
MICROFINANCE IN INDIA: ITS ISSUES AND CHALLENGES

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ABSTRACT:

Microfinance refers to small savings, credit and insurance services extended to socially and economically disadvantaged segments of society. It is emerging as a powerful tool for poverty alleviation in India. This working paper tries to outline the prevailing condition of the Microfinance in India in the light of its emergence till now. The prospect of Micro-Finance is dominated by SHGs (Self Help Groups) - Banks linkage Program. Its main aim is to provide a cost effective mechanism for providing financial services to the poor. Finally paper concludes with practicable suggestions to overcome the issues and challenges associated with microfinance in India.

Key words: MFI, SHG, NBFC

INTRODUCTION:

Microfinance can be described as an umbrella under which financial services including microcredit are provided to the low income group. The need for the unfolding of microfinance began in the developing nations more than 30 years ago. With organized financial sectors like the banks not having anything on their platter to offer the unsalaried and low income group, mushrooming of money lenders and chit fund owners was inevitable. Financial crimes and default became common place in such a scenario. While it was not always the money lenders who were at fault, the borrowers themselves had little choice in the matter. This led to a world-wide movement that culminated in the making of the Microfinance Institutions, or the MFIs.

Microfinance sector has grown rapidly over the past few decades. Nobel Laureate Muhammad Yunus is credited with laying the foundation of the modern MFIs with establishment of Grameen Bank, Bangladesh in 1976. Today it has evolved into a vibrant

industry exhibiting a variety of business models. Microfinance Institutions (MFIs) in India exist as NGOs (registered as societies or trusts), Section 25 companies and Non-Banking Financial Companies (NBFCs). Commercial Banks, Regional Rural Banks (RRBs), cooperative societies and other large lenders have played an important role in providing refinance facility to MFIs. Banks have also leveraged the Self-Help Group (SHGs) channel to provide direct credit to group borrowers.

With financial inclusion emerging as a major policy objective in the country, Microfinance has occupied centre stage as a promising conduit for extending financial services to unbanked sections of population. At the same time, practices followed by certain lenders have subjected the sector to greater scrutiny and need for stricter regulation.

Although the microfinance sector is having a healthy growth rate, there have been a number of concerns related to the sector, like grey areas in regulation, transparent pricing, low financial literacy etc. In addition to these concerns there are a few emerging concerns like cluster formation, insufficient funds, multiple lending and over-indebtedness which are arising because of the increasing competition among the MFIs. On a national level there has been a spate of actions taken to strengthen the regulation of MF sector including, enactment of microfinance regulation bill by the Government of Andhra Pradesh, implementation of sector-specific regulation by Reserve Bank of India and most recently, release of Draft Microfinance Institutions (development and regulation) Bill, 2011 for comments.

Based on the research work, a few major recommendations made in the report include field supervision of MFIs to check ground realities and the operational efficiency of such institutions. Offer incentives to MFIs for opening branches in unbanked villages, so as to increase rural penetration. Also MFIs be encouraged to offer complete range of products to their clients. Transparent pricing and technology implementation to maintain uniformity and efficiency are among the others which these institutions should adopt. Inability of MFIs in getting sufficient funds is a major hindrance in the microfinance growth and so these institutions should look for alternative sources of funds. Some of the alternative fund sources include outside equity investment, portfolio buyouts and securitization of loans which only a few large MFIs are currently availing.

Introduction to Microfinance:

“Microfinance is the provision of financial services to low-income clients or solidarity lending groups including consumers and the self-employed, who traditionally lack access to banking and related services.”

Microfinance is not just about giving micro credit to the poor rather it is an economic development tool whose objective is to assist poor to work their way out of poverty. It covers a wide range of services like credit, savings, insurance, remittance and also non-financial services like training, counselling etc.

