CHAPTER – 3
CONCEPTUAL FRAMEWORK
FOR MICRO FINANCE AND
MICRO FINANCE
INSTITUTIONS
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3.1 INTRODUCTION  
The governance practice of MFIs in Karnataka is a very valuable subject matter for the research work. The performance of the MFIs in the state of Karnataka, the social performance indicators and the problems associated with these institutions which have caught the national attention are the areas to be addressed. The research work will be carried out based only on the understanding of conceptual framework persisting with the MFIs. The researcher here has attempted to find the conceptual understanding of various terms associated with the MFIs and the profiles of MFIs selected for the study across Karnataka. 

3.2 MEANING OF MICROFINANCE  
The unemployed or low income individuals who don’t have access to financial services need not remain the same in the present world. They deserve a chance to grow, and all that is required is a little push, and a little help. It is an option to those who dream of doing something incredible with their ideas and dedication. That is where we see the emergence of the concept called Micro Finance. The micro finance is a formal financial facility available to the needy under-privileged rural poor. Micro finance, also referred as micro credit, is a type of banking service which is provided to the low income individuals or groups or unemployed who do not otherwise have any access to other financial services. In other words micro finance is a broad category of services, which includes microcredit. The micro finance is a facility which includes providing the financial assistance to those who are poor, socially marginalized and rural households who have less access to formal financial services in India. The micro finance includes providing savings, insurance and high quality financial products to the poor and who are at the bottom of the pyramid. It is that service which includes the people who are excluded from the formal financial services, trapped in poverty and who do not have enough income to take up any businesses. Micro finance in its own capacity allows the
borrowers of loans to engage in small businesses with safety and reasonable returns also.

Microfinance is often defined as financial services for poor and low-income clients. In practice, the term is often used more narrowly to refer to loans and other services from providers that identify themselves as “microfinance institutions” (MFIs). These institutions commonly tend to use new methods developed over the last 30 years to deliver very small loans to unsalaried borrowers, taking little or no collateral. These methods include group lending and liability, pre-loan savings requirements, gradually increasing loan sizes, and an implicit guarantee of ready access to future loans if present loans are repaid fully and promptly.

A microfinance institution is a financial institution which is specialized in providing financial services to the poor and needy. The purpose of establishing this institution involves providing financial as well as non-financial services having wider legal structure, mission and objectives. The institutions with different ideology and means of business have a common agenda of providing financial services to that section of the society who are deprived of formal banking services. With the advent of technology and increased need for the services the role of MFIs is dynamic and has increased manifold.

At the end one can rightly say, Micro finance is a system of banking the unbankables by bringing together savings, insurance, training and other essential services to the millions of people who far away from accessing these formal services from a regular financial institution.

The conceptual clarity regarding microfinance and microcredit is essential in highlighting the impact the microfinance has made over the years. There are quite a few differences between microfinance and microcredit, though the purpose of both are same and are used simultaneously. Ultimately what matters is the efficiency of the institutions in providing financial assistance and making it available to poorest of the poor not to fall to informal debt traps and survive in life. The following table will give an insight into the differences between the microfinance and microcredit so as to arrive at the conceptual clarity based on the characteristics of the loans offered.
### Table No. 3.1 Difference between Micro Finance and Micro Credit

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Characteristics of Loan</th>
<th>Micro Finance</th>
<th>Micro Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Size of Loan</td>
<td>Small</td>
<td>Small</td>
</tr>
<tr>
<td>2</td>
<td>Repayment period</td>
<td>Short</td>
<td>Short</td>
</tr>
<tr>
<td>3</td>
<td>Sources of Mobilization</td>
<td>Both external and internal</td>
<td>External</td>
</tr>
<tr>
<td>4</td>
<td>Repayment</td>
<td>Obligation if source external</td>
<td>Define obligation to repay</td>
</tr>
<tr>
<td>5</td>
<td>Collateral</td>
<td>Not Needed</td>
<td>May or may not be needed</td>
</tr>
<tr>
<td>6</td>
<td>Purpose of use</td>
<td>Flexible, consumption income generation</td>
<td>Mostly fixed, limited scope for deviation</td>
</tr>
<tr>
<td>7</td>
<td>Scope of operation</td>
<td>Mostly group Loan trickling down to individuals</td>
<td>Usually individual loans, though group loans might be given</td>
</tr>
</tbody>
</table>

Source: shodhganga.inflibnet.ac.in/bitstream/10603/103689/9/09_chapter%201.pdf

RBI’s Master Circular issued in 2004 on Micro Credit states that interest rates on loans from banks to MFIs or from MFIs to SHGs and individuals are left to the discretion of the loaning agency. It is the autonomy given to the MFIs to cater to the needs of the borrowers keeping their ability to repay the same.

### Table No. 3.2 Effective Interest Rates from the service providers

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Various Sources</th>
<th>Quoted Interest Rates</th>
<th>Effective Interest Rates incl. of transaction costs</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bank Loans to SHGs</td>
<td>12% - 13.5%</td>
<td>21% - 24%</td>
<td>No of visits to banks, compulsory savings and costs incurred for payments to animators/staff/local leaders</td>
</tr>
<tr>
<td>2</td>
<td>MFI loans to borrowers</td>
<td>15% - 24%</td>
<td>15% - 24%</td>
<td>No transaction costs except time spent in meetings</td>
</tr>
<tr>
<td>3</td>
<td>Money Lenders, landlords, traders</td>
<td>36% - 120%</td>
<td>48% - 150%</td>
<td></td>
</tr>
</tbody>
</table>

Source: shodhganga.inflibnet.ac.in/bitstream/10603/110401/10/10_chapter%203.pdf
The above table gives an idea as to the different rates of interest charged by the banks and MFIs to their immediate customers.

