new model of microcredit, its founder the prophet of the microcredit movement. The term *microfinance,* originally meant to comprise financial intermediation between savers and borrowers, was created only in 1990. In the mid-1990s it was taken up by CGAP, the donor *Consultancy Group to Assist the Poor,* which has turned the microcredit revolution into the microfinance revolution and professionalized microfinance. To some extent it has reinvented history not only in Europe but also in Asia and elsewhere where micro- or informal finance and indigenous banking have always been based on principles of self-reliance, viability and sustainability. CGAP re-discovered the principles, but not the indigenous financial sector, be it informal or formal. Has the time come to revisit indigenous finance in Asia and re-examine its potential for *upgrading, mainstreaming and innovating* (Seibel 1997, 2001)? India may serve as an example: far older and more complex, yet also far less conclusive, than the European experience.

1. Is microfinance a new solution for poor people in newly developing countries?

Microfinance[1] is not a recent development, and neither are regulation and supervision of microfinance institutions (MFIs). Every now developed country and some developing countries, particularly in Asia, have a long history of microfinance. It is important to recognize this because it presents a view different from that of many in the microfinance community who associate microfinance with credit NGOs and believe that microfinance was invented in Bangladesh some thirty years ago. We first take a look at the microfinance history of two European countries, Ireland and Germany. There are good reasons for that: (i) Attributing the origin of microfinance to recent initiatives misses the historical depth and scale of microfinance. As a consequence, centuries of experience, of learning from trial and error, failure and success in the past are being missed. (ii) Conducive policies in several European countries have created an environment in which small microfinance beginnings have evolved into vast networks of local financial institutions which are now part of the formal banking system. (iii) This may present a vision to those who may think that microfinance is a poor solution for poor countries to be replaced by large commercial banks once development takes off. (iv) Informal finance and self-help have been at the origin of microfinance in Europe. Realizing how informal finance evolved into a major part of the banking system and contributed to poverty alleviation and development may induce policymakers, donors and researchers to take a fresh look at indigenous and informal finance in the developing world. We then take a look at the long and complex and sometimes warped history of microfinance and banking in India.

2. Microfinance in Europe: Ireland and Germany

The birth of microfinance in Europe dates back to tremendous increases in poverty since the 16th and 17th century. In response, microfinance in a number of European countries evolved from informal beginnings as a type of banking with the poor, juxtaposed to the commercial and private banking sector. Almost from the onset, microfinance meant financial intermediation between microsavings and microcredit, and was powered by that intermediation. Legal recognition, prudential regulation and mandatory supervision evolved in due course and led to a process of mainstreaming during the twentieth century when microfinance became part of the formal banking sector. However, in one case, that of Ireland, regulation has also been used, upon the initiative of commercial banks, to curtail the further growth of microfinance.

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[1] *A note on terminology:* When I first coined the term microfinance in 1990, I defined it as as a sphere of finance comprising microcredit, microsavings and other microfinancial services. I also have used it as a synonym for financial intermediation between microsavers and microborrowers or microinvestors. In the IFAD Rural Finance Policy (2000) I have defined microfinance as that part of the financial sector which comprises formal and informal financial institutions, small and large, that provide small-size financial services to the poorer sections of the population as well as larger-size financial services to agro-processing and other small and medium rural enterprises. It covers a wide array of microfinance institutions (MFIs), ranging from indigenous rotating savings and credit associations (RoSCAs) and financial cooperatives to rural banks and agricultural development banks. Only a small number of MFIs have the status of a non-governmental organization (NGO) or have the support of donors. For pragmatic reasons I have always left out moneylenders. However, if we define microfinance as the provision of financial services to the lower segements of the population, the poor or the unbanked, moneylenders would have to be included. If the economy grows over extended periods of time, and with it the household economies and incomes of the lower segments of the population as an integral part of the economy as well as the microfinance institutions – do we still call them *micro*-finance institutions? At the workshop we need to agree on a working definition.

2.1 The case of Ireland

The early history of microfinance in Ireland covers the period 1720 to 1950; it is unrelated to recent initiatives to introduced credit unions. It is the story of how self-help led to a financial innovation, legal backing and conducive regulation created a mass microfinance movement, and adverse regulation instigated by commercial banking interests brought it down. The so-called Irish loan funds emerged in the 1720s as charities, initially financed from donated resources and providing interest-free loans, but soon replaced by financial intermediation between savers and borrowers. Loans were short-term and instalments weekly. Peer monitoring was used to enforce repayment. After a century of slow growth, a boom was initiated by two events: (a) a special law in 1823, which legalized financial intermediation by allowing the funds to collect interest-bearing deposits and to charge interest on loans; and (b) the establishment in1836 of a Loan Fund Board for their regulation and supervision. By 1840, around 300 funds had emerged as self-reliant and sustainable institutions, generating their own resources through deposit collection and providing small loans to the poor. Financing their expansion from profits and deposits, their outreach eventually covered 20% of households in Ireland. The funds went aggressively after deposit mobilization, offering three times higher deposit rates than the commercial banks, charging of course at the same time higher interest rates on loans. The threat of competition brought the commercial bankers onto the barricades. They used their clout to stop the growth of the Loan Funds: through what we would now call financial repression. In1843 the commercial banks induced the government to put a cap on interest rates. The Loan Funds lost thus their competitive advantage, which caused their gradual decline during the second half of the 19th century, until they finally disappeared in the 1950s. The history of the Irish Loan Funds thus comprises three phases: a century of gradual growth as informal institutions; a few decades of rapid expansion as formal institutions in a conducive regulatory environment; and a century of decline due to financial repression.

2.2 The case of Germany

The story of microfinance in Germany, covering more than two centuries, is one of self-help, regulation and supervision, which have created, relative to its population, the largest microfinance sector of any country. It comprises two networks: community savings funds, now referred to as savings banks in English[2], and member-owned cooperative associations, now referred to as cooperative banks.

