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MICRO FINANCE IN INDIA: CHALLENGES

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Abstract
Micro Finance is buzzing word, used when financing for micro entrepreneurs. Concept of micro finance is emerged in need of meeting special goal to empower under-privileged class of society, women, and poor, subjugated by natural reasons or men made; caste, creed, religion or otherwise. It is the supply of loans, savings, and other basic financial services low-income clients, 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. Microcredit, or microfinance, is banking the unbankables, bringing credit, savings and other essential financial services within the reach of millions of people who are too poor to be served by regular banks, in most cases because they are unable to offer sufficient collateral.

Keywords: Financial Services, Banking, Micro Entrepreneur, Poverty, Loans and Savings.

INTRODUCTION

Microfinance is the provision of financial services to low-income clients, including consumers and the self-employed, who traditionally lack access to banking and related services. The two main mechanisms for the delivery of financial services to such clients are: (1) relationship-based banking for individual entrepreneurs and small businesses; and (2) group-based models, where several entrepreneurs come together to apply for loans and other services as a group. More broadly, it is a movement whose object is "a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers." Those who promote microfinance generally believe that such access will help poor people out of poverty. Microfinance institutions and other financial service providers have worked over the past decades to develop products and delivery methods to meet the diverse financial needs of low-income people. Microfinance providers today continue to improve their understanding of the financial needs of their target clients and tailor their products and methodologies accordingly.

The language of microfinance has undergone a fundamental change in the two decades of its evolution. Microfinance started with the recognition that poor people had the capability to lift themselves out of poverty if they had access to affordable loans. High repayment rates in the industry have changed the perception that the poor are not credit worthy. With the right opportunities, the poor have proved themselves to be productive and capable of borrowing, saving and repaying, even without collateral.
According to consultative group to assist the poor (CGAP), the main objectives of micro finance institutions (MFIs) are:

- To help the poor and needy meet their requirements and reduce risks
- To improve their economic condition through small loans and saving products
- To provide self-employment opportunities especially to women

OBJECTIVES OF THE STUDY

- To examine the current status of microfinance industry in India
- To understand various challenges associated with micro finance in India and suggestions to face them.

RESEARCH METHODOLOGY

This is a descriptive research paper based on secondary data. Data have been collected through various websites and publications of recent research papers available in different websites.

HISTORY OF MICRO FINANCE

Loans to poor people by banks have many limitations including lack of security and high operating costs. As a result, microfinance was developed as an alternative to provide loans to poor people with the goal of creating financial inclusion and equality. **Muhammad Yunus**, a Nobel Prize winner, introduced the concept of Microfinance in Bangladesh in the form of the **"Grameen Bank".** Micro-finance has existed in various forms for centuries, and even longer in Asia, where informal lending and borrowing stretches back for several thousand years. However, the formal birth of 'modern' micro-finance is said to have occurred in the mid 1970s in rural Bangladesh. The beginnings of the microfinance movement are most closely associated with the **economist Muhammad Yunus**, who in the early 1970's was a **professor in Bangladesh**. In the midst of a country-wide famine, he began making small loans to poor families in neighbouring villages in an effort to break their cycle of poverty. The experiment was a surprising success, with Yunus receiving timely repayment and observing significant changes in the quality of life for his loan recipients. Unable to self-finance an expansion of his project, he sought governmental assistance, and the Grameen Bank was born. In order to focus on the very poor, the Bank only lent to households owning less than a half-acre of land. Repayment rates remained high, and the Bank began to spread its operations to other regions of the country. In less than a decade, the Bank was operating independently from its governmental founders and was advertising consistent repayment rates of about 98%. In 2006 Yunus was awarded the Nobel Peace Prize. The success of the Grameen Bank did not go unnoticed. Institutions replicating its model sprang up in virtually every region of the globe.

MICRO FINANCE IN INDIA

Microfinance in India has had a significant shift from the days when microfinance was being discussed as the next big innovation to address the poverty issues in India to being discussed in terms of the next big investment opportunity.The National Bank for Agriculture and Rural Development (NABARD) took this idea and started the concept of microfinance in India. Under this mechanism, there exists a link between SHGs (Self-help groups), NGOs and banks. SHGs are formed and nurtured by NGOs and only after accomplishing a certain level of maturity in terms of their internal thrift and credit operations are they entitled to seek credit from the banks. There is an involvement from the concerned NGO before and even after the SHG-Bank linkage. It involves commercial banks, regional rural banks (RRBs) and cooperative banks in its operations. Based on the concept of “self-help,” small groups of women have formed into groups of ten to twenty and operate a savings-first business model whereby the member’s savings are used to fund loans. The results from these self-help groups (SHGs) are promising and have become a focus of intense examination as it is proving to be an effective method of poverty reduction. The loan portfolio of India’s microfinance sector is set to grow at a compounded annual rate of 35 per cent, to reach Rs.450 billion by end-March 2016. Unlike in the period prior to the Andhra Pradesh crisis, the microfinance institutions’ (MFIs’) current growth phase is more resilient, supported by stronger building blocks and a rebound in stakeholder confidence. But to sustain the current pace of growth, MFIs will have to raise equity. To do so, they will need to address challenges associated with low promoter shareholdings and a near-term decline in profitability.