3.3 EVOLUTION OF MICROFINANCE IN INDIA

Microfinance has evolved rapidly into a global movement dedicated to providing access to a range of financial services to poor and near poor households. The organizations that provide these services, known as Microfinance institutions (MFIs) may operate as formal micro banks, non-bank financial institutions, non-governmental organizations, or community-based financial institutions\(^1\).

The world has realized the significance of MFIs in helping the poor and marginalized households and the growth of micro finance industry at the world stage is quite phenomenal.

The evolution of micro finance dates back to 18\(^{th}\) century when small operations began with the help of small finance. The very first lending in the form of micro finance happened through an Irish Loan fund system which was introduced by Jonathan Swift for the welfare of impoverished Irish people. The then started revolution of micro finance spread into various other parts of the world. Modern form of Micro finance was started at a larger scale during 1970s.

The establishment of first micro finance institution in the name of Grameen Bank in the year 1976 under the leadership of Mohammad Yunus paved way for the incorporation of many such institutions for the welfare of the people. The grameen bank establishment also stressed upon the importance of implementing the ’16 decisions’ propositions they made while starting these operations. In the honor of the works done in the field of micro finance, the Mohammad Yunus was awarded with Nobel Peace Prize which he deserves every bit of it. During this period only another premier pioneer was Akhtar Hameed Khan who brought in a new wave of microfinance with new initiatives and innovations.

It is when the people started experimenting different possibilities of loaning and succeeded. The increase in number of institutions or services is credited to these people who have encouraged other possibility of financing to the poor.

The major development with regard to micro finance happened in India with the formation of one of India’s revolutionary MFI, SKS micro finance in the year 1998. The best thing SKS did was instilling confidence among the needy and encouraging them to take decisions on their own and grow consistently.
That is where SKS used a method of pooling all the borrowers under one roof and dividing them to a group of 5 members to do business together and to repay the loan regularly. This method of administering yielded good results.

Since its rise in the late 20th century, microfinance has grown exponentially in its ability to reach and empower people living in poverty to transform their lives.

However, between 2008 and 2010, there was a microfinance crisis that affected developing countries heavily. Some say this crash was due to the repercussions of the microfinance industry expanding too quickly and others maintain the opinion that there were direct links to the Global Financial Crisis in 2008. Regardless of the cause, the Universal Standards for Social Performance were developed in order to regulate the operations of microfinance organizations².

The micro finance initiative in private sector in India can be traced to the initiative undertaken by Shri Mahila SEWA (Self Employed Women’s Association) Sahakari Bank set up in 1974 by registering as an Urban Cooperative Bank at Ahmedabad City of Gujarat State.

The main aim of SEWA bank was to provide banking services to the poor women employed in the unorganized sector. In the midst of the apparent inadequacies of the formal financial system to cater to the financial needs of the rural poor, National Bank

for Agriculture and Rural Development (NABARD) sponsored an action research project related to formation of credit groups in 1987 through an NGO called MYRADA at Karnataka state.

The then started evolution is witnessing the tremendous growth where it is observed that the increase in client base from 371 lakhs in 2015 to 399 lakhs in 2016. The following figure provides the information about how India has witnessed the growth of Micro Finance from 2001 to till date.

This phenomenal growth, on the one side is a matter to cherish as it indicates the kind of influence the micro finance has on the people and the impact it has created on the lives of the needy that are dependent on it and on the other side, a matter to cautiously monitor the negative impact it is creating on the borrowers, the image it is carrying of exploiting the interest of the stakeholders as it will have a long term effects on the MFIs and the field of micro finance too.

**Figure No. 3.1: Growth of Micro Finance in India**

![Figure No. 3.1: Growth of Micro Finance in India](https://indiamicrofinance.com/indian-mfi-rs-64000-2016-2017.html)


Encouraged by the results of field level experiments in group based approach for lending to the poor, NABARD launched a Pilot Project in 1991-92 in partnership with
Non-Governmental Organizations (NGOs) for promoting and grooming self-help groups (SHGs) of homogeneous members and making savings from existing banks and within the existing legal framework. Steady progress of the pilot project led to the mainstreaming of the SHG-Bank Linkage Programme (SBLP) in 1996 as a normal banking activity of the banks with widespread acceptance. The Reserve Bank of India (RBI) set the right policy environment by allowing savings bank accounts of informal groups to be opened by the formal banking system. Launched at a time when regulated interest rates were in vogue, the banks were expected to lend to SHGs at the prescribed rates, but the RBI advised the banks not to interfere with the management of affairs of SHGs, particularly on the terms and conditions on which the SHGs disbursed loans to their members. This has laid the foundation stone of self-governance of the SHGs. The SHGs grown to federation and culminated to NGO-MFIs but the issues of governance remained unresolved. The seriousness of the issue can be attributed to the increased number of access to MFI services. According to the most recent data from the World Bank, the microfinance industry is estimated at $60 to 100 billion, with 200 million clients. However, there is much criticism on the concept\(^3\).

In order to prove the notion and to understand the shift in customer base it is said as per 2016 statistics given by one of the Major Microfinance Institution that 73% of the borrowers belongs to urban population.

