CHAPTER – 2

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2.1 INTRODUCTION
The research on governance of MFIs will be successful only on the basis of understanding the work already done and the scope for future research in the given area. The literatures available in various forms will help in finding the research gap prevailing and the scope for quality output. The literature on the present research topic is available in good numbers only focusing more on Micro Finance Institutions around the world and India. It is evident that only a few studies have been carried specifically on the issue of governance of MFI’s in India and the materials regarding the same at the Karnataka State level is significantly less if not zero. The research work on governance issues of MFIs in Karnataka is the first of its kind and an attempt is made to do justice for the research topic by considering the existing data available in various forms. So this study is the compilation of the earlier studies undertaken by many researchers and the experiences of the current researcher.

2.2 MICRO FINANCE, MICRO FINANCE INSTITUTIONS IN INDIA AND ITS IMPLICATIONS
Gallardo (2002) the experience of Ghana and the Philippines shows that a transparent, inclusive regulatory framework is indispensable for enabling microfinance institutions to maintain market specialization and to pursue institutional development that leads to sustainability. Clear pathways for institutional transformation facilitate the integration of microfinance institutions into the formal financial system.

Wijewardena (2003) in his works finds, microfinance has largely been left to itself, and the systems have sprung up almost automatically to meet the demands of this particular clientele. In this context, the numerous microfinance systems that are operating have stood the test of time and, therefore, could be considered more sustainable than formal financial systems regulated by authorities.
Mahajan & Ramola (2003) since the onset of reforms, the mainstream financial sector has turned its back to the needs of India's small farmers and informal sector producers. In the meanwhile, the growth of micro-credit, mainly through SHGs, is distracting attention from the big picture of the systematic financial exclusion of the majority. Village moneylenders in India are as old as villages, agricultural credit cooperatives are about a hundred years old, commercial banks' involvement in agricultural and small loans nearly 50 years old, the regional rural bank network over 25 years old, and the first 'new generation' microfinance efforts about 10 years old. Thus microfinance in India is still in its infancy, though its growth rate is impressive, and particularly the SHG-bank linkage program appears to have the potential of becoming a big banyan tree.

Tiwari et al. (2004) are of the view that, once microfinance institutions are engaged in deposit taking in order to mobilize household savings, they become financial intermediaries. Consequently, prudential financial regulations become necessary to ensure the solvency and financial soundness of the institution and to protect the depositors. However, excessive regulations that do not consider the nature of microfinance institution and their operation can hamper their viability.

Sriram et al. (2004), find that the issues that have triggered transformation of MFI s include size, diversity, sustainability, focus, and taxation. Transformation experiences in India are few. To move to the mainstream, non-governmental organizations (NGOs) choose from three popular forms of organizations: non-banking finance companies (NBFCs), banks, and cooperatives. It appears that there is no ideal path for spin-off. Regulatory changes are needed to allow MFOs to graduate to other legal forms as they grow organically.

Tsai (2004) banking authorities in both China and India have attempted to limit most forms of informal finance by regulating them, banning them, and allowing certain types of microfinance institutions. The latter policy aims to increase the availability of credit to low-income entrepreneurs and eliminate their reliance on usurious financing.
Nonetheless, the intended clients of microfinance continue to draw on informal finance in both rural China and India.

Dasgupta (2005) in his work observes a paradigm shift ‘financial sector reform’ to ‘microfinance reform’. While the priority sector needs to be made lean, mandatory microcredit must be monitored rigorously. Simultaneously, space and scope have to be properly designed for providing competitive environment for microfinance services. Extensive database needs to be created by the RBI for understanding microfinance.

M. S. Sriram (2005) writes in his article, since the early 1990s, there have been many significant state initiatives in the institutional and policy spheres to facilitate access to financial services by more poverty-stricken groups.

Basu et al., (2005) are of the view that, India's rural poor currently have very little access to finance from formal sources. Microfinance approaches have tried to fill the gap. Among these, the growth of SHG Bank Linkage has been particularly remarkable, but outreach remains modest in terms of the proportion of poor households served. In addition, if SHG Bank Linkage is to be scaled-up to offer mass access to finance for the rural poor, then much more attention will need to be paid towards: the promotion of high quality SHGs that are sustainable, clear targeting of clients, and ensuring that banks linked to SHGs price loans at cost-covering levels.

Holvoet (2005) Evaluations of the effects of microfinance programmes on women’s empowerment generate mixed results. While some are supportive of micro finance’s ability to induce a process of economic, social and political empowerment, others are more sceptical and even point to deterioration of women’s overall well-being. Against this background, development scholars and practitioners have sought to distil some of ingredients that might increase the likelihood of empowerment or at least reduce adverse effects. This article formally tests the impact of some of the suggested changes in programme features on one particular dimension of empowerment: decision-making agency. Using household survey data from South India, the author explores the
importance of borrower’s gender and the lending technology for intra-household decision making process.

Tulchin Drew et al., (2006) microfinance as a sustainable tool for urban poverty alleviation in Latin America and the impact government actors have on the sector. Their paper begins by defining the value of microfinance and its role in development within the urban Latin American context. Initial findings established priority policy recommendations to maximize microfinance effectiveness. However, given the challenges in acquiring clear information and the complexity of the data discovered, the initial foray was expanded to establish an agenda for ongoing research on the subject. Government actors can make important contributions to the microfinance industry, but they must act carefully to ensure their efforts result in positive impact.