Salient features of Microfinance:

- Borrowers are from the low income group
- Loans are of small amount – micro loans
- Short duration loans
- Loans are offered without collaterals
- High frequency of repayment
- Loans are generally taken for income generation purpose

The History and Evolution:

The poor and needy have a frequent need for cash and hence save in highly liquid assets like jewellery, live stock, etc. These assets are both the livelihood of the poor and their savings. In times of need they are faced with a catch-22 like situation. If they do not sell the asset, they will not be able to repay the loans and if they did, they would not have a livelihood. This scenario encouraged a host of Non-governmental Organisations to start the movement which caters, in a micro level to the financial needs of the poor. The micro loans are given to these people and they are allowed the freedom to choose a livelihood.

The basic issue being constant, issues like size, diversity, taxation, reach and sustainability affected the transformation of Microfinance over the years. It is safe to assume that current day microfinance started in India sometime around 1980. It started as small groups formed to help themselves or the self help groups (SHG). Slowly the movement picked up momentum

and national bodies like the Small Industries Development Bank of India (SIDBI) and the National Bank for Agriculture and Rural Development (NABARD) jumped into the band wagon. They have been devoting significant time and financial resources to microfinance. This has ushered in a sense of coming of age of this sector. The microfinance organizations (MFOs) in India have evolved over time and their strength lies in their diverse approach.

The Process of Transformation:

Though the basic aim of providing small, unsecured loan to the poor remains the same, with the advent of Microfinance the intent of such as loan has assumed a laudable intention. These types of loans therefore have lent themselves an organized and institutional connotation, erasing with it, the exploitative undertone of the previous model.

The microfinance is seen targeting the poor women who need the funds to establish in their chosen fields. Pottery, Agriculture and the like have women who can perform better with a little financial assistance. They have defaulted much lesser than their male counterparts.

In Bangladesh, for example, it has been proved that women default on loans less often. The credit extended to women has a positive impact on household consumption thereby improving the quality of life for children.

Gaps in Financial system and Need for Microfinance:

According to the latest research done by the World Bank, India is home to almost one third of the world's poor (surviving on an equivalent of one dollar a day). Though many central government and state government poverty alleviation programs are currently active in India, microfinance plays a major contributor to financial inclusion. In the past few decades it has helped out remarkably in eradicating poverty. Reports show that people who have taken microfinance have been able to increase their income and hence the standard of living.

About half of the Indian population still doesn't have a savings bank account and they are deprived of all banking services. Poor also need financial services to fulfill their needs like consumption, building of assets and protection against risk. Microfinance institutions serve as a supplement to banks and in some sense a better one too. These institutions not only offer micro credit but they also provide other financial services like savings, insurance, remittance and non-financial services like individual counselling, training and support to start own business and the most importantly in a convenient way. The borrower receives all these services at her/his door step and in most cases with a repayment schedule of borrower's convenience. But all this comes at a cost and the interest rates charged by these institutions are higher than commercial banks and vary widely from 10 to 30 percent. Some claim that the interest rates charged by some of these institutions are very high while others feel that considering the cost of capital and the cost incurred in giving the service, the high interest rates are justified

Channels of Micro finance

In India microfinance operates through two channels:

1. SHG – Bank Linkage Programme (SBLP)
2. Micro Finance Institutions (MFIs)

SHG – Bank Linkage Programme

This is the bank-led microfinance channel which was initiated by NABARD in 1992. Under the SHG model the members, usually women in villages are encouraged to form groups of around 10-15. The members contribute their savings in the group periodically and from these savings small loans are provided to the members. In the later period these SHGs are provided with bank loans generally for income generation purpose. The group's members meet periodically when the new savings come in, recovery of past loans are made from the members and also new loans are disbursed. This model has been very much successful in the past and with time it is becoming more popular. The SHGs are self-sustaining and once the group becomes stable it starts working on its own with some support from NGOs and institutions like NABARD and SIDBI.