The community-owned financial institutions started during the latter part of the 18th century. Having learned from the early Irish charities (a) that charity is not sustainable and (b) that there is a strong demand among the poorer sections of the population to for safe deposit facilities, the first thrift society was established in Hamburg in 1778, followed by the first communal savings fund (*Sparkasse*) in 1801. As the movement spread, the influx of savings forced the savings funds to expand their credit business, including agricultural lending. The Prussian state responded with regulation, passing the first Prussian Savings Banks Decree in 1838 – fifteen years after the Irish government had passed a law on loan funds. In 1884 the savings banks formed the German savings banks association.

The second microfinance movement started after the hunger year of 1846/47**.** Starvation was widespread; many peasants lost their fields to the moneylenders, and many small businesses went bankrupt. Two men are prominent among those who took action: Raiffeisen in rural areas, creating credit associations (*Darlehnskassen-Vereine*) predominantly of farmers, later known as *Raiffeisenkassen* and now *Raiffeisenbanken*; and Schulze-Delitzsch in urban areas, establishing savings and credit cooperatives among craftsmen and other small entrepreneurs, now called *Volksbanken* (people's banks). In 1847, with the help of contributions by some wealthy people, Raiffeisen established a rural charity association in Weyerbusch, bringing in grain from non-affected areas in the East. Within a few months, this

[2] In German they have retained their original name: *Sparkasse.*

brought down the price of bread by 50 %. His initiative was paralleled in 1850 by Schulze-Delitzsch's first urban credit association, who insisted on self-help without charity from the beginning. Raiffeisen soon realized that charity did not lead to sustainable institutions. In 1864 he established the first rural credit association in Heddesdorf, following Schulze-Delitzsch's example who rejected charity. During the next twenty years, the initiative gradually turned into a movement, but growth was slow, reaching not more than 245 rural cooperatives in the mid-1880s. The turn-around came in 1889, when both the rural and the urban networks of credit associations were brought under the law: the Cooperative Act of the German Reich, the first cooperative law in the world. At the same time, joint liability, which had kept back the growth of the system, was replaced by limited liability. Until 1914, the number of rural cooperatives in Germany increased to more than 15,000 and spread to many other countries around the world.[3] In 1934 all financial institutions were brought under the banking law. But both networks kept their identity, adding their respective legal provisions to those of the general banking law. Historically there have been three stages: informal beginnings with slow growth; regulation of MFIs as special financial institutions which led not only to rapid growth of outreach but also to worldwide institutional dissemination; and consolidation under the banking law, which turned them into universal banks.

Until recently, there has been a sharp distinction between rural and urban MFIs: Cooperative banks comprised *Raiffeisenbanken* which were rural and *Volksbanken* which were urban; savings banks comprised *Kreissparkassen* which were rural and *Stadtsparkassen* which were urban. In recent years a process of amalgamation has set in within the networks, but only at the local level. The two types of institutions have spread throughout Europe and beyond, but are more prominent in continental Europe than in the Anglo-Saxon part. The spectacular success of microfinance in Germany, which pushed moneylenders out of business, is due to several factors:

- self-help and self-reliance based on the dynamic growth of savings
- local outreach with lasting *house-banking* relationships
- the evolution of a legal framework: 1838 first savings funds decree; 1889 first Cooperative Act[4]; 1934 expansion of the banking law to savings funds (or savings banks) and cooperative banks
- establishment of regional and national apex organizations of savings funds and cooperatives during the 1870s and 1880s[5]
- delegated supervision through auditing federations of the national and regional apex organizations evolving in several stages.[6]

This has resulted in a financial system in Germany which is dominated by these former microfinance institutions. In 1997 the two microfinance networks comprised 39,000 branches,

[3] In 1866, Raiffeisen published his first cooperative handbook (Die Darlehnskassen-Vereine), which went through several revised editions until 1887, reflecting the trials and errors of the movement. It has lost little of its actuality and could teach many a microfinance expert a lesson, eg, when and when not to use joint and several liability as a collateral substitute; and how to avoid moral hazard in setting up cattle insurance.

[4] The law also abolished joint and several liability of cooperative members, which had kept back the expansion of the movement, in favor of limited liability.

[5] A Savings Banks Association (DSV) was established in 1884, followed by DSGV in 1924. The rural and urban cooperatives had separate associations, united into the DGRV only in 1971.

[6] These evolved in several stages: (1) 1860s-80s voluntary auditing, emergence of auditing federations; financial difficulties during the 1880s due to inadequacies in auditing. (2) In the case of cooperatives mandatory auditing as part of the new cooperative law in 1889, but optionally either by auditing federations or freelance auditors. This again resulted in financial difficulties under freelance auditors during the 1920s. (3) 1934 mandatory auditing by separate auditing federations for all banking networks including savings and cooperative banks; the auditing federations were in turn supervised by the financial authorities. (4) Today DGRV and DSGV serve as supervisory apexes, comprising a national auditing federation as well as regional and specialized auditing federations.

75 million customers, 64% of all financial intermediation and 51.4% of all banking assets. Since then, a process of consolidation has set in, reducing the number of branches of the two networks to 29,500 as of 2002; this is 93% of all bank branches in Germany. One may question the term MFI for these banks; but they have retained their traditional orientation to smaller individual clients and small businesses. In 2002 savings and cooperative banks accounted for 53% of all retail loans to private individuals and 57% of all loans to small and medium enterprises. Compared to the four big commercial banks, *small and local* is profitable. In 2002 pre-tax return on equity was 8.2% among savings banks, 9.2% among cooperative banks and –3.1% among the four big commercial banks. No wonder that the latter have become envious of microfinance and taken action in Brussels, comparable to the intervention of commercial banks in Ireland in 1843, to revoke community guarantees to savings banks.

