sdmimd
JOURNAL OF MANAGEMENT



DOI : 10.15533/sdm/2016/v7i1/90219

# For the Poor, But Who Pays the Price? Effect of Microfinance Proscription on the Poor in India

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## Abstract

Recently, the policymakers in India swung into action and issued an order for banning Maggi, when the samples were tested positively for lead content. Few years back, a similar thing happened with the microfinance sector, which intends to cater to the poor.A number cases of farmers' suicidesin one of the Indian states—Andhra Pradesh,were linked to exacting practices adopted by microfinance institutions (MFIs) in recovering the loans lent to the poor. The policymakers of Andhra Pradesh were prompt in issuing proscriptionto the banks to stop lending to MFIs, which resulted in cripplingthe entire microfinance sector in the country. Many MFIs suffered loss of business and even some were permanently pushed out of business. But this kind of rush to issuing public policiesraises several questions. Like why microfinance, which was once considered as an important tool for inclusive development, was seen using predatory practices? Does that mean microfinance is bad per se?Is such rush for proscribing really benefitthe poor? Given these questions, the paper examines significance of access to financial services in the lives of poor and what affect does it have on the entire ecosystem and associated components in microfinance.

**Keywords:** *Microfinance, Inclusive Development, Poor, Marginalisation, Organisation, Ecosystem*

## 1. The "Class" Divide: Extent of Financial Exclusion

"Inclusion" has now become a widely used termin various developmental discourses around the world. Simply putting inclusion can be referred to as an effort of mainstreaming the poor or disadvantaged sections of the people into the development process of a country. Several attempts have been made across geographies to mainstream the poor into the process of inclusion. Yet the term seems to be a mirage for many of them around the world, India being a no exception to this. Despite country's progress on many economic indicators like the gross domestic product, growth rate, national income and industrial production, the status of the poor remains dismal. The official statistics onhuman development show that India is far behind several other small and developing countries(Jha, 2015). The gap between the incomes of the people belonging to the lowest quintiles and the highest quintiles is increasing (PTI, 2014). For 90% of people, annual growth in income is just over 3-4%, while it is much higher for the people in the top quintile of the incomes (Varma, 2013).This divide is clearly visible in the formal financial and economic structures of the country. While the Indian economic structure consists of a critical mass of impoverished citizens who are deprived of even basic rights and services, there is another 'formal' minority of rich and wealthy, who are being serviced by Indian financial structure more willingly(Shetty, 2010). This is regardless of government's efforts on developing a sound and inclusive banking system in order to distribute the benefits of economic growth in a democratic manner since independence. Inclusion has always been at the core of most banking/ financial policies that were formulated after independence. Be it is expansion of cooperatives in fifties, or nationalisation of banks, establishment of Regional Rural Banks

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(RRBs), introduction of the concept of priority sectors in seventies and eighties, or financial sector reforms in nineties, or focus on financial inclusion in the last decade including the recently launched Pradhan Mantri Jan Dhan Yojana. Apparently these efforts have not yielded the much desired results (Table 1) (Sinha G. Present Indefinite, Future imperfect: The missing elements in financial inclusion policies, 2015). For instance, only 35 percent of the Indian adults had access to a formal bank account and only eight percent of the total Indian population accessed credit by formal financial institutions in the last 12 months (The World Bank, 2012).

## 2. Lacking Financial Access: Where does it Lead to?

"*The poorer the group, the greater is the exclusion*", Dr. C. Rangarajan (Committee on Financial Inclusion, 2008). Clearly this statement appears true in the light of statistics made available by some of the renowned agencies.Research in the financial exclusion space show that it is mostly the underprivileged sections of the society i.e. the farmers, small vendors, agricultural or industrial labourers, people engaged in unorganised sector, or unemployable people etc. whichare financially excluded (Committee on Financial Inclusion, 2008; Kocchar, 2009).Access to financial services also depends on banking infrastructure which varies widely across regions. For example, there are approximately 78 to 96% of the total farm households in the central, eastern and north-eastern who do not have access to credit (Committee on Financial Inclusion, 2008). Apart from this, there are reasons like lack of easy and convenient access to formal sources is one of the reasons why the poor always find recourse in the informal or non-institutional sources. The literature is replete with data and studies highlighting dependence of the poor on informal or non-institutional sources (Pradhan, 2013). The state of affairs is such that only 15-20% of the small and marginal farmers, which constitute 84% of the total farmer households, have access to credit from the banks (RBI, 2012).

