

# Microfinance Institutions in India: Issues and Challenges

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## ABSTRACT:

*India is one of the developing countries in the world. It is argued that among others absence of access to credit is presumed to be the cause for the failure of the poor to come out of poverty. Lending to the poor involves high transaction cost and risks associated with information asymmetries and moral hazards. Microfinance is one of the ways of building the capacities of the poor who are largely ignored by commercial banks and other lending institutions and graduating them to sustainable self-employment activities by providing them financial services like credit, savings and insurance.*

*To provide microfinance and other support services, Microfinance Institutions (MFIs) should be able to sustain themselves for a long period. Therefore, this paper tries to identify the major issues and challenges faced by the Indian microfinance institutions.*

## INTRODUCTION

India is a developing nation. The GDP per capita of India, though it has shown improvement in recent years, is only (USD) \$1514 as at the end of 2011. It is argued that, among others, absence of access to credit is presumed to be the cause for the failure of the poor to come out of poverty. Meeting the gap between demand and supply of credit in the formal financial institutions frontier has been challenging. In fact, the gap has not arisen merely because of shortage of loan-able funds to the poor rather it arises because it is costly for the formal financial institutions to lend to the poor. Lending to the poor involves high transaction cost and risks associated with information asymmetries. Nevertheless, in several developing economies governments have intervened, through introduction of microfinance institutions to provide microcredit to the poor.

Microfinance is one of the ways of building the capacities of the poor who are largely ignored by commercial banks and other lending institutions and graduating them to sustainable self-employment activities by providing them financial services like credits, savings and insurance. The reasons of this neglect are many. Often, such credits are just not profitable enough for banks because of economies of scale. By focusing on small amounts, and easing collateral requirements, microfinance institutions are better equipped to target poor individuals or groups who need resources to finance small scale investments. To provide microfinance and other support services, MFIs should be able to sustain themselves for a long period.

In India microfinance traces its roots to mid 1970s when some prominent Indian NGO's like Myrada & Pradan started using the Self Help Group (SHG) model. The SHG is used as a platform for social mobilization and finance is one of the various services provided to the grassroots community through this model. It was widely replicated across other developmental NGOs. It is a community driven and managed microfinance model where the NGO plays the role of a facilitator, for instance providing capacity building services to the groups and building relationships with banks.

It is only from last 15 years that the MFIs, using Grameen model or Joint-Liability Groups (JLG), created a pace in outreach and credit growth. With the phenomenal growth recorded by the MFIs in India in recent years, 62% per annum in terms of

numbers of unique clients and 88% per annum in terms of portfolio over the past five years i.e. Year 2005 to Year 2010 and around 32 million borrower accounts by March-end 2011, India has the largest microfinance industry in the world.

Yet question remains whether it is a sustainable business model or not? The purpose of this paper is to identify the issues and challenges faced by microfinance institutions of India.

Some researchers have found the evidence to be not so favourable. Many MFIs seem to have trouble reaching self sustainability at the financial level, even after the set up period. In this case, microcredit becomes more akin to subsidized credit which has a long record in developing countries, but often fails to achieve lasting positive results.

Still even if the MFI's do not reach financial sustainability and fail, therefore, to conform to the "win-win" assumption, they can still be considered valuable if they provide credit facility to poor households who would not be able to find financial resources otherwise. In this perspective, outreach has social value in itself, which may more than offset the cost associated with permanent financial subsidies needed by the MFIs.

In other words, MFIs face double challenge: not only do they have to provide financial services to the poor (outreach), but they also have to cover their cost in order to avoid bankruptcy (sustainability). Both dimensions must, therefore, be taken into account in order to access their performance.

## APPROACHES OF MICROFINANCE

The concept of microfinance has influenced by two major schools; the Institutional school and the Welfarist school. Institutional school focuses on developing a financially sustainable institution that is expected to serve the poor. The basic foundation of such an approach is to provide financial services to poor at an affordable cost. Numerous large-scale, profit seeking microfinance organisations come under this approach that provides high quality financial services to the poor. This approach is expressed in nearly all literatures published by World Bank, CGAP, USAID, ACCION International and Ohio State Universities Rural Finance program.