2.3 Lessons to be learned

Three centuries of microfinance in Europe have taught a number of lessons that financial systems developers should be aware of, including the following: Informal local initiatives based on self-help have a tremendous potential. Their foundation are savings, provided by depositors or shareholders. Savings are the essence of self-help and self-reliance, both of the household or small enterprise and of local financial organizations. The viability and sustainability of small enterprises (farm or non-farm) and of local financial institutions are intertwined: they fall or grow together. Continual access to financial services, particularly savings and credit, over long periods of time are crucial in poverty alleviation and economic development, which are both interrelated; there is no sustainable poverty alleviation without economic development. Local financial institutions, some of them very small, have proven their ability of providing such services for generation after generation.[7] Of crucial importance in the evolution of local financial institutions have been two factors:

- The first is regulation through an appropriate legal framework, with changes and amendments over time.
- The second is effective supervision, delegated because of their large number to apex organizations of MFI networks, which in turn are supervised by the national financial authorities[8].

Beyond this, we have to be careful with generalizations: different European countries have taken different paths in microfinance. Eg, while Germany and countries like Italy have stuck to a multitude of local financial institutions, the Netherlands have created a central cooperative banking institution, Rabobank; France has its Crédit Agricole; and Sweden has merged its savings and cooperative banks into a single national banking institution. One may hypothesize that Germany is a federation and therefore tends to institutional diversity; but Italy shows a similarly diversified structure of local financial institutions and is not a federation. There just is no single *best practice* model.

Presenting experience from Europe is not meant as a proposal to replicate European models. Unfortunately, mechanical replication around the world of models which are successful in one country is bound to failure as the experience of Grameen banking in many countries outside of Bangladesh has shown. Similarly, the replication of Raiffeisen banking has failed in many developing countries when usurped and perverted by the state. Just as

[7] Take the *Raiffeisenkasse Urmitz* as an example, about 100 years old and since 1934 a cooperative bank. When the author grew up in Urmitz, the village had 1700 inhabitants. Since its inception, the Raiffeisenkasse has been viable and sustainable, with just a few hundred customers. Only recently, under pressures to offer more than basic services, has it been amalgamated with the Raiffeisenkassen of seven neighboring villages and turned into a branch. CGAP claims that it takes at least 3000 customers for an MFI to be viable. Historically, this has not been the experience of Germany.
[8] *Bundesbank* and since 1962 *Bundesaufsichtsamt für das Kreditwesen*, replaced in 2002 by *Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).*

science proceeds not by verification but falsification of theories and their underlying hypotheses as Popper (1959) has shown, there may be more to be learned from errors than faithful adherence to doctrine. The history of errors in European microfinance is yet to be written, but two may be mentioned here, the first perhaps of interest to policymakers in francophone Africa and believers in *appropriate* interest rates, the other to Grameen bankers and other proponents of group lending: (1) Interest ceilings imposed in Ireland in 1843 undermined the competitiveness of the Irish Funds and eventually led to their extinction. (2) Joint and several liability were an effective collateral substitute and risk management tool in early credit associations in Germany, but proved an impediment to the further growth of loan sizes and the spread of institutions until abolished by the Cooperative Act of 1889.

3. Microfinance in India

3.1 Origins and early developments[9]

The case of India shows that the origins of microfinance predate those reported above in Ireland and Germany by more than two and perhaps even three millenniums. There are at least three strands of indigenous finance of great historical depth in India: moneylenders, chit funds or rotating savings and credit associations (ROSCAs), and merchant bankers – each with a complex and interlinked history, much of it yet to be written. To draw lessons from this experience would require systematic historical research from a microfinance perspective. The following may serve as an inducement to embark on such research and share the results with the microfinance community. This is all the more important as India, over a period of three thousand years, has spread its culture, trade and banking through vast parts of south and south-east Asia and may continue to do so as far as its latest rural finance innovation is concerned: SHG banking.

Moneylenders who provide loans from their own resources as their only financial service are the oldest of these professions, dating back to prehistoric times. There was probably a long period of transition from gift-exchange, reciprocal lending and trading-cum-lending to specialized lending, and from lending-in-kind to lending-in-money before the first millennium B.C. Moneylending became an organized and subsequently regulated profession in India around 1700-2200 years ago as shown below. Information on rural moneylending in medieval and British India will be given below. Moneylending is still widespread today, and remnants of its historical informal precedents are still in existence, re-emerging time and again according to demand. Many (informal and formal) moneylenders may have turned into (formal) merchant bankers at various times in history, or into organizers of (informal or formal) chit funds; this is a subject on which I have no information.

Chit funds[10] or ROSCAs are widespread institutions of ancient origin in India[11]; but I have not been able to determine the time of origin. A number of people, usually under an organizer, join together to regularly (eg, daily, weekly, monthly) contribute equal amounts of money (or kind) allocated to one member at a time; a cycle ends when each participant had his turn. It appears that historically they were relatively small and unregulated. There are two types: the conventional type, found all over the world, in which the full amount contributed (apart from minor deductions) is allocated to one member at a time, either by lot, demonstrated need or in an agreed-upon sequence; and an advanced type found in a number of Asian countries including China, Vietnam and Nepal where the amount collected is allocated by auction to the lowest bidder and the balance returned to the members, or by tender. In response to increasing business opportunities, the bidding type has been gradually replacing the conventional type, but I do not know over which period of time. As chit funds grew in size and volume and the risk of fraudulent pyramid schemes increased, there has been a tendency of regulating the chits. Starting with the Travancore Chit Act of 1945 followed by other state-level laws, they were increasingly included in the formal financial sector. Chit funds attained such importance that in 1982, after ten years of deliberations, a federal Chit Funds Act was passed, providing legal status to chits as non-banking financial intermediaries. The act regulates minimum capital, ceilings on aggregate chit amounts, procedures of dispute settlement, etc. This has greatly contributed to the growth of licensed chit funds, which are found all over India in large numbers.

