CHAPTER – 1
INTRODUCTION
1.1 INTRODUCTION

Micro finance is one of the most important revolutions that Indian financial sectors have been witnessing in the recent days. The innovations in the field of micro finance, especially in designing customized products or services for the different categories of beneficiaries have imparted a significant change in the Indian financial sector. Now micro finance is seen as an intervention for the socio-economic development of the rural poor and for those people who do not have an access to formal financial system. As a result, microfinance has not remained as micro scale banking but it is recognized as a valuable tool for socio economic development of the poor across the world. Due to the diversified needs of the poor, the role of micro finance has also changed. Now micro finance is into women empowerment, poverty alleviation, micro entrepreneurship development, networking and linkage building, improved standards of living, increased literacy level, betterment of health issues and providing career oriented multiple advantages.

This is very evident from the experiences of many beneficiaries and observers of the financial sector. Research across the globe has shown that, over time, microfinance has influenced the clients to increase their income and assets, increase the number of years of schooling their children receive, and improve the health and nutrition of their families\(^1\). The growth in the field of micro finance can be attributed to the various developments which have happened over the years. The earliest phase of Indian Microfinance can be described from early 20\(^{th}\) century until 1969, when credit cooperatives largely dominated as institutions in provision of microfinance services. This phase began with the passing of Cooperative Societies Act 1904, to extend credit in Indian villages under government sponsorship.

This step was provoked by agrarian riots in the Deccan in the late 19\(^{th}\) century that brought forth the issue of farmer indebtedness to moneylender to British Government. The agrarian riots prompted the British Government to give thrust to the system of Taccavi loans to farmers, regulate money lending and promote rural credit cooperatives

as an alternative to money lenders. Between 1950 and 1969, the emphasis was on promoting the cooperatives.

Nationalization of the major commercial banks in 1969 marks a watershed in as much as from this time onwards the focus shifted from the cooperatives as the sole providers of rural credit to the multi-agency approach. This also marks the beginning of the phenomenal expansion of the institutional structure in terms of commercial bank branch expansion in the rural and semi-urban areas. For the next decade and half, the Indian banking scene was dominated by this expansion.

However, even as this expansion was taking place, doubts were being raised about the systemic capability to reach the poor. Regional Rural Banks were set up in 1976 as low cost institutions mandated to reach the poorest in the credit-deficient areas of the country. In hindsight it may not be wrong to say that RRBs are perhaps the only institutions in the Indian context which were created with a specific poverty alleviation - microfinance – mandate.

During this period, intervention of the Central Bank (Reserve Bank of India) was essential to enable the system to overcome factors which were perceived as discouraging the flow of credit to the rural sector such as absence of collateral among the poor, high cost of servicing geographically dispersed customers, lack of trained and motivated rural bankers, etc. The policy response was multidimensional and included special credit programmes for channeling subsidized credit to the rural sector and operationalizing the concept of “priority sector”. The latter was evolved in the late sixties to focus attention on the credit needs of neglected sectors and under-privileged borrowers. The rural credit cooperatives in India became a means of pooling the few resources of the poor and providing them with access to different financial services.

The nationalization of Banks in 1969 along with a strong political emphasis towards poverty eradication led to a new rural finance policy that was directed at reducing the lending imbalances in particular sectors. This new policy resulted in among other things

to establishment of Regional Rural Banks (RRBs) and adoption of priority sector lending by Banks under direct specifications of the Reserve Bank of India (RBI). A decade later rural financial delivery got further boost in 1980-81 with the government sponsored Integrated Rural Development Programme (IRDP), under which loans of less than Rs. 15,000 (USD 330) were given to the poor. In 20 years, since its implementation, the financial assistance of approximately Rs. 250 billion ($5.6 billion) was provided to roughly 55 million families.

However, underneath such aggregated figures, at the ground level the IRDP led to large scale misuse of credit. This created a negative perception about the credibility of the micro borrowers among bankers further hindering access to banking services for the low-income people. By 1990s the problems with both the State promoted institutional forms viz. credit cooperative and RRBs in delivery of rural credit were quite evident. The credit cooperatives were crippled with the poor governance, management and the poor financial health due to intrusive state patronage and politicization. RRB’s financial position deteriorated due to the burden of directed credit and priority sector lending and a restrictive interest rate regime. The share of rural credit in the total credit disbursement by commercial banks, which grew from 3.5 to 15 percent from 1971 to 1991, has now declined again to 11 percent in 1998 (Sa-Dhan, 2004). For the first two decades of their existence, political pressure and focus on outreach at the expense of prudent lending practices led to very high default rates with accumulated losses exceeding Rs. 3,000 crores in 1999. In this background various qualitative issues such as concerns about financial viability of institutions on account of high rate of loan delinquency, cornering of subsidy by well off people, continued presence of moneylenders, inability to reach the core poor came out in forefront and resulted in reorientation in thinking around the1990s. In addition to inherent problems with the existing institution, the external factors also influenced Indian Microfinance. The macroeconomic crisis in early 1990s that led to introduction of Economic Reforms of 1991 resulted in greater autonomy to the financial sector3.