**Table 1.** Extent of financial exclusion in India

| | Total households | Households availing banking services | Households having access to banking services (%) |
|---|---|---|---|
| Rural | 167,826,730 | 91,369,805 | 54.4 |
| Urban | 78,865,937 | 53,444,983 | 67.8 |
| All India | 246,692,667 | 144,814,788 | 58.7 |

**Source.** (GoI, 2011; MoF, 2013); **Note:** This data includes households with dormant accounts too(Ramakumar, 2014)

For the poor, lacking access to basic financial services does not only mean taking recourse to non-institutional or informal sources but also end up paying heavy price for it. Lacking access to banking services means paying high cost (Figure 1). The latest All-India Debt and Investment Survey (AIDIS), 2013 shows that there are still 44% rural households accessing credit from non-institutional sources (including the moneylenders who account for a majority share i.e. 80%). Even the reports submitted by various government committee have highlighted prevalence of fairly high rate of interest on loans accessed through informal sources (Ministry of Agriculture, 2010; Ministry of Finance, 2007). Moreover, there is another dimension to this price of exclusion, which the poor pay. It is in the form of transactions cost for accessing formal services(Basu & Srivastava, 2004). The transaction cost for accessing a loan from formal institutions by a poor person includes, but not limited to factors such as:

a. Distance to the nearest financial institutions, which is mostly around two to five kms and takes around 30 minutes. The poor pay nearly 50% of their daily

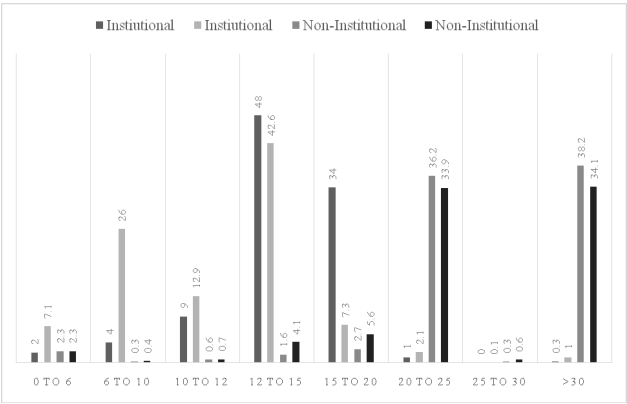



**Figure 1.** Interest rates for accessing credit in rural India.

**Source.** All-India Debt and Investment Survey (AIDIS), 2002 and 2013

wage to travel to the bank (Morawczynski, Hutchful, Rangaswam, & Cutrell, 2010)

b. Cumbersome procedures and paper works for opening an account or seeking a loan keeping in view with high rejection rates
c. Paying hefty bribes (10%-20% of the loan amount) to access loans
d. Managing collaterals for accessing loans or introducer for opening an account

Not much to the surprise, these are clear reasons why majority of the poor do not prefer access to formal sources. Moreover, those who cannot meet all the requirements of the formal sector are either left out or have to pay even higher price to the informal sources. However, in both the cases, whether accessing services from formal or informal sources, there are *top ups* to exacerbate the problems of the poor. High chances of humiliation or paying higher costs, or facing time delays in getting money, or on the worst side losing the hard earned money to fly-by-night operators are among many examples. A research on dormancy of No-Frill Saving Accounts conducted by MicroSave shows that customers are afraid or shy of going to bank branches due to the fear of being abused or ridiculed by bank staff (MicroSave, 2010). Many a times, the poor farmers lose whatever small assets they have in the process of debt redemption (Rao, 2010). There are several other negative aspects of financial exclusion, such as, social exclusion, complications in day today cash flow management making the poor susceptible to irregular cash flows, lesser security for their hard-earned money resulted from the cases of fly by night operators who looted millions of rupees of the people who were outside the formal financial system, compromised standards of living, increased exposure to unethical, predatory and unregulated providers, vulnerability to uninsured risks, long-term or extended dependence on welfare as opposed to savings (Chant Link and Associates, 2004; IIMS, 2007; Mohan, 2006).