Table No. 3.3 Increase in Borrowers Base in the year 2016

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Name of the Institution</th>
<th>Gross Loan(in crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Janalakshmi financial Services Ltd</td>
<td>10983</td>
</tr>
<tr>
<td>2</td>
<td>SKS Microfinance Ltd</td>
<td>7682</td>
</tr>
<tr>
<td>3</td>
<td>Ujjivan Financial Services Ltd</td>
<td>5389</td>
</tr>
<tr>
<td>4</td>
<td>SKDRDP</td>
<td>4994</td>
</tr>
<tr>
<td>5</td>
<td>Equitas Microfinance Ltd</td>
<td>3283</td>
</tr>
<tr>
<td>6</td>
<td>Satin Creditcare Network Ltd</td>
<td>3271</td>
</tr>
<tr>
<td>7</td>
<td>Grameena Kuta Financial Services Ltd.</td>
<td>2539</td>
</tr>
</tbody>
</table>

Source: Data as of May 2017, Directory of Micro Finance Institutions in India

\(^3\)https://www.businessnewsdaily.com
With the emergence of specialized Microfinance Institutions as a provider of financial services to the poor rural and semi urban folks with their unique dual mission ‘to serve the poor’ and ‘remain financially sustainable’, Non-Bank Finance Companies (NBFCs) took the lead as an integral part of their business enhancement programme and successfully increased their client outreach through this business model. Section 25 companies (under Indian Companies Act, 1956) and the Mutually Aided Cooperative societies (MACS) were the latest entrants to this programme and concentrating in the truly remote areas with very less or no presence of commercial banks.

There is a huge unmet demand for financial services in the microfinance sector. Despite some success stories, MFIs probably reach fewer than 5 percent of the potential clients. Serving this market will require access to funding far beyond what donors and 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. 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.

The changes every day taking place in the field of finance lead by increased population, need for money, shortage of sources for funds and ignorance of the formal banking sector has influenced the need for the emergence of more MFIs in India. The need for providing financial services with a sense of responsibility and the wider gap created due to the shift in the priority of MFIs has called for increased need for regulatory frameworks for the field of Micro finance. 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. In view of small loan size,
microfinance institutions should be subjected to a minimum capital requirement which is lower than that applicable to commercial banks.

On the other hand, a more stringent capital adequacy rate (the ratio between capital and risk assets) should be maintained because microfinance institutions provide uncollateralized loans. 80% of MFI penetration in India is concentrated in 3 southern regions: Tamil Nadu, Andra Pradesh and Karnataka.

While there has been significant growth in access to finance in the last decade, there is still a huge unmet demand: The finance accessed by poor households is evaluated at US$ 2.5 billion, whereas the demand from 160 million Poor and Vulnerable Households in India is evaluated at $100 billion4.

Microfinance evolved as an instrument to reduce poverty and bring about sustainable development. As an alternative to traditional means of finance such as banking and insurance (which failed to meet the needs of poorer sections of society), microfinance was pioneered by self-help groups, non-governmental organizations and other non-profit institutions. However, with a view to building a scalable model that engenders overall sustainable development, the microfinance sector has witnessed the emergence of for-profit institutions that are structured along the lines of the modern business corporation. These microfinance companies adopt market-based mechanisms to raise capital that is employed in financing the poor and less-privileged.

On the other side, when it comes to providing loans, there are various models for disbursement of microfinance products and services used by micro finance institutions throughout the world.

The credit lending can either be individual lending or group lending. In individual lending, credit is provided to individuals whereas group lending involves formation of a group and provision of credit to these groups. Individual lending models are adopted by formal financial institution like banks whereas group lending models are used by MFIs as well as banks. Credit and micro credit is the appropriate tool for societal upliftment and poverty alleviation. But only micro credit cannot bring a positive change in the socio-economic status unless micro credit is provided along with savings, insurance,

and money transfer etc. Poor people need a wide range of financial products and services like credit, savings, insurance, payment transfer, provident fund, pension etc. The provision of the mentioned wide range financial products and services will not solve the problem unless the products and services are flexible, accessible and reasonably priced. Micro credit coupled with other financial and non-financial products will serve as package for development.

The outreach of MFIs over the years is significant to record as it gives an idea of the dependence of the borrowers on informal financial services. The following table highlights the spread of MFIs across India marking the growth that the sector has witnessed in the recent years.

**Table No. 3.4 No. of MFIs in Indian States**

<table>
<thead>
<tr>
<th>No of States/UTs</th>
<th>No of MFI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>90</td>
</tr>
<tr>
<td>2 – 5</td>
<td>57</td>
</tr>
<tr>
<td>6 – 10</td>
<td>13</td>
</tr>
<tr>
<td>11 – 15</td>
<td>4</td>
</tr>
<tr>
<td>More than 15</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: The Bharat Microfinance Report 2017

The number of MFIs operating in only one state stands at 90 and there are four major MFIs which are operating in more than 15 states delivering varieties of services to cater to the needs of the borrowers. The numbers given here are of 2017 and this shows how the MFIs are expanding their outreach in the 29 states, 4 Union Territories and 523 districts. The growth is clearly visible and it must be appreciated to meet the purpose of its inception to serve more with all the care and humanity.

The return on investment mainly depends on the interest shown by the borrowers and the loan portfolio is that x factor which acts as a revenue generating asset for any MFI. The role of these MFIs is currently required in a sense to improve the access to credit by those who are striving for these facilities. The growth of business can be measured through the loan portfolio it carries in a year.
Table No. 3.5 List of Top MFIs with Loan Portfolio as of March 2017

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Name of MFI</th>
<th>Gross Loan Portfolio (in Crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>BFIL</td>
<td>9150</td>
</tr>
<tr>
<td>2</td>
<td>SKDRDP</td>
<td>6399</td>
</tr>
<tr>
<td>3</td>
<td>Satin Creditcare</td>
<td>3617</td>
</tr>
<tr>
<td>4</td>
<td>Grameena Kuta</td>
<td>3075</td>
</tr>
<tr>
<td>5</td>
<td>Muthoot Microfin</td>
<td>1972</td>
</tr>
<tr>
<td>6</td>
<td>Asirvad Micro Finance</td>
<td>1793</td>
</tr>
<tr>
<td>7</td>
<td>Cashpor Micro Credit</td>
<td>1330</td>
</tr>
<tr>
<td>8</td>
<td>Disha Microfin Ltd</td>
<td>1314</td>
</tr>
<tr>
<td>9</td>
<td>Spandana Spoorthy</td>
<td>1297</td>
</tr>
<tr>
<td>10</td>
<td>Annapurna Microfinance</td>
<td>1239</td>
</tr>
</tbody>
</table>

Source: The Bharat Microfinance Report 2017

The above table shows that loan portfolio of the top ten MFIs which are operating in India as well as in Karnataka. Top ten MFIs contribute ₹31,185 crores of loan portfolios which is 67% of the sector’s total and rest of the other MFIs hold 33% only.