1.2 MICRO FINANCE

Microfinance means the provision of small scale financial products and services to the poor. Microfinance is of ancient origin in India. Traders and moneylenders have traditionally provided micro credit to the rural poor but charged exorbitant rates of interest, which led to considerable hardship and impoverishment of the borrowers; and later this resulted into debt trap, bonded labor, and illegal and forced transfer of entitlement of properties. Microfinance today does not include such exploitative practices; rather it refers to “lending to the poor at reasonable but sustainable rates from the government and the private institutional sources”. Micro-Finance is emerging as a powerful instrument for poverty alleviation in the new economy. In India, micro-finance scene is dominated by Self Help Groups (SHGs) – Banks’ Linkage Programme, aimed at providing a cost effective mechanism for providing financial services to the 'unreached poor'. In the Indian context terms like "small and marginal farmers", "Rural artisans" and "economically weaker sections" have been used to broadly define micro-finance customers.

1.3 MICRO FINANCE IN INDIA

The macro economic crisis and the economic reforms of 1991 led to emergence of new generation private sector banks viz. UTI Bank, ICICI Bank, IDBI Bank and HDFC Bank that would become important players in microfinance sector a decade later. Since 2000, the microfinance sector saw some radical changes in many aspects.

While the prime objective remains, poverty alleviation with new terms of inclusive growth or financial inclusion, this sector moved from sole social return approach to double bottom line approach of social and financial returns.

This change in approach led to many changes in the functioning of microfinance. The emphasis on ‘bottom of the pyramid’ and good financial returns of some of leading MFIs, brought many main stream commercial entities taking interest in the sector not only as part of their corporate responsibility but as new business line. One among prominent example in Indian context is ICICI Bank that adopted innovative ways in

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partnering with NGO MFIs and other rural organizations to extend their reach into rural markets. UN declaration of Microfinance year in 2005 gave further impetus towards recognition of microfinance as a poverty alleviation tool and was able to attract a lot interest from large commercial entities such as foreign banks, investors, pension funds etc. This resulted in their participation in the sector for social and commercial return.

India is a country where demand for microfinance services amongst the poor far exceeds supply. Fewer than 10 percent of India’s 75-80 million households that could make use of micro-finance have access to it. One of the greatest barriers is the industry’s lack of capital.

Inclusive growth always received special emphasis in the Indian policy making. Governments of India and the Reserve Bank of India have taken several initiatives to expand access to financial systems to the poor. Some of the salient measures are nationalization of banks, prescription of priority sector lending, differential interest rate schemes for the weaker sections, development of credit institutions such as Regional Rural Banks, etc.

Despite the policy efforts, gap remains in the availability of financial services in rural areas. The dependence of the rural poor on money lenders continues, especially for meeting emergent requirements. Such dependence is more pronounced in the case of marginal farmers, agricultural laborers, and petty traders and rural artisans belonging to socially and economically backward classes and tribes whose capacity to save is too small.

It is in this backdrop that microfinance emerged in India. The Self-Help Group (SHG)-Bank Linkage Program (SBLP) which was launched in 1992 on a pilot basis soon grew significantly. As per the latest estimates, SHGs enable 97 million poor households’ access to sustainable financial services from the banking system and have an outstanding institutional credit exceeding Rs. 31,200 crore as at the end March 2011. SBLP is considered to be the fastest growing microfinance initiative in the world. The other model of microfinance, i.e. MFI model comprising of various entities, such as, non-banking financial companies (NBFCs), non-governmental organizations (NGOs), trusts, cooperatives, etc. has also been growing significantly in the recent years. Micro finance services are provided by banks, credit unions and microfinance organizations,
which are also known as microenterprise development organizations (MDSs). These are
for profit or non-profit or nongovernmental organizations (NGOs), private voluntary
organizations legally chartered, where necessary to lend money to poor people. MDOs
such as ACCION International were started in early 1960s; other such as the Grameen
Bank began in the 1970s when its founder, Mohammad Yunus, an economics professor
in Bangladesh, began lending small amounts of money to poor people, mostly. These
small loans were used to start or expand small enterprise, such as vegetable farming,
weaving and livestock holding.

As the spotlight is now on the MFIs, they are expected to be transparent in their
policies, systems, procedures, and transactions, which call for good governance and
accountable to the stakeholders. The attempt is to address the key issues of good
governance, which has a direct impact on all the stake holders starting from the
investors, promoters, managers of microfinance institutions as well as to the regulators
and the public in general they serve.

The impact of microfinance institutions in terms of inclusive development, poverty
reduction and economic empowerment is phenomenal and it also attracted the attention
of UN. Validating its impact, UN declared the year 2005 as the year of microfinance
and the man who pioneered micro finance, Mohammad Yunus of Grameen Bank,
Bangladesh received the Nobel Prize.

These two incidents almost confirmed and validated efforts of MFIs as far as
empowering poor and their services to the marginalized section of the society. The crux
of issue is the MFIs were initially promoted by voluntary agencies popularly referred as
NGOs with the firm focus on community services and emancipation of the poor from
poverty.

With the global attention attached to microfinance, promotion of MFIs itself, was
transformed in to a global business opportunity and servicing the poor itself became a
business goal of such institutions.