Merchant banking – ie, financial intermediation comprising lending, deposit taking and other financial services – evolved in India during the first millennium B.C. and was widespread in

[9] Chapter 3.1 and and part of 3.2 have greatly benefited from Schrader 1997.
[10] Known under various names such as chitty or kuri (*cowry*).
[11] The alternative term *kuri* indicates that it must have existed at least at medieval times when cowries were used as a means of exchange.

India and beyond as early as the third century B.C. Merchant guilds, which dealt in goods and money, appeared already in the Vedic scripts, the oldest parts of which date back beyond the first millennium B.C. Between 200 B.C. and 300 A.D. a differentiation took place between the guild of moneylenders and the guild of traders, followed by the emergence of a guild of merchant bankers. The guilds eventually turned into strictly hereditary castes, and banking became a sub-caste of the traders' caste (*vaisya*).[12] Regulation evolved during the first two centuries A.D. when a law code, *dharmashastras*, was written regulating loan deeds, law courts and debt procedures in detail. Moneylending and banking became licensed and tax-paying professions.[13] Usury initially was a major issue of religious disputation. This was eventually resolved by agreements over "reasonable" interest rates, eg, 15% p.a. on secured loans and higher rates on unsecured loans. The latter ranged from 2% p.m. on loans to a priest (*Brahman*) to 5% p.m. to a cultivator (*shudra*), supposedly reflecting different assessments of risk by caste[14] Interest payments could also be made in kind, but at a substantially higher rate. Unrecovered loans were written off after 10 years. In addition there was social banking, ie, interest-free loans to the deserving and the poor. (Bhargava 1934; Schrader 1997:71-83)

Medieval India, the period from the mid-thirteenth century to the beginning of British rule during the eighteenth century, with its highly monetized economy was the heyday of indigenous banking. With domestic and international long-distance trade, merchant banking grew enormously, held by individual firms, joint family firms and partnership firms – all within the same *baniya* caste, but differentiated into numerous sub-castes. Their customers included European private merchants and trading companies. They also advanced working capital to weavers and other artisans to produce goods on order for Indian or European merchants – an Indian (monetized!) version of the putting-out system. Some secured commercial interest rates during the 17th century were reported between 0.5 and 1.25% p.m.; risky commercial credit fetched a flat rate of 40-60% per trade venture. The basic principle of merchant banking were mutual trust and mutual benefit: very much in contrast to what emerged at the same time in rural finance.

Rural finance, mostly in the form of abusive moneylending, spread under the Delhi sultanate with the introduction of a system of land revenue, housing tax and cattle tax to be paid in cash. Land was abundant; but the payment of taxes in cash was difficult, forcing the peasants to produce for the market. This resulted in the overall commercialization and monetization of the rural economy and the expansion of trade. At the same time it created a new market for the financial professions: rural moneylenders advanced land revenue payments to the peasantry; merchant bankers financed trade. Indigenous banking in Mughal India, ie, during the period from the sixteenth to the eighteenth century, is described in detail by Schrader 1997. The urban population paid a mere 5% of their income in taxes, while land assessments in rural areas varied from one third to one half of the produce. Assessments of actual production were soon replaced by average pre-assessments, which caused severe hardship during bad years. This created a large class of rent-seekers, comprising tax collectors, moneylenders and a ruling class of landlords and officials without a salary but with rights to collect revenues; they kept about one quarter and transferred between one quarter and one third of the revenue to the government. Moneylending became part of everyday life

[12] Financial services provided by the merchant bankers included lending, deposit-taking, discounting bills and promissory notes, providing guarantees, issuing drafts, letters of credit and circular notes, *hundi (written drafts)*, money-changing and safekeeping of valuables. Some top bankers also provided state financial functions: treasury, minting, revenue collection, and the financing of wars.

[13] It appears that moneylending and banking were not monopolized by the respective castes, as Hindu temples and Buddhist monasteries were frequently involved in financial services as a means of self-financing.

[14] These figures are based on the *Manu*, one of the ancient texts of the time. The older *Kautalya* reports interest rates of 5% p.m. on ordinary monetary loans irrespective of caste and rates of 10% and 20% p.m. on loans to high-risk borrowers such as sea-faring merchants and forest explorers, respectively. The regulation thus led to a substantial lowering of interest rates.

in Indian villages. As rural indebtedness and the loss of land to moneylenders surged, microfinance turned into *usurious moneylending* of the worst kind. Peasants became serfs; they could not be displaced as long as the revenue was paid, but, if not, were punished by expropriation, bonded labor, enslavement and even death for what was considered an act of rebellion against the government. This led to a land revolution-in-reverse: dispossessing the peasants and converting their rights of occupancy into rights of tax collection (*zamindari*): inheritable, alienable and mortgageable.

In British India microfinance and banking changed substantially, starting in 1757 (*Battle of Plassey*). The imposition of trade restrictions and the exclusion of Indian merchants from long-distance maritime trade led led to a decline of indigenous trading and merchant banking. Interventionist policies such as the preferential importation of cloth from England dealt a death-blow to Indian textile manufacturing and the ancient commercial structure. However, this was followed by a rise in domestic trade and a shift to Bombay as the main centre of indigenous industry and banking. European finance limited itself largely to European enterprise. In rural areas, new legislation on land revenue collection, private property and land mortgaging and the transformation of subsistence agriculture into cash-crop production created new opportunities for moneylender, who could now enforce their claims in court. During the first half of the 20th century, rural indebtedness first increased, then was reigned in by moneylender, usury and tenancy legislation, but finally led to the rise of new types of lenders with an interest in acquiring the land of their borrowers. Cooperatives, introduced top-down, At the same time, the bankers' castes rose to new heights. In the sphere of big business they adopted Western banking by pooling their capital, establishing joint-stock companies or buying shares of banks; in the small and medium business sphere indigenous-style banking continued.

