

# PERFORMANCE OF MICRO FINANCE IN INDIA RECENT CHALLENGES AND REMEDIES .

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The paper attempts to define microfinance based on the financial needs of poor people, identify the constraints in carrying out this business, and find out solutions to the problems. It discusses the merit of linkage of formal and informal systems of financial operations and evaluates the functioning of different models of micro financing in India. Whereas the formal system ensures access to large and cheap financial source, the informal system facilitates convenient financial transactions according to need. The paper then compares (i) individualistic and cooperation approach, (ii) Self Help Group (SHG) and Bangladesh Grameen Group (BGG) models and (iii) Federation and Cooperatives. It argues that although individualistic approach has less hassle, transaction cost and risk are high. The group formation cost in cooperation approach, although high in the short run, tapers down in the long run. Empowerment content in SHG is much higher than in BGG, as members of the former are trained to undertake larger responsibilities. Scope of savings and self reliance so far as financial dependence is concerned is much higher in SHG. That's why financial institutions may prefer BGGs with whom they may have credit relationship for a longer period. Whereas cooperatives generally have been hijacked by richer people because of management of a large, heterogeneous group by a small group of people, in Federation the possibility of the same is non-existent. In India the microcredit is in a dismal situation. Even among the 196 Regional Rural Banks, 28 per cent have Credit-Deposit (CD) ratio of less than 25 per cent; only 25 per cent have more than 50 per cent of CD ratio. Only 22 per cent of public sector banks have financed 10 per cent of their net bank credit to weaker section, i.e. customers of microcredit. Informal market after declining in 1981 has again grown in 1991 in rural areas. This gap is mainly because of two types of constraints: (i) attitudinal and (ii) institutional. Appropriate policies are required to

overcome these constraints. These are (i) official definition of microfinance, (ii) ensuring the microfinance services, (iii) approach to subsidy, (iv) banking policies, (v) management information system and (vi) legislation processes.

The majority of developing nations are struck with poverty as a leading roadblock to their progress. The main factor that influences the widespread poverty in regions like India is the massive disparity in income distribution. Being an agrarian economy primarily, more than half of the Indian population sustains on agriculture and allied activities.

Both the manufacturing and tertiary sector have been making steady progress since the last two decades, but still, there is a long way before they outgrow the former. The large agrarian sector of the Indian population seems deprived of formal financial services due to the limited functioning of the tertiary industry. It is an important reason why the agricultural industry has suffered from staggering growth in the past.

**The concept of microfinance** was introduced in the Indian economy with the primary objective of financial inclusion of more impoverished and backward sections, especially the women. The growth trajectory of the Indian microfinance industry has been phenomenal since the time it was introduced.

Factors like the support of the National Bank for Agriculture and Rural Development (NABARD), linkage of the banking system with the self-help

groups have further steered the underserved sectors of the Indian economy towards success through microfinance.

However, when it comes down to comparing the plush success of commercial banks, it is only fair to conclude that microfinance institutions have a long way to go. Not only do microfinance institutions lag in structural and operational approach, but also in overall financial processes.

## Here are Challenges faced by Microfinance Institutions

### 1. Over-Indebtedness

The microfinance sector deals with marginalized sections of Indian society intending to improve their standard of living, and thus over-indebtedness poses a severe challenge to its growth. The growing trend of multiple borrowing by clients and inefficient risk management are the most significant factors that stress the microfinance industry in India. The microfinance sector gives loans without collateral, which increases the risk of bad debts. Fast-paced growth needs proper infrastructural planning, in which the Indian microfinance sector evidently lacks.

## **2. Higher Interest Rates in Comparison to Mainstream Banks**

The financial success of MFIs is limited when compared to commercial banks in India. The centuries-old banking system has a strong foothold in Indian grounds and is slowly evolving to meet the needs of the times. Most Microfinance Institutions charge a very high rate of interest (12-30%) when compared to commercial banks (8-12%). The regulatory authority RBI issued guidelines to remove the upper limit of 26% interest on MFI loans.

While many MFI sector players benefited from the RBI guideline update, the borrowers were left for the worse. A massive trend of farmer suicide in states like Andhra Pradesh and Maharashtra is the outcome of borrower indebtedness that resulted from the higher interest rates.

## **3. Widespread Dependence on Indian Banking System**

Because most microfinance institutions function as registered Non-Governmental Organizations (NGOs), they are dependent on financial institutions such as commercial banks for stabilized funding to carry out their own lending activities. Most of these commercial banks are private institutions charging a higher rate of interest. They also sanction loans for shorter periods. The massive dependence of Indian MFIs on banks makes them incompetent as a lending partner.

