CHAPTER-7

VARIOUS ISSUES AND CHALLENGES

Despite having a strong base for our rural economy, there is consensus that more than 250 million people remain poor in India even after 67 years of independence, irrespective of the debate on the methodology and indicators used for poverty estimates. Despite of its several positive contribution, micro finance in India did not produce miracles. The realization of the fact that, despite the introduction of micro finance, there has not been any major upsurge in credit off-take, prompted the search for new strategies of credit dispensation which is an urgent need for the upliftment of rural life. More precisely, micro finance is a subset of the wider agenda of financial inclusion. Financial inclusion has been challenging with respect to the economically weaker sections of society residing in rural areas. However, there is rapid growth in the sector, but this expansion has not been without any repercussions. In the recent years, many areas of concern have emerged as the MFIs continued to grow exponentially. Various regulatory and operational hurdles are a great hindrance to its growth as they are jeopardizing the smooth functioning of Microfinance Institutions (MFIs). It appeared that the main hindrance faced by MFIs (including banks) in financing the very poor was the comparatively high transaction cost and low profitability in reaching out to the populace who need very small amounts of credit at frequent intervals. Issues relating to funding, structure, sustainability etc. affect substantially the outreach and growth of MFIs as well as quantum of micro-credit. Study of various issues and challenges will help to know the shortcomings of regulatory framework, practical aspects of implementing programs of micro finance and will guide to overcome the hurdles coming in the way of growth of micro finance.
sector. A glance of various issues and challenges in different areas of micro finance is presented as under.

**REGULATORY ISSUES PERTAINING TO MFIs, NGOs, SHGs AND MICRO-CREDIT INSTITUTIONS**

- It is observed by the scholar over the study that **there is plurality in regulatory mechanism in the sector of micro-finance.** The organizations undertaking micro-finance activities are incorporated under various legislations. The entities like trusts, public societies, cooperatives and for-profit and non-profit companies are unregulated. Some of them are partially regulated – to the extent that they have sought grants from foreign sources and have to file annual returns. NBFCs and banks operating in the field of microfinance - which are a few in number are regulated by the Reserve Bank of India. Other entities, like MFIs are covered in varying degrees of regulation under their respective State legislations. There is no single regulator for micro finance sector. As a result, MFIs are not required to follow any standard rules for minimum capital requirements and prudential norms. Since MFIs are unregulated, no one can know about their internal financial health and growth. There is no specific code of conduct for the MFIs. In recent past, some erring MFIs in Andhra Pradesh have been charged with exploiting the poor with exorbitant interest rates and intimidating the borrowers by forced loan recovery practices, the combined effect of which forced the debt-ridden poor to suicide. This provides an overview of the key factors to be considered when assessing legislative and regulatory frameworks for delivering microfinance from MFIs to governments, non-governmental organizations (NGOs), SHGs and commercial banks.
Lack of conducive regulatory framework for NGOs is an issue before microfinance sector. Excluding the formal financial institutions, the sector consists of a large number of unregulated NGOs dealing with the poor and other small clients. In the absence of a suitable regulatory framework, many NGOs are either stagnating in the delivery of microfinance or able to deliver only a fragmented service. Mainstream institutions such as SIDBI, RMK, FWWB and NABARD are to finance only NGOs, or NGO promoted SHGs, that are three years old, could hinder the emergence of new institutions. As NGOs being registered as societies or trusts without any equity capital and dependent on limited grants can never be said as "capital adequate". NGOs can’t earn their income from lending activity, which can violate section 11(4) of the Income Tax Act and can lose their charitable status under Section-12. Since the entry point and other prudential norms are so rigid or high under existing legal framework, many NGOs, despite having good past record, have decided to limit their microfinance activities, to convert as non-banking financial companies (NBFC) providing only partial service, others are forced to run two institutions which cause additional cost. Only a very few states have enacted acts for autonomous or self-reliant cooperatives under which full-fledged MFIs could be formed. Hence limited autonomy and regulation can hinder the growth of MFIs for a larger outreach and impact. Therefore it also justifies Hypothesis-8 that government acts as a facilitator rather than of a regulator.

Inappropriate Legal and regulatory environment for MFIs and SHGs is a major issue for formation of Mutually Aided Cooperative society (MACS). Section 4(2) of the Mutually Aided Cooperatives Act requires that 10 individual members from twenty different families have to join together to form a
cooperative. As SHGs are not individuals therefore if they want to form a Mutually Aided Cooperative Society (MACS), they need the intermediation of ten individuals. But even after that whether SHGs could become members of MACS is an issue to be examined under the main cooperative law.

- **Under Reserve Bank of India Act.** There is no separate category created for NBFCs operating in the Microfinance sector. Therefore NBFCs operating in the Microfinance sector not only compete amongst themselves but also directly compete with the SHG-Bank Linkage Program. These practices have reinforced the need for a separate and focused regulation. To encourage the growth of the Microfinance sector and the vulnerable nature of the borrowers in the sector a separate category should be created for NBFCs operating in the Microfinance sector, designated as NBFC-MFI.

- To raise equity capital for financially sustainability, MFI either can be a cooperative or as a company. In most states, with exception of Andhra Pradesh, Maharashtra, and Gujarat, cooperatives are state controlled and thus not an appropriate form of incorporation for an MFI. Therefore MFIs have the only choice to be incorporated as a company and then become an NBFC or a Bank. The latter requires a license and a minimum start up equity of Rs100 crores, which is very difficult for an MFI to raise. If an MFI opts to become an NBFC, it has minimum entry-level capital requirements of Rs 2 crores (now raised to Rs. 5 crores). This limit is too high for NBFCs working in the microfinance domain as compared to banking sector. But to increase the business of microfinance, they need to raise their capital base.