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Believers of Institutional approach are opposed to the idea of dependency on subsidies because earlier attempts on poverty alleviation through subsidies by various development agencies, NGOs and the governments of developing countries failed. The reason behind the failure included; high cost of transactions, lack of assets for the poor households, institutions lacking in saving mobilization and high level of corruption. The impact was very insignificant and that leads to dried up donor fund.

According to Institutionalists, a significant impact on poverty can be achieved only if MFIs are financially self-sufficient and independent from any subsidised funding from donor or government.

Examples of MFIs operating under this approach are Bank Rakyat Indonesia, SKS Microfinance, and Uganda Microfinance Union etc.

On the other hand, Welfarist focuses on immediate improvement of the economic safety for the poor. They focus on providing financial services to the poorest of the poor at subsidised rate of interest. The MFIs that fall under this approach are heavily reliant on the government subsidies and grants as well as donor subsidies. Saving mobilisation is not a part of the lending process in this approach.

Though they understand that the long term sustainability of MFI is very important, however, they do not agree that avoiding donor subsidies completely will be required to achieve that state. Examples of MFIs operating under this approach are Grameen Bank Bangladesh, FINCA in Latin America etc.

## MICROFINANCE DELIVERY MODELS

Microfinance services are provided with different methods in India and elsewhere. Delivery models can be divided into two broad categories.

- I) Group models
- II) Individual models

Group models can be divided into three categories.

- I) Self-help Groups (SHG)- Bank-linkage
- II) The Grameen model
- III) Joint Liability Groups (JLG)

The individual model corresponds to individual banking.

As of March 2011, over 1.8 million Self-help Groups (SHGs) active in India represented over 60 million microfinance clients, while the MFI model, growing at a staggering 60 percent per annum, served another 30 million.

## SELF-HELP GROUP-BANK-LINKAGE

The SHG model, in the form of the SHG-Bank-linkage program (SBPL) was initiated in the early 1990s by the National Bank for Agriculture and Rural Development (NABARD). SHG linkage is based on the principle of 'savings first'. These savings are not only a way of creating group solidarity and, testing people's willingness regularly to keep some cash aside, they also create a loan fund from which the group can borrow. Such groups normally comprise of 15-20 women. Peer-pressure replaces traditional guarantees, such as references and assets or collateral. The existing network of government banks binds the SHGs to credit channels, and having demonstrated the financial success of this endeavor. The private banks are also increasingly venturing into this field.

To obtain loans from banks, the SHG members must first establish their credit-worthiness, by maintaining scrupulous records of savings and mutual lending, usually for a period of six months. Further, the mechanism guards against defaults on loan payments, as no new member may receive a fresh loan until the previous arrears are cleared. Another repayment incentive is the ability to access larger repeat loans upon on-time repayment. The loans offered to the SHGs are usually a multiple (2-4 times) of their savings, and are granted to the SHG as a whole, which then decides autonomously on the disbursement among the members. It is argued that the meetings reinforce a culture of discipline, routine payments and staff accountability, while others counter the claim arguing that daily or weekly congregation compounds the workload of the borrowers and at times discourages new entrants. There is also the assertion that the 'group leader' may wield undue control over loans issued to the other members.

While ideally, once members have managed to build up their assets, they should be able to operate individual accounts; this is not always the case. Critics of the SHG movement argue that poor people, given the choice, prefer an individual service and the simplicity of a reliable retailer managing the bookkeeping, rather than taking on the added responsibilities and risks of running their own mini-financial institution (SHG). Among the other drawbacks, SHGs entail a process of mutual self-selection, which may lead to the exclusion of the economically weakest members in a community. Further, it is noted that repayment does not depend solely on peer pressure; rather it also requires management, transparency and accountability, for which apparatus of training and supervision should be in place.

### The Grameen Model

The Grameen model was initiated by Mohd. Yunus in Bangladesh. With this model, the institution lends to affinity groups of 5 individuals. These groups are very standardized in structure. They organize weekly meetings and saving is mandatory for members. Credit is not given to all members simultaneously, but all hope to have their turn and all stand for each other's obligations. The groups are created under supervision of the MFI, according to a well-defined structure to facilitate access to microfinance services.