The lack of access to credit for the poor is attributable to practical difficulties arising
from the discrepancy between the mode of operation followed by financial institutions
and the economic characteristics and financing needs of low-income households. For
example, commercial lending institutions require that borrowers have a stable source of
income out of which principal and interest can be paid back according to the agreed terms. However, the income of many self-employed households is not stable, regardless of its size. A large number of small loans are needed to serve the poor, but lenders prefer dealing with large loans in small numbers to minimize administration costs. They also look for collateral with a clear title - which many low-income households do not have. In addition bankers tend to consider low income households a bad risk imposing exceedingly high information monitoring costs on operation. Microfinance institutions can broaden their resource base by mobilizing savings, accessing capital markets, loan funds and effective institutional development support. A logical way to tap capital market is securitization through a corporation that purchases loans made by microenterprise institutions with the funds raised through the bonds issuance on the capital market.

Micro finance is not only development but also an integrated part of financial sector in India. In India, microfinance is considered as a concern of donors, charity organizations, and the government development programmes. But micro finance programme meets the financial needs of the major section of people who are poor and do not have an access to formal banking. Thus, microfinance is not only acting as a development tool but also meeting financial needs of people by submitting in the financial system.

Micro finance also acts as a tool for the development of local financial institutions. It is based on local level intervention for saving mobilization, extension of credits, provision of insurance and provision for payment transfer and other products. These products and services can efficiently and effectively be delivered by creation of local level institutions. Local NGOs can act as intermediary between clients and microfinance wholesalers like banks and insurance companies. At the same time, intermediaries develop local level institutions like groups, federations etc. for disbursement of microfinance products. Sustainable microfinance operations can be ensured by development and effective performance of these local institutions.

One should not ignore that poor people’s preferences for the micro credit are dependent on the rate of interest and repayment period. For better outreach and increase in cliental base of MFIs, the rate of interest of the loan meant for lending should be higher than the bank rate but lower than the informal sources of finance. By no chance, the designing of
the rate of the capital meant for lending should exceed the interest rate of capital sourced from local non-institutional sources. The moment, the interest rate of micro loan is equal to or more than the interest rate of non-institutional sources like money lender; there is a switch over of institutional micro finance clients to non-institutional sources due to the advantages of the non-financial sources. The repayment period of the capital meant for lending should be customized as per the cash flow of the clients otherwise it will lead to non-willful defaults.

In the early 1990s, following explosive demand for their services, a number of non-governmental organizations (NGOs) that provided loans to the poor decided that the only way to keep up with the demand was to spin off commercial microfinance organizations. These new organizations combined two previously separate institutional “logics”: a development logic that guided their mission to help the poor, and a banking logic that required profits sufficient to support on-going operations and fulfil fiduciary obligations.

Commercial microfinance organizations faced the risk of mission drift and a credible possibility because of the relative ease with which circumstances might divert these organizations into prioritizing the banking logic over the development one. What circumstances would these be? One is the cost of making loans; this is about the same whether $500 or $5,000 is loaned, but the latter yields ten times more revenue\(^5\).

The microfinance movement has built on innovations in financial intermediation that reduce the costs and risks of lending to poor households. Replications of the movement’s flagship, the Grameen Bank of Bangladesh, have now spread around the world. While programs aim to bring social and economic benefits to clients, few attempts have been made to quantify benefits rigorously.

Microfinance has captured the imaginations of many people working to reduce poverty. The premise is simple. Rather than giving hand-outs to poor households, microfinance programs offer small loans to foster small-scale entrepreneurial activities. Such credit would otherwise not be available - or would be only available at the very high interest

rates charged by moneylenders (who often charge as much as 10% per month)\(^6\). MFI and donor hype has created the impression that microfinance is a cure for poverty. This is encapsulated in the work of the Microcredit Summit and the thousands of well-intentioned but misguided supporters who believe that microcredit is the answer to the problems of poverty. This is a potentially dangerous line of argument as it distracts attention from the fact that poverty reduction requires action on many fronts social safety nets for the poorest and most vulnerable, an effective education system, low-cost and reliable health services, governments that can provide social inclusion (and thus maintain law and order) and sound macroeconomic policies, and many other issues\(^7\). Microfinance thus offers the potential for a self-propelling cycle of sustainability and massive growth, while providing a powerful impact on the lives of the poor, even the extremely poor. Evidence shows that this impact intensifies the longer clients stay with a given program, thus deepening the power of this virtuous cycle. Unfortunately poor people in most countries have virtually no access to formal financial services.

Their informal alternatives such as family loans, savings clubs, or moneylenders are usually limited by amount, rigidly administered, or available only at exorbitant interest rates. The challenge ahead is to ensure access to financial services for the poor majority\(^8\).

The MFIs being the guiding light for this poor majority have a big role to play in uplifting them from poverty. Microfinance offers the finance discipline, a possible


avenue to make a significant difference in the lives of millions of poor people.⁹ It is indeed a much needed avenue for bringing a social change.

Microfinance continues to reduce poverty among poor borrowers and within the local economy, albeit at a lower rate. It raises per capita household consumption for both participants and nonparticipants. The average returns to cumulative borrowing for female members of microfinance programs are as much as 21% in 1998/99, up from 18% in 1991/92. Despite higher returns to cumulative borrowing, the impact on poverty reduction among program participants was lower in 1998/99 (2 percentage points) than in 1991/92 (5 percentage points). This is due to diminishing returns to additional borrowing, so that despite the increase in the stock of borrowing by female members, the resulting increases in consumption were not large enough to reduce poverty as expected¹⁰.