## 3. Role Playing: What Role does Microfinance Play?

Critiques raise several questions on the relevance and contribution of microfinance in socioeconomic development. But, programme reviews across the world have proved that finance is a much required service to the poor and vulnerable sections of the society and also helps in improving their living standards. For example, in The *Portfolios of the Poor: How the World's Poor Live on $2 a Day*, Daryl et al. (2009) presents results of year-long financial diaries collected about twice a month from hundreds of rural and urban households in India, Bangladesh, and South Africa. These diaries reveal that financial instruments are vital tools for the poor in helping them to cope with poverty. Credit and savings are used not only to smooth consumption, but also to deal with emergencies like health problems and to accumulate the larger sums for meeting their life cycle requirements like business opportunities and paying for expenses like education, weddings, or funerals. Similarly, Small Industries Development Bank of India (SIDBI) commissioned a seven-year impact assessment study in India to assess, on a national scale, the development impact of microfinance in relation to different product designs and delivery systems in various parts of the country. The study revealed increase in income of the customers, enterprise activities, positive changes in livelihoods patterns by giving impetus to enterprise activity, inculcating savings habit, acquisition of productive assets, less dependence on moneylenders on costly services, increased involvement of women in asset ownership, and enhanced food security—from one or two meals a day to three meals a day (SIDBI, 2008). Taking cognizance of the fact that around three billion people across the world did not have access to formal financial services like savings accounts, credit, insurance, and payment services, the United Nations (UN) recognised positive impact of inclusive finance on the overall reduction in poverty. It stated in one of its reports that inclusive finance, including safe savings, appropriately designed loans for poor and low-income households and for micro, small and medium-sized enterprises, and appropriate insurance and payments services can help people to enhance incomes, acquire capital, manage risk, and come out of poverty (United Nations, 2006). However, these claims have been contested by a majority of researchers because scientific testing of the impact of microfinance is quite difficult. This is mainly because of the challengesassociated with identifying controls group for

comparison in microfinance (CGAP). Despite this fact, some of the world leading international organisations – ACCION International, FINCA, Grameen Foundation, Opportunity International, UNITUS, Women's World Banking—have come together, accepted, reinforced and summarised the impact of microfinance based on their work experience in a paper and signed it jointly (see the excerpt below).

- *Facilitating economic transactions*: Lack of payment services mean micro entrepreneurs often travel long distances and wait in line to make transactions, which is time-consuming and risky. Mobile payment services can both save time and reduce risk.
- *Managing day-to-day resources*: Low-income families can use credit and savings to tap into past or future income, helping them to both take advantage of immediate opportunities or, for example, to survive the annual 'hungry season.'
- *Accessing services that improve quality of life*: Financial services give families access to education, healthcare and other necessities that improve quality of life, through such tools as school fee loans, health insurance and home-improvement loans.
- *Protecting against vulnerability*: Savings, credit and insurance provide sustainable and low-cost coping strategies. If a household loses a source of income, it might not have to withdraw a child from school, sell a valuable asset, or fall deeper into poverty.
- *Making productivity-enhancing investments*: Clients can improve their businesses using credit or savings for investments such as sewing machines, refrigerators or farm tools.
- *Leveraging assets*: The poor own assets, but without recognition by the formal sector, they cannot leverage them, as Hernando De Soto has argued. Allowing poor households, particularly the women who run them, to borrow against these assets helps them capture the existing financial value, facilitating long-term investments.
- *Building economic citizenship*: Financial services foster independence. Microfinance can help clients to grow more self-confident and, with that economic citizenship, to step out and become involved in local government, garnering the respect of their communities.