### Joint Liability Groups or Individual Liability

MFIs serve as 'lending intermediaries' between investors (banks/private equity firms) and the microcredit borrowers. In India, they exist either as NGOs or as Non-Banking Finance Companies (NBFCs). The Joint Liability Group method was made famous by Grameen Bank in Bangladesh and has been replicated by MFIs across the world.

Under the JLG model, MFIs organize members into groups with the understanding that even though members will be given individual loans, the group as a whole will be liable for repayment. As in the case of the SHGs, social pressure ensures that repayment levels remains over 98 per cent in India. The size of the group is much smaller than an SHG with each group comprising of 5 women. Certain MFIs also lend to individuals with individual liability. In order to qualify for a bigger individual loan, members must have demonstrated good credit history over one to two years.

The advantage of the JLG model over the SHG model lies in the former's ability to scale. It is highly replicable and allows MFIs to rapidly expand their client base and become more profitable. In fact, 30 percent of the 70 million microfinance clients in India are members of the top 10 MFIs. Critics of the MFI/JLG model argue that high growth rate experienced by MFIs in India has translated into a mission drift with the focus shifting from client satisfaction to profit making.

## COMPARATIVE STRENGTHS AND WEAKNESSES OF MICROFINANCE

### STRENGTHS

#### Cost Effectiveness

Many researchers point out, the greater the microfinance institution's outreach (i.e. the more clients it serves) the more cost effective and sustainable it becomes. In most development initiatives, the more people you serve, the greater the cost becomes; with microfinance initiatives, the opposite is true.

#### Powerful Leveraging Effect

Macro-economic policies linked to structural adjustment processes, although subsequently oriented in ways that tended to limit or minimize social problems, could hardly bring about a lasting solution. Such policies support the traditional approach, in which poverty is deemed to be alleviated by top-down money transfers initiated by the State in the direction of the poor.

When the Lower Rural Bank, using entirely its own loan capital, had been offering Credit with Education for about four years. at that time, the program had an operating self-sufficiency ratio of 81% (meaning that the interest paid by borrowers covered 81% of the Lower Rural Bank's costs of delivering Credit with Education as one of its several services to surroundings Communities). These operating costs included financial costs, including interest on debt but not loan-loss reserve. As of June 2007, the reported operating self-sufficiency was 130%.

### WEAKNESSES

#### Less Universal in its Application

Where market opportunities are constrained by low population density and limited purchasing power or are flooded with similar goods and services, training, technological development or assistance with marketing may have a greater impact than microfinance. Even where market opportunities are promising, basic services and infrastructure that improve the productivity of existing livelihood activities such as agricultural extension or veterinary services, improve natural resource management, and irrigation or health services which prevent sickness destroying livelihoods may be more appropriate than microfinance.

For microcredit to be an appropriate intervention, certain pre-conditions should not hold. Lending under these conditions may not produce tangible benefits. These include:

- i) Immediately after emergencies
- ii) For the chronically destitute
- iii) In severely disadvantaged areas lacking infrastructure, services or access to markets
- iv) Where illness such as HIV/AIDS pervades

#### Borrowers need to be suitably entrepreneurial

The sources of the success of microcredit are also the sources of its weaknesses. Microcredit is self-targeting and hence cost-effective. But not all rural poor are able to benefit from microcredit programs; utilizing loans in productive activities requires entrepreneurial skills that most people lack. Microcredit programs must target only those poor who have some ability to initiate activities with growth potential but lack capital. For the rural poor who are unable to become self-employed, targeted food programs and wage employment may be more appropriate. Microcredit also suffers from its limited ability to increase the size of the loan per borrower because of the limited capacity of borrowers to absorb loans.