- As NGOs and trusts cannot hold equity in NBFCs. So, MFIs approach banks or public to fulfill these minimum capital requirements. A suitable amendment to the
Companies Act is needed to place higher capital requirements for MFIs that seek to go public. As MFIs are lending to small scale poor borrowers, profitability would be too less to show growth to the satisfaction of the investors. On the other way, MFIs could not approach banks to mobilize any borrowings and deposit at least for the first three years, till a satisfactory credit rating is obtained. That leaves the option of borrowing from foreign institutions, which is difficult in the first place, due to RBI’s requirement of at least two credit ratings, requiring clearances and permissions. Further, very few foreign institutions are willing to give rupee denominated loans which are subject to exchange risks.

❖ **State vs. Central Regulatory Jurisdiction Uncertainty:** A major limitation of the current regulation is the lack of clarity regarding central and state regulatory jurisdiction. During late 2010 and early 2011, both Andhra Pradesh and Gujarat passed legislation barring specific microfinance practices within the state, requiring specific consumer protection policies and capping interest rates. States currently have great discretionary power as to how to interpret the Money Lending Act without central jurisdiction. Stability and confidence will lack in the sector until this regulatory ambiguity is resolved.

❖ **Implementation of Priority Sector Lending Qualification:** A second limitation is the implementation of the new RBI requirements regarding priority sector lending, particularly with regard to borrower income and borrower indebtedness. Since majority of microfinance customers have no tax filings or credit reports, therefore customers misrepresent their income and indebtedness in order to qualify for a loan.

❖ **Lack of Diversification in Services:** The prohibition for large MFIs (serviced by NBFCs and Section-25 Companies) to provide financial services beyond just
microcredit – especially on accepting savings from clients is a important barrier to the expansion of microfinance. MFIs which are barred by law from taking deposits tend to rely heavily on debt with commercial banks for their growth, or donations, which limits the flexibility and multiplicity in services.

- **Negatives of Micro Finance Bill:** Microfinance bill has made it compulsory on the part of Microfinance Organizations to adopt the group methodology that want to mobilize thrift/savings, which is not perfect in all cases. As NBFCs are regulated by the Reserve Bank of India (RBI), But the Bill introduces different legislation for NBFCs and Section 25 companies operating in the micro finance sector. This will lead to dual regulation and complexities in structuring operations. MFOs offering thrift need to create a reserve fund into which they should deposit 15% of their net profit before dividend every year. This will lead to reduction in savings, which will adversely affect the future growth and development of the MFI sector. NABARD has been appointed as sole regulator by the Bill, this is not conducive for healthy competition in the sector. The Bill therefore needs to be reworked to remove the anomalies.

- The micro finance sector does not treat residuary NBFCs as MFOs because they do not have ‘value attributes’. When entry norms are eased, there may be several other institutions-without the value attributes-claiming to be MFOs, and the micro finance sector will encounter a credibility crisis.

- Graduating from the status of an NGO to NBFC, to LAB and ultimately to a commercial bank is nearly impossible in India because the laws do not provide for such a transformation, because the steps between these stages are steep.

  However, one common denominator for regulatory frameworks is the need for the supervisory authorities to carefully adjust the benefits which microfinance
regulation is expected to create. MFIs have reached 20 million people in a few years, a success owing something to light regulation that facilitated much innovation and experimentation. Some MFIs have become large institutions, and large ones need tougher regulation. But care should be taken to give MFIs, especially smaller ones, continued scope for innovation and experimentation.

**ISSUES RELATED TO STRUCTURE AND SUSTAINABILITY**

Sustainability is closely linked to growth. The long term future of the micro finance sector depends on MFIs being able to achieve operational, financial and institutional sustainability. Beyond a certain level, MFOs have to obtain external funds to carry on credit activity. When MFOs seek funds from financial institutions, issues like ownership structure and capital adequacy become critical. For an MFO to survive in the long run, it has to transform itself into an institution with transparent systems and accountability. NGOs have no clear-cut ownership structure, and making people liable under this format is a problem. If they wish to be sustainable, the only option is to deal with mainstream institutions.

NGOs are registered as societies or trusts; they don’t have any equity capital and the concept of capital adequacy does not apply to them. NGOs get funds through grants from donors or development banks, which are very limited. Moreover, NGOs cannot carry out lending activity as they will violate section 11(4) of the Income Tax Act and can lose their charitable status under section 12. As such micro financing, to whomsoever it may concern, is not a charitable activity under section 2(15) of the IT Act. Therefore NGO format is not suited for carrying out other support services to borrowers, owing to stringent regulations. Hence The entity that is constituted to carry
out microfinance should be understood by the mainstream and therefore it should have an appropriate institutional form which is lacking in case of NGOs.

An important issue relates to the lack of clarity over who is to bear the burden of promoting and maintaining groups to ensure quality. In the initial stage of the SHG movement, NGOs play the role of promoting, nurturing and strengthening. Inadequate attention to group quality could threaten the long term prosperity and viability of the entire program. Issues have also been expressed about the financial sustainability of SHG Bank Linkage.

**Issues Related to Financial Sustainability:** NABARD refines Commercial Banks/RRBs/Cooperative Banks who lend to MFIs. Earlier many enthusiastic foreign institutional and private donors were considered as important source of promotional fund for SHGs. Now it has been up to Governments at Centre and in the States to invest in increasing quality of SHG institutions. Although many MFIs are focused on profit, the vast majority of them were created for poverty alleviation and empowerment for the poor. No program directed at the poor is financially sustainable. Advocates for the microfinance approach to poverty alleviation are continuously haunted by statistics such as only 1% of MFIs are financially self-sufficient.