The sectorial growth of MFIs in the last 5 years has been commendable and it ignites a responsibility of assessing the services delivered by the MFIs, the effects of the MFI operations and the impact it has made on the community where it is operating. The available literature and experiences prove that the development in the micro finance sector is fluctuating. Moreover, there is a shift in the approach of the service providers towards profit making and the resistance from the borrowers to the same. This is evident from the drop in clients’ base in the year 2016-17.

Despite the measures undertaken by governance and RBI, the intention of controlling the wrong doings of MFI’s is not reaching the desired state. Until and unless, proper mechanism is 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. So the relevance of this study is to ascertain 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.
3.4 MFIS IN KARNATAKA:
The status of Karnataka as a state of art and culture has a significant impact on the livelihood of people. The people of Karnataka are highly dependent on the traditional methods of earning income. That means, the majority of the people still believe that agriculture is their main source of income and agriculture is mainly dependent on the monsoon. Likewise, Karnataka in the last one decade or so has witnessed the drought and the reality of farmers’ suicide. Like this the states which are highly affected by these drought and agriculture prone casualties like farmers suicide are Andhra Pradesh, Karnataka and Maharashtra. The role of MFIs in changing the scenario is attributed to the establishment of MFIs in Karnataka since 1980s. The efforts of helping these farmers during emergencies are sincerely done by the financial institutions.

The first NGO in Karnataka was started in the year 1984 in Mysore and it was MYRADA (Mysore Resettlement and Development Authority). Due to the efforts and initiatives of MYRADA, it is considered as the pioneer of micro finance in Karnataka. In the year, 1981-82 the SHG-Bank Linkage Programme were started and proved to be one of the successful initiatives of NABARD and in the mid 1980’s NABARD came in to foray with various proposals of providing financial assistance. As a result, number of MFIs started operating and expanding their business in Karnataka. The Vysya Bank became the first private micro credit firm to provide the micro finance services in Karnataka. Cauvery Grameen Bank became the first RRB to promote and credit line the SHGs during 1990s. The growth of MFIs in numbers and outreach is phenomenal and it is evident from the fact that the MFIs in Karnataka have 57000 Crore portfolio in the microfinance sector with 14% share in the micro finance market which is the highest in India.

3.5 TYPES OF MICRO FINANCE:
The financial services offered by the institutions vary from one to another especially from commercial banks to micro finance institutions. There will be differences in the types of formal finance and informal finance offered by the institutions. The types of loans or financial services offered by the MFIs are very important for the study to draw a line between formal and informal credits available to the borrowers. There are
different types of credits available to the clients from a MFI which are dependent on the nature of the institution and the area where it is located.

As the MFIs are viewed as the saviors for the people who are deprived of the access to formal banking, they have a greater role to play by providing all types of small loans to the needy to overcome their problems. The different type loans which may be in the form of income generating, emergency, soft loans, personal loans, short term, medium term or long term loans by whatever names may be. Ultimately the purpose of loans must be to meet the needs of the rural poor with a comfortable and convenient mode of access.

**Figure No. 3.2 Types of Micro Finance/Credit**

<table>
<thead>
<tr>
<th>Product</th>
<th>Purpose</th>
<th>Terms</th>
<th>Interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Generation Loan (IGL)</td>
<td>Income generation, asset development</td>
<td>50 weeks loan paid weekly</td>
<td>12.5% (appx)</td>
</tr>
<tr>
<td>Mid-Term Loan (MTL)</td>
<td>Same as IGL, available at middle (week 25) of IGL</td>
<td>50 weeks loan paid weekly</td>
<td>12.5% (appx)</td>
</tr>
<tr>
<td>Emergency Loan (EL)</td>
<td>All emergencies such as health, funerals, hospitalization</td>
<td>20 weeks loan</td>
<td>0%</td>
</tr>
<tr>
<td>Individual Loan (IL)</td>
<td>Income generation, asset development</td>
<td>1-2 years loan repaid monthly</td>
<td>11% (appx)</td>
</tr>
</tbody>
</table>

Source: Meghana Bhogle, Impact-of-microfinance-on-the-indian-economy-12-728

The above table shows the different categories of loans which are normally offered by majority of the MFIs across India benefiting lakhs of borrowers and transforming them to enjoy a better livelihood.
3.6 TYPES OF MICRO FINANCE INSTITUTIONS

Microfinance is all about disbursement. And intermediation is done by MFIs. These MFIs receive loan from public and private commercial banks and national and international donors and lend them to the poor who have no access to formal banking. MFIs can be any of the five types of legal entities.

a. Non-banking Financial Institutions (NBFIs)
b. Mutually Aided Cooperative Thrift and Credit Societies (MACTS)
c. Societies (Registered under 1860 Societies Act)
d. Trusts (Registered under Trust Act)
e. Private Companies (Registered under Section 25 of Companies Act of India)

Broadly, the societies, trusts and section 25 companies are put under the section “NGOs”. So based on this classification, the MFIs can be 1) NBFIs 2) NGOs and 3) MACTS. Basically, NBFIs are for-profit institutions and NGOs and MACTS are not-for-profit institutions. In India, there are more than 600 MFIs working with an accumulated outreach of 1.25 crores of the poor households. In India about 80% of such institutions operate as societies and trusts, 10% of the MFIs operate under the company structure, 5% are section 25 Companies Act, 2% work as cooperatives, 2% are non-banking companies and about 1% is structured as LABs.