During the last three decades, another major observation highlighted is the failure of formal financial system. This formal institutional financial system had increased the supply of financial products as well as insurance products to the rural poor not realising the relative ability of the poor to repay the loan. Due to various barriers prevailing in the existing system, this formal financial system failed to deliver the desired result.

The barriers which were identified for this failure are, large collateral requirements, poor’s demand for very micro-scale products, high transaction cost, high transition period, non-customised repayment schedule and non-customised products. And an answer to this failure is Micro finance.

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1.4 THE CONCEPT OF GOVERNANCE

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.\(^{11}\)

Governance system represents the value framework, the ethical framework, and the moral framework as also the legal framework under which business decisions are taken. The governance is required to uphold the organization’s goals and mission and see that they are implemented. 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. Thus, it helps to ensure accountability throughout the organization. Finally, Governance 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). As Micro finance institutions grow in their outreach, increase their assets, and in increasing numbers become regulated entities that can capture savings deposits, they require clear articulation of how their boards will ensure effective governance. More importantly, for a growing number of microfinance institutions, the source of capital has shifted or is shifting from being donor dependent to accessing financial markets in increasingly sophisticated ways. The recent entrance of investors who are providing capital for the most advanced microfinance institutions also raises important issues regarding the characteristics and quality of the governing bodies that lead these institutions.

The microfinance institutions have been very successful in the South India and the credit goes to the efforts taken by the state governments there. Nearly two thirds of the MFIs are situated in the Southern States. The main impetus given to this system in these states was by the state government. Several successful schemes and innovative steps

\(^{11}\)Jayadev M, Daitha Krishna Sundar, Changing Contours of Microfinance in India, Routledge India Publications, 1 edition (12 May 2016), Pg No. 45.
have been taken by the state which provided a favorable environment to the MFIs. Thus, the role of the state government is to facilitate the working of the MFIs and not just by regulating them.

Even though we are far from having inclusive financial services for the poor in India with all its components, the microfinance sector has come a long way in the last decade. It is facilitating microfinance (to face the present in the area of poverty) and facilitating micro insurance and micro pension (to face the future, in the area of vulnerability and social security). So far, our discussion goes the factors of good governance have direct bearings on the growth and development paradigm of MFIs in the emerging scenario of financial market in India. The impact of the good governance is visible both in the financial and non-financial areas of operation.

1.5 MICRO FINANCE AND MICRO FINANCE INSTITUTIONS IN INDIA
“Microfinance” is often defined as financial services for the 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 the 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 (MFI) is an organization that provides financial services to the poor. This very broad definition includes a wide range of providers that vary in their legal structure, mission, and methodology. However, all of these MFIs share the common characteristic of providing financial services to clients who are poorer and more vulnerable than traditional bank clients.
1.6 REGULATIONS ON MFIs
For any microfinance operation, it is necessary to scan and understand the legal-financial frameworks of India. Regulation of microfinance refers to a set of rules developed by the government which are imposed on microfinance, and supervision refers to the process of enforcing compliance with the regulation rules (CGAP).

The regulation of MFIs is the legal registration by the government to perform as an MFI. An MFI will be subjected to regulation when it is mobilizing the savings from the clients. As the individual clients cannot monitor their savings, so there should be a legal framework in which the legal authority will monitor the MFI.

MFIs have to maintain the compliance with the prudential regulatory norms. Prudential regulations are the regulations enforced by the government on MFIs to protect the small depositors from losing their money. So any MFI, mobilizing saving, should be under appropriate legal entity and prudential regulations. The regulations help the regulatory body to track the financial soundness of the MFIs and see that the small savers’ money will not be lost. The MFIs, who are not in the business of saving mobilization, are not coming under the prudential regulations.

Prudential regulation 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 can undermine sufficient confidence so that the banking system suffers a run on deposits. Prudential regulation mandates such things as capital adequacy requirements and rules for provisioning loan losses, which almost always require a specialized financial authority for their implementation. (Debadutta K. Panda, 2010)

1.7 RESEARCH GAP
The present research work will not be useful unless it covers the area which is not yet explored in research. The present research work is the outcome of the area of study which is less travelled by the researchers in the field of micro finance. The literature available on micro finance and governance of MFIs shows that there are studies highlighting the importance of MFIs, the role of MFIs in improving SHG performance,
SHG – Bank linkage programmes and the impact of Micro Finance on the poor and under privileged people etc. The earlier researches have not covered the role of government or RBI in ensuring the protection of clients interest from the unethical practices of MFIs.

No study has made an attempt yet to understand the need for governance in the MFIs of Karnataka. There are very few studies done on the issues of governance, the problems faced by both MFIs and individuals who expect to be benefited by the services. The existing studies have not focused on the transparency practices of MFIs, need for regulatory framework for the effective performance of MFIs towards the stakeholders, model regulatory frameworks for the MFIs or not even the impacts of lack of governance in the MFIs in Karnataka.

However, the present research work will add value to the concept of micro finance by highlighting the need for regulations and a regulatory body to look after the affairs of MFIs based on studying the perceptions of MFIs towards governance, factors influencing governance, governance practices which can be incorporated in the MFIs for the purpose of bringing efficiency in operations. So it is in this regard, this work is an attempt to study the governance practices of MFIs in Karnataka.