**Issues Related to Restructuring Rural Subsidiaries by Commercial Banks:**

With the introduction of provisioning norms and more transparency in accounts, the share of flow of credit to agriculture, microfinance and rural sector has been declining on account of high transaction costs and risk costs. Further, commercial banks also face difficulties in placement of staff in rural branches on account of staff preference for urban centers. Declining number of SCBs could come in the way of improving the outreach. **This justifies Hypothesis-7 that**
administrative cost is major stumbling block for banks in providing small loans to the poor.

- **Issues Related to Governance Structure:** There is no statutory requirement on the composition of Board, induction of independent directors, Committee of Board, Audit Committee. The governance structure of MFIs are very weak and needs redesigning.

- **Issues Related to Unhealthy competition from NBFC MFIs:** In the quest for exponential growth, MFIs split well-functioning SHGs to form Joint Liability Groups. Well trained and active SHG members and federation leaders are lured by MFIs to become their agents. With weekly repayments to MFIs and their strong arm tactics, women find it difficult to repay their loans to SHGs resulting in SHGs defaulting to banks.

- **Credit has taken precedence over savings:** SHGs are traditionally savings-based organizations. However, in the last three years or so, SHGs have become credit providers financed by banks. They need to return to their basic objective.

- **Banks prioritize MFI lending:** It is observed that growth rates of Bank loans to MFIs seem to grow at a much faster pace compared to SHG banking, as banks see rural lending as social obligation than business proposition. Banks are reluctant to lend to SHGs composed of scheduled castes and scheduled tribes. In contrast, lending to MFIs is an easier route to fulfill the requirements of priority sector lending.

- **Withdrawal of Support Affects Sustainability:** After the completion of project for which SHG is formed, agency withdraws the support and Group is left to its own. The formation and maturity of SHGs depends on evolving group dynamics.
which can take one to three years. Therefore, hastening the process of SHG formation by setting unrealistic targets could do more harm than good.

- **Process of Group and Cluster Formation Needs Care:** Process of groups, cluster and federation promotion needs to be carefully designed and implemented with clear roles and responsibilities, be they financial or non-financial. Bearing the whole cost by the government agencies for group promotion is a big threat for the sustainability of SHG Linkage program.

- **Unviable Interest Rate Ceiling on Small Loans of Commercial Banks:** Though the interest rates have been deregulated, the commercial banks are stipulated to charge a rate not exceeding their Prime Lending Rate (PLR) which is generally their lowest rate, in respect of small loans up to Rs. 2 lakh. The low rate of interest lending dispensed in agriculture sector negatively affects the bankers margin due to high transaction cost.

- **Impact of Inflationary Pressure on Sustainability:** Increased cost of operations due to inflation affects the demand for microfinance and client’s repayment ability, ultimately reducing the margins of Indian MFIs. At the same time, demand for micro loans towards consumption, primary agriculture, livestock or poultry related activities and manufacturing of non-essential commodities might accelerate risk to the MFI. In addition, cost of living will rise faster than loan amounts, further reducing household savings and affecting repayment schedule.

Without a clear legal framework and institutional form no sector can survive and grow. Hence regulatory issues needed to be resolved and required modifications and improvements to sort out the problems faced by MFIs, SHGs and micro-credit institutions.
ISSUES RELATED TO FUNDING

Even though MFIs have shown that micro-finance can be a self sustaining business, most MFIs still rely on a limited pool of donor funds. Without access of sufficient capital, growth stops once initial grant funds are distributed as micro-credit loans. Large amount of capital is accessible only through the formal markets which most of the MFIs could not attract as they have neither the track record nor a clearly articulated business plan. There are so many other financial issues which hinder the growth of Micro finance sector and financial sustainability are discussed below.

✧ **Lack of Capital:** The main area of concern for MFIs, which is on the growth path, is that they face shortage of owned funds, a critical constraint to scale up their activities. Presently, there is no reliable mechanism in the country for meeting the equity requirements of MFIs. Regarding mobilization of loan able funds, a major hurdle is the inability of unregulated NGOs/MFIs to raise and pool deposits from the members and SHGs. Even regulated MFIs like the NBFCs are not able to raise deposits due to prescription of a high level limit of owned capital (Rs. 20 million). NGOs can neither pool SHG level savings for lending, nor can leverage it for mobilizing external funds due to constraint of its structure. So far NGOs/MFIs have been able to get mainly grant support from donors and apex agencies for their microfinance programs. NGOs have used these grant funds for initial capacity building as well as for meeting their operational expenses. Without access to capital, growth stops once initial grant money is distributed as micro-credit loans. However, with many NGOs keen to promote MFIs there is hardly any source from which they can easily mobilize the required equity.
Though many NGOs have received some support from donor agencies for the purpose, the flow from the apex agencies like SIDBI and NABARD has been of limited nature. As against the Taskforce’s estimation of Rs. 2.57 billion required cumulatively for capacity building till 2003-2004, the two apex agencies have spent about Rs. 289.10 million towards capacity building.

At the same time, though many revolving fund schemes are being operated by the apex agencies (like NABARD, SIDBI, RMK and FWWB), the extent of support received so far by the MFIs is limited. The apex agencies have been criticized for their rigid approach in extending revolving fund support and failing to come out with suitable products required by the sector.

Even though the entry of commercial banks recently has improved the situation up to some extent, smaller and newer MFIs continue to face the same difficulties. With the RBI’s Priority Sector Lending Requirement (PSLR), major banks are now lending to MFIs. Mostly these banks feel more comfortable to lend to NBFCs, which caused many MFIs to transform from societies and trusts to NBFCs. These NBFCs require capitalization as per bank’s requirement, thus prompting the development of venture/equity investment market. Under the SHG-Bank Linkage Programme, though banks can raise their own huge deposit base for lending to SHGs, but again loan is linked to the SHG savings base.