Ramesh S Arunachalam (2007) granting of loans to internal members of the NBFC MFI’s should be taken care of and be monitored properly. The NBFC and their practice of lending to rural poor should be encouraged and it should be properly governed by well-established regulatory norms of the government. In this connection RBI circular on ‘connected lending’ should be implemented.

Thapa et al., (2007) the sustainability of an MFI requires not only financial viability but also a clear strategic vision and an organization that is transparent, efficient, and accepted by all the stakeholders. There is a need to continuously innovate new institutional models of MFIs which can reach the rural poor in a sustainable manner.

Shankar (2007) it is suggested that MFIs, in order to reduce direct transaction costs, increase the number of groups per square kilometer. In order to reduce indirect costs, MFIs should minimize the number of layers of fixed costs in their system and examine alternative revenue-generating activities that can be undertaken with minimal incremental costs. Policymakers need to take into account transaction costs when examining the interest rates charged by MFIs. The regional variation in
transaction costs that the study has found is an important factor that suggests that no uniform view can be taken on the rates charged by MFIs in different regions.

Nilakanth Rath’s (2008) the farmer’s suicide and debt burden by various reasons influencing on the life of the poor is to be addressed urgently. Poor farmer’s death due to the unbearable burden of debt is the matter of concern. It highlights how loan waiver will lighten the burden of the farmers though, in the long run it adversely affect the rural credit institutions that extend loans to farmers. Since the bulk of the loans will be from outside institutions, there is a strong possibility of the demand for writing off loans in times to come.

Hudson (2008) in his article writes that, microfinance services may be provided by any type of institution, large or small, be it a formal bank or an informal SHG. At the beginning, Indian MFIs were completely de-regulated; some did not even have a legal existence. To gain in transparency and credibility, such informal MFIs opted for an official legal status only as an afterthought. As a consequence, most MFIs evolved without a common status, particularly given that India did not have specific legislation for microfinance activities either. This is the case in many countries as institutional frameworks have almost always come after the development of the microfinance sector.

Field & Pande (2009) In stark contrast to bank debt contracts, most micro finance contracts require that repayments start nearly immediately after loan disbursement and occur weekly thereafter. Even though economic theory suggests that a more flexible repayment schedule would benefit clients and potentially improve their repayment capacity. Micro finance practitioners argue that the fiscal discipline imposed by frequent repayment is critical to preventing loan default.

Roy Mersland et al., (2009) endorsing the earlier facts, feel that the non-profit organizations are quite common in traditional microfinance. But a non-profit firm needs return on its capital in order to lend again. Also due to competition the non-profit organization, too, needs return on its capital in order to survive in the market. For the
purpose of effective performance of the institution internal governance must play a vital role.

R Vijaykumar (2009) the activities of self-help groups and their federations, the Grameen Bank replicators and commercial micro finance institutions, leading to the belief that in empowering the poor the positive attributes of one are shared by the others is what the noticeable change we are witnessing.

Anu Muhammad (2009) in his work states, Grameen Bank’s micro credit programme has been organized internationally as a successful model. This model has become an integral part of development thinking and has earned global attention as a new form of banking. But it has more as an effective tool for alleviating poverty and empowering women. The model created a good opportunity for expanding the market for finance, thereby ensuring GB’s spectacular success.

Debadutta K Panda (2009) writes that micro Finance is not only for social and rural development, but also for business and profit making, based on the organizational missions. Anyway, for the organizational sustainability, outreach and development of cost – effective affordable financial products, there must be a systematic marketing process is the opinion of the author. The role of NGO’s in providing Micro Finance and the need of proper channelizing the flow of fund in a right direction are identified in the works of the author.

Sriram (2010) in the past two decades of microfinance, we find three distinct waves of action. The first wave was when people who were working in the development sector discovered the methodology of reaching micro-loans to the poor through a methodology that was mastered by Grameen Bank. The wave second came in when the first generation organizations reached scale and sought methods to morph into for-profit commercial organizations. The wave 3 is when mainstream commercial institutions like L&T finance, Equitas and the private equity players started looking at microfinance as an interesting business.
Imai, Arun, & Annim (2010), using national household data from India, treatment effects model is employed to estimate the poverty-reducing effects of Micro Finance Institutions (MFIs) loans for productive purposes, such as investment in agriculture or non-farm businesses on household poverty levels. These models take into account the endogenous binary treatment effects and sample selection bias associated with access to MFIs. Despite some limitations, such as those arising from potential unobservable important determinants of access to MFIs, significant positive effect of MFI productive loans on multidimensional welfare indicator has been confirmed.

Prof Zohra Bi et al., (2011) micro finance in India has been viewed as a developmental tool which would alleviate poverty and enhance growth of the country through financial inclusion. Out of 6 lakh villages in India, only approximately 50000 have access to finance. India is a country which has the highest number of households which are excluded from banking. In their study it is also found, only a few MFI’s are dominating the sector and many small MFI’s are having shortage of capital and identifies the need of regulations and governance to achieve the goal.