3.2 Independent India: searching for new approaches to reach the rural poor

Upon independence India faced an underdeveloped rural economy, high levels of indebtedness and a lack of efficient financial services. Since the 1950s the lack of rural development has been attributed to a lack of access to credit to finance production assets. Private banks that should have provided such credit were absent from rural areas; and informal finance, through moneylenders, friends, relatives and rotating *chit* funds, was inadequate. 80% of the population lived in rural areas; 40% of GDP was contributed by agriculture; but only 2.2% of total credit went to agriculture – almost exclusively to medium and big farmers. No attempts were made to build on indigenous informal finance, despite the fact that, according to Reserve Bank of India findings, informal credit accounted in 1951 for 90% and in 1971 for 70% of rural indebtedness; there was no mentioning of savings. Instead, to remedy the situation, the Union Government took three related measures in 1969: the nationalization of 14 private banks (followed by another six in 1980); the requirement to open two rural branches for every urban branch; and a mandatory system of priority sector lending.

A stocktaking in 1975 revealed that as a result of the institutional expansion policy, 10,882 rural and semi-urban branches had been opened; yet the poor still lacked access to credit. It was concluded that rural branches of large commercial banks, be they private or public, are thus not the right answer. Hence, the government introduced a new network of government-owned Regional Rural Banks (RRBs), regulated and supervised banking institutions with a low capital base of around $250,000, each covering with its branches a designated service area of 1-3 districts. By 2005 there were 196 RRBs with a rural branch network of 14,000, including 12,084 rural and 1,875 semi-urban branches. Yet the problem persisted: RRBs and cooperative banks catered for farmers, not the vast numbers of landless, migrant laborers and illiterate women.

In 1981 RBI carried out the All-India Debt and Investment Survey, published in 1983. After years of massive branch expansion, policies of directing credit to the rural areas, massive

self-employment programs, and large numbers of donor credit lines – among them over $1 billion from the World Bank with the requirement that at least 60% went to small farmers –, a total of 14 million small loans had been provided by banks, yet some 250 million of the rural poor had no access to formal finance, and 39% of rural indebtedness stemmed from informal sources (though a huge reduction compared to 1951 and 1971!).

In 1982 RBI transformed its agricultural credit department into a new apex bank: the National Bank for Agriculture and Rural Development (NABARD), with responsibility eventually for some 160,000 rural financial outlets, among them around 100,000 credit cooperatives (PACS). On the basis of the 1981 survey NABARD concluded that, while India had one of the most complex rural financial infrastructures of any developing country, that system had failed to attain its objective of reaching the rural poor. Among the reasons identified were a sole emphasis on production loans, prohibitive transaction costs for lenders and borrowers, failure to mobilize savings, and overly complicated procedures.

The contradiction between a highly diversified rural financial infrastructure and lack of access of the rural masses to financial services continues to plague India; this is paralleled by another contradiction: between an emphasis on institutional diversity and a lack of emphasis on institutional viability. There are 97 commercial banks with 57,772 branches, 32,244 of them (56%) located in rural areas. Among them are 27 state banks which hold more than 80% of commercial banking assets and dominating the banking sector. There are 196 Regional Rural Banks with 11,944 rural retail outlets. In addition there are 115,000 rural cooperative outlets. The total number of rural outlets of the formal sector is thus around 160,000. Yet, according to a rural finance access survey conducted in 2003, over 70% of small farmers and landless have no deposit account; 87% have no access to formal credit. The commercial banking sector has been the first to be reformed, followed by the regional rural banks which is still ongoing.

Turning from the old to a new world of rural finance during the second half of the 1980s, NABARD argued that programs with the poor have to be savings-led and not credit-driven; and that the poor have to have a say in their design. In the years to come they looked for new partners, new delivery systems and new financial products. One of these new partners was MYRADA, one of now 700 credit NGOs and MFIs, whose action research into *credit management groups* during 1985-88 was funded by NABARD jointly with CIDA. The study was based on a new paradigm: savings first. Three options were discussed, all hinging on prior savings by the groups: matching grants, matching interest-free loans, or loans with interest. In search for a sustainable solution, NABARD opted for the latter. (Seibel 2005)

3.3 Cooperative finance: replication gone astray

It is difficult to do justice to the complexities of the Indian financial sector and its changes over time. The financial cooperative sector is a major part of rural finance in India which must be included here however briefly. It dates back to 1892 when the Government of Madras Presidency felt inspired by the German Raiffeisen movement of savings and credit cooperatives and recommended, just three years after the passing of the German Cooperative Act in 1889, to replicate the approach in India. In 1901 the Government of India accepted the proposal and in 1904 enacted the Co-operative Credit Societies Act, followed by the more comprehensive Co-operative Societies Act in 1912. This was to serve as a framework for promoting self-help among farmers and artisans. Under the Government of India Act of 1919, authority over cooperatives was transferred to the provinces, which were authorized to enact their own co-operative laws. It is not clear whether state dominance evolved from here and how soon self-help and self-reliance were undermined by well-meaning state interventions.

Following the recommendations of the All India Rural Credit Committee in 1954 and the Committee of Co-operative Law in 1955, many states introduced “state partnership” in their

cooperative laws, placing the cooperative sector under government control. The resulting laws were encumbered by the ideology of a planned economy, giving the state a dominant role in all institutions including cooperatives. Extensive regulatory power is conferred to state governments in matters such as appointment of chief executives, suspension of elected boards of directors, compulsory fusion or fission of co-operative banks, amendment of bylaws, vetoing of bank decisions, issuing of directives, and supervision. The state cooperative administration is in charge of registration, licensing, statutory inspections and audit of the cooperative banks. The states participate also in the ownership of cooperative institutions all levels down to primary societies. Bureaucracy, government intervention and loan channelling have replaced self-management and self-reliance.