Microfinance Institutions Network, the industry body of Microfinance Companies in India announced that MFI’s registered a growth of 44% on their Gross Loan Portfolio to touch Rs 26,150 crore in the first quarter of FY2015 when compared to Q1 of FY2014. The top states which saw the largest increase in disbursements were West Bengal, Tamil Nadu, Karnataka, Maharashtra and Uttar Pradesh. These states totally accounted for 60% of the disbursements carried out by Microfinance Companies.

In this context the main **features** of microfinance are:

- Loan given without security.
- Loans to those people who live below the poverty line.
- Members of SHGs may benefit from micro finance.
- Maximum limit of loan under micro finance Rs25,000/- which means loans are of small amount- micro loans.
- Terms and conditions offered to poor people are decided by NGOs.
- Microfinance is different from Microcredit- under the latter, small loans are given to the borrower but under microfinance alongside many other financial services including savings accounts and insurance. Therefore microfinance has a wider concept than microcredit.
- High frequency of repayment.
- Loans are generally taken for income generation purpose.

WHO ARE MICROFINANCE CLIENTS?

Typical microfinance clients have low incomes and are often self-employed in the informal economy, conditions that together typically deny them access to banks and other formal financial institutions. They commonly run small stores or street stalls, create and sell items they make in their homes, and in rural areas, microfinance clients may be small-scale farmers and those who process or trade crops and goods.

Microfinance clients are often just below or above the poverty line, and women constitute a majority of borrowers. Over the past decades, financial institutions have been developing a range of products to meet the diverse needs of this broad and underserved market.

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PRINCIPLES OF MICROFINANCE

Some principles that summarize a century and a half of development practice were encapsulated in 2004 by CGAP and endorsed by the Group of Eight leaders at the G8 Summit on June 10, 2004:

- Poor people need not just loans but also savings, insurance and money transfer services.
- Microfinance must be useful to poor households: helping them raise income, build up assets and/or cushion themselves against external shocks.
- "Microfinance can pay for itself."[22] Subsidies from donors and government are scarce and uncertain and so, to reach large numbers of poor people, microfinance must pay for itself.
- Microfinance means building permanent local institutions.
- Microfinance also means integrating the financial needs of poor people into a country's mainstream financial system.
- "The job of government is to enable financial services, not to provide them."
- "Donor funds should complement private capital, not compete with it."
- "The key bottleneck is the shortage of strong institutions and managers."
- Donors should focus on capacity building.
- Interest rate ceilings hurt poor people by preventing microfinance institutions from covering their costs, which chokes off the supply of credit.
- Microfinance institutions should measure and disclose their performance—both financially and socially.

CHALLENGES ASSOCIATED WITH MICRO FINANCE

Ultimately, microfinance is designed as a tool to reach impoverishes households that are not otherwise served by more traditional financial institutions. There are several reasons why it is difficult to lend money to the poor.

Hidden information: The primary problem with lending to the poor, and the main obstacle that microfinance is designed to overcome, is banks' lack of information about the inherent riskiness of potential clients. The transaction costs of evaluating individual borrowers are very high relative to the size of the loans likely to be made to poor borrowers. This means that to cover the expense of screening individual borrowers banks would be forced to charge correspondingly high interest rates to their clients. Moreover, it is doubtful whether screening will provide accurate information. Without accurate information, banks will still charge high rates to cover the frequent incidence of default among the risky borrowers that will inevitably join their client base. Either way, interest rates will be high enough to drive borrowers with safe but relatively low returns out of the market.

Governments sometimes respond to this problem by imposing restrictions on interest rates charged by financial institutions in the form of usury laws or interest rate caps. With rates constrained, it would become impossible to provide banking services to the poor without significant and costly subsidies.

