A COMPREHENSIVE STUDY ON MICRO FINANCE INSTITUTIONS IN INDIA

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ABSTRACT
Microfinance in India has been viewed as a development tool which would alleviate poverty and enhance growth of the country through financial inclusion. Out of 6 lakh villages in India, only approximately 50,000 have access to finance. India is a country which has the highest number of households which are excluded from banking. More than subsidies poor need access to credit. Absence of formal employment make them non ‘bankable’. This forces them to borrow from local moneylenders at exorbitant interest rates. Many innovative institutional mechanisms have been developed across the world to enhance credit to poor even in the absence of formal mortgage. The present paper discusses the conceptual framework of a microfinance institution in India. Types of microfinance institutions, benefits extended by MFIs, ills of micro finance institutes, and future prospects of MFIs.

KEY WORDS: Micro finance institutions, Bank Linkage Programme.

Introduction to Micro Finance

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 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.

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
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.

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<th>Sl. No.</th>
<th>Type of MFI</th>
<th>Number</th>
<th>Legal Registration</th>
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| 1      | NGOs        | 400-500| Society Registration Act, 1860  
Indian Trust Act, 1882 |
| 2      | Non-Profit companies | 20    | Section-25 of Indian Companies Act, 1956 |
| 3      | Mutual benefit MFIs – Mutually Aided Cooperative Societies (MACS) | 200-250 | Mutually Aided Co-operative societies, Act enacted by State Governments |
| 4      | Non-Banking Companies (NBFCs) | 45    | Indian companies Act, 1956  
Reserve Bank of India Act, 1934 |

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.

Growth of Micro finance in India:
- MFIs operate in 517 districts in India spread across 27 states. The total MFI client outreach as of March 2011 was 3.17 crores, while the total microcredit outstanding was Rs. 2500 crores which have been scrutinized to banks.
- During 2010-11, the microfinance through MFI channel has grown 18.75 percent in 2011 in terms of client outreach and 13.15 percent in terms of credit portfolio.
- This year loan portfolio growth rate has decreased to 13.15 percent compared to 56 percent in the previous year.
- MFIs collectively disbursed Rs. 33730 crores as loans to clients during 2010-11. Also, the average loan per client stood at Rs. 5706, which is less than that of Rs. 9766 in the last year.
- In 2010-11, more than one third of the MFIs displayed negative growth in client and loan portfolio.

MAJOR SCHEMES OFFERED BY MFIs:
1. **GIDKA** (Group Insurance Scheme for Khadi Artisan) With a view to provide safe and secured life to Khadi Artisan a Group Insurance Scheme for Khadi Artisans has been introduced. The Scheme covers all the spinners, weavers, pre-spinning artisans and post-weaving artisans engaged in Khadi activity, associated with Khadi Institutions (NGO’s) throughout the Country.

2. **DRDA** (The District Rural Development Agency) The district Rural Development Agency is visualized as specialized and professional agency capable of managing the anti-poverty Programmes of the Ministry of Rural Development on the one hand and to effectively relate these to the overall effort of poverty eradication in the district.

3. **NIRD** (National Institute of Rural Development) National Institute of Rural Development (NIRD) facilitates rural development through government and non-governmental initiatives. NIRD is the country’s apex body for undertaking training, research, action and consultancy functions in the rural development sector. It works as an autonomous organization supported by the Ministry of Rural Development, Government of India.
4. **NRRDA** (National Rural Road Development) Construction of rural roads brings multifaceted benefits to the hitherto deprived rural areas and also an effective poverty reduction strategy. Pradhan Mantri Gram SadakYojana Awareness of Schemes and Services of Micro Finance Institutes (PMGSY) were taken up by the Government of India with an objective to provide connectivity to the unconnected Habitations in the rural areas.

5. **CAPART** (Council for Advancement of people’s Action and Rural Technology) Council for Advancement of People’s Action and Rural Technology (CAPART) is an autonomous body registered under the Societies Registration Act, 1860 and is functioning under the aegis of the Ministry of Rural Development. CAPART is involved in catalyzing and co-coordinating the emerging partnership between Voluntary Organizations and the Government of India for sustainable development of Rural Areas.

6. **RIDF** (Rural Infrastructure Development Fund): It provides by State Governments, Panchayat Raj Institutions (PRIs), Non-Governmental Organizations” (NGOs) and Self-Help Groups (SHGs). Activities Covered: Primary Schools, Primary Health Centres, Village Haats, Joint Forest Management, Terminal and Rural Market, Rain Water Harvesting, Fish Jetties, Mini Hydel and System Improvement Projects in Power Sector, Rural Drinking Water Supply Scheme, Citizen Information Centers, Anganwadi Centers and ShishuShikshaKendras.

**Ills of Micro Finance:**

**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. 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.

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 other’s’ 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.

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. 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.

**Future of MFI Sector**
- Regulatory framework will increase with the formation of NBFC-MFIs
- Cap on Interest pricing to further limit the profitability of the sector.
- Increased competition from other financial Institutions like Banks & NBFCs entering the MFI sector.
- Increase in defaults on loan has already hampered the MFI sector in Andhra Pradesh and this may spread to other states.

**Conclusion**
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, counseling etc.

Microfinance has the unique ability to provide sustainable development services if they are designed and implemented properly. Clients do not want lending or savings facilities just for the next three to five years. They want-and deserve-a safe place to save their money and a convenient place to borrow funds indefinitely. Only by fulfilling the commercial mission of microfinance, lenders provide this valuable service over time-and generate its important development benefits. In the last two decades, two new aspects were incorporated into microfinance that made it a more effective and enduring development strategy. If micro lending was done well, it could be part of a sustainable development strategy.

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