The cooperative sector with short-term financial services now comprises 98,247 primary credit cooperatives with 100 million members; and 368 district cooperative banks with 12,652 branches, acting as federations of the primaries and providing wholesale and retail finance. Long-term finance is provided by 768 primary cooperative agricultural and rural development banks with 1,091 district branches and 13 million members; and 20 state banks with 887 branches. 30 state cooperative banks act as apex banks to the district banks and provide both short- and long-term finance. In addition there are 2,015 urban cooperative banks. Accounting for 69% of all rural retail outlets, the sector mobilizes 31% of rural savings and provides 57% of agricultural and 29% of investment credit. Yet, while outreach is large, efficiency is low: loan recovery rates of district cooperative banks and primary societies are around 67% and substantially lower among the two providers of long-term credit (46% and 55%, respectively; the rates of loss-making institutions are 20% among state cooperative banks, 30% among district banks,43% among primary societies, and 75% and 55%, respectively, among the two providers of term finance: primary and state cooperative banks. Following the reforms of the commercial and regional rural banking sectors, steps are now being taken to reform the cooperative financial sector; GTZ is assisting. (Hannover & Haberberger 2004)

3.4 Linking formal and non-formal finance: a financial innovation

Yet, reform of the regional rural and cooperative financial sectors is not seen as a solution for reaching some 250-300 million rural poor. The trigger in the search for rural financial innovations in India to reach the poor was an external event: the APRACA regional workshop in Nanjing, China, in May 1986, where GTZ presented a linkage model based on the existing formal and nonformal financial infrastructure (Seibel 1985). Elements included SHGs as informal financial intermediaries; savings-based credit linkages with banks; informal groups holding savings and credit accounts in banks; NGOs (SHPIs) as social, and initially also financial, intermediaries; flexible models of cooperation between SHGs, NGOs and banks as autonomous business partners, each with its own existing financial and institutional resources (APRACA 1986). Several Asian countries took up the challenge. In contrast to those countries were a GTZ expert carried out feasibility studies, NABARD coordinated a field study of SHGs in 1987 with a team from various Indian institutions. To identify SHGs, the team approached NGOs; SHGs without any link to an NGO, including the ubiquitous chit funds, were thus not included in the study. Almost all the groups were of recent origin, emphasized self-help, were largely homogeneous in terms of caste and activity, built a common fund from very small regular savings and interest income, and lent to their members for periods of 1-3 months at 2-3% interest per month. Recovery of these loans was excellent, and an impact, however small, was felt, reaching from emergency assistance to release from bonded labor. While the groups preferred to remain informal, they shared basic features of formal bodies in terms of bookkeeping and management. Access to formal credit was virtually nonexistent. NGOs reportedly had “played a commendable role in organising the rural poor into self-help groups and thereafter promoting their proper functioning.” Given the very low resource base of internally generated savings on the one hand and some notable exceptions of “effectively developed credit links between the target groups and banks”, the team thought it “desirable to consider development of flexible models of linkages appropriate

for various situations” and asked “what types of pilot or action-research projects need to be developed for evolving appropriate linkage models” (NABARD 1989: 53-58)

In1988 Bank Indonesia, the central bank, started a *Pilot Project Linking Banks and SHGs* in Indonesia, with technical assistance from GTZ. With increasing participation from banks and NGOs, this became APRACA’s and GTZ’s first experimental station for linkage banking in Asia. Given an abundance of financial self-help groups in Indonesia, the project limited itself to those and made no attempt to establish new groups. The general manager and later chairman of NABARD, Y.C. Nanda, visited the project several times, learning that the central bank had authorized its public and private banks to accept informal groups as customers and lend to them without physical collateral; repayment rates at the time were close to 100%. Intensely monitored and reported upon at APRACA meetings and international conventions, it attracted widespread attention, among others by the president of the World Bank, who declared in the foreword of the World Development Report 1989 (pp. iv; 119): “Informal financial institutions have proved able to serve the household, agricultural, and microenterprise sectors on a sustained basis. Measures that link informal institutions to the formal financial system will improve that service and ensure a competitive environment.” APRACA member institutions, including NABARD, felt inspired.

Reviewing the situation of rural finance in India again in 1989, it was observed that most of the 196 Regional Rural Banks (RRBs) were loss-making and thus did not present a viable solution. This led to a discussion in parliament about the feasibility of a Grameen Bank, following the model of Bangladesh, as a new national banking structure. On the basis of its own studies and also inspired by the linkage experience under APRACA, NABARD instead argued for a different approach with the following distinguishing elements:

- using the existing infrastructure of banks and social organizations;
- it should be savings- rather than credit-led;
- and using bank rather than donor resources in the provision of credit.

Between 1989 and 1991, NABARD (1991) entered into a policy dialogue with RBI to make preparations for a pilot project linking informal groups to banks. On 24 July 1991 RBI issued a circular to commercial banks (RPCD.No.Plan.BC.13/PL-09-22/90-91) advising them to actively participate in the pilot project, refinanced by NABARD, for linking SHGs with banks. The groups may be registered or unregistered, have 10-25 members, should have been in existence for at least six months, and should have actively promoted the savings habit.

The pilot phase covered the period 1992-96. The banks noted a contradiction between a directive of the RBI of 27 December 1985, which restricted the opening of savings accounts, and the circulars of RBI and NABARD authorizing bank linkages of informal groups: did the SHG banking circulars allow for savings accounts or just credit? This was finally decided in a circular (DBOD.No.BC.63/13:01:08/92-93) by RBI on January 4, 1993: “… such Self-Help Groups, registered or unregistered, may be allowed to open Savings Bank Accounts with banks.” At mid-term, March 1994, 637 SHGs (80% women’s groups) with 11,000 members, most of them women, had been credit-linked to 28 banks, comprising 16 commercial and 12 regional rural banks. 34 NGOs were involved as facilitators. Large numbers of officers of NABARD were sent to MYRADA and other NGOs for exposure training. By March 1996, 4,757 SHGs with 80,000 members had been mobilized by 127 NGOs and credit-linked to 95 bank branches. During the pilot phase mainly SHGs were linked to banks that had previously been established by NGOs.