1.8 RESEARCH QUESTIONS:

This research study is undertaken to answer the following questions with respect to Micro Finance Institutions in Karnataka.

1. What is the level of clarity and understanding of the concept of governance by the MFIs?
2. What is the role of governance in micro finance institutions and what are the perceptions of micro finance institutions towards the issues of governance?
3. What is the level of adherence to the governance guidelines issued by RBI?
4. What are the factors of governance impacting on the MFIs in Karnataka?
5. Whether there is a need for regulatory bodies to regulate the MFIs in Karnataka.
1.9 STATEMENT OF THE PROBLEM

The micro finance institutions all over the world have received greater emphasis due to the impact they have made on that section of the society which has always experienced problems like poverty, unemployment and a life full of problems. The institutions which had the recognition of transforming the lives of the rural poor slowly started deviating from the objectives for which they were established. The institutions which were identified as the change makers have also compromised with the purpose and initiated profit making ideology.

This has led to the formal collapse of the institutions for a short span of time on the world stage of finance. The reasons for this are:

- Changed preference from providing service to making profit.
- Increased demand for the financial services negatively influencing the MFIs to charge higher interest.
- Arbitrary lending models followed by various MFIs indirectly ensuring more return of investments.
- Free entry and easy access to the market and clients leading to exploitation of customers’ dependency and helplessness.
- Lack of regulations on the institutions giving them the freedom of playing with the needs of borrowers thereby violating the basic purpose of MFIs.

Thus, it is evident from the above reasons that it is the time for institutions to go for introspection and to come to terms with the guidelines given by the RBI.

Hence, it becomes necessary for the researcher to highlight the problems prevailing in the MFIs related to registration, accountability, transparency issues, decision making and accounting and matters related to auditing.
1.10 NEED FOR THE STUDY
As the MFIs have deviated from their prime objectives, it becomes necessary for the borrowers to remind the MFIs about their core responsibilities and not to indulge in unethical practices. It is with this backdrop need for the study can be recorded in the following manner.

- Presently, majority of the MFI’s and NGO’s meant for serving the poor and welfare of the society are indulging in unscrupulous activities causing threat to the good health of the community. There is lack of awareness about the governance and of understanding the concept of governance. As it is very essential for any MFI there is the need of creating awareness.

- In order to make MFIs more reasonable and accountable towards the stakeholders, there is a need for making the board of directors’ responsible in their actions as the leaders of the MFIs. Identification of determinant factors for the effective performance of the board will ensure the proper governance of the MFIs benefitting the community.

- Now a day’s MFI’s are becoming popular not because of the service they render but because of not practicing ethics and governance in their operation. Thus, there is a need of studying the level of adherence to the governance guidelines issued by RBI and the impact of the same. This study will throw light on this aspect.

- In order to protect the interest of various stakeholders, Micro Finance Institutions should be properly controlled and regulated. This research on the governance explores the importance of ability of the board, quality of reporting, the level of commitment of management, and stakeholders’ participation etc., for the better governance of MFIs.

- The present research will identify the need for establishing regulatory frameworks or bodies for the effective governance of MFIs ensuring the fair and equitable treatment of all the stakeholders.

- As the number of researches undertaken on the governance of Micro Finance is very limited in number, this research work will prove to be highly useful in the days to come in the area of Micro Finance in Karnataka.
1.11 OBJECTIVES OF THE STUDY

On the one side the field of Microfinance is growing and on the other side it’s failing to live up to the expectations of the stakeholders, affecting the wellbeing of the poor and also posing a lot of challenges to the policy makers. MFIs, in the process of providing services to the poor have neglected the need of abiding by the rules and regulations set by the Government and RBI. As the purpose of MFIs has not been achieved in line, it becomes necessary to study the governance practices of MFIs in Karnataka with the following objectives.

The objectives of the study are:

1. To study the level of clarity and understanding the concept of governance among Micro Finance Institutions.
2. To identify and analyze the determinants of the board performance influencing governance of Micro Finance Institutions.
3. To study the level of adherence to governance guidelines issued by RBI amongst Micro Finance Institutions.
4. To evaluate ability of the board and quality of reporting factors impacting governance of Micro Finance Institutions.
5. To study the need for a regulatory body to ensure better governance of Micro Finance Institutions.

1.12 HYPOTHESES

A hypothesis is a statistical test that ascertains whether there is enough evidence in a sample of data to infer that a certain condition is true for the entire population. Hypotheses can be expressed as Null and Alternative Hypotheses. The purpose of Hypotheses testing is to ensure the credibility of the data collected and to be interpreted.

As discussed already, microfinance institutions are primarily meant for providing financial assistance to the needy. But in the process these MFIs are said to be exploiting the interest of the rural poor. So it becomes necessary to check the degree of exploitation or the failure of the MFIs to deliver the desired satisfaction to the stakeholders and the degree to which the regulations can be established to correct the wrongdoings of MFIs.
In this regard, the hypotheses to be tested are formulated, the plan for analysis is developed on the basis of sample data and attempts are made to accept or reject the hypotheses based on the result and analysis.

The hypotheses are testable only when there are some realistic assumptions involved in the statements provided in the study. The attempt is made to evaluate the statements about the population to determine which statement is the best supported by the sample data taken for the study.