## 4. Inadequate Investment Validation

Investment valuation is a crucial capability for the healthy functioning of an MFI. The developing nature of the markets in which MFIs operate, the market activity is often limited. That is why it becomes difficult for MFI to gain access to market data for valuation purposes.

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Lack of consistent and reliable valuation procedures, MFI management teams, are unable to achieve the level of quality information that they need to be able to make investment decisions

## 5. Lack of Enough Awareness of Financial Services in the Economy

A developing country in the making, India has a low literacy rate, which is still more moderate in its rural areas. A large chunk of the Indian population fails to understand the basic financial concepts. There is a severe lack of awareness of financial services provided by the microfinance industry among the masses. This lack of adequate knowledge is a significant factor that keeps the rural population from accessing MFIs for easy credit to meet their financial needs.

It also contributes to widespread financial exclusion in the country. The additional task of educating masses and establishing trust before they initiate loans also falls on the shoulders of MFIs. The severe lack of awareness about policies and products



offered by MFIs make it difficult for these institutions to sustain in excessively competitive environments that developing nations are home to.

## 6. Regulatory Issues

The Reserve Bank of India (RBI) is the premier regulatory body for the microfinance industry in India. However, RBI more or less caters to commercial and traditional banks more than it helps MFIs. Even the needs and the structure of microfinance institutions are entirely different from those of other conventional lending institutions.

Some regulations seem to have benefitted the MFIs, but others left numerous issues unaddressed. In spite of sporadic and unprecedented regulatory changes, the Microfinance industry appears to have been struggling to sustain. While new regulations result in structural and operational changes, they also result in ambiguity in norms of conduct. The result is sub-optimal performance and failure in the development of new financial products and services. Conclusively, there is a need for a separate regulatory authority for the microfinance industry.

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## 7. Choice of Appropriate Model

Most Indian MFIs follow the Self-Help Group model (SHG model) or the Joint Liability Group model (JLG model) of lending. They hardly select the model based

on scientific reasoning. Most MFIs choose the models randomly, regardless of the situation.

What's more, is that the choice of the model increases the risk of borrowings for the weaker section beyond they can bear and is irreversible. In the end, the decision of the model affects the sustainability of the MFI organization in the long-run.

### **Over-indebtedness due to multiple borrowings and inefficient risk management**

*Microfinance institutions (MFI)* provide financial services to the poorer section of the society in order to improve their standard of living. Therefore over-indebtedness is major issue. Lack of [risk management framework](#) and multiple borrowings by most clients led to micro-finance crisis in India in 2008. In some cases, it has been seen that there is no apex control over the *MFIs*'. This sector gives loans without collateral which increases the risk of bad debts. Moreover the fast paced growth of the sector has not been met with proper infrastructure planning. This kind of problems has been reported in states like Andhra Pradesh, Karnataka, and Madhya Pradesh (Singh, 2016). Over indebtedness is a cause of concern for *MFIs*' as it negatively affects their portfolio. It also makes them vulnerable to [credit risk](#) and increases the cost of monitoring (Schicks 2013).

### **High rates of interest as compared to mainstream banks**

*MFIs*' when compared to commercial banks do not enjoy the same rate of financial success. One of the reason is that while banking system is centuries old, micro finance is only a few decades old in India (Pathneja, Narwal and Kumar, 2015). *MFIs*' charge a very high rate of interest (12-30%) as compared to commercial banks (8-12%). Recently, the RBI (India's regulatory bank) announced the removal of upper limit of 26% interest on MFI loans (ET, 2014). This has benefited the industry's players but left the customers in a worse situation than before. Due to the issues of over-indebtedness caused by the charging of high interest rate, rate of [suicide of farmers](#) increased in states like Andhra Pradesh and Maharashtra

## Over-dependence on banking system for funding

Majority of the *MFIs*' in India are registered as Non Governmental Organizations (NGOs). They are dependent on financial institutions such as commercial banks for stabilised funding for their own lending activities. Around 80% of their funds come from banks. Most of these are private banks which charge a high rate of interest and also the term of loans is of shorter period. Most of the times, banks lend to microlending firms in order to meet their so-called priority sector loan targets (Unnikrishnan, 2012). The over dependence of Indian microfinance industry on banks make them incompetent and less reactive towards dealing with default and delinquencies (Sapundzhieva 2011)).