In India, NGOs have undertaken the major role in financial and social intermediation. Majority of these NGOs are registered as trust or society. These NGO-MFIs have worked as catalytic agents to organise the poor into groups known as SHGs/or JLGs and have delivered financial products and services to these groups. The NGO-MFIs are different in their size, philosophy and approach. These NGO-MFIs are not very structured financial intermediaries like NBFIs, but are generally restrictive in operating any commercial operations either due to their legal status or due to their mission statements. These organizations by their charter are non-profit organizations and as a result they face several problems in borrowing funds from the higher financial institutions.
3.7 NON-GOVERNMENT ORGANIZATIONS AND MICRO FINANCE INSTITUTIONS:

In India, trusts, societies and private limited non-profit companies are considered as not-for-profit organizations and initiated as public charitable organizations. These charitable organizations are self-governed, independent and prohibited from distributing monetary benefits to their own members. These charitable organizations are neither allowed to raise the equity nor allowed to mobilize the deposits.

Most of the Indian MFIs are NGOs, and the NGOs are not regulated by prudential regulations. Therefore, they are not considered as the mainstream financial institutions. Also, there are many debates on the legality of NGO-MFIs providing financial products. As per the legal status, NGOs are not-for-profit organizations. Hence, the microfinance clients of the NGOs are not considered as the legal members of the NGOs. On principle, the microfinance operations carried by NGOs are not for microfinance business rather for socio-economic development of the people. If NGOs decide to operate microfinance practices on a large scale as commercial operations beyond certain limit, they have to register under NBFIs.

The NGOs provide microfinance products to the poor who are organized into groups. NGOs who are engaged in providing group based microfinance products (providing microfinance to the SHGs or JLGs) should not provide the microfinance services beyond their groups.

As per the prudential norms, the MFIs who are providing only credit products (not in any other microfinance services including mobilization of savings) will have to furnish their periodical statements on their financial operations. Again, MFIs, who receive loans from banks, will have to comply with certain prudential accounting norms in relation to asset classification, income recognition and provisioning.

The NGOs generally provide microfinance products to clients who are broadly organised into SHGs or JLGs. These NGOs get the fund from donors or wholesalers in microfinance like SIDBI, NABARD, RMK, FWWB, and commercial banks etc. and lend to their clients. For example, KAS foundation has got fund from ICICI Bank and ABN Amro Bank.

The problems with NGO MFIs are:
1. Issues regarding legal structure: Many of the MFIs are working as societies which suffer from legal hurdles as imposed by apex legal institution in financial sector in India. Under the existing legal framework of India, NGO-MFIs are unable to mobilize the savings.

2. Lack of commercial orientation: most of the MFIs are dependent on fund and technical assistance from the donors. The operations are generally confined to social motive. So many of the NGO based microfinance operations work as projects of small durations.

Lack of efficient organizational structure: Many of the NGO-MFIs have been initiated by social workers who have lacked expertise on financial operations. Again the staff members are found to be not efficient in microfinance operations. So, many of the NGO-MFIs have suffered losses from microfinance programmes and subsequently switched over to other development projects.

Upon studying the above facts and narrations one can conclude that, saving mobilization of NGO based MFIs are not permissible. Doing so will lead into a practice as against the norms prescribed by the government. Even if it is done, there are existing mechanisms to monitor such practices. The lending practices of NBFCs, LABs and commercial banks fall under the RBI regulations and they are regulated by the RBI. But, the regulations imposed by RBI are not enough to control the wrong doings of the financial institutions acting as MFIs in view of protecting the interest of stakeholders of these financial products.

In this backdrop, this study looks into the governance issues and the protection of the stakeholders in the background of the proliferation of MFIs in the present society. For the convenience, this study has been restricted to the selected micro finance institutions of Karnataka. This study probes on the issues related to the determinant, influencing factors and independent factors that ultimately decide why a particular institution is a successful one and others are not.

In terms of significance, the study can be extended to any part of the nation or even to other countries. Theoretical framework of the study looks into the structural and

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dimensional changes in the field of micro finance and how best it can be enhanced through best governance and management so as to make the MFI’s contribute more towards the rural development and poverty reduction.

3.8 GOVERNANCE IN MICRO FINANCE INSTITUTIONS:

Governance is based on the basic tenets of transparency and accountability. Transparency in decision-making provides comfort to all the stakeholders and accountability which follows from transparency fixes the 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. Governance, broadly defined, is the system of people and processes that keep an organization on track and through which it makes major decisions. In the broadest terms, the functions of governance are:

1. To uphold the organization’s goals and mission and see that they are implemented
2. To guide the organization’s major strategic directions
3. To maintain the organization’s health over time and to mitigate risks
4. To ensure accountability throughout the organization
5. To ensure that the organization has the necessary human and financial resources to operate effectively

A broad range of stakeholders have an active role in MFI governance. These stakeholders play a pivotal role in governance issues related to MFIs. We can see these actors broadly as external or internal according to their roles in the governance process. The external factors, as regards to governance are those entities that oversee the institutions’ financial health: regulators and auditors and the providers of financing: shareholders, lenders, and depositors. The internal actors are the board members,

Good governance is the ability of the board members to monitor the status of the organization, make good strategic decisions, and hold executives accountable for their execution. Ultimately, that comes down to the quality of the board members, the culture
and practice of the board, and the power relationships among board members and executives.

Good Corporate Governance refers to a system of people, values, criteria, processes and procedures that ensure that an organization is managed properly and that guides it towards its mission and vision.

The general duties of the Corporate Governance system are:

1. Defending the organization's mission, vision and fundamental goals.
2. Moving the organization along its main strategic guidelines.
3. Maintaining the organization's long-term sustainability.
4. Ensuring that corporate responsibility is applied throughout the organization.
5. Good Corporate Governance makes sure mechanisms are in place and put into practice in order to strike a balance between management and control and to meet the needs of Stakeholders (everyone involved in the organization and/or affected by its activity).