## MICROFINANCE IN INDIA

### THE NEED FOR MICROFINANCE

In the Indian context, especially in rural areas, there remains a vast lacuna in the availability of formal finance, and informal finance often comes tagged with extortionary terms or conditions of servitude. Following the bank nationalization drive started by Indira Gandhi in 1969, where commercial banks were required to open rural branches, India's banking network grew exponentially. Today, India boasts of over 32,000 rural branches of commercial banks and regional rural banks, around 14,000 cooperative bank branches, 98,000 primary agricultural credit societies, 154,000 outlets of the post office network, as well as several other non-bank finance companies and mutual fund sellers. While the numbers seem impressive, it has been estimated that 70% of the marginal and landless farmers do not have a bank account and 87% have no access to credit from a formal source, leading to the conclusion that rural banks primarily serve the interests of the richer rural populace. From among the households surveyed under the RFAS-2003 (Rural Finance Access Survey 2003), over 90% reported that they funded unexpected expenses from cash at home, and the second most significant source was informal borrowing from friends, relatives and moneylenders. These statistics gave microfinance a vast playing-field, and taking heed of this potential, the industry has grown to serve over 80 million clients in India alone.

### FAILURE OF BANK NETWORK TO DELIVER

In order to understand why most Indians are unable to borrow from formal financial institutions, Basu and Srivastava cite a combination of factors involving the banks and the clients themselves. They argue that the banks are wary of the repayment capacity of poor borrowers, their volatile income streams and incapability to provide collateral. The clients also make bad-borrowers as they typically avail of loans for consumption smoothing rather than investment in business and when the loans are for entrepreneurial purposes the poor borrowers often lack the technical/business skills and market information to make their businesses viable. Further, the transaction costs of rural loans are significantly higher since the loan size is usually small, there is widespread illiteracy among poorer clients and they are spread over a large geographical area.

From the perspective of the borrowers, rural banks are unattractive for multiple reasons as well. As noted previously,



the services offered by banks are not well suited to the non-uniform income patterns of the poor, compounded with the transaction costs and in some cases bribes to bank officials, banks begin to seem as tedious an option as usurious moneylenders. Borrowers also usually have to travel long distances from their villages to reach the bank, and alongside paying for the transportation cost, lose close to a day's wages due to the time spent traveling. Finally, bank loans take, on average, about 33 weeks to process, and are made out against collateral, making them unviable for poorer rural borrowers.

### **DRAWBACKS OF INFORMAL FINANCE**

The RFAS-2003 report indicates that informal finance remains the mainstay of rural borrowers, where 44% of the households surveyed had borrowed from informal sources at least once over the past year and the interest charged on these loans averaged 48% per annum. Interestingly, while nearly half the loans were used to finance "family emergencies" and "social expenditures" (related to births, deaths, marriages etc.) and only 13% were used for investment related purposes. The attractions of informal finance range from flexible repayment schedules to ease of access to the loans and less reliance on collateral. However, it was noted that in most cases where collateral was involved, landless and marginal farmers tended to pledge self-labor in lieu of other assets, thereby leaving them vulnerable to exploitation as bonded labor. Until the 1980s, credit for agriculture was accorded high priority and the presence of informal microenterprises – street vendors, home workshops, market stalls, providers of informal transportation services etc. were perceived by policymakers and economists to be a result of economic dysfunction. The typical profile of those operating in the informal economy include a scarcity of capital, non-legal status, operation in unregulated markets, labor intensive production modes, non-formal education and low skill levels, irregular work hours and small inventories. While these traits formerly led to their exclusion from access to formal finance, commercial microfinance recognizes the profit-potential of the informal sector, which not only provides employment to millions in India, but is also an important contributor to the economy.

### **THE MICROFINANCE AGENDA**

To begin with, microfinance set out to address income and gender inequality by empowering poor women. In the course of time, the emphasis shifted to sustainability and outreach and lately, the core emphasis seems to have become profit generation.

Institutional microfinance started as a means of alleviating poverty and helping the poor to create sustainable livelihoods for themselves. Optimists argue that "microfinance seems to have squared the circle; this was an intervention that could not only alleviate poverty, but that could and should also pay for itself, be sustainable and even make profits. Only in that way, it is argued, can it reach the millions who need it." Against the backdrop of the global financial/liquidity crisis, the microfinance sector has stood firm and continually shown higher profits and weathered the global financial crisis better than many of the trusted institutions of mainstream finance. The perception that catering to the poor is risky business seems to have firmly been proved wrong by microfinance.

Writing about the limitations of the post-independence development initiatives in India, Udaia Kumar rightly points out that "The experts and technocrats, who tailored development programs for such a vast country (India), failed to provide the necessary space for the involvement of the local community in the design, implementation and monitoring of such programs." Microfinance is poised well to infuse some democratic spirit into development initiatives, seeing client satisfaction as the premise for its financial sustainability.