## 4. Vox Populi: Getting the Facts Right

Every coin has two sides, and so has microfinance. Although "goods" can be seen in the above paragraphs, but not everything is "*good*" with microfinance.There are differences in the opinion of the stakeholders on microfinance. Some find it good and reasonable while other criticise it on various frontiers. The most common critique of microfinance is associated with its high cost i.e. the interest rate. One reason for this perception is the reference to interest rates as a percentage of the loan amount. Recently, the Malegam Committee set up by the RBI to look into the issues and concerns related to microfinance has argued that interest rate should be in the tune of around 22% or putting a margin rate of 10-12% over the cost of funds to MFIs (RBI, 2011). However, it appears that the Malegam committee did not consider the other costs which occurred before accessing loans from mainstream banks in the form of opportunity costs, processing charges plus margin money requirements sought by banks, which is all the more high for new MFIs. The committee also forgot to consider the cost associated with geographical spread. For example breakeven rate would be lower for an MFI working in coastal Andhra Pradesh districts compared to an MFI working in tribal Jharkhand or the north-east, since operations in remote locations cost more. In addition, cost would be higher for MFIs who follow careful practices of staff selection and training, borrower education and post-loan follow-up have higher operating costs compared to MFIs that merely cherry-pick others' borrowers (Mahajan, 2010). On the cost issue, it is important to note here an observation of RBI which raises concerns on hindrances while expansion of banking services to low income groups because of high operating cost associated with providing services to small accounts (RBI, 2009). This observation is based on the fact that the cost of providing a financial service for Rs 5, 000 loans and Rs. 25, 000 loans is same. In fact the cost of giving a loan includes costs of funds, operating costs, loan loss provisions etc. (Table 2) which roughly translates into 20-30% depending upon the size and age of business.

Intellecap (2010) in its white paper has also attempted to analyse various costs associated with the MFIs on the basis of portfolio (Table 3).

**Table 2.** Basic cost constituents in microfinance

| Cost | Constituents of Costs | Average |
|---|---|---|
| Cost of funds | Procuring funds for on lending it to the poor, bank's administration and documentation charges, security for loans | 12-14.5%+ security |
| Operating Cost/ Expenses | Cost of finding, identifying and selecting customers, disbursing money, collecting repayments documentation and other administration charges. | 12-18% |
| Loan loss provisions | Small amount of provisions for losses amounting from the delayed or non-repayments by a few customers | 1-2% |
| Margin | For meeting the capital adequacy norms or sustaining the operations | 1-2% |

**Source.** Gupta and Chaudhary (2010)

**Table 3.** Cost analysis of MFIS (calculated as% of loan outstanding)

| Gross Loan Portfolio (INR) | <500 Million | 500 million-5 billion | >5 Billion |
|---|---|---|---|
| Branch Cost | 11%-12% | 6%-8% | 4%-6% |
| Area Office and Head Office Cost | 4%-5% | 3%-4% | 1%-1.5% |
| Loan Loss Provisions | 1%-2% | 1%-2% | 1%-1.5% |
| Total Cost of Operations | 16%-19% | 10%-14% | 6%-9% |
| Cost of Financing | 13%-15% | 12%-14% | 11%-13% |
| Total Cost | 29%-34% | 22%-28% | 17%-22% |

**Source.** Intellecap (2010)

One of the most common perceptions about poor's business or economic activity viability to meet these charges of microfinance is quite natural. But the fact remains contrary to the popular perception. The financial returns of the activities which the poor are engaged in are surprisingly high. Mahajan (2010)gives several examples to sustain this. One example of a vegetable vendor who earns around 20% per day by selling vegetables after buying it at Rs. 1, 000 and selling it again at Rs. 1,200 can be noteworthy. He also cites profits from the activity as a major reason as to why a vendor prefers easy loan every day at the rate of 10% per day. However, the profitability of poor people is not sustainable because of the low overall output per person per annum(Mahajan, 2010).

## 5. The Response of "Other" India: Why do Poor Prefer Microfinance?

Regardless of these criticisms, one must not forget the importance of access to formal financial services in the lives of the poor. Studies have proved that lacking access to formal services mean end up paying higher costs or get trapped in the vicious net of informal sources and thereby losing money. For instance, the seven years long longitudinal impact study commissioned by SIDBI revealed that poor people without access to loans from formal sources would pay on an average 60% perannum or more interest on loans from informal moneylenders (EDA, 2004). If we factor in the costs incurred by a poor (multiple trips to banks, dealing with the red tape and bribery) we can realise that the poor end up paying price for accessing even some of the basic financial services (Figure 2).This cost can be as high as 10%for the rural poor who access savings services from a formal institution.