Moral hazard: Even borrowers whose projects are not inherently risky may refuse either to use their loans productively or, if they do use the loans productively, to repay their loans if their lenders have no means of enforcing their obligations. This problem of moral hazard may arise because, for instance, local judges are biased in favour of debtors or police forces are stretched too thin to provide assistance. This problem can be exacerbated by competition among lenders, as in the absence of competition a lender can encourage repayment by refusing to provide future credit.

Lack of collateral: Another response to problems of hidden information is to require that borrowers provide collateral, meaning an asset that the lender can easily seize and, perhaps, sell in the event of default. This allows banks to charge low interest rates even in the face of poor information about the borrower's prospects. But many of the impoverished borrowers that microfinance seeks to reach lack assets that can effectively serve as collateral. When they do have assets, they have are often illiquid. Livestock, for example, is not only subject to destruction, but can be very difficult to convert on the market for a traditional bank inexperienced in selling it. Furthermore, among these sorts of clients the only assets they have may be critical to their means of subsistence and legal or ethical restrictions may prevent banks from foreclosing upon them.

Absence of credit history: In societies with developed credit markets, problems stemming from inadequate information and moral hazard are mitigated by the fact that lenders routinely investigate borrowers' credit histories. A record of a borrower's repayment history provides lenders with valuable information about the likelihood of future repayment. In addition, the ability to tarnish a borrower's credit history and thereby limit the borrower's access to future credit provides lenders with leverage that they can use to induce repayment.

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Uncertainty and default risk: Uncertainty and default risk are the major challenges faced by the Microfinance institutions in India. Most of the rural people in India have volatile and irregular income and their expenditure patterns are very bad. The rural people in India are highly exposed to the systematic risks like the crop failures or the fall in the commodity prices and as a result, they face difficulties while servicing the loans. So, the microfinance institutions have legitimate concerns when they are dealing with the poor people living in the rural areas and they tend to perceive the loans very risky.

Lack of policy planning: The regulatory and financial policies of the Government in India are also not so strong and there are various gaps in the policies announced by it and the policies often end up with higher financial risk for the MFIs. The risks can be like high fiscal deficits, interest rate policies and improper credit planning policy of RBI etc.

Profit Motive: A paradigm shift in the focus of the MFI's from "social motive" to "profit motive" has led to emergence of "For Profit MFI's" in the recent years. This change in focus is putting a lot of stress on the managements of the MFI's to show increased growth and astounding loan portfolios. Since these MFI's have equity participation from fund managers and private individuals, they are faced with increased competition to show financial growth and improved rate of return.

Regional Disparity: It has been observed that the microfinance programme is mainly run by formal financial institutions with the help of SHGs. As a result, microfinance programme is progressing in those areas of the country where there is tremendous growth of formal financial institutions. Microfinance institutions were expected to reach those areas where the formal banking system failed to reach and the poor people have to depend on the money-lenders in order to meet their financial requirements. But actually, many big MFIs are activated in those states where the banking network is very strong. In the southern states, such as Andhra Pradesh, Tamil Nadu, Karnataka and Kerala, the spread of SHG bank linkage programme as well as the MFI programme is very large. But the north and north-eastern region is almost neglected.

Not aimed at lifting people out of poverty: Micro finance serves not to lift people out of poverty but, assist those near or slightly above the poverty line. Money is given to those people who have a possibility of returning the principle amount. This leads to the fact that lending money to these people is feasible and sustainable, while lending to the poorest of the poor is not.

RECOMMENDATIONS

Proper regulation: The regulation was not a major concern when the microfinance was in its growing 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.

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.

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.

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.

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.

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

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unit money lent (9%-10%) of such institutions. Also initiatives like development of common MIS and other software for all MFIs can be taken to make the operation more transparent and efficient.

CONCLUSION

Microfinance can play a role in the battle against poverty in India. The microfinance sector in India has developed a successful and sustainable business model which has been able to overcome challenges traditionally faced by the financial services sector in servicing the low income population by catering to its specific needs, capacities and leveraging pre-existing community support networks.

In the last two decades, substantial progress has been made in developing techniques to deliver financial services to the poor on a sustainable basis. Over the years, major commercial banks and multinational corporations have decided to sponsor it. However, this type of financing has a darker side too. Poor people are being harassed by the microfinance institutions (MFIs) for their inability to repay the debt. This has raised serious moral and ethical issues against the institutions. The aggressive debt-collection tactics of these MFIs have left us wondering if the government has been playing ignorant to the modus operandi of MFIs. Moreover, the interest rates charged by micro financing institutions are usurious.

Thus, there is a great need to set out rules limiting interest rates and stipulating legal consequences for the MFIs who badger/ harass borrowers for payments.

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