M.S Sriram (2011) in his article extending his earlier thoughts writes, “Micro Finance Industry in India: More Thoughts” finds that, Micro finance institutions need not be treated as holy cows. Shows there need not be any soft regulations on MFI’s. MFI should be treated on par with Non-Banking companies. Soft corner on MFI’s will certainly allow them to deviate from their specified objectives. Also provides an insight into behavioral problems prevailing in MFI’s.

David Hulme et al., (2011) in their article state, recent events in south Asia have led to an expected reversal in the narrative of micro finance, long presented as a development success. Despite charges of poor treatment of clients, exaggeration of the impact on the poorest as well as the risks of credit bubbles, the sector can play a non – negligible role in reaching financial services to low- income households. The article, exhibits the lending mechanisms of MFI’s and need of ceiling the interest rate on micro loans in order to bring the Micro Finance Industry to a right path. Study also mentions the
initiative of the government to pass the Micro Finance (development & Regulations) Bill 2011.

**Priyadarshee et al., (2011)** the recent events relating to MFIs in the Indian state of Andhra Pradesh (AP) have been in the news, whereby microfinance, which had been hitherto promoted as a solution to various poverty problems over the past few decades, was seen as exploitative of the poor by a large section of Indian media and the people in Andhra Pradesh. The root cause of this persistent decline lies in MFIs having lost sight of why microloans were introduced in the first place: providing credit to those who could not access mainstream financial services and thus faced difficulties in borrowing at low interest rates, thereby having to resort to borrowing from moneylenders at exorbitant rates. As the sector grew and expanded over the years, MFIs gradually “turned from ‘non-profit’ to ‘profit-making’ institutions.

**Chakrabarti et al., (2011)** in their study reckon, notwithstanding its phenomenal growth, the microfinance industry in India today stands at a juncture marked with uncertainty. Much depends on the policy stance and a settlement between the Centre and the states about jurisdictional issues. Whether the visible hand of the state in India would prove to be a nurturing one for the industry or a crushing one, only future can tell. And it better tell it soon, for there is hardly much time to dither.

**M. Malarvizhi et al., (2012)** express their opinion saying that the importance of Micro Finance Institutions to small and medium scale income people like agriculturists and agriculture laborers.

**M.S. Govindaraju et al., (2012)** Micro Finance Institutions outreach is limited in comparison with the mainstream financial institutions because of the shortage of finance and human resource. Micro finance institutions need grants to build their own capacity as well as that of the borrower for self-help groups.
**T Shankaraiah et al., (2012)** are of the view that the focuses on assessing the performance of financial institutions. Repayment performance of the borrowers and suggested measures for the recovery of over dues from the borrowers is discussed thoroughly.

**Ms. Tara S Nair (2012)** express that the using of foreign funds to develop domestic markets and establishing of a robust regulatory mechanisms to ensure the responsible behavior from the principal actors within the Micro finance System is the view expressed by in Economic and Political Weekly in her article “Financing of Indian Micro Finance - Evidence and Implications”.

**Zerai et al., (2012)** in their work, identify that, the Microfinance institutions predominantly originated with a mission of social objective which is “poverty reduction”. However, in the last two decades or more there has been a major shift in emphasis from the social objective of poverty alleviation towards the economic objective of sustainable and market based financial services.

**M. Chandran (2012)** citing the need of women empowerment through microfinance and scope for future research in this regard, write in “Women Empowerment through Micro Enterprises Development in Tamilnadu” that onus is on social empowerment, family employment and individual employment through micro finance. The paper also stresses on according priority on commercial efficacy.

**Nasir (2013)** no doubt, microfinance programme has shown impressive achievements, but a number of challenges are there: Did this programme help the underprivileged? Whether everyone in need of microfinance intervention had been reached by any of the agencies? Even if everyone had been reached, did they get the required quantum of assistance to have sustainability? Answer to these questions is the future of micro finance.
Jayeeck Nag (2016) after a thorough study argues that, MFIs are getting affected because borrowers are failing to make payments and hence their recovery rates are falling. While over indebtedness is making the borrower go to depression and in some cases forcing them to commit suicide. Some experts advocate that multiple lending is not but over indebtedness is dangerous. This may be true but multiple lending is eating away the opportunity of new borrowers, and in a country where it is believed that the microfinance sector is able to cater to only 10-15 percent of its potential clients, even multiple lending proves out to be a big concern.

2.3 CORPORATE GOVERNANCE

CGAP (1997), the review of governance and micro-finance operations raises more questions than it answers. Indeed, there are no easy answers, particularly in an infant industry that has yet to establish governance guidelines. Future steps on this topic could include: developing a recruiting kit to assist a board in identifying its role and the skills necessary for an MFI board; training board members about the hybrid objectives of micro-finance; preparing guidelines about the appropriate role of board members to avoid conflicts of interest; and conducting research to suggest ways of aligning incentives and compensation for senior management and board members with the social objective of the institution.

Van Greuning et al., (1998) are of the view that, governance can be viewed as a framework of checks and balances designed to ensure that no party or parties within an MFI impede the attainment of corporate objectives by diverting its resources for private gain. Effective governance depends on a carefully designed system which links shareholders/ members/donors to the board of directors or trustees, to executive management, the staff and clients, and the general public.