However, it is still debatable whether microfinance can make profits and pursue the social welfare agenda at the same time. Christopher Dunford of 'Freedom from Hunger' believes that these are irreconcilable aims. He argues that "profitability and growth are more likely to be achieved by offering more services to the same clients, rather than reaching out to new ones" and if this is achieved "the client profile will inevitably drift upwards and away from the poor, and what started like a businesslike activity with charitable goals will become no more than another profit seeking business."

## **CONCERN IN INDIAN MICROFINANCE SECTOR**

### **MISSION DRIFT**

It would be foolhardy to believe that the involvement of banks and other financial institutions is simply altruistic. After all, microfinance has been recognized as an astute business opportunity, and herein lies another potential negative turn of events. There is an apparent shift in the focus of MFIs, from the philanthropic bent and missionary zeal to alleviate poverty, towards the hard-nosed business ethic of calculating success based on the financial bottom line. In an environment where the measure for success often remains the number of loans disbursed or the number of clients acquired, the poor often become casualties rather than beneficiaries. Malcolm Harper points out that poor people have always been prey to unscrupulous and recalcitrant moneylenders or other bogus savings institutions. Therefore, there is a very real risk that in the guise of genuine MFIs, swindlers or worse incompetent people may injure them even further.

### **USE OF LOANS**

There is a latent assumption that microloans will lead to entrepreneurial and profit generating activity, thereby perpetuating a virtuous cycle of poverty reduction. However, the reality is that a large portion of loans are taken for non-productive activities, such as weddings, funerals, dowries, roof-repair, subsistence etc. This is not to say that such activities do no merit loans, in fact, one of the primary merits of microfinance is that it makes the poor less vulnerable to destitution by making available these small loans. It may also be argued that by smoothing over the expenditure on food consumption of a farmer for instance, a microloan may allow him/her to work better in the fields, and is therefore eventually remunerative.

"The clients of microfinance institutions have always used some of their loans for purposes other than microenterprise investment. This may still be known as 'misuse' by some agencies but most providers of microfinance services are coming to realize that money is fungible, and that their

customers probably know better than they do how to best use their money.”

However, a cautionary note must be added that when microloans are made available of for non-remunerative purposes, by an over-zealous loan officer to a financially-uneducated client, they may engender a spiral of further poverty. The State of the Sector (SOS) Report 2009 explicitly warns against such loans and recommends that the ability of the client to repay the loan amount must be established prior to the disbursement of the loan.

## MULTIPLE-BORROWING

Often when a borrower is unable to repay a microloan within the stipulated time, she may be forced to take another loan, from a different MFI in order to meet her commitment. The problem of multiple lending has permeated most regions in southern India, where there is a high concentration of MFIs, and intense competition to woo the maximum number of clients. In such a scenario, it would be appropriate to cite Pischke's dictum that 'microcredit is also micro debt'.

As MFIs expand and loan officer incentives are tied to client repayment, there may be a clash between profitability and sensitivity to client needs and circumstances. The most heinous consequence of taking a microloan and being unable to repay it was evident in the much publicized Krishna district debacle of 2006 where some farmers committed suicide due to the debt-burden. However, to the credit of the microfinance community, there is a concerted effort towards sensitizing field officers and higher management towards the needs of the microfinance clientele. In fact, Indian NBFC MFIs have come together to initiate the formation of a 'credit-bureau' in order to avoid the cataclysmic consequences being repeated elsewhere. Most MFIs have some sort of procedure in place to re-schedule loan repayments in the face of genuine circumstances.

## QUALITY ISSUES

There have also been allegations against the quality of MFIs in India, many of which suffer from weak governance and management structures, the absence of internal controls and the lack of financial discipline. This is particularly true of the many opportunistic start-up enterprises that are keen on cashing-in on the current microfinance boom. Attracted by the high returns that established MFIs have yielded for their investors, these start-ups are able to break even in a mere 18 months of operation, at the risk of providing poor quality services and charging high rates of interest to clients.