In fact the World Bank's RFAS found out that a poor had to bear transaction and opportunity costs (such as loan processing including collateral-related documents, bribes, several visits to the institution, cost of finding guarantors, loss of productive time, delayed access to finance resulting in productivity or market related losses) of accessing a formal financial service. The study also cited prevalence and popularity of non-institutional sources such as local commission agents

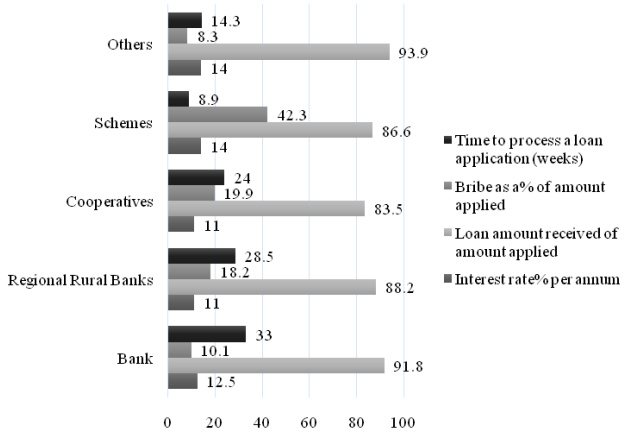



**Figure 2.** Aspects of formal borrowing and its costs.

**Source.** RFAS, 2003, World Bank (Basu and Srivastava, 2004)

to an extent of 95%in prosperous agricultural belt of Kurukshetra (Anderson & Verma, 2004).Possibly these were the reasons coupled with some other like illiteracy, lengthy documentation, banker's apathy and poor's experience which made a large number of poor to remain with unregulated, non-reliable or informal sources like chits, *bishis*, *matkas*, local traders, merchants, cooperatives and companiesin order to meet their financial requirements. This happens despite the fact that these unregulated financial entities have resulted siphoning off the hard earned money of more than half of the poor.

Not surprisingly, when the poor were offered secured, convenient and safe financial services at their doorstep, they preferred being catered to by private players (especially so called microfinance service providers) than to formal mechanisms (Figure 3) (Sinha G. , Present Indefinite, Future imperfect: The missing elements in financial inclusion policies, 2015).

## 6. Regulating the Growth: Government's Response and Thereafter

The growth in the microfinance sector came along with various systemic issues such as process overrides, shortcuts, cut throat competition in acquiring more and more customers, increasing profit margins,

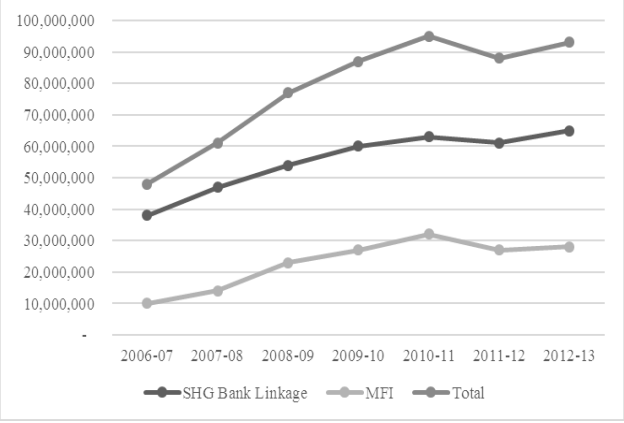



**Figure 3.** Microfinance customers in India.
**Source.** Nair and Tankha (2014)

insufficient managerial controls, increasing interest rates while lending to the poor, multiple lending, lack of staff training on dealing with customers, deteriorating work condition for employees, increasing political interference and many more. (Sinha S. , 2010; Venkata & Yamini, 2010). The list does not end here. Many MFIs were accused of being strict with delinquent client, at times using inhuman means for the recovery of loans. Particularly the pressure of lending institutions and investors also played an important role in unprecedented growth of microfinance. Such instances have resulted in maligned image of the entire sector as "*anti-poor*" or "*modern moneylenders*". Allegations of all sorts such as predatory lending practices, mishandling the poor customers, stringent processes, profiteering,etc.were attached flatly to all the institutions across the country without even understanding the cost and consequences of such charges. Even, the cases of suicides in Andhra Pradesh were attributed to harsh field practices followed by MFI. The impact has further been intensified by the statements and actions of representatives belonging to religious or political parties and by stringent actions by government. The Government of Andhra Pradesh even went ahead with passing an ordinance for capping the interest rates charged by MFIs.