Rock et al., (1998) governance is a process by which a board of directors, through management, guides an institution in fulfilling its corporate mission and protects the institution’s assets. Fundamental to good governance is the ability of individual directors to work in partnership to balance strategic and operational responsibilities.
Effective governance occurs when a board provides proper guidance to management regarding the strategic direction for the institution, and oversees management’s efforts to move in this direction.

Campion et al., (1999) find a different view and say, corporate structure does not define effective governance, but for each type of microfinance institution – non-profit, profit, credit union – factors exist that may strengthen or weaken a board’s ability to fulfill its roles and responsibilities. The characteristics and the perspectives of owners who exercise the governance role are perhaps the most important factors related to effective governance.

The Governance Guide developed by IRAM – CERISE, “A Tool for Analyzing the Governance of MFI” explores, to be sustainable in the long term, microfinance institutions do not just need to be financially viable and compatible with existing legal frameworks. They also need transparent and efficient internal organization that is acceptable to all the institutions stakeholders. This study expresses the key areas in meeting the challenges of governance. It also emphasizes on the relationship between governance and social performance which will help an MFI to analyze its SWOT.

Labie et al., (2008), in a study conducted highlight that, corporate governance tend to be more complex in cooperative structures, compared with classical firms, due to their democratic principle for decision-making, but also because their ownership is usually much more diffuse. This makes corporate governance a fairly touchy issue for credit unions, even more so when they enter growth dynamics. Growth compels credit unions to act increasingly like formal financial intermediaries.

Mersland et al., (2009) in spite of all these arguments, the bright spot is, the microfinance is high on the public agenda. Better corporate governance of MFIs has been identified as a key to enhancing the viability of the industry. However, the recent literature on the subject has struggled to identify the corporate governance mechanisms influencing the performance of MFIs.
**Bassem (2009)** the results identify trade-offs between MFIs outreach and sustainability depending on larger board size, and on higher proportion of unaffiliated directors. Moreover, the study shows that the more women there are on the board the better the performance, and reveals that external governance mechanisms help MFIs to achieve better financial performance. This study also allows us to distinguish other factors leading to better sustainability such as Regulation, and the use of individual lending methodology. However, the MFIs, active as NGOs, seem to be more consistent with their social mission than with their financial performance.

**M S Sriram (2010)** the institutional representatives on the boards of these MFIs have not exercised their independence. The promoters have gotten away with significant instances of skimming and there seems to be no dissent voiced on the greedy executive compensations and short-sighted behavior of the management of the top MFIs.

**Mersland (2011)** the importance placed on microfinance as a development instrument, combined with the increasing inflow of capital to the industry, indicate a need to better understand governance systems for MFIs. Further studies are needed. In particular, future research could consider how a combination of organizational types enhances competition in the microfinance market and how competition affects MFIs’ performance. The author is of the opinion that, studies are also needed on how donor monitoring, apex organizations and mismatches in the maturity of liabilities and assets influence management behavior and MFI performance.

**Hartarska et al., (2012)** in their article argue that, the results show that MFI efficiency is affected by certain governance mechanisms as suggested in the literature. In particular, MFIs are less efficient when the positions of the CEO and the board chair are merged; similarly, MFIs with a larger proportion of insiders (employees) on the board are less efficient. They also find that efficiency increases with a board size of up to eight or nine members and decreases after that. The evidence suggests that donors’ presence on the board is not beneficial, while that of creditors may be.
Tadele & Rao (2014) the main aim of Microfinance institutions (MFIs) is to serve the poor through providing financial services such as giving loans, provision of insurance coverage and a channel for their savings. Corporate governance in Microfinance is a mechanism where board of director’s establish an appropriate business environment to follow the day to day activities of the management and to achieve mission and vision of the MFI.

Chakrabarty et al., (2014), write, MFIs with boards that have more socio-economic expertise and female representation are better able to lower the MFI’s cost of operating at the BOP. However, this relationship weakens when the effectiveness of agrarian institutions at the BOP is low. When agrarian institutions are ineffective, the board of the MFI may have difficulty in helping the MFI reduce its cost of operating at the BOP. Agrarian crisis arising from ineffective agrarian institutions tend to aggravate the various institutional voids present at the BOP, making it harder for the board to guide the MFI around the institutional voids.

Jayadev M et al., (2016) governance is based on the basic tenets of transparency and accountability. Transparency in decision-making provides comfort to all stakeholders and accountability which follows from transparency fixes responsibilities for actions taken or not taken. Together they safeguard the interests of the stakeholders in the organization. Governance system represents the value framework, the ethical framework, and the moral framework as also the legal framework under which business decisions are taken.

2.4 FACTORS AFFECTING GOVERNANCE
The governance is required to uphold the organization’s goals and mission and see that they are implemented and it is needed to guide the organization’s major strategic directions. Governance helps to maintain the organization’s health over time and to mitigate risks. It thus helps to ensure accountability throughout the organization. Governance finally is required to ensure that the organization has the necessary human
and financial resources to operate effectively. Governance has assumed increasing importance for microfinance institutions (MFIs).