## Lack of awareness of financial services

Like all other developing and underdeveloped countries, the literacy rate in India is very low and the rate is much lower in the rural areas. Nearly 76% of India's adult population does not understand basic financial concepts (Sud, 2017). Lack of awareness of financial services provided by the Indian microfinance industry is a challenge for both, customer and *MFIs*'. This factor not only causes hindrance for villagers to join hands with *MFIs*' to meet their financial needs but also makes them financially excluded. *MFIs*' are faced with the task of educating the people and establish trust before selling their product. Micro finance institutions struggle to make their business more financially viable due to this lack of awareness (Ancona 2014).

## Regulatory issues

Presently the Reserve Bank of India (RBI) is the regulatory body for the microfinance industry in India. However it has traditionally catered to commercial and traditional banks rather than *MFIs*'. Moreover the needs and the anatomy of micro finance industry is supremely different from that of banks (*Business Standard*, 2016). In the past the industry has undergone sporadic and unprecedented regulatory changes. Some of these have benefited the industry greatly, but a lot of issues were unaddressed, like creating barriers for entry to restrict unworthy players (PwC, 2016). Not only has it led to constant structural and operational changes but also created ambiguity in norms of conduct. Therefore there is a need for a separate regulatory authority for this industry. Regulatory issues have led to sub-optimal performance and



failure in the development of new financial products and services through which the poorer section can be benefitted.

### **Problem in identification of appropriate model**

In India, most of the *MFIs* follow [Self-Help Group model](#) (SHG model) or [Joint Liability Group model](#) (JLG model). The problem is that most of the time, selection of model are not scientific in nature. The models are selected randomly, not according to the situation and also the decision of selection is irreversible in nature. So, it affects the sustainability of the organisation in the long-run and also increases the risk of borrowings for the poorer section beyond they can bear. This is also one of the main reasons of crisis of microlending in the state of Andhra Pradesh. It has been repeatedly stressed that the industry needs to undergo business process reengineering to effectively reach out to the under-financed (PwC, 2016).

### **3.2 Financial performance**

In recent times, financial performance is equally essential for the *MFIs* along with social performance. With a decrease in grants and subsidies, they must attain sustainability to continue and further expand their operations. Even the present donor agencies prefer those non-profit *MFIs* which are financially sound and efficient to ensure efficient utilization of the funds allocated to them ([Quayes, 2012](#)). For profit-making *MFIs*, financial sustainability is a necessary condition to sustain in the market due to mainly two reasons; first, the use of the commercial source of funding increases pressure on them to pay interest on time. Second, providing some income to private equity holders is also crucial to attract more investments. In the changed environment, *MFIs*' attempt to achieve social objectives along with financial sustainability with no or reduced reliance on subsidies ([Robinson, 2001](#)). It is argued that access to credit is a more critical factor than its price ([Yaron, 1994](#)). Therefore, *MFIs* should attempt to create sustainable financial intermediation for the poor at large scale without compromising with the financial self-sufficiency ([Woller et al., 1999](#)).

There are numerous indicators to measure the financial performance of an institution. However, keeping in view the distinct feature of microfinance operations, the current study primarily defines financial performance as the extent to which MFIs can generate revenues to cover the cost of providing services to their clients ([Yaron, 1992](#); [Copestake, 2007](#)). The study employs Operational Self-Sustainability (OSS) as an indicator to gauge the financial performance of the MFIs. Another indicator, profit margin, is used to check the robustness of the results.

### 3.3 Depth of outreach vs financial performance

The researchers and market practitioners have contrary views on the issue of the association between MFI's depth of outreach and financial performance. One view emphasizes that catering financial needs of the poor clients and achieving financial sustainability are broadly complementary while other rejects this complementarity between the two sets of objectives ([Rhyne, 1998](#)).

Though financial sustainability is not an essential or sufficient condition for social welfare, it aids the welfare activities of the organisations ([Navajas et al., 2000](#)). For MFIs, performing financially well is always good, as it helps them to pay back their creditors on time, expand their outreach to newer locations and provide funds for their innovation projects. Financially sustainable non-profit MFIs can gain access to more grants and donations. Financially stable for-profit MFIs can give some returns to their investors, and thereby, attract fresh capital to expand their operations. On this line of thought, there seems no problem if MFIs are trying to do financially well along with their social goals. It further reveals that the primary objective is the only one that is, outreach. Sustainability helps to attain it (no way an end in itself).