The challenges involved in implementing Corporate Governance include:

1. Identifying the path to follow and the solutions that best meet the organization's needs.
2. Hiring people who can guarantee efficient management and administration.
3. Conveying that credibility in the eyes of the market is a fundamental pillar.
4. Commitment to stakeholders (shareholders or partners, customers, suppliers, institutions and markets, and so on).

3.9 NEED FOR CORPORATE GOVERNANCE IN MFIS

The governance in any MFI or organization is very important for the following reasons:

- It helps in establishing a framework for long-term relationship between the institutions and the stakeholders.
- It brings dynamism in the monitoring and mentoring the services of MFIs.
- It will incorporate the strategic thinking through which different ideas for the exhaustive financial services can be initiated.
- The governance practice helps in reducing the risk of the management by articulating the decision making process.
It will have a cascading impact on the institutional practices ensuring the safety, benefit and growth for the different stakeholders of the institution.

It will bring a healthy environment of being accountable and responsible for the acts and deeds one prefers to practice.

In the changing scenario of doing business it is necessary to develop a sense of responsibility among the institutions which are in public domain all over India so that they remain grounded in their primary objective and do not exploit the poor majority of the country.

3.10 OBJECTIVES OF CORPORATE GOVERNANCE

Effective practice of governance is an undeniable tool for the very existence and survival of any MFI. It will have long lasting impact on the institutional practices by inspiring and influencing the investors’ confidence towards the company thereby helping the institution to scale newer heights.

The objectives of governance can be listed as below:

- To strengthen the board which will be capable of taking independent and timely decisions for the effective execution of service delivery.
- To ensure that the board has a powerful machinery to serve the needs of stakeholders.
- To prove that the board has a balanced approach towards the institution and the stakeholders dependent on it.
- To ensure that the institution is transparent in its activities and practices leading in to the strengthening of the customer base.
- To make sure that the institution maintains a solitary profile and keeps its stakeholders informed about the developments influencing the services.
- To develop an atmosphere of forward looking and ensuring effective control of what the institution does not harming the wellbeing of those who are dependent on the institutional services.
- To maximize the stakeholders value and developing an ethical environment of creating stakeholders wealth than institutional wealth.
The institution with the above objectives can only be trusted and allowed to do the business in the society. Otherwise it will lead to the decisive practices of institutions affecting the lives of lakhs of clients.

3.11 FACTORS INFLUENCING GOVERNANCE PRACTICES OF MFIs.

It is not wrong to make wealth or money by whatever the activities or business one does. However, it is important to note how the business is carried on. The primary objective of corporate governance is to develop an atmosphere of creating wealth legally and ethically. This means, being reasonable and satisfying the different stakeholders of the community like, borrowers, employees, investors, vendors and the society at large. The way society has opened up for changes in accessing financial services; it becomes necessary to incorporate a sense of moral responsibility among the service providers not to indulge in unethical practices in the process of earning wealth. Hence, one must understand the need for implementing the governance in the MFIs for the better future of this financial sector.

The quality of governance basically depends on the following factors of governance:

- Ability of the board.
- Adequacy of the process.
- Commitment level of individual board members.
- Transparency.
- Quality of corporate reporting.
- Participation of stakeholders in the management.

The analysis of the above factors will give an insight into what transpires MFIs to perform better and become responsible and reasonable towards the borrowers of the financial services all over Karnataka.

1. **Ability of the board:** the board constitutes as a major player in ensuring the smooth functioning of the any institution. It is the board which oversees the management and governance of the institution which is required for the purpose of monitoring service delivery and management’s performance. The role of board is very significant in ensuring proper financial system, financial control, preparation of
financial statements, reporting of the statements and legal compliance of the institution and review of ethical standards of the MFIs. It is indeed important to assure the relationship with shareholders, employees and society are harmonious and mutually beneficial. The institutions while doing business must engage in strengthening the board by efficiently defining the board size and composition, selection of directors and their roles and responsibilities. Ability of the board is of foremost importance in ensuring ethical conduct of the business.

2. **Adequacy of the process:** the capital adequacy of the institution is necessary to build confidence among the investors and customers. This can be attained by practicing continuous and comprehensive review of information, continuous monitoring of the results, internal audit and review of the effectiveness of the company. The adequacy and frequency of the information related to the MFI activities and processes, risk management and capital adequacy assessment is pivotal for the success of any corporate governance practice of any institution.

3. **Commitment level of individual board members:** the role of board members in developing an atmosphere of confidence among the stakeholders is significant. They are the ones who are there to exercise the business judgment with which strategic decisions are taken and implemented for the better future of the MFI. It is for this reason they are expected to attend the board meetings regularly, meet frequently, discharge their duties with utmost sincerity, develop a standard communication channel with all those concerned with the institutional affairs, assess the board performance and bring out the best with necessary confidentiality. All this will work for the good of the institution in creating an image of committed board towards the noble cause of serving the poor and needy.

4. **Transparency:** it is the eagerness or the willingness to be open, to provide the needed information to the stakeholders with utmost truth and accuracy of information. It is much needed to communicate the decisions taken and the effects of those decisions on the beneficiaries of the institutional services. The institution which practice self-regulation will have a magnanimous effect on the society and thereby ensuring the effective transformation of the society. The institutions over the life time may come across those situations of survival and success which may be
transpired on to the stakeholders, to which they are unaware of. It is in this condition the need for transparency is significant and highly influential.