The idea is to ascertain the relativity or non-relativity between the variables taken for the study. So, on the basis of the objectives highlighted in the discussion above, the following hypotheses are formulated and stated in null form to ascertain the governance issues in the selected Micro Finance Institutions.

1. Ho: The level of clarity and understanding the concept of governance among MFIs is significantly low.
   H₁: The level of clarity and understanding the concept of governance among MFIs is significantly high.

2. Ho: The determinants of board performance are not significantly influential on the governance of Micro Finance Institutions.
   H₂: The determinants of board performance are significantly influential on the governance of Micro Finance Institutions.

3. Ho: The level of adherence to governance guidelines issued by RBI amongst MFIs is significantly low.
   H₃: The level of adherence to governance guidelines issued by RBI amongst MFIs is significantly high.

4. Ho: The ability of the board and quality of reporting are not the most significant factors impacting the governance of MFIs.
   H₄: The ability of the board and quality of reporting are the most significant factors influencing the governance of MFIs.

5. H₀: There is no significant need of Regulatory body for the better governance of MFIs in Karnataka.
   H₅: There is a significant need of Regulatory body for the better governance of MFIs in Karnataka.
1.13 SCOPE OF THE STUDY
The micro finance service by its nature has an unparalleled impact on the society in providing the financial services to those who need it. By providing various services of micro finance the MFI helps in bringing a positive change in the lives of many. The institutions situated in the coastal Karnataka, Bangalore and North Karnataka have made a significant difference in the field of providing financial services and have made a mark of their own at the national level also. It is in this regard the study has been undertaken to understand the governance practices, issues of transparency, regulations, accountability and ethical practices of those MFIs which are providing services in various parts of Karnataka.

The empirical study has been undertaken in the selected Micro finance Institutions identified in Karnataka for the study. This study is concentrated on those institutions situated in the 15 selected districts of Karnataka. The main focus of the study is to draw the inferences on the governance issues prevailing in the MFI’s and other regulatory issues concerning the effective management of the micro finance institutions situated in various parts of Karnataka. The information by the researcher is sought through questionnaire, through meeting the respondents personally.
1.14 RESEARCH METHODOLOGY

The micro finance service by its nature has an unparalleled impact on the society in providing the financial services to those who need it. By providing various services of micro finance the MFI helps in bringing a positive change in the lives of many. The institutions situated in the coastal Karnataka, Bangalore and North Karnataka have made a significant difference in the field of providing financial services and have made a mark of their own at the national level also. It is in this regard the study has been undertaken to understand the governance practices, issues of transparency, regulations, accountability and ethical practices of those MFIs which are providing services in various parts of Karnataka.

1.14.1 SELECTION OF STUDY AREA:

The empirical study has been undertaken in the selected Micro finance Institutions identified in Karnataka for the study. This study is concentrated on those institutions situated in the 14 selected districts of Karnataka. The main focus of the study is to draw the inferences on the governance issues prevailing in the MFI’s and other regulatory issues concerning the effective management of the micro finance institutions situated in various parts of Karnataka. The information by the researcher is sought through questionnaire, through meeting the respondents personally.

Table No. 1.1: Districts Selected for the Study in Karnataka

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<td>03</td>
</tr>
<tr>
<td>2</td>
<td>Shimoga</td>
<td>02</td>
</tr>
<tr>
<td>3</td>
<td>Dharwad</td>
<td>01</td>
</tr>
<tr>
<td>4</td>
<td>Haveri</td>
<td>01</td>
</tr>
<tr>
<td>5</td>
<td>Hassan</td>
<td>02</td>
</tr>
</tbody>
</table>

Source: Compiled from Primary Data
1.14.2 SELECTION OF SAMPLING METHODS:
The samples for the present research work classified into two categories.

a) Primary Data:

1. Institutional Respondents: The population for the current study in this category are from the selected Micro Finance Institutions operating in Karnataka: The Chairman, Directors, Managing Directors, Chief Executive Officers, and the General Managers of MFIs. The researcher has taken 37 Leading Micro Finance Institutions of Karnataka which are registered under AKMI as samples and respondents of these institutions were asked to respond to the questionnaire. The Chairman, Director and Managers of these institutions have responded being part of Policy Making and these responses are taken in order to test the hypothesis. Simple Random Sampling Technique is used for collection of data. Micro Finance Institutions were selected on the basis of the list available with the AKMI as it is appropriate in selecting the MFIs which are less in number in Karnataka to pool under any category.
Table No 1.2: Sample Distribution – Institutional Respondents

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Districts</th>
<th>No of MFIs Selected</th>
<th>No of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bidar</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Dharwad</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>Koppal</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>Uthara Kannada</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>5</td>
<td>Haveri</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>6</td>
<td>Bellary</td>
<td>02</td>
<td>1</td>
</tr>
<tr>
<td>7</td>
<td>Shimoga</td>
<td>02</td>
<td>1</td>
</tr>
<tr>
<td>8</td>
<td>Davanagere</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>9</td>
<td>Tumkur</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>10</td>
<td>Kolar</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>11</td>
<td>Dakshina Kannada</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>12</td>
<td>Hassan</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>13</td>
<td>Mysore</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>14</td>
<td>Bangalore</td>
<td>18</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>37</strong></td>
<td><strong>37</strong></td>
</tr>
</tbody>
</table>