Micro Finance Institutions:

Those institutions which have microfinance as their main operation are known as micro finance institutions. A number of organizations with varied size and legal forms offer microfinance service. These institutions lend through the concept of Joint Liability Group (JLG). A JLG is an informal group comprising of 5 to 10 individual members who come together for the purpose of availing bank loans either individually or through the group mechanism against a mutual guarantee. The reason for existence of separate institutions i.e. MFIs for offering microfinance are as follows:

- High transaction cost – generally micro credits fall below the break-even point of providing loans by banks
- Absence of collaterals – the poor usually are not in a state to offer collaterals to secure the credit
- Loans are generally taken for very short duration periods
- Higher frequency of repayment of installments and higher rate of Default

Non-Banking Financial Companies (NBFCs), Co-operative societies, Section-25 companies, Societies and Trusts, all such institutions operating in microfinance sector constitute MFIs and together they account for about 42 percent of the microfinance sector in terms of loan portfolio. The MFI channel is dominated by NBFCs which cover more than 80 percent of the total loan portfolio through the MFI channel.

Sl. No.	Type of MFI	Number	Legal Registration
Not-for Profit MFIs			
1	NGOs	400-500	Society Registration Act, 1860 Indian Trust Act, 1882
2	Non-Profit companies	20	Section-25 of Indian Companies Act, 1956

Mutual Benefit MFIs

3	Mutual benefit MFIs –200-250 Mutually Aided Cooperative Societies (MACS)	Mutually Aided Co-operative societies, Act enacted by State Governments
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For Profit MFIs

4	Non-Banking Financial Companies (NBFCs)	Indian companies Act, 1956 Reserve Bank of India Act, 1934
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Source: NABARD ISSUES RELATED TO MICROFINANCE

Legal Structure and Regulation:

Although the SHG-Bank linkage model is well managed in India by NABARD, currently there is no proper regulatory body for the supervision of MFIs. The presence of institutions with a variety of legal forms makes it difficult for the regulation of all such institutions by a single regulatory body in the current Indian legal structure. Though NBFCs, which cover the major part of the outstanding loan portfolio by the microfinance channel, are regulated by Reserve Bank of India, other MFIs like societies, trusts, Section-25 companies and cooperative societies fall outside the purview of RBI's regulation. The acceptance of the Malegam committee recommendations by the RBI is a big step forward in addressing the above concern but again it will cover only a section of the MFIs i.e. NBFCs. The microfinance bill which was introduced in the year 2007 is still pending. The most recent and the strongest step taken by the government, The Micro Finance Institutions (Development and regulation) Bill, 2011 is a major step in the microfinance sector. The proposed bill clarifies all doubts pertaining to regulation of the MFIs by appointing RBI as the sole regulator for all MFIs.

Financial Illiteracy:

One of the major hindrances in the growth of the microfinance sector is the financial illiteracy of the people. This makes it difficult in creating awareness of microfinance and even more difficult to serve them as microfinance clients. Though most of the microfinance

institutions claim to have educational trainings and programmes for the benefit of the people, according to some of the experts the first thing these SHG and JLG members are taught is to do their own signature. The worst part is that many MFIs think that this is what financial literacy means. We all know how dangerous it can be when one doesn't know how to read but he/she knows how to accept or approve it (by signing it).

Inability to generate sufficient funds:

Inability of MFIs to raise sufficient fund remains one of the important concern in the microfinance sector. Though NBFCs are able to raise funds through private equity investments because of the for-profit motive, such MFIs are restricted from taking public deposits. Not-for-profit companies which constitute a major chunk of the MFI sector have to primarily rely on donations and grants from Government and apex institutions like NABARD and SIDBI. In absence of adequate funding from the equity market, the major source of funds for MFIs are the bank loans, which is the reason for high Debt to Equity ratio of most MFIs. MFIs receive debt from banks against their equity and in order to increase their portfolio size they need to increase their debts for which they further need to increase their equity. After the Andhra crisis, it is reported that banks have stopped issuing fresh loans and even though currently few banks have resumed, they want MFIs to increase their equity to get fresh loans. So the only mode for the MFIs to increase their portfolio size is to increase their equity. The problem of inadequate funds is even bigger for small and nascent MFIs as they find it very difficult to get bank loans because of their small portfolio size and so they have to look for other costlier sources of fund.