5. **Quality of corporate reporting:** any institution will be seen as trustworthy and beneficial only upon assessing its disclosure mechanisms. The way institution presents its information to the public domain will have a ulterior impact on its borrowers base and the service by large. Disclosure of information helps the firm and investors together to participate, to get the benefits and develop a societal environment of mutual trust and confidence. It is highly important for the institutions to let the world know about the sources of funds, clarity of the services offered, consistency in operations etc. The commitment in explaining the changes, negative and positive developments witnessed over the years and a summary of the true and fair practices of the MFI in its reporting will add on to the effective governance practices of any institution.

6. **Participation of stakeholders in the management:** the participation of the various stakeholders ion the affairs of the MFIs will be mutually beneficial and the association of different parties brought together the betterment of the firm and the society is further guaranteed. That is where the stakeholders should be given with the right to consultation, consideration of their interest in the form of right for nominating the board members, to receive compensation by becoming shareholders, access to information, full disclosure and openness. Ultimately, the efforts of the board must be to empower even a common employee to become the shareholder of the company. Such level of freedom to participation will certainly boost the confidence of the different parties to remain loyal to the institution and reap the benefits together.
3.12 ELEMENTS OF GOOD GOVERNANCE

The success of any MFI is highly acceptable only when its measured in terms its ethical behavior towards the stakeholders and not just financial success it has attained. To make this possible, the institution needs to incorporate governance in its activities. It must not be just governance but the fair and equitable governance. The following points provide an idea of elements of good governance in any MFI.

- **Role and powers of board:** the foremost requirement of good governance is the clear identification of powers, roles, responsibilities and accountability of the board, CEO, and the Chairman of the board.

- **Legislation:** the legislation and regulations which are clear and unambiguous avoiding the misrepresentation or misinterpretation of the facts are core to the practice of governance of any MFI.

- **Code of conduct:** the institutional norms for the ethical practices being code of conduct must be in writing and to be communicated to all the stakeholders to abide by that always.

- **Institution and community interaction:** the role of any institution will be complete only when it has a regular interaction or negotiation with the community at large ant takes the members into confidence.

- **Regular reporting:** the institution or the board being the higher authority should have an implied responsibility of providing the information about the financial matters for the effective governance of the institution.

- **Setting of institutional strategy:** the purpose for which the institution was set up and the vision it has must be properly documented and the same must be inculcated in its day to day activities.

- **Board independence:** along with defining the role of board members it is important to draw a line as to the extent to which the independency they have and do not have so that their actions do not hurt the institutional borrowers at any cost.

- **Management environment:** it involves creating an operational environment which involves self-discipline, accountability, responsibility, risk taking ability,
human resource management and recognition for the individual and group performances for developing a feeling of belongingness.

Auditing: the authenticity of the business transactions can be ensured through the proper practice of review of transactions recorded, internal control and compliance to policy and procedures established. Quality auditing and audit report is a key to the success of governance as well as institution.

Risk Management: there must be a well-established system of risk assessment, prevention of problems associated with the operations and management of failures so that the institution remains successful against all odds.

The governance is a measure to stop the misdeeds what an institution carries in its lifetime. It is needed and needs to be nurtured so that the institution does not dilute from its objectives.

Despite the corporate governance revolution, there exists no universal benchmark for effective levels of disclosure and transparency. So it is always an attempt from the institutions to become better from the rest by trying to follow the most possible governance factors to most possible extent.

3.13 DETERMINANTS OF BOARD PERFORMANCE AND QUALITY OF REPORTING

In the recent past, practice of governance has been an integral part of the companies doing various businesses. Governance is not only a prerequisite for doing business but also an all important tool for the sustainable development of the business and protection of the stakeholders with the intervention of fairness in operation, transparency, quality of reporting, stakeholders participation and disclosure mechanisms.

The practice of governance solely rests on the interest and involvement of the management which has forward looking vision and mission. As part of governance practice, the constitution of board and its performance and the quality of reporting of the state of affairs of the business has a huge role to play in ensuring effective governance of MFIs operating in India. The following factors are the important determinants which

are integral to assess the ability of the board and the board performance of any MFI.

1. **Board Skills/Experiences** – the capacity of the board is necessarily important to uphold the institutional democracy and to enable the institution to function effectively. This is possible only when the board consists of the members with sufficient educational qualifications, required qualities, managerial skills, thorough knowledge and experience to make impactful contributions. The board skills must include operational or technical expertise, financial skills, legal skills as well as knowledge of government and regulatory requirements. A board with these parameters will serve as a valuable tenant in governing the MFIs.

2. **Role and Powers of Board** – the major problem most of the MFIs face is regarding the powers, roles, and responsibilities of the board and administrators. As part of role and powers of the board, the purpose of the company must be defined, the values by which the company will perform its duties must be defined and the relevant stakeholders of the company are to be identified to develop the strategies. Clear articulation of the powers, roles and responsibilities of the board, CEOs and the chairman of the board is significantly important to make the board accountable and responsible towards the aspirations of those who are dependent on the services of the MFIs.

3. **Structure and independence of the Board** – there is no standard formula as to composition of the board. The most common composition of the board will consist of executive directors being full time employees of the company and non-executive directors who are not regular employees of the company performing the balancing acts in resolution of conflicts and external perspective to the management. The board may consist of key positions like the chairman, CEO and Secretary performing administrative activities. The independence of the board is essential by having equal distance from the management and from any commercial obligations with the company. The independence of the board will ensure the effectiveness of the management and avoidance of any actual or perceived conflict of interest.
4. **Board Meetings** – the board meetings are the integral part of any institution in its desire to grow sustainably. The number of board meetings held in a year’s time with the active participation of all the board members to discuss about the policy changes needs to be made, decisions to be taken, implementation of the decisions so taken and sharing of the responsibilities are very much required to affirm the faith of all the stakeholders in the MFIs.

5. **Board Appointments** – every year the appointments for the positions vacant in the board are necessary. It is highly important to appoint or reappoint the right kind and number of competent people to the board with a well-defined procedure. This will bring the quality and competency in the board thereby ensuring the correct discharge of duties by everyone concerned.