**Source:** Designed by Researcher

2. **Beneficiaries of MFIs:** The population for the current study under this category is the beneficiaries/clients/borrowers of selected Micro Finance Institutions operating in Karnataka. To cross examine the opinions of Institutional respondents the customers of MFIs operating in 5 selected Districts of Karnataka which are registered under AKMI were taken in to consideration and were provided with questionnaire. Sample sizes of 384 were selected with a margin of error at 5% and confidence level at 95% and it has been rounded off to 500 samples for the study (R.V. Krejcie and D.W. Morgan). The clients of MFIs were consulted personally and responses were recorded. Simple Random Sampling Technique was used for collection of data. It was important to collect the responses of the ultimate beneficiaries of MFI services to evaluate the extent to which MFIs are accountable and responsible in their actions towards the customers of their institutions.
### Table No 1.3: Sample Distribution – Beneficiary Respondents

<table>
<thead>
<tr>
<th>Sl. No</th>
<th>Districts</th>
<th>SHG Members/ Beneficiaries</th>
<th>Population in Percentage</th>
<th>Beneficiaries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Dakshina Kannada</td>
<td>1,30,000</td>
<td>72.42%</td>
<td>360 (500x72.42%)</td>
</tr>
<tr>
<td>2</td>
<td>Shimoga</td>
<td>12,000</td>
<td>6.69%</td>
<td>33 (500x6.69%)</td>
</tr>
<tr>
<td>3</td>
<td>Dharwad</td>
<td>27,000</td>
<td>15.04%</td>
<td>75 (500x15.04%)</td>
</tr>
<tr>
<td>4</td>
<td>Haveri</td>
<td>7,000</td>
<td>3.89%</td>
<td>20 (500x3.89%)</td>
</tr>
<tr>
<td>5</td>
<td>Hassan</td>
<td>3,500</td>
<td>1.96%</td>
<td>12 (500x1.96%)</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>1,79,500</td>
<td>100%</td>
<td>500</td>
</tr>
</tbody>
</table>

**Source:** Designed by Researcher based on (R.V. Krejcie and D.W. Morgan) table

**b) Secondary Data** The secondary data was collected in the form of annual reports, press releases and brochures of the MFIs. The available research articles, journal publications and economic and social science magazines were taken to study the developments of microfinance and institutions. One of the important secondary data was the websites and blogs on the internet. Importantly, the RBI circulars and guidelines and Malegam Committee report were collected and used in the research work.

**Figure No.1.2: Sample Distribution**

### Source: Designed by Researcher
1.14.3 SAMPLING DESIGN

a) Framework of Analysis

The respondents for the present study are the institutional respondents of 37 MFIs spread across 15 districts and 500 beneficiaries being SHG members of MFIs operating in the 5 selected districts of Karnataka. These MFIs mainly include NBFCs and trusts and section 25 companies operating in Karnataka. The list of MFIs selected for the study is presented in the following table. The researcher, by using the convenience sampling method, has selected 500 beneficiaries of 5 MFIs operating in the 5 selected districts out of 37 MFIs which were taken to study at the institutional level and the responses of these clients were recorded with the help of a neatly designed questionnaire which contained open ended and close ended questions to collect the primary data.

b) Construction of questionnaire

The prevailing issues regarding the governance of MFIs were examined through the preliminary survey (pilot study) on 10 MFIs in selected districts of Karnataka. The questionnaire drafted was circulated among the research experts, individuals involved in micro finance operations, members of MFIs to get an analytical idea of governance in MFIs. Based on the experiences the questionnaire was re-drafted and used for further study.

c) Pre-test

In order to get the idea of governance practices in MFIs the questionnaire was used as part of pre-test conducted on 10 selected MFIs in Karnataka. Upon ascertaining the results of the study, necessary modifications were made in the questionnaire to fit in with the objectives of the present study.

d) Discussions and Informal Interviews

The purpose of understanding the governance practices of MFIs was served significantly only on the basis of having several rounds of informal discussions with MFI authorities, field experts and the clients of MFIs and research guide.
1.14.4 NATURE AND SOURCES OF DATA COLLECTION

In order to collect the data, both primary and secondary sources of data collection have been used. The following is the nature and sources of data collected for the present study.

<table>
<thead>
<tr>
<th>Name of the Institute</th>
<th>Type of Information</th>
<th>Category of Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>IIM Bangalore</td>
<td>Reference Materials</td>
<td>Secondary</td>
</tr>
<tr>
<td>Annual Reports of MFIs</td>
<td>Reference Materials</td>
<td>Secondary</td>
</tr>
<tr>
<td>Institutional responses on governance practices of 37 MFIs</td>
<td>Structured Questionnaire for analyzing governance practices from institutional perspective</td>
<td>Primary</td>
</tr>
<tr>
<td>500 Respondents - Beneficiaries/Clients/Borrowers</td>
<td>Service receivers responses on the governance practices of MFIs</td>
<td>Primary</td>
</tr>
<tr>
<td>Library, University of Mysore</td>
<td>Reference Materials</td>
<td>Secondary</td>
</tr>
<tr>
<td>Library, SDM College</td>
<td>Reference Materials</td>
<td>Secondary</td>
</tr>
</tbody>
</table>

Source: Designed by Researcher

As it is new of its kind this study has been completed on the basis of a large source of information collected. The data required for the research was collected from primary and secondary sources. Various Books, magazines, newspaper articles, journals, publications, government reports, and RBI Reports on governance and Micro finance Institutions have been used as sources of secondary data.