Hartarska (2005) in her research work finds, results indicate that governance mechanisms impact outreach and sustainability differently. External governance mechanisms play a limited role as only audit improves breadth of outreach. After controlling for institutional, MFI-specific, and economic factors, external governance mechanisms do not impact sustainability. The board is an effective internal governance mechanism and MFIs with local boards have higher sustainability. Board diversity improves both outreach and sustainability. The pursuit of both outreach and sustainability, it seems, may create difficulties for stakeholders who, by being represented on the board, hope to protect their interest.

Focus Note No. 7 of CGAP (2007) in the article “Effective Governance for Micro Finance Institutions” further enhances, a closer examination of governance includes an outline of the roles of the board members, board composition and an explanation of important issues of trust and conflicts of interest. This section then explores governance issues in the particular case of micro finance. It also expresses concern on responsibilities of the board, board composition accountability, transformation and relationship between MFI and NGO.

Prior et al., (2009) the systems for analyzing bank credit risk in developing countries are based on an analysis of the forecast cash flows of the customer asking for the loan. Financial institutions also include other variables in their risk analysis that enable them to refine the default expectations for their customers, namely, variables concerning their relationship with the institution and socio-demographic variables, but the use of such variables is marginal. The cash flow forecasts are calculated from the net income of the customer asking for the loan, which is compared with the expected loan repayment installments to determine his ability to pay.
T. G. Arun et al., (2010) as part of governance the responsibility is to ensure the credit information availability and lesser time in securing property maximize should be the objective of poverty lending focus of MFIs. Product diversification leading to economies of scope also enables institutions to reach poorer clients. In the case of MFIs’ financial performance, while external governance systems appear to be unnecessary, good internal operational systems are sufficient.

Ndulu (2010) in addition, regulating microfinance activities has been an important policy concern in improving financial inclusion and extending financial services to all. However, introducing a regulatory framework of any kind pushes targeted institutions to change. In this case, microfinance regulatory framework in Kenya that came to effect in 2008 has created three tiers of microfinance institutions: prudentially regulated deposit-taking institutions, credit only unregulated informal groups. Those undertaking deposit-taking business were required by this regulation to transform their operations to comply with the requirements.

Njeru Warue (2012) in spite of the above observations it is true that, the main goal of every microfinance institution (MFI) is to operate profitably in order to maintain its stability and improve growth and sustainability. However, existence of high levels of loan delinquency problem in microfinance industry negatively affect the level of private investment and constrain the scope of microfinance institution credit to borrowers as MFIs have to compensate for loan delinquency losses. The success of individual MFIs in credit risk management is largely reflected in the proportion of delinquency’s loans to gross lending.

Thrikawala et al., (2013) are of the opinion that the responsibility of MFIs towards society largely depends on the practice of governance criterias by the MFIs. Good corporate governance has been noted as even more important due to the demand for transparency and accountability of funds utilized in the microfinance activities. Further, MFIs need to have a solid governance framework to minimize the possibilities of management failures which may jeopardize the efficacious application of received funds.
from governments and donors. In prior studies, the nature of corporate governance practiced by MFIs is less understood and no substantive work using multiple MFI outcomes over a number of years has been undertaken.

Fundación Microfinanzas BBVA explores that a high standard of good governance is a key factor in regulating companies, and ensures their continuity and good management, in addition to generating value. They must also have mechanisms and structures to avoid asymmetries of information, conflicts of interest and ethical problems. The governing bodies of institutions are responsible for supervising the implementation of solid and sound corporate governance and for reviewing its operation. Training in best practices contributes to more effective internal control (risks and auditing) and allows greater regulatory and ethical compliance (code of conduct).

2.5 REGULATIONS AND ROLE OF REGULATORY BODIES

Recent events in India have brought a fresh focus upon the problem of regulation in the field of microfinance. Their study delineates the three distinct aspects where government needs to play a role. The first is to protect the rights of the micro-borrower, the consumer of micro-financial services. The second is that of prudential oversight of risk-taking by firms operating in micro-finance, since this could have systemic implications.

Rock et al., (1998) in their article observed, as microfinance institutions (MFIs) expand their outreach and increase their assets, and as more MFIs become regulated entities that can capture savings deposits, clear articulation of the functions of their boards of directors is essential for effective governance. As part of effective governance, all board members must follow basic codes of conduct to carry out their governance roles and responsibilities in good faith. “Duty of loyalty” requires board members place the interest of the institution above all others. “Duty of care” calls for board members to be informed and to participate in decisions prudently. Finally, “duty of obedience” requires that board members be faithful to the institution’s mission.
**Christen et al., (2003)** insists in his work by going a step ahead, the regulation we need today is not a normal one. The one we need today is Prudential Regulations. Regulation is “prudential” when it is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions. When a deposit-taking institution becomes insolvent, it cannot repay its depositors, and—if it is a large institution—its failure could undermine public confidence enough so that the banking system suffers a run on deposits. Therefore, prudential regulation involves the government in overseeing the financial soundness of the regulated institutions.

**Hardy et al., (2003)** many governments and nongovernmental organizations have adopted policies to promote the growth of microfinance institutions (MFIs). The appropriate level and form of support for MFIs are discussed in this paper on the basis of a review of key MFI characteristics. Governments are also responsible for the regulation of MFIs; here, some principles concerning the extent and coverage of MFI regulation and supervision are developed.