NABARD evaluated the project and found that the program was highly suitable for poor and very poor women particularly in marginal, resource-poor areas; membership has come mostly from the poorest section of the society; women frequently need credit, but at irregular intervals; they use the loans for productive and non-productive purposes, with a trend towards productive investments; incomes have gone up; even the poorest of the poor do save, and their savings increase with the income; transaction costs of banks and SHG

members go down; the repayment rate is close to 100%, in contrast to the usual rate of 50-60% in agricultural credit. In comparison to the Grameen Bank model, NABARD found that "the SHG linkage model appears more sustainable and appropriate in the Indian conditions where (India has) in place a vast network of rural bank branches… (and) SHGs which are functioning on their own and waiting to be linked to the banking system." (Nanda 1995)

Nationwide mainstreaming started in 1996 after clarifying two issues by circular: (i) SHG members who had earlier defaulted on bank loans and were therefore not bankable could obtain loans from the groups' own internal funds if so decided; (ii) informal groups were limited to 20 members, beyond which they would be required to legally register. To implement mainstreaming, NABARD did the following: (i) it provided refinancing to participating banks; (ii) it declared SHG banking the dominant, but non-mandatory approach of lending to the poor, replacing bank retail lending; (iii) it propagated its *grand vision of one million SHGs*, representing a population of 100 million of the rural poor, to be credit-linked by the year 2008 endorsed by NABARD's regional directors and subsequently articulated by union government in all its budget speeches; (iv) it created a Micro Credit Innovations Department (MCID) as the program steering unit, with representations in all states through Micro Credit Innovations Cells; (v) it set up a special fund to finance massive capacity-building measures[15] as the motor of expansion; (vi) it supported the establishment and maintenance of SHGs through numerous NGOs and GOs; and (vii) it subsequently allowed for initiatives to organize SHGs in self-sustained federations (Nair 2005) under a new legal form as ***Mutually Aided Cooperative Societies (MACS)*****.**

Backed by the joint political will of the Union Government, state governments, the Reserve Bank of India and NABARD, program dissemination and capacity building expanded rapidly in the following years. The number of SHGs credit-linked to banks grew to 33,000 in 1999 and 115,000 in 2000. By the turn of the year 2003/04 it had reached the goal of one million credit-linked SHGs: now the largest and fastest-growing microfinance program in the developing world. As of March 2005 it has reached 1.6 million savings-based groups credit-linked to 35,294 bank branches and primary cooperatives, with 23.96 million members covering a population of over 120 million people predominantly from the lowest social strata. The majority of members (90%) are women: by choice, not program design. As transaction costs are low and repayment rates near 100%, SHG banking is highly profitable to the banks, despite lending rates, which are deregulated, from banks to SHGs between 10% and 13% (Seibel & Dave 2002). At very low transaction costs to the SHGs and onlending rates to members around 24% (higher among new and lower among older groups), internal resources grow rapidly, increasing the financial self-reliance of the groups (Karduck & Seibel 2004). Growth continues, performance is excellent, and impact is deeply felt by the members: on employment, income, self-confidence, children's education and, last but not least, moneylenders; they have largely gone out of business in the areas of operation of SHGs. Challenges remain, particularly in terms of further expansion into underserved areas, effective supervision, institutional sustainability of informal groups, and the role of SHG federations. Yet, there are good prospects that SHG banking will continue to grow in outreach and financial depth.

[15] Available on NABARD's website: http://www.NABARD.org/roles/microfinance/

3. Summary and conclusions

The history of microfinance in Europe tells us that local financial institutions may evolve from very small informal beginnings through a stage of semiformal finance, in which networking and self-regulation are instrumental, to mainstreaming as a major part of the banking sector is feasible. In some European countries the microfinance institutions-turned-banks are in the thousands, some of them very small and yet sustainable. in others they been centralized in single national institutions. Also, ownership may be public, in this case by communities, or cooperative. There does not seem to be a single *best practice* model. After an initial period of trial and error, charity as a source of funds and joint and several liability as a collateral substitute were found to be *bad practices* and abandoned. Invariably savings have served as the foundation of self-reliance and the motor of growth. In the case of Germany crucial inputs into the historical process of mainstreaming have been the provision early-on of a conducive legal framework, appropriate regulation, and effective delegated supervision through auditing federations of the microfinance networks. In the case of Ireland, inappropriate regulation in the form of interest ceilings have led to the withering-away of the oldest microfinance network in Europe. On the whole the history of microfinance in the various European countries is spotty and requires further research. This would provide a basis for a discussion of elements of the European experience which may be replicable and included among lessons learned.

In most developing countries the history of microfinance is yet to be written. In many it will be difficult to do so for want of written documents. This makes it difficult to build on the existing, mostly informal, foundations of microfinance and learn from past experience. Eg, Nigeria is the only African country south of the Sahara of which I know that microfinance existed at least as early as 500 years ago, namely in the form of rotating savings and credit associations. They are called *esusu* among the Yoruba in Nigeria, now a lingua franca term in many West African countries. As a form of social capital, the *esusu* was transported during the slave trade to the Caribbean islands, where both the institution and the term still exist today; they are now being carried to major American cities by a new wave of migrants who are unbankable in their new environment. Their origin were probably rotating work groups, in which labor as a scarce commodity was accumulated and allocated to one member at a time; and then, with the spreading of commercial transactions, replaced by money, such as cowries, manilas, pounds and Naira. Nigeria is one of the countries where informal financial institutions are pervasive, and still the most important form of microfinance, albeit informal. Ignorance or poor judgment has taken its toll on Nigeria: In 1934 C.F. Strickland, a British cooperative expert, examined the *esusu* as a possible basis for modern cooperative societies in Western Nigeria. Having previously worked in India where he encountered the rotating *chit funds*, he speculated that the *esusu* must have been imported from India, which he considered a superior culture, at some unknown time and concluded that in this case one might as well import cooperatives from England instead of modernizing the *esusu* (Strickland 1934). The consequences of his judgment were far-reaching: the Co-operative Societies Ordinance, introduced in 1935 and modelled after British-Indian cooperatives, became the blueprint for the British colonies in Africa. It was only in Eastern Nigeria where financial cooperatives flourished: encouraged by enlightened cooperative officers to build on the ubiquitous *isusu*, the Igbo version of the *esusu*. Had a legal and supervisory framework been provided for the *esusu, isusu, adashi, bam* and whatever ROSCAs are called in the 350 ethnic groups, and had their origin not been misjudged, would Nigeria have needed cooperatives, community banks, MFIs and an agricultural development bank – all struggling along? (Seibel & Damachi 1982; Seibel 1984)