As a result, even cumulatively in the last one and a half decade the microfinance programmes through SHGs have been able to disburse about Rs. 107191.36 crore till 2012-2013, which account for only a small proportion of total estimated needs, out of this disbursement refinance assistance by FIs is about Rs.
22396.24 crore\textsuperscript{1}. It is identified that absence of guarantee of risk funds is also affecting the smooth flow of loanable funds to the sector.

\begin{itemize}
\item \textbf{Unchanged Capital Structure and Financial Sources:} Most MFIs in the country are promoted by NGOs or entrepreneurs with an NGO background. However, organizations incorporated as Trusts, Public Societies and not-for-profit companies are not formed to undertake commercial activities of borrowing and lending. The state should recognize that there are interested developmental professionals, willing to work in microfinance sector, having the necessary social mobilization skills but lack capital. Capital for MFIs flows generally through the charitable route because of the interests of the donor agencies. The donor agencies are prohibited from making equity/risky investments in commercial companies. However, they are willing to create a permanent fund that can be rotated and grown. These funds by definition are routed into the not-for-profit entity. These entities are not permitted to invest in commercial microfinance operations because of their tax status. As a result, there is a danger that the NGOs lose the tax exempt status even if they continue the microfinance operations under the inappropriate form of a charitable organization. Therefore it is best for the state to allow for not-for-profit entities to invest in commercial microfinance. The issue of taxation should not pose a great problem as microfinance will be carried out by distinct commercial entities and therefore gain no special benefits. Since dividends paid to the promoters will be post tax the state should not be worried about any loss of revenue. This would attract more capital and would help the private initiatives of microfinance grow organically for the well being of the sector.
\end{itemize}

\textsuperscript{1}Source: NABARD Report, 2012-13.
Further, there is an element of indirect subsidy as presently NABARD supports the costs involved in formation and nurturing of SHGs up to the stage of credit linkage. This financial support is around Rs. 3,000 per SHG. The Ministry of Rural Development (MoRD) has established a norm of Rs. 10,000 per group for the Swarnajayanti Gram Swarojgar Yojana (SGSY) Programme, payable over four phases. If an additional one million SHGs have to be formed, the fund support would amount to nearly Rs. 1,000 crore, going by the MoRD norms. But now the existing dispensation of subsidy in the form of a revolving fund initially and as capital subsidy for income generating activities in the second stage may not be sustainable with the exponential growth observed in the formation of groups under the programme. Subsidy is used to make self employment programmes for poorer households viable. Sometimes this leads to promotion of unviable products which fail once the subsidy component is withdrawn.

❖ **Lack of Funding Diversification**: Due to lack of diversification, Microfinance institutions are heavily dependent on lending from Indian banks/FIs. One MFI is reported to have borrowing arrangement from more than 45 banks/FIs. But all these banks lack diversification in benefits, which could have negative impact on business growth and continuity.¹

❖ **Demand and Supply Gap in Provision of Microcredit and Micro-savings in Rural Areas**: The availability of banking services to the rural population is just 18.4% through saving accounts. The availability of rural loans is still lower at 17.2% coverage of the rural population. It is obvious now that there is a huge gap in the supply of both savings and credit facilities to the rural population. This

¹Source: The Journal of Institute of Banking & Finance. October-December 2011, Vol. 82.No.4, PP. 52-59
really needs to be covered by the Micro-finance institutions. All this is again due to the inadequacy of funds.

- **Unattractive for External Funding**: To scale rapidly, to expand operations, to provide loans and other financial products to more clients, MFIs must access large amounts of capital. These large amounts of capital are accessible only through the formal capital markets, but currently most MFIs have neither the track record nor a clearly articulated business plan to attract this funding.

- **Slow Down In Debt Capital From Commercial Banks**: In the wake of the recent macroeconomic crisis, liquidity crunch, the growth in risk profile of the sector and the increasing appetite of the big four or five players will prove a big growth and sustainability challenge due to scarcity of credit for many MFIs. MFIs face increasing delays in disbursements to clients as loan sanctions, even from existing lenders like commercial banks and other FIs, are delayed. Some banks that have traditionally issued medium term loans of 3 years are now issuing 1 year loans in their fresh sanction. However, such approach will affect the growth plans of several promising small and mid-segment MFIs. The coming years will test the credit-worthiness of many MFIs to stay close to their banks and compete successfully for debt funds. In fact, scarcity of funds for on-lending along with the increasing competition may lead to mergers and consolidation in India as an emerging trend in Africa.

**MULTIPLICITY OF ISSUES**

In Indian context, some more issues in specific areas of concern have been identified. These are discussed as follows.
Variations in SHG-Bank linkage program’s Growth Composition: The growth in the loan outstanding of SHGs with banks (8.4%) is almost 4 times the growth in the number of SHGs having outstanding loans with banks (2.2%). If this growth in loan outstanding is attributed to the increase in NPAs of SHG loans with banks, it should be viewed with utmost concern by micro finance implementing organizations.

Unbalanced Geographical Growth: The spread of microfinance programme is unequal among various regions of India (exponential growth especially in southern part, on the other side eastern, northern, north-eastern and western states are lagging behind) and there is limited spread in the poorer states. This has happened on account of various factors like pro-active role of some State Governments, presence of well performing NGOs, growth of formal financial institutions, socio-cultural factors, better performance of SHGs, etc.