**Brau et al., (2004)** in their article, mention, as with most issues in microfinance, the effectiveness of microfinance as a policy tool for poverty alleviation and the optimal regulatory context for MFI development are still open questions. Researching these issues has the potential to be a rich area for discovery.

**Basu et al., (2004)** microfinance institutions, especially those engaged in full financial intermediation, complement effectively the banking sector in extending financial services and successfully draw on the rich experience of community-based development and preexisting informal methods of financial intermediation in Africa. Growing linkages between microfinance institutions and the banking system and the dissemination of good practices by nongovernment organizations contribute to the sound development of the sector, supported by regulation and supervision by local authorities.
T. Arun (2005) the rationale for regulation in the microfinance sector and the major regulatory approaches and its impact on the microfinance sector is aptly analyzed by various researchers. The sector-specific regulations along with prudential reforms may facilitate and environment, which allows microfinance institutions to mobilize savings and to reduce the problems in enforcing normal banking regulations. The emphasis is to incorporate the country specificities in the regulatory approach to encapsulate the specificities of macroeconomic environment and different stages of development.

Nair (2005) ascertains in his work that, globally there is a visible trend of the commercialization of microfinance, with NGOs transforming themselves into regulated financial institutions or non-banking financial companies and commercial banks entering the business of microfinance.

Satish (2005) says, the significant feature of microfinance in India is that it has been built upon the existing banking infrastructure. In the process, it has obviated the need for the creation of a new institutional set up or introduction of a separate legal and regulatory framework. In the linkage model, the financial resources are being sourced from regular banking channels as well as members’ savings. Thus the problems related to regulation and supervision of MFIs, the accessing of public deposits by MFIs and reliance on donor and grant funding are obviated. It has to be realized that microfinance is a means or an instrument for development, not an end in itself.

Sisodia et al., (2005) in his study finds, it is important to recognize that the state also has a role to play in regulation and development (at policy level) and in support infrastructure but it should not be a ‘player’ especially in loans. The regulatory framework has constrained the development of full financial services microfinance institutions. However, within this regulatory framework, mainstream banks and microfinance institutions can work as partners and this perhaps is the way to the future.

Parikh (2006) it is also true that, currently we are left with – a fragmented international microfinance software market where no clear industry standards have emerged and the
vast majority of current MIS implementations are unsuccessful, flailing or barely meeting the institutions information needs. As we discuss the future of rural microfinance service delivery, we must also keep in mind that microfinance is a young and evolving industry. Only very recently has it been seen on an international scale as a viable commercial opportunity, and not as a fringe activity for non-profit organizations. As the industry develops it is quite likely that we will see some shifting of roles and responsibilities in the microfinance sector. (Parikh, 2006)

Hartarska et al., (2007) upon addressing the issue, it is pretty clear, in spite of increasing pressure on microfinance institutions (MFIs) operating in developing countries to transform into regulated financial intermediaries, to date, no study has investigated whether regulated MFIs actually achieve better financial results and reach more poor clients than non-regulated MFIs. The article also finds that less leveraged MFIs have better sustainability. The policy implication is that MFIs’ transformation into regulated financial institutions is may not lead to improved financial results and outreach. However, the finding that MFIs collecting savings reach more borrowers suggests that there may be indirect benefits from regulation, if regulation is the only way for MFIs to access savings.

Sinha (2007) in the Indian context, policymakers’ approach to microfinance has been akin to that of most people towards street children: everyone agrees that they need nurturing, but no one wants to do anything about it. To begin with, the country’s central bank, the Reserve Bank of India (RBI), has repeatedly stated both in private meetings and at microfinance seminars that it regards both the lending and deposit-taking activities of microfinance institutions as extra-legal. However, since banks and other formal institutions have failed to provide financial services to the poor in any meaningful way, the RBI has felt that it would not be socially responsible for it to attempt to terminate these activities.

Hartarska et al., (2007) in spite of increasing pressure on microfinance institutions (MFIs) operating in developing countries to transform into regulated financial
intermediaries, to date, no study has investigated whether regulated MFIs actually achieve better financial results and reach more poor clients than non-regulated MFIs. This article explores the impact of regulation on MFI performance using newly released data for 114 MFIs from 62 countries in an empirical model where performance is specified as a function of MFI-specific, regulatory, macroeconomic and institutional variables.

Shetty (2008) in his article writes, Microfinance programmes have a potentially significant contribution to economic, social, political and psychological empowerment of the poor in general, women in particular. Through access to timely credit, savings, insurance and entrepreneurial training women have become successful entrepreneurs, increased their household income and well-being. Regardless of their scale, outreach, location and the type of clients, all microfinance programme interventions target one thing in common –human development that is geared towards both the economic and social uplift of the people that they cater for.

Langer (2008) the effort is to assess the current supply and demand for commercial investment in microfinance and to analyse some of the legal and regulatory challenges affecting the capacity of participating investors in the microfinance industry to satisfy unmet worldwide demand. In recent years, the increasing number of large, innovative transactions indicates that private investors are poised to supply as much capital as microfinance institutions can successfully and profitably deploy. This development could enable microfinance institutions to satisfy a vast portion of currently unmet worldwide demand for microfinance services.