Dropouts and Migration of group members

Majority of the microfinance loans are disbursed on group lending concept and a past record of the group plays an important role in getting new loans either through SHG-Bank linkage or through MFIs. The two major problems with the group concept are dropouts (when one or more members leave the group) and migration (when one or more members move to another group). Most MFIs lend on the basis of the past record of the group i.e. SHG or JLG and also on the individuals repayment performance. In absence of a decent past record, members are deprived of getting bigger loan amounts and additional services.

Transparent Pricing

Though the concern about the transparent pricing in the microfinance sector has been an older one, it is gaining significance with the growing size and the increasing competition in the sector. Non-transparent pricing by MFIs confines the bargaining power of the borrowers and their ability to compare different loan products, because they don't know the actual price. In absence of the proper understanding of the pricing, clients end up borrowing more than their ability to payback which results in over-indebtedness of the borrower.

MFIs, in order to make their products look less expensive and more attractive, are disguising their actual/effective interest rates (better known as the Annualized Percentage Rates – APR) by including other charges like service charge, processing fee etc. Some MFIs even take interest free deposits for lending microloans. There have been cases where the interest rates are linked with the loan amount, which means a higher interest rate for smaller loans (because of higher transaction cost). This is resulting in highest interest rate being charged to the poorest clients, which contradicts with the social aspect of microfinance.

Ambiguity in the pricing by MFIs is inviting regulatory bodies to implement strict measures like interest rate caps. But simply putting an interest rate cap may encourage MFIs to look for clients with larger loan requirements. This may deprive the clients with smaller loan requirements who are supposed to be the actual beneficiary of microfinance.

Cluster formation – fight to grab established market

MFIs' drive to grab an established market and reduce their costs is resulting in formation of clusters in some areas leaving the others out of the microfinance outreach. By getting an established microfinance market, MFIs reduce their initial cost in group formation of clients, educating them and creating awareness about microfinance. This is one of the reasons for the dominance of the microfinance sector in the southern states. Now the problem is that a similar trend is being followed in the northern states as well. We have already seen what happened in A.P and it seems that most of the MFIs have not taken a lesson from the Andhra crisis.

This cluster formation is restricting MFIs from reaching to rural areas where there is the actual need for microfinance. People in urban and semi-urban areas are already having access to microfinance through SHG-bank linkage or individual lending, but in rural areas people

don't have access to banks and so SBLP is not much active in such areas. Because of the initial cost involved in serving a new location, MFIs are not willing to go to such remote locations. This is the reason most of the MFIs have their branches in urban and semi-urban areas only resulting in a very low rural penetration of microfinance.

It is high time for the MFIs to understand that though microfinance is a resalable product, increasing the outreach of the microfinance sector by including new clients and serving new locations is what which is needed the most at the moment.

Multiple Lending and Over-Indebtedness:

Both of these are outcome of the competition among the MFIs. Microfinance is one such sector where the Neo-liberal theory of free market operation fails, at least to some extent. Though competition is good for many sectors but in this case it is going against both the parties. In order to eat away each others' market share, MFIs are ending up giving multiple loans to same borrowers which in some cases is leading to over-indebtedness (a situation where the borrower has taken loans more than her/his repaying capacity) of the borrower. MFIs are getting affected because borrowers are failing to make payments and hence their recovery rates are falling, while over-indebtedness is making the borrower go to depression and in some cases forcing them to commit suicide.

Some experts advocate that multiple lending is not but over-indebtedness is dangerous. This may be true but multiple lending is eating away the opportunity of new borrowers, and in a country where it is believed that the microfinance sector is able to cater to only 10-15 percent of its potential clients, even multiple lending proves out to be a big concern.

RECOMMENDATIONS:

1. **Proper Regulation:** The regulation was not a major concern when the microfinance was in its nascent stage and individual institutions were free to bring in innovative operational models. However, as the sector completes almost two decades of age with a high growth trajectory, an enabling regulatory environment that protects interest of stakeholders as well as promotes growth, is needed.