Nevertheless, strategic decisions of MFIs often involve situations where MFIs have to compromise with their social objectives to achieve their financial objectives (or vice versa). Depth of outreach increases not only social value (or welfare) but also a social cost. Targeting poor for small loans with daily or weekly repayment schedules increases the operational costs, mainly when clients are scattered in the vast geographical rural region. Moreover, despite the higher repayment rates as reported by many studies, the financial position of the poor remains highly vulnerable to external shocks making them highly risky for the lender. Furthermore, the poor are more heterogeneous and less able to indicate their ability and readiness to repay the loan ([Conning, 1999](#)). All these issues make targeting the poor an expensive affair for MFIs. Charging the poor higher rate of interest is likely to increase the earnings but will hamper the current social performance, termed as poverty penalty [Mendoza \(2011\)](#). A constant support in the form of subsidies and grants can allow an MFI to increase its operations without attaining sustainability ([Morduch, 1998](#); [Woller et al., 1999](#)). However, the failure of similar government institutions and programs to ensure repayments (often due to wilful defaults), raises questions on the existence of the MFIs. More extended outreach through sustainability supports the structures of incentives that serve to maximize social welfare ([Navajas et al., 2000](#)).

On the other hand, providing bigger loans to better-off customers, preferably in urban areas, always has a desirable option for MFIs as it helps them to reap the advantage of economies of scale and low operating costs along with low credit risk. This way, it improves the financial health of the MFIs. Improved financial performance generates funds needed for the expansion of the operations and to initiate innovation projects. Innovations which reduce the costs of providing services can result in immediate improvement in social as well as financial performance ([Mosley and Hulme, 1998](#)).

However, such innovations often require huge investments which again depends on the earnings of the MFIs and, this may lower the actual social performance but will enhance the social performance in future. However, the presence of private capital increases the chances that a large share of profits are distributed among the shareholders [8]. This increases the risk that MFIs become overly focused on financial performance at the cost of serving poor clients. This situation is termed as mission drift. In the current time, when more and more MFIs are converting their legal status from NGO to NBFIs with an aspiration to become full-fledged banks in the near future and using the commercial sources of funding, the debate on the risk of mission drift has further accelerated ([Dichter and Harper, 2007](#); [Rosenberg, 2007](#)).

The trade-off situation is a problem of dual maximization. Mathematically, in such a situation, there is no single solution and, any one objective is to be treated as a constraint while maximizing the other. This way, a curve can be derived to trace the trade-off between the objectives. However, evaluating the performance of MFIs in the light of the dual objectives, “doing good” and “doing well”, involves the problem of subjectivity in the sense that how much “good” is actually good and how “well” is actually well ([Sriram, 2011](#)). [Mosley \(1996\)](#) investigates the multitask problem of an MFI and presents the conflicting nature of the two objectives with the help of a figure. [Figure 1](#) shows the level of social performance and financial performance at different loan sizes provided by an MFI keeping other key factors constant. Initially, when loan size is relatively small, it has a high impact against poverty; however, it is financially unviable. This is the time when MFI is highly dependent on subsidies. With the gradual rise in a loan size at an early stage, the MFI manages to improve its performance, socially as well as financially. However, with a further rise in loan size, financial performance improves but only at the cost of social impact ([Figure 2](#)).

Here, the management has to decide whether to go for more profit or to strengthen its determination to reduce poverty. In such a situation, it can opt a middle path by affirming that a certain level social performance must be achieved while earning a reasonable amount of returns which is crucial for the future growth of the organisation. Therefore, the commitment of the owners and management for the MFI's social mission can avoid any such trade-off situation that the institution may face sooner or later. In the Figure 1,  $a^*$  and  $b^*$  are the target levels for social and financial performance, respectively, decided by the MFI management to guide the MFI operations. The distance between  $X_1$  and  $X_2$  provides a feasible range for the MFI to select an optimum path. The feasible range will not allow MFI to go for any particular objective, mostly the financial one, at the cost of the other.

In the light of the discussion mentioned above on the theoretical and empirical findings on the relationship between MFI's depth of outreach and financial performance, the study proposes the following hypotheses would be tested to ascertain their relationship:

*H1.*

Emphasis on the depth of outreach adversely affects the financial performance of an MFI.

*H2.*

Improvement in financial performance impairs MFI's depth of outreach.



#### 4. Empirical model

The study aims to find the nature of the relationship exists between social and financial performance of an MFI. The financial sustainability, a measure of the financial performance of an MFI, is measured by OSS. The OSS quantified by the following equation:

(1)

$$\ln OSS_{it} = \alpha_0 + \lambda_1 \ln ALS_{it} + \alpha_1 \ln GLP_{it} + \alpha_2 \ln Yield_{it} + \alpha_3 \ln Yield_{it}^2 + \alpha_4 \ln PAR30_{it} + Age + \epsilon_{it}$$

MFI's depth of outreach increases with a decrease in the average loan amount granted to its clients. The following equation states the average loan size (ALS):