In March, 2001, 71% of the linked SHGs were from Southern Region consisting of Andhra Pradesh, Karnataka, Kerala and Tamil Nadu. The share of Southern Region has come down progressively over the years but it is still at 55%. Many States such as Uttar Pradesh and Bihar with high incidence of poverty have shown poor performance under the program.

NABARD has identified 13 states (Assam, Bihar, Jharkhand, Gujarat, Himachal Pradesh, Maharashtra, Madhya Pradesh, Chhattisgarh, Orissa, Rajasthan, Uttar Pradesh, Uttarakhand and West Bengal) as ‘priority states’ in the country with large population of the poor, for focused attention of the microfinance programme in order to reduce the regional disparity. But still the average quantum of loans issued to SHGs was Rs.1.69 lakh per SHG and this ranged from Rs.70,600 in Eastern region to
over Rs.2,00,000 in Southern region. This leads to the question whether banks are getting more cautious to lend to SHGs in states other than in the Southern region. This has serious implications while planning for extending the outreach of SHG-BLP to other regions. It justifies Hypothesis-10 that the socio-economic conditions of region / area affect the borrower’s ability to secure adequate credit and repaying capacity.

- Challenges to Lack of Capacity building: In the recent past capacity building and investment in human resources in India have increased but the quality and quantity of such services do not necessarily fulfill the current requirements of the sector. 47% groups formed under government programs had not received any kind of capacity building input for the last two years. Even when groups received capacity building inputs, the overwhelming focus was on group and finances related management. Only 6% groups formed under government programs had received inputs on gender issues and only 19% had received inputs on income generation and livelihoods.

MFIs need grants to build their own capacity as well as that of borrowers and SHGs. Some of the current capacity building gaps are in the areas of governance, human resource management, risk management, keeping pace with the fast growth of the sector, geographical spread, diversity and local language constraints and social performance management. However, the regulatory framework is not conducive for these MFIs. Therefore it justifies Hypothesis-1 that there is scope for substantially improving the quality and efficiency of service delivery by the organizations providing micro finance services.

- Issues Related to Exclusion of the Poorest, Marginalized and Vulnerable: Though the program is spreading rapidly but with a slow progress in targeting the bottom poor
households. Approximately 75 million households in India are poor and about 22 percent of these poor households (i.e. 16.5 million) are currently receiving microfinance services\(^1\). Also, the average loans provided to the SHG members under both the SHG-BLM and MFI models range between Rs. 3,500 to 5,000 which can meet the liquidity requirements only and are not sufficient to help a member to start productive activities. So far the government has been succeeded in providing only Rs. 2,000 crore annually against a demand of over Rs. 50,000 crore by the 75 million poor households. Hence, there is a vast unmet demand in the rural and urban sectors. Staff members of microfinance institutions and other group members also prefer to exclude the core poor since lending to them is seen as extremely risky. It justifies Hypothesis-10 that the socio-economic conditions of region / area affect the borrower’s ability to secure adequate credit and repaying capacity.

- **Issues Related to High lending rates:** Banks are charging PLR or below PLR interest to MFIs/ NGOs who in turn are to charge 2% or 3% extra to SHGs. So the average comes to 12% to 15% p.a. But actually MFIs/NGOs charge interest up to 24% p.a. Demand for credit is higher than supply, i.e. the big reason for charging higher rate of interest. The high operational cost such as staff cost, overheads has also pushed up interest rates on loans by the MFIs, otherwise financial viability would be lost and will affect the profitability in the long run. But this interest rate varies significantly according to the lending conditions and policy of the MFI. Table 7.1 shows interest rates charged by some of the MFIs working in India.

Table 7.1: Interest Rate Charged by Some of MFIs Working in India

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Name of MFI</th>
<th>Purpose of Loan</th>
<th>Interest Rate (% p.a.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>SHARE</td>
<td>Production/ Housing</td>
<td>15</td>
</tr>
<tr>
<td>2.</td>
<td>Nari Nidhi</td>
<td>Production</td>
<td>12</td>
</tr>
<tr>
<td>3.</td>
<td>WWF</td>
<td>Production</td>
<td>18</td>
</tr>
<tr>
<td>4.</td>
<td>RDT</td>
<td>Production/ Consumption</td>
<td>24</td>
</tr>
<tr>
<td>5.</td>
<td>Shantidhan</td>
<td>Production/Consumption</td>
<td>13</td>
</tr>
<tr>
<td>6.</td>
<td>MYRADA</td>
<td>Production/Consumption</td>
<td>24-36</td>
</tr>
<tr>
<td>7.</td>
<td>SPMS</td>
<td>Production/Consumption and Marriage</td>
<td>24-60 and 20</td>
</tr>
</tbody>
</table>

Source: SIDBI and EDA impact study, unpublished document, 2004. EDA.

Due to these high costs of credit, a poor borrower would be trapped in a low-present and low-future income vicious cycle. This justifies Hypothesis-7 that administrative cost is major stumbling block for banks in providing small loans to the poor.

❖ Issues Related to Multiple-lending, Over-borrowing and Ghost-borrowers:

Due to rapid growth, MFIs generally lure existing SHGs not only to increase profit but also to reduce their transaction costs. Generally loans are used for agricultural and consumption needs by the poor borrowers, that also leads to the problem of repayment and over-borrowing. These borrowers are, therefore, induced to take additional loans beyond their repayment capacity which causes multiple lending and over-borrowing. Problem of Ghost borrowers arises when fictitious loans are recorded in the books for multiple lending or over-borrowing. This would create fictitious assets and is often used to record fictitious repayments and thus hide the actual level of delinquencies.
Coercive Methods of Recovery: Coercive methods of recovery are, to some extent, linked with the issues of multiple lending and over-lending. Coercive methods of recovery are used when the growth of the MFI is faster than its ability to recruit the required staff of the right quality and to provide them adequate training for sanctioning of credit and recovery practices. It is also noticed that sometimes some abusive collection practices adopted by the loan officers of certain MFIs in India that has led to the suicide of several farmers in the state of Andhra Pradesh. This led to a challenge to MFIs to make a effort to stop such activities and coercive methods of loan recovery.