The attention and care towards the composition and ability of the board is of greater difficulty yet significantly important to ensure the field of micro finance is handled properly and MFI remains as a dedicated entity in providing quality service to the rural poor and does not take the path of profit making. As part of governance of the MFIs, the ability of the board is one of the important factors which will have a long lasting effect on the MFIs.

The other important factor which influences the effective governance of the MFIs is the quality of reporting. The way the financial reports are presented and communicated to the stakeholders is one of the major influencing factors on the governance of MFIs. If the financial performances of the institutions are presented fairly and honestly, it will add great value in ensuring the protection of stakeholders interest thereby creating the goodwill for the institution. The following are the determinants which will play a greater role in ensuring the quality of reporting of any MFI.

1. **Relevance** – the financial reports which are prepared and presented must be relevant to the needs of the decisions to be made having futuristic visions. The quality of reporting should be such that it should generate the cash inflows consistently which will enable the firm to cater to the needs of different sections of the society.
2. **Understandability** – one of the most required elements in the quality of reporting is the understandability of the reports so prepared. The level of comprehension established in the way the reports are prepared will genuinely add value to the reports and more importantly will provide a lot of clarity in the reports so presented.

3. **Comparability** – the stakeholders who wish to access the information from the reports should be provided with an opportunity of comparing the similarity and differences between the two sets of economic data presented to them. The reports which are prepared with the same accounting principles and policies imparting a high level consistency will definitely help the institutions in creating a positive image towards the institution and thereby will become the integral part of governance of any MFI.

4. **Faithful Representation** – the chances of viewing the information furnished in the annual reports as biased is very common among the institutions. It becomes important to facilitate the financial or annual reports with sufficient documentary evidences to support the claims made in the reports. This will certainly ensure that the reports are prepared according to the accounting standards and are up to the standards of reporting ensuring the increased faith on the reports so furnished.

5. **Timeliness** – the decision making process of any institution will certainly have long lasting impact on the future of the institution. The timely presentation of the financial reports during the decision making process of the organization is of utmost importance for the purpose of ensuring the influence of the reports over the decisions to be made with a view to grab the opportunities for the growth in the financial sector.

The study of the above determinants will help to identify to what extent ability of the board, board performance and quality of reporting being part of governance practices ensure the quality of governance in the MFIs to enhance the performance of the institutions. These practices of governance will surely bring the change which is rightly deserved by the sector and make sure that the institutions grow in the right context and remain highly useful in transforming the lives of rural poor. This kind of change and
positivity will impart the sustainable growth of the institutions as well as the community by large.

3.13 AREA OF STUDY – KARNATAKA STATE – A PROFILE
Geographically, Karnataka occupies three natural regions like the Coastal strip, the Sahyadris and the Deccan plateau. They are known in Kannada as Paschima Karavali, Malnad and Maidan respectively.

The Sahyadris are covered with evergreen forests. They drop abruptly towards the Arabian Sea, thus forming a natural barrier between the plateau and the coastal regions. Four passes provide access to the coast. They are the Subrahmanya Ghat, the Charmadi Ghat, the Shiradi Ghat and, the famous Agumbe Ghat. The western Ghats slope gently towards the Bay of Bengal. This is the plateau region drained by the two principal rivers Krishna and the Kaveri. The average elevation of the plateau is about 610 meters above sea-level.
The western strip across the Arabian Sea is humid & warm in summer, water-soaked in monsoon, profuse with coconut grooves & paddy fields criss crossed by strips of silvery streams & sparkling stretches of sand.

The hilly uplands of Malnad, One of the wettest regions of the world, where the bamboo flourishes wild & areca, teak, rosewood & matti are grown. It is also the home of the stately gaur & langur. In its southern reaches frequent kheddas are held to capture roaming groups of elephants. Also the swift deer & the deadly tiger, whose eyes burning bright in forest night, roam animatedly in the forests.

The east of the ghats is strikingly bare. This elevated stretch is supposed to be the oldest land on the earth where ancient rocks of earth are seen jutting in & out odd shapes. Rivers like Cauvery, Sharavathi & Ghataprabha pass through upgraded valleys &
resulting in water-falls & occasional rapids. The torrential fall of these rivers have been harnessed to generate hydro-electric power in an area where black coal is scarce.

There are seven river systems in Karnataka which with their tributaries, drain the state. The river Cauvery is an Inter-State river and is one of the major rivers of the Peninsular flowing east and running into the Bay of Bengal. The principal tributaries of Cauvery are the Harangi, the Hemavathy, the Lakshmanathirtha, the Kabini, the Shimsha, the Arkavathi and the Suvarnavathy. The river Krishna is also an Inter-State river in Southern India flowing through Maharashtra, Karnataka and Andhra Pradesh. The principal tributaries of Krishna in Karnataka are Ghataprabha, Malaprabha, Bhima and Tungabhadra.

The climate is salubrious for the major part of the year. Karnataka enjoys a tropical climate with three distinct seasons-hot and dry from February to May; rainy with plenty of sunshine from June to October; and cool from November to January. Much lower temperatures are experienced in the North and Northeast during nighttime. The South has a tropical rainforest climate with temperatures averaging 28 degrees Celsius almost all year round.

3.14 SUMMARY

The present chapter, conceptual framework for micro finance and micro finance institutions acts like a road map for the current research work. The conceptual framework covers the meaning of micro finance, evolution of micro finance, the types of MFIs, the relationship between the NGOs and MFIs, governance of MFIs, need for and objectives of governance on the institutions and the factors which influence governance practices of MFIs. Understanding these issues will certainly help in studying the present scenario of MFIs in Karnataka and their practices of governance supplementing the efforts of government as well as RBI.