India is a country, or subcontinent, where microfinance and banking have evolved over more than 3000 years and spread through trading relations over the wider region. We may know little about the dissemination process, but perhaps far more about India itself than any other country. The origins of indigenous microfinance in India predate those reported above in Ireland and Germany by around 3000 years, covering three major strands: moneylenders,

chit funds or rotating savings and credit associations (ROSCAs), and merchant bankers – each with a complex and interlinked history, much of it yet to be systematized, and all still in existence today. Moneylenders are the oldest of the three strands, with a variegated and checkered history. After early efforts at regulation, they went out of control in rural areas during medieval and British India, became part of a feudal system, and destroyed the independent peasantry, relegating themselves to the role of the evil moneylender. They have remained *lenders of last resort*, at the opposite end of the central bank.

Rotating savings and credit associations (*chit funds, kuris*) are ancient; but I have no information on how far they date back. It appears that traditionally they were unregulated and small. Since 1945 they have increasingly, and since 1982 fully, come under regulation, which probably greatly contributed to their strength and outreach. Informal chits continue to exist; there is no information on their spread and relevance in urban and rural areas. In rural finance surveys they are notably absent. There is also no information on the use of the chit technology as an instrument of resource mobilization by banks, as found in Indonesia where *arisan* are ubiquitous but unregulated.

Regulation and self-regulation of merchant banking, embedded into the caste system, have evolved over a period of over 2000 years and produced a strong and resilient indigenous banking sector, which has been weakened by, but ultimately survived, interventionist colonial policies. Western-type banks have been juxtaposed during British rule. In the sphere of big business indigenous bankers adopted Western banking by pooling their capital, establishing joint-stock companies or buying shares of banks; in the small and medium business sphere indigenous-style banking has continued.

Credit cooperatives were introduced before 1900, in an attempt to replicate the German Raiffeisen model; a legal framework evolved since 1904. I am not aware that any effort was made to build on indigenous institutions. Numerically cooperatives dominate the formal rural financial sector, together with cooperative banks as state-owned apex institutions. Yet, in the policy environment of a command economy, state dominance and interference in their operations have perverted their character as self-help organizations; subsidies, loan channelling and a lack of stringent supervision have undermined their viability and the depth of their service. Reform is on the agenda. Will the damage done to the movement be undone? At least there is a great potential to remedy replication.

Appalled by the level of rural indebtedness and the lack of access to formal credit independent India added state banking to the spectrum: nationalizing commercial banks, expanding their rural branch network and adding a network of Regional Rural Banks. In addition, every state and every district has its own state-owned cooperative bank. This greatly contributed to outreach, but at the expense of institutional viability and depth of financial services. The state turned out to be a poor banker, running its institutions into losses for which they were compensated from the state budget. Reform of the commercial banking sector during the 1990s has been successful; reform of the Regional Rural Banks is ongoing, reform of the cooperative banks initiated.

India has perhaps the most diversified rural financial infrastructure of any country, comprising around 160,000 outlets as part of the formal financial sector. Yet some 250-300 million of the rural poor are not served. Reform of the formal rural financial sector is not seen as a solution. The National Bank for Agriculture and Rural Development (NABARD), carved out of RBI in 1982, has therefore embarked on an innovation: *SHG banking*. Building on the experience of its 700 credit NGOs and MFIs and a pilot project in Indonesia by the central bank of Indonesia (BI) under the auspices of APRACA, it has embarked on a massive, but non-mandatory program of linking banks and self-help groups. Debating the pros and cons of Grameen banking vs linkage banking, it decided in favor of the latter: activating the existing infrastructure of banks and social organizations; using bank rather than donor resources in the provision of credit; and being savings- rather than credit-driven. NABARD provides

resources to NGOs and GOs for mobilizing SHGs, to banks for refinancing them, and to all agencies involved for capacity building. The SHGs comprise groups previously or newly established by NGOs or GOs; there is no link to indigenous institutions. The majority of groups, with up to 20 members, are not legally registered. In some states there is a strong movement in forming federations with a new type of cooperative legal status (MACS). At very low transaction costs, and repayment rates near 100%, SHG banking is highly profitable to both banks and SHGs, whose internal resources grow rapidly.

RBI has provided a conducive policy framework, Union and state governments have given their backing, thus creating the political will for what has become, over a period of ten years, the largest and fastest-growing microfinance program in the developing world. As of March 2005 it has reached 1.6 million savings-based groups credit-linked to 35,000 bank branches and primary cooperatives, with 24 million members, covering a population of over 120 million. Growth continues, and impact is deeply felt by the members; moneylenders have largely gone out of business in the areas of operation of SHGs. Major challenges include expansion into underserved areas, effective supervisionand the role of SHG federations in providing a sustainable institutional framework for informal groups.

Digging into the history of rural and microfinance in Europe, Africa and Asia generates a wealth of data and insights But it is far from producing a fully coherent picture of what propels or keeps back the growth in outreach and viability of microfinance, rural finance, microbanking and their mainstreaming. We are calling for a coordinated effort at microfinance history in developed and developing countries:

A History of Microfinance Project.

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