## OVER-EMPOWERMENT

Shahin Yaqub of BRAC offers another interesting perspective when he writes that "poor people save and repay as instructed and work within the often inconvenient group mechanisms. When microfinance helps them to become less poor, they become empowered." He writes that, "Empowerment and virtue are not the same thing" suggesting that in their empowered position, poor people are better able to resist not just unjust socio-political conditions, but also the legitimate claims of microfinance and are no longer willing to be subservient to the MFIs various procedural demands.

## REGULATION OF INDIAN MFIS

The Indian government mandates a policy where banks are required to direct 40% of their lending to the "priority sector" segment (including agriculturalists and other rural borrowers) of the economy. Banks have the option of subscribing to government issued bonds to fulfill this requirement, but more and more commercial banks are now financing microfinance loans, as these are more lucrative.

Two separate incidents, in recent years, that greatly embarrassed the Indian microfinance community have reinforced the need to put regulatory mechanisms in place. In the Krishna district of Andhra Pradesh the government shut down certain MFI branches after farmers committed suicide due to indebtedness, while in Kolar district of Karnataka, the local Muslim leadership forbid Muslim women from repaying MFI loans, leading to large scale default with the crisis, spreading to non-Muslim communities as well. Interestingly, after the debacles in the Krishna and Kolar, the microfinance industry has become increasingly keen on establishing a regulatory framework, and a microfinance bill, pending in the parliament is eagerly anticipated.

Currently, non-profit MFIs in the form of trusts or societies are unregulated, while NBFC MFIs are regulated by the reserve bank.

However, the RBI includes them under the broad spectrum of all Non-Banking Finance Companies. There are therefore no special regulations for the microfinance industry, an oversight which will hopefully be corrected by the microfinance bill.

## THE NORTH-SOUTH SKEW IN INDIA

There is a distinct regional imbalance in the access to financial services, whereby the most heavily populated and poverty stricken regions of eastern, central and north-eastern India have a disproportionately lower level of financial access. While these states account for 54 percent of the country's population and 40.5 percent of the total bank branches, they have only a 20 percent share in outstanding bank credit and 29 percent share of deposits. The growth and spread of MFIs has reflected a similarly skewed trend, where the more prosperous southern states are nearly saturated, and the poorer states show a rather sparse presence of MFIs.

## CONCLUSIONS

While microfinance remains a small proportion of the overall financial system in terms of portfolio size, it is growing much faster; bank credit grew by 17.5% during 2008-09 while microfinance portfolios grew by around 100%. As a result, in terms of portfolio size as well as number of clients served it is becoming an increasingly significant part of the financial system. Deposit services remain a distant dream. Thrift deposits are accepted formally by MFIs from their members and are recorded as part of their balance sheets wherever these are legally permitted. The magnitude of MFIs deposit services in India is limited by the fact that not all MFIs are allowed by the regulator to offer such services.

Given recent actions by the Government of Andhra Pradesh, the expected deterioration in portfolio quality as a result, it is quite likely that there will be an increase in costs incurred by Indian

MFIs to maintain lending standards while ensuring portfolio

quality. At the same time, it is likely that the portfolio yield will decline in response to the political and media pressure on interest rates to end-clients. The implications of such drastic interventions by the government for the long-term sustainability of MFIs are difficult to predict. At best it will result in a decline in capital available for microfinance, thereby slowing down the financial inclusion effect of MFIs operations; at worst it could destroy microfinance altogether, resulting in throwing low income families back into the not-so-benevolent arms of moneylenders.

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## APPENDIX

Top 10 MFIs with their Gross Loan Portfolio (GLP) and active number of borrowers as on 30th Sep 2012.

SN	MFIs	GLP (Million \$)	Active number of borrowers
1	BANDHAN	663.197	3,968,326
2	SPANDANA	531.670	3,399,958
3	SHARE	366.692	2,187,952
4	SKDRDP	295.975*	1,015,440**
5	SKS	249.733	3,976,564
6	AML	241.782	1,136,100
7	EQUITAS	175.796	1,113,576
8	UJJIVAN	156.676	890,491
9	Grama Vidyalaya Microfinance	83.627	711,815
10	BASIX	55.974	406,423

\* Figures as of 30th June 2012

\*\* Figures as of 31st March 2012