The results came as expected and this severely obstructed the operations of many MFIs across Andhra Pradesh. The capital flow to the entire microfinance sector in India has come to a halt despite the fact that formal channels found it a lucrative and more secured opportunity to fulfil their targets of priority sector by lending to MFIs.[1] The Malegam committee was also appointed by the RBI to look into the matter. But the merit of stopping capital flow to the sector did not seem to work out. In fact measures such as capping of interest rates can do more harm to the poor. Research studies across the world have proved that capping interest rates result in limiting access of the poor to financial services and less transparency in pricing (CGAP, 2004). This invariably hurts the poor more because once the MFIs back out from the area

[1] Banks lend through MFIs with a net interest margin of around five% (assuming 13% minus 8% base rate), which is even higher is many cases. In some cases there are provisions of keeping security with the banks for taking on lending funds.

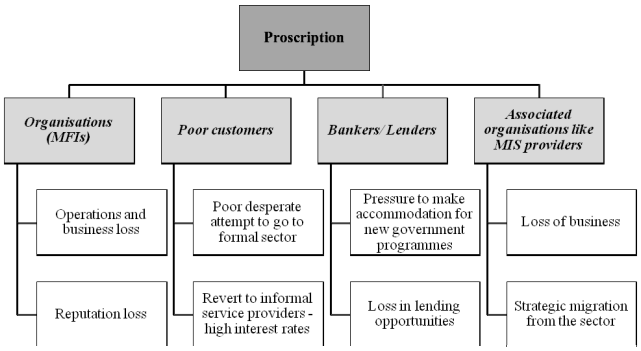



**Figure 4.** Effect of proscription in microfinance.

or close down their operations to reduce their cost-sthe options left with the poor are limited. They may have to bank on informal sources for meeting their financial needs which in turn make them trapped in a circle of low output and low income (Mahajan, 2010). Leading newspapers in India reported about money-lenders, who started approaching the slum dwellers with loans at 60 to 100% interest which was 2.5-3 times higher than the rates offered by MFIs. Even the poor are being forced into debt trap to meet the ends (Chandrasekaran, 2010). Many MFIs suffered loss of business and even some were permanently pushed out of business. The effect of legal proscriptions, as the one mentioned above, is not limited to only the customers or the MFIs. Sometimes, it has a multiplier effect on the bankers and associated organisations as well (Sinha G. 2014) which lead to loss of business and even migrating from the sector. Figure 4 sums up the effect of proscription on microfinance.

## 7. Conclusion

The case here suggests enhancing efforts for a greater financial inclusion more "*responsibly*" by all the stakeholders rather than merely taking some radical steps which reduces chances of poor to get main-streamed. Even if a single case of suicide is due to faulty practices in microfinance, the practitioners and promoters of microfinance should give it a proper thought before calling microfinance a pro-poor activity.*Profiteering* cannot be given space in the disguise of sustainability and cost covering while serving the poor as they would be the worst affected by any policy level interventions,such as stopping capital flow to the microfinance sector. In addition, the service providers also need to focus on protecting the poor customers and giving comfort to the policy makers and other stakeholders. Possibly, the sector player scan adopt a set of following measures to serve their customers responsibly vis-à-vis showing collective integrity towards the values and principles of working with the poor.

At the same time, there is a need for poor-friendly ecosystems or responsive alternatives. The role of the government is not to discourage profitable social businesses, but its role is to regulate institutions in such a way that larger public interest is served. Merely criticising the operating process and practices of the microfinance sector would not yield much dividend in favour of the poor. It requires a conscious effort by all who have concerns about mainstreaming the poor. It is quite clear that only going by numbers of bank accounts opened or quoting areas with 100% financial inclusion does not serve the purpose unless the poor are treated well or provided need based services or educated about financial transactions. It is indeed a good idea to view the role, which access to financial services plays in the lives of a poor, holistically.

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