Unattractive Rural Banks for Small Rural Borrowers: The rural banks have been noticed to become unattractive because procedures for opening an account or seeking a loan are cumbersome and costly (with high rejection rates), having more distance to nearest bank as compared to Post office, clients have to pay hefty bribes to agents to access loans, so the ultimate cost to borrowers is very high. There is rigidity in terms and conditions and products, lack of timeliness and adequacy of funds. Repeat loans except for crop production are rare, even though borrowers have repaid fully. In addition to this, there are not much innovations to develop appropriate products and efforts to adapt the delivery system to meet the requirements of the poor. It justifies Hypothesis-6 that micro credit has not been an area of significant importance so far as to commercial banks.

Operational / Structural Issues for Micro Enterprises: Generally all micro-enterprises operate outside the formal legal system. Arbitrary informal enforcement system limits the ability of entrepreneurs to be productive as well. Whether self-regulatory mechanism can be the best option for MFI-growth and entrepreneurs in the market-led environment is a big issue for micro enterprises.
Emerging Risks in Indian Microfinance: The rapidly increasing industry size, greater integration with the mainstream markets and an ever-growing list of microfinance stakeholders are leading to fears within the industry of how to meet increasingly varied expectations. As the MFIs are growing with new equity options, variations in portfolio and product services, it can create operational risks. Due to increased geographic area of operations, there are increasing overlaps between MFI clients, which would make difficult to determine the client’s use of capital and his/her repayment capacity across multiple loans, which ultimately poses a threat to the institution’s portfolio quality.

Issues Related to Impact of Banking Reforms on Rural Sector: Using autonomy as per Liberalization Privatization Globalization policy, the banks have decreased their number of rural branches and converted RRBs from weaker section institutions into regular banks significantly in the last one decade. The share of small loan accounts has declined very drastically, both in the total number of accounts and in the loan amount outstanding in the post reform period. Statutory preemptions like Statutory Liquidity Ratio and Cash Reserve Ratio, prescribed 40 percent of their lending to “priority sector” including agriculture and other rural borrowers encouraging banks to divert their investments into relatively safer and more attractive Government securities than lending to poor rural clients who are perceived as riskier and unprofitable. It justifies Hypothesis-6 that micro credit has not been an area of significant importance so far as to commercial banks. This situation has paved the way to accept the challenge by the banks and Unlike in the past, now the banks are being encouraged to adopt initiatives like SHG Bank linkage more as a viable profitable proposition rather than out of sheer social concern for reaching out to the poor.
Microfinance as a Part of Global Agenda: Microfinance has attracted the attention of all major global developmental players like multilateral agencies, bilateral agencies and various private donor organizations. The national policies might be getting influenced by the present global focus on microfinance. At the same time, the other concern is that the global agencies could be using microfinance as a way to sideline various other agendas like reducing subsidies by developing countries for poverty alleviation, pushing forward cost recovery and market based approaches in poverty alleviation, and increased role for NGOs. Therefore formation and implementation of microfinance policies based on global agenda by national governments might suffer from credibility, or may even not framed as per national interests leading to insufficient credit to real poor living in backward areas of the nation.

ISSUES RELATED TO TAXATION

Tax issues present obstacles to rural finance and microfinance institutions from more effectively providing access to financial services. The legal and nonprofit status of NGO MFIs may sometimes be questioned by tax authorities on the grounds that the credit services they are providing to their clientele are priced at commercial rates, rather than at “charitable” levels. In other instances, licensed specialized banks and non-bank finance institutions may not be permitted by tax accounting laws and regulations to expense provisions for possible loan losses, in spite of prudential regulations issued by the central supervisory authority, which creates an unnecessary real economic burden to such specialized banks and non-bank finance institutions. A related problem stems from the requirement by tax authorities that delinquent loans may be written off only when the sale and disposition of collateral securing such a
defaulted loan results in recovering a monetary value that is less than the value of the collateral.

For NGOs, there is always a conflict between microfinance, which earns returns and is therefore ‘commercial’, and other activities are ‘developmental’. Therefore there is a problem for NGOs to segregate the commercial and developmental activities to get tax benefit. Not-for-profit entities may be allowed to invest in companies undertaking finance for the poor without any prejudice to their tax status. Conversion to a regulated structure normally involves high conversion costs in addition to permanent cost increases due to regulatory and reporting requirements. The immediate introduction of high tax burdens can make this transition extremely burdensome. To encourage converting MFIs to maintain their focus on financing the poor, temporary tax relief may be justified

MAJOR CHALLENGES

In the last twenty years the microfinance sector, both under the SHG Bank Linkage Program and under the NGO-MFI on-lending program, has shown an impressive growth in terms of the outreach. But still much to be accomplished in terms of outreach to make a serious dent on poverty. The expansionary zeal of microcredit institutions should be balanced with the quality of loans – a major challenge. However, there have been many other serious constraints or challenges faced at SHGs and NGO/MFIs level which seem to be coming in the way of promoting microfinance in a more effective way for poverty alleviation. Some of such constraints are highlighted below.

❖ Bringing Millions of People under Micro Finance is not Easy: The bottom three income categories with per capita income up to Rs 250 per month and
accounting for 31.7 percent of all rural households, reported incomes below expenditures. It is very challenging to bring them under the fold of micro-credit.