2. Field Supervision: In addition to proper regulation of the microfinance sector, field visits can be adopted as a medium for monitoring the conditions on ground and initiating corrective action if needed. This will keep a check on the performance of ground staff of various MFIs and their recovery practices. This will also encourage MFIs to abide by proper code of conduct and work more efficiently. However, the problem of feasibility and cost involved in physical monitoring of this vast sector remains an issue in this regard.

3. Encourage rural penetration: It has been seen that in lieu of reducing the initial cost, MFIs are opening their branches in places which already have a few MFIs operating. Encouraging MFIs for opening new branches in areas of low microfinance penetration by providing financial assistance will increase the outreach of the microfinance in the state and check multiple lending. This will also increase rural penetration of microfinance in the state.

4. Complete range of Products: MFIs should provide complete range of products including credit, savings, remittance, financial advice and also non-financial services like training and support. As MFIs are acting as a substitute to banks in areas where people don't have access to banks, providing a complete range of products will enable the poor to avail all services.

5. Transparency of Interest rates: As it has been observed that, MFIs are employing different patterns of charging interest rates and a few are also charging additional charges and interest free deposits (a part of the loan amount is kept as deposit on which no interest is paid). All this make the pricing very confusing and hence the borrower feels incompetent in terms of bargaining power. So a common practice for charging interest should be followed by all MFIs so that it makes the sector more competitive and the beneficiary gets the freedom to compare different financial products before buying.

6. Technology to reduce Operating Cost: MFIs should use new technologies and IT tools & applications to reduce their operating costs. Though most NBFCs are adopting such cost cutting measures, which is clearly evident from the low cost per unit money lent (9%-10%) of such institutions. NGOs and Section 25 companies are having a very high value of cost per unit money lent i.e. 15-35 percent and hence such institutions should be encouraged to adopt cost-cutting measures to reduce their operating costs. Also initiatives like development of common MIS and other software for all MFIs can be taken to make the operation more transparent and efficient.

7. Alternative sources of Fund: In absence of adequate funds the growth and the reach of MFIs become restricted and to overcome this problem MFIs should look for other sources for funding their loan portfolio.

Some of the ways through which MFIs can raise their fund are:

- By getting converted to for-profit company i.e. NBFC: Without investment by outside investors, MFIs are limited to what they can borrow to a multiple of total profits and equity investment. To increase their borrowings further, MFIs need to raise their Equity through outside investors. The first and the most crucial step to receive equity investment are getting converted to for-profit NBFC. Along with the change in status the MFI should also develop strong board, a quality management information system (MIS) and obtain a credit rating to attract potential investors.
- Portfolio Buyout: It is when banks or other institutions purchase the rights to future payment stream from a set of outstanding loans granted by MFIs. In such transactions MFIs are responsible for making up any loss in repayment up to a certain percentage of the portfolio and this clause is known as “first loss default guarantee”. The above clause ensures that the MFI retains the correct incentive to collect these loans. To ensure security to the buying institution, MFIs are allowed to sell off as much of the outstanding portfolio as is financed by accumulated earnings or equity.
- Securitization of Loans: This refers to a transaction in which the repayments from a set of microloans from one or more MFIs are packaged into a special purpose vehicle, from which tradable securities are issued. As the loans from multiple MFIs can be pooled together the risk gets diversified. Though securitization of loans and portfolio buyout are similar in many ways like first loss default guarantee clause, limit to the amount of loans that can be sold off etc. The major difference between the two is that securitizations require a rating from a credit rating agency and that it can be re-sold, which makes securitized loans attract more potential buyers. Also unlike portfolio buyout, there can be multiple buyers and sellers for each transaction in case of securitization of loans as compared to single buyer and single seller in portfolio buyout. Through securitization, MFIs can tap new sources of investments because

fund of certain types like mutual funds, which are barred from directly investing in MFIs, can invest through securitized loans.

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