Haq et al., (2008) in their article, specifically write, MFI regulation protects the industry from improper practices and through good governance, should improve managerial processes. Hence, these stronger MFIs should expand their outreach to the poor households and increase their lending as well as attain financial sustainability.
Hasan et al., (2009) though not a regular one, their study finds that, the results indicate that regulatory involvement and financial statement transparency do not impact performance, while some but not all rating agencies may play a disciplining role.

M. Rajashekar (2010) in his article “RBI to MFI’s: Shape Up or Face Music” tells that, India’s booming microfinance segment is under the scanner, with the Reserve Bank of India (RBI) issuing a veiled warning that it could be taken off the priority sector lending list of banks if the industry fails to improve its governance standard. The article tells about considering the loan to MFI’s as priority sector lending and its impact. The article also shows how central bank is closely observing the activities.

Shankar et al., (2010) Still, it is time to address regulatory issues to enable the microfinance sector to contribute more effectively to the goal of financial inclusion, and to provide an environment in which all stakeholders can participate with confidence. The creation of regulatory capacity for prudential and non-prudential regulation of the Indian microfinance sector will be a major challenge, but is likely to be a worthwhile investment for the country as in the long run, it could result in large-scale financial inclusion and financial deepening.

Augsburg et al., (2010) in his article gives a slightly different view saying, critics, after seeing the development of the sector, fear that MFIs tend to become so overly pre-occupied with their own financial sustainability that they move away from the poor as their preferred clientele and tend to start providing bigger loans for those in the low income section of the population instead of deepening their outreach to include the most needy.

Sane et al., (2011) the third is a developmental role, emphasizing scale-up of the microfinance industry where the key issues are diversification of access to funds, innovations in distribution and product structure, and the use of new technologies such as credit bureaus and the UID. Each of these roles needs to be placed in an existing or a new
regulatory agency. There is a case for creating a new regulatory agency which unifies the consumer protection function across all financial products.

Shankar et al., (2011) the microfinance sector, which earlier was heralded as representing a commercially viable solution to the problems of financial inclusion, poverty reduction and female empowerment, has within a span of a few months been accused of being an obstacle in the accomplishment of these goals. The sector participants have been alleged to engage in various improprieties, such as multiple lending and coercive collection practices.

Yerramilli (2013) on a typical note highlights, how Andhra Pradesh is negatively portrayed the reasons for series of farmers suicide in the state and the real reason behind the debacle is political influence on MFIs. The first section provides the historical background surrounding government regulation, particular in regard to development projects and the banking system. The paper then focuses on the relationship between the World Bank and the central government of India, and the effects of political competition on welfare and development programs in Andhra Pradesh. The final sections discuss the competition between the government and private actors, and analyze the factors that differentiate MFI outcomes in Karnataka and Andhra Pradesh.

Ghosh (2013), explain, microfinance cannot be seen as a silver bullet for development and that profit oriented microfinance institutions are problematic. To fulfill even some of its progressive goals, it must be regulated and sibsidised, and other strategies for viable financial inclusion of the poor and small producers must be more actively pursued.

2.6 NABARD AND MFIS

Sapovadia (2007) it is also observed that, despite the large scale growth and development of informal sector finance in India and particularly in the state of Manipur few issues and challenges are in front of us. Some of them are lack of finance, lack of knowledge and skill to conduct informal activities, no transparency of the government
rules and regulation in the informal sector, lack of infrastructure, no proper way of connecting it in the formal financial system, etc. So, Micro finance is more than a commercial activity; it is more of a social activity. It provides finance (micro) and plenty of confidence to the needy and enthusiastic entrepreneurs.

Singh (2009) in his research work recognizes, the Intellecap study estimates that the demand for micro insurance service ranges between INR 20.4 bn. to INR 88.3bn. The potential annual savings from these clients is estimated to be around INR 120 bn. The size of micro pension market is estimated at INR 21 bn. The Self Help Group (SHG) - bank linkage programme supported by National Bank for Agriculture and Rural Development (NABARD) and the MFI route have emerged as two important delivery channels for micro finance. While the SHG-Bank linkage has remained predominant in the past, the MFI channel has become increasingly significant in the last few years.

Ramaratnam et al., (2011) during these ad-hoc developments, there is a need of reforms and any reform without human face cannot be regarded as an effective reform. A reform should be kept at poor-centric in which the policies need to be framed to get the poor out of the clutches from poverty and enable them to contribute in the growth process in terms of income, employment and consumption. In India our national agenda always emphasize to achieve inclusive growth in which economic growth is measured with respect to availability of opportunity, enhancement of capability, easy accesses and livelihood's security of the poorest of the poor.

Batra et al., (2012) in their study are of the opinion that, in the recent times microfinance has received increased attention among the researchers and financial service providers, as a good alternative in the rural credit market. Various studies revealed that microfinance is a powerful instrument for poverty alleviation, enabling the poor to accumulate the assets, boost their incomes, and reduce their economic vulnerability. There are various opinions about the micro credit demand in India. M-CRIL, a leading microcredit rating agency provides a conservative estimate for the
annual demand at Rs. 480 billion based on 60-70 million poor families with an average household credit demand of Rs. 8,000 (less than $160).