**Challenges Towards Deepening Outreach:** Poverty penetration of microfinance is at relatively low levels due to many difficulties both in demand and supply side in expanding outreach. This comprises the challenges of reaching below poverty line (BPL) populations with limited infrastructure, the small size of their needs which increases the unit cost of operations and the challenge of financial literacy that also affects the cost to be incurred by the service provider. Bank branch manager are also unsure whether the poor are really bankable. The rural poor could not be sure that whether they would get services if they approached the banks in spite of the costs involved, including loss of earning on being away from work while visiting bank branch. These members have many other constraints like fewer income sources, poor health and education, which prevent them from investing loans into high-return activity.

**Challenges for NGOs:** NGO microfinance institutions' dependence on grants, their financial viability, management, internal governance, monitoring capacity and their repayment performance may occasionally pose problems. Their inability to publicly mobilize deposits and their limited links to financial markets make it difficult for them to expand without continued access to wholesale funds from governments and international donors. Legal restrictions on the scope of services provided by NGOs may also limit the effectiveness in addressing heterogeneous needs of poor people. At some point, therefore, growth-oriented NGO microfinance institutions find themselves constrained by lack of funding, that becomes a fundamental reason behind the transformation of many NGO microfinance institutions into bank microfinance institutions.
Wrong Assumptions of Micro-Finance: MFIs make this assumption that poor would like to be self-employed after getting facility of Micro Finance with the help of micro-scale farming, processing, manufacturing or trading activities, but usually they do so to support their income from wage-employment. Most Microfinance institutions assume that all the poor need is credit, but savings and insurance also act as a cushion for sudden demands of cash like illness in the family or natural disasters or for repayment of loans. Microfinance cannot be considered a sufficient condition for microenterprise promotion. Other inputs such as identifying livelihood opportunities, business & production training, establishing market linkages and demand, and policy reform are also required which are not available from MFIs. People slightly above the poverty line also need micro-credit to generate the much needed wage employment opportunities for the poorest.

Quality of SHGs: Generally NGOs easily get the node of the district authorities to promote SGSY groups or SHGs without reviewing their target, working or quality check. Members and leaders are ignorant about the working of loan and subsidy granting mechanism and the technical aspects of linkage to the groups. lack of literacy, training, knowledge, credit planning and improper transactional records pave the ways to default. Less importance is given to improve the quality, branding and packaging, understanding the market demand and creating fresh demand for the products and services delivered by the Self-Help groups.

Operational Factors That Impede Extension of Rural Credit: Lack of documentary evidence of identity, collaterals and income streams exclude the rural folk from credit system. As without documentary evidence repayment tracking becomes a huge operational task. Further, in times of emergencies like
natural disasters where the entire rural economy is affected, the FIs have the only option to write-off of the entire portfolio as there is no alternative to risk mitigation. Moreover, moneylenders provide the temporary fund on flexible terms, without basing it on any particular need. Therefore, MFIs have the challenge of lending to the same population on same footing to replace the role of the money lenders. It justifies Hypothesis-1 that there is scope for substantially improving the quality and efficiency of service delivery by the organizations providing micro finance services.

- **Challenges of Individual Banking Model for MFIs:** Lack of peer pressure in this model leads to more program management and client appraisal challenges for MFIs. Technical assistance for repayment schedule, business management training, deep field research and monitoring would lead to increased cost of servicing a loan given to poor and illiterate rural people.

- **Collection of Information From Remote Rural Clients:** Conducting millions of small transactions every month in remote rural areas with very little infrastructure with minimum operating margins pose to be big operating and technical challenge. Thousands of transactions have to be captured and processed every week in a timely manner, so that the institution can have an accurate view on its current loans, delinquency and potential trouble spots. To meet this challenge, MFIs need to turn to information technology based solutions to optimize data collection. But integration of mobile hand-held computing for collecting field information is an expensive and time-consuming process.

- **Conducting Financial Transactions in Remote Rural Areas:** Where bank branches are not accessible nearby, loan officers would need to travel to villages regularly for collection and disbursement of money with large amounts of cash.
However, security issues make cash difficult to transport into and out of villages. Transacting in cash increases the potential for fraud by loan officers that would be difficult to track down.

❖ **From Credit to Enterprise:** There is a challenge on the part of The SHG Bank-Linkage program to investigate and meet the investment capital requirements, non-financial requirements like investments in infrastructure, technology transfer, skill development and market linkages etc. of matured SHGs, which have met their consumption needs and are now on the path of conversion into ‘Enterprise’. This is a challenge that is to be taken in some way by occasional donor funded programs or by government funded NGO programs systemically on a national scale.

❖ **Deposit Services:** The Indian microfinance sector is directed towards credit and other aspects of financial services and does not take into consideration savings and insurance. Although some institutions are innovating and experimenting with insurance products through MFIs as a delivery channel, deposit services still remain a distant dream for practitioners. Data from the SHG-Bank linkage programme shows an increase in the overall savings amount deposited by clients but the overall amount is too low to be able to meet any emergency. However, bankers mostly lend to SHGs at a multiple of the savings that the latter deposit with the bank.

❖ **Timely Availability of Trained HR for MFI Operations:** In a rapid scale up phase, a well thought through HR strategy with adequate attention paid to career development and training needs is not yet existing in many MFIs. Many could face competition from mainstream banks, other financial institutions, booming retail and telecommunications market in India that may create a competing
demand. Employees are also unwilling to take rural posting as there is no pay protection or other perks such as higher HRA and CCA and it causes loss of energy, time, zeal for work and money for daily commuters from city to place of posting.

- **Financial Education of Microfinance Members**: Currently any stakeholder is not imparting financial education to empower the borrower to make financial decisions such as ascertaining the effective cost of loans, and the extent of debt s/he can handle from the utilization and repayment point of view. With increasing pressure on MFIs to reduce interest rates, MFIs are reluctant to incur additional transaction costs on financial education which is the need of hour to spur the working of MFIs.

- **Demonstration Effect**: Some borrowers/members use the given credit for non-productive ends, if imitated by other poor people, could spread a negative practice and adversely impact the future growth of micro-credit.

- **Internal Systems and Processes**: Many MFIs move into new geographies and handle new products, without adequate attention paid to standardizing systems and processes and evaluating their sufficiency against the proposed scale up. It could slow down their pace of growth.

- **Potentially Harmful to Women Gender Issues**: Men of rural India usually don’t approach SHG or NGOs for small amount of credit or savings or they are unable to find the time to spend with an SHG/MFI but ultimately they control the loan amount and females are held responsible for repayment of loans. Therefore, around 90% of the aggregate groups are women self help groups. But these groups face certain problems like indifferent attitude of bank officers, exploitation by NGOs, lack of marketing facilities for products/services. Another challenge that
women face with microfinance is that they have a double workload of running a business and childcare.

❖ **Challenges to Create Large Debt:** Small businesses have to face a great number of obstacles; for example, lack of adequate infrastructure, inadequate competence to switch over to innovative production processes using new raw materials and technology, inability to access supplies needed for a business, flooded markets if enterprises operate in similar products, difficulties of financial management due to incomplete schooling and lack of training or skill, and a special vulnerability to crises such as a death in the family or a medical emergency. This scenario creates many challenges like where to run a business; other issues such as what kind of business, who will work there, and what to do if the business fails, are equally complex and can lead the poor into a large debt trap.

❖ **Challenges of Urban Microfinance:** Due to the migratory nature of the urban poor from the rural areas, there are no clear estimates of the number of people in urban areas with no access to organized financial services. Even money lenders often shy away from lending to urban poor. There have been a few instances of MFI\(s\) venturing into this area of lending to urban poor who are undertaking micro-enterprises and small business activities. Urban branches of banks, even though having manpower and technology support, are not attuned to SHG lending or microfinance. **It justifies Hypothesis-6 that micro credit has not been an area of significant importance so far to commercial banks.** The migratory nature of the low income urban population is also contributing that urban bankers are not venturing into this field, although there is a scope of increased demand for urban microfinance due to growing industrialization in the economy. **Therefore it**
justifies Hypothesis-2 that increasing urbanization poses new challenges and opportunities.

- **Financial Complexities in the Micro Finance Market**: Today Securitization is justified on the grounds that it allows raising resources at low cost for the originator of the securitized transaction even for unrated entities. On the other side, there are large capital deals taking place between international venture capital funds and large sized MF-NBFCs in India to satisfy growing resource requirements of MFIs. As these funds look for capital growth of 30-40% per annum but when investors sell their shares to realize the profit, negative publicity would likely to occur in the surrounding. In light of the general lessons learnt from the recent crisis, the growing trend of securitization and entry of foreign funds for commercial purposes requires a close monitoring of MFIs and their operations to exist in today’s competitive world.

- **Social Reporting**: New initiatives are to be taken to make disclosures about social performance for the efficiency of internal management in microfinance. The dimensions include aspects of process like clarity of mission and social values of responsibility, social goals and objectives, alignment of governance, human resources and management information systems to track achievement and monitor compliance and results including client profile at entry, client satisfaction, client awareness of product terms, client dropout and tracking change over time. This is a relatively new management area for the MFIs and it is a challenge for them to emphasize and pursue this while maintaining proper focus on profitability and sustainability of activities.

- **Not Universal in Application**: It can also be stressed that there is a big challenge to find a more universal approach to poverty alleviation. Credit alone cannot
reduce poverty until other important issues such as agrarian reforms, illiteracy, financial exclusion, corruption, lack of expertise, information of skills are not addressed in time.

**CONCLUSION**

While there is a good progress in the last one and a half decades, the sector is faced with many constraints and problems which are coming in the way of emergence of the sector in a full-fledged way. Many macro level challenges like lack of conducive legal and regulatory framework, inaccessibility of the micro finance services to the rural poor, the capital inadequacy of the MFIs, the demand supply gap in provision of microcredit and micro savings, lack of women orientation in marketing, evaluation and delivery of microfinance, quality of SHGs etc. are coming in the way of MFIs of providing full-fledged services to the poor. Simultaneously, certain macro economic conditions like the structural adjustment program and banking sector reforms which seem to be having certain adverse effects on rural banking and weaker sections lending in the country. The micro challenges include the inability to reduce the high transaction cost involved in delivering microfinance, the non availability of documentary evidence and collateral among majority of rural poor, difficulty in reducing the dependency of the rural poor on money lenders and lastly the problem of repayment tracking where lending is not based on documentary evidence. There is also the scenario of microfinance being pushed under the global agenda of bringing in market-based developments and state agencies with their own limitations co-opting microfinance for scaling-up under such circumstances.

Reflecting all these concerns, There is a strong belief that the SHG movement has the potential to satisfy the financial service needs of India’s unbanked people in a
sustainable way. However, the approach has faced a few concerns of being fundamentally focused on credit without adequate room for intensifying the space for allowing greater flexibility to accommodate multiplicity of credit borrowing at the SHG level. NABARD’s attempt at present has been to better appreciate the concerns being expressed from different quarters which are aimed at addressing some of these critical concerns to make the approach more flexible, client friendly in tune with the changing needs.