**Jhamb (2014)** Micro financing has emerged as a significant and well recognized buzzword in today’s financing environment. The basic objectives of micro finance are developing the financial forecasting and continuous saving practices among the large numbers of people in India especially in the rural areas. There are growth potentials for the growth of micro financing in India due to more than two third population of India belongs to rural area and whereas only one third population has bank deposits. The newly elected NDA govt. come with an innovative idea of connecting people especially from rural and remote areas with banking industry by launching PRADHAN MANTRI JAN DHAN YOJANA. The vision of govt. is economic liberalization and opportunities of development and growth of India with the help of micro financing.

**Kumar et al., (2014)** Financial Inclusion is a delivery of banking services and various financial products at an affordable price to the lower segment of people. There are still a vast majority of the people who are financially excluded in India. To embrace all the sections of the society particularly the poor disadvantaged group of our country, The Government of India has taken various initiatives during the past years. The Reserve Bank of India (RBI) has therefore, framed the policy of Financial Inclusion with a view to bring in the financially excluded people who lack basic financial infrastructure within the fold of inclusive segment.

**Ahmad Bhat et al., (2016)** find in their research work that, microfinance in India is playing an important role in poverty alleviation and is widely credited for its success both nationally and internationally. As we know India's labour force is composed of Agriculture (60%), Industry (12%) and services (28%) which clearly indicate that even today agriculture is a major source of income and employment, keeping this in view government of India came up with National Bank for Agricultural and Rural Development (NABARD) in the year 1982 as a National development bank.
2.7 RESEARCH GAP:
The review of literature on the issues of micro finance in India, and regulations on MFIs, NGOs has revealed that there is significant number of research work being carried out at the national level. However, there is a very limited data available on the issues related to governance practices of MFIs. But in no way it is sufficient to address the problems associated with MFIs. The problems due to not implementing governance norms issued by RBI are significantly damaging the normal health of the society. Hence, it is important to investigate the reasons for these negative practices of the institutions and causes and effects of the same. Based on the review of existing literature, the following points have been listed to identify the research gap pertaining to the preset study.

- There is a huge unmet demand for financial services in the microfinance sector. Despite some success stories, MFIs probably reach lesser than 5 percent of the potential clients. Serving this market requires access to funding far beyond what the donors and the governments can provide. Thus, many MFIs want to expand their outreach by raising funds from commercial sources, including deposits. Some commercial banks are also looking to extend their financial services into the microenterprise market. Moreover, the government has already drafted the Micro Finance Sector (Development and Regulation) Bill, 2011. The Bill seeks to make it mandatory for all micro finance institutions (MFIs) to be registered with the Reserve Bank of India (RBI). It also entrusts the task of regulating the sector with the RBI. Consequently, the studies are not available to know the impact of existing regulations of RBI to monitor the wrong doings of MFIs in Karnataka.

- According to government data, over 5000 farmers committed suicide between 2005 and 2009 in Maharashtra. About 3000 farmers in Andhra Pradesh committed suicide in the past five years owing to debt trap, drought and crop failure. In many cases extreme step of suicide was taken as a course of action due to heavy pressure and humiliation from the private moneylenders and MFI’s. Desperate farmers are made to commit suicide with the hope of getting the relief package. In order to avoid these developments, there is scope for
conducting this study to set right the issues connected with wrong practices of MFIs.

- A recent study done by the Govt. of Andhra Pradesh reported that more than 55 percent of the farmers are not getting the Minimum Support Price (MSP). Even in Karnataka, in the vast tract of drought-prone area, farmers are in deep financial crisis and on the verge of debt trap. It is said that the state has a disproportionate share of drought-prone areas in the country. The northern districts of Karnataka are considered backward compared to other parts of the state. Therefore, the present study has opportunity to know whether the farmers/borrowers who are in need of financial assistance are properly attended by the institutions are not.

- Despite the measures undertaken by governance and RBI, the intention of controlling the wrong doings of MFI’s is not reaching the desired status. Until and unless, proper mechanisms are developed and implemented to monitor the activities of Micro Finance Institutions there is a danger of adverse growth of MFI’s at a rapid speed. Hence, this study has ample scope for ascertaining the degree of governance prevailing and the degree of governance to be established in order to ensure that the interest of MFI stakeholders is protected by and large.

- The studies conducted so far on the issue address the problems of MFIs in general located in various parts of India. However, there is no study being done yet on the problems pertaining to Karnataka and the need of regulations or regulatory frameworks to ensure the credibility of the MFIs operating in Karnataka.

- Micro financing has emerged as a significant and well recognized buzzword in today’s financing environment. There are service providers in the form of NGOs, NABARD, NBFCs and Commercial Banks. The Existing regulatory norms are not standard and uniform to all the categories of institutions. In this regard there is a need to define governance and regulatory norms applicable to all the MFIs in general. Therefore, this study attempts to establish suitable governance practices for the MFIs in Karnataka.
2.8 SUMMARY
Upon studying the various articles and books on MFI, it is hereby observed that the number of researches undertaken previously concentrate mainly on the impact of Micro finance on the marginalized, backward people of India. No study has made an attempt towards realizing the need for regulations and to propose the need for establishment of a regulatory body exclusively for the field of micro finance just like IRDA for insurance sector and SEBI for the security market.
Hence, this research work is undertaken to study the problems faced by the borrowers in the absence of governance and to highlight the need for the incorporation of MFI regulatory authority.