One of the sources of information, the internet, has been taken as an important source of secondary data for the present study.

Preparation of questionnaire to evaluate the governance aspects in the functioning and sustenance of MFI’s was used as the source of primary data. Through the structured questionnaire, the relevant information has been sought from the respondents. Field survey type of research is undertaken for collecting the primary data. Questionnaire Administration and tabulation has been done in the light of the research objectives.

To establish relationship with the variables like determinants, influencing factors and independent factors relevant to inferential statistical techniques have been applied to test the hypothesis.
1.14.5 DATA COLLECTION TECHNIQUE: for the purpose of knowing the governance practices and the opinions of beneficiaries, two separate questionnaires were designed.

1. **Institutional Respondents:** In order to collect the data from the respondents a questionnaire containing 45 questions on different aspects with six divisions was mainly used. Following are the areas on which the data was collected.

- MFI Profile
- Nature of Functioning
- Financial Management
- Social Performance Indicators
- Ease of Access to Services
- Governance and Implications

The researcher has collected information related to the MFIs covering the nature of operation, the sources of fund for operation, the kind of services offered by the institution, the performance of the MFIs and mainly the issues of governance. It was important for the researcher to know the level of understanding of MFIs towards governance. Therefore, based on the objectives, the factors influencing governance, practices of governance in the MFIs and the implications and impact of governance on the institutions were covered through the questions. As the purpose of research was to study the governance practices of MFIs, only the heads of the institutions were considered as respondents and the same is interpreted. The questionnaire contained close ended or dichotomous questions and ranking based questions.

2. **Beneficiaries of MFIs:** as part of data collection, another questionnaire was prepared containing 30 different questions prepared for collecting the responses. The questionnaire covered questions regarding the services offered, rights and obligations of the clients, rate of interest charged, repayment installments, other services provided, factors influencing governance; follow up of RBI guidelines, transparency practices, disclosure mechanisms used, board members involvement, reasons for clients dropout and the need for regulations to safeguard the interest of these beneficiaries.
It was equally important for the researcher to know the opinions of clients for the same operations carried out by MFIs along with the perception of the MFIs towards their operations for evaluating the governance practices in Karnataka. So based on the objectives, the factors influencing governance, practices of governance in the MFIs and the implications and impact of governance on the institutions were covered through the questions. As the purpose of research was to study the governance practices of MFIs, the questions related to factors influencing governance, follow up of RBI guidelines of governance, the problems experienced by the beneficiaries while receiving the services has been taken into consideration to test the hypotheses.

1.14.6 STATISTICAL METHODS APPLIED:
To analyze the parameters of governance practiced in Micro Finance Institutions, tools like Arithmetic Mean, Standard Deviation, Percentage, T-Test, Test for Proportions, chi-square tests are used in order to prove the hypothesis. Statistical analysis has been done using SPSS. In order to draw suitable conclusions with meaningful analysis, interpretation of data is made using tables and graphs. However, the study is not out of the limitations. As the probability of an element of subjectivity creeping into the responses could not be ruled out while the respondents expressing their views on the issues covered. But an attempt is made to reduce such effects to the minimum by providing the necessary clarification where ever it is required. The major limitation was getting Micro Finance Institutions with large scale operations having a structured management.

Frequencies
Frequency analysis is an important primary tool for analyzing the data collected, where varieties of variables can be interpreted with the help of graphs and figures. The responses of the MFIs and beneficiaries have been presented in the form of frequencies in order to analyze the data. The responses in questionnaire have been converted into frequencies so as to know the responses for the various questions in the form of Percentages. Various variables are depicted in Percentages giving a fair idea about the issues prevailing with regards to governance of MFIs in Karnataka.
**Chi-square Test**

A chi-square test is useful for testing the ‘goodness-of-fit of an observed distribution with a theoretical distribution. Chi-square test is a non-parametric test which is easy to calculate and interpret. In order to check the validity of the data collected and frequency variables calculated, the chi-square test is very useful. In order to understand the board members involvement in the business the chi-square test has been conducted and the results have been presented in the suitable manner.

**Test of Proportions**

Test of proportions is a reliable technique when the sampling method selected is simple random sampling. For the purpose of testing hypotheses to determine whether the differences between two proportions is significant. Test of proportions has been used in the present study to analyze whether the existing governance norms are sufficient to govern the MFIs or whether there is a need for establishment of regulatory bodies.

**T-Test**

A T-test is an analysis of two population means through the use of statistical examination. The significance level for a given hypothesis and the whether it is statistically significant or not is tested, compared and considered on the basis of t test applied on the values derived in a research study. The T-test is applied in the present study to ascertain the factors influencing governance and governance guidelines followed by the MFIs in serving the poor. The results obtained have been interpreted to draw suitable conclusions.

This study has been completed on the basis of a large source of information collected as it is new of its kind. The data required for the research was collected from primary and secondary sources. Various Books, magazines, newspapers, articles, journals, publications, government reports, RBI Reports on governance and Micro finance Institutions have been used as sources of secondary data.

As internet is one of the important sources of information it has been be taken as an important source of secondary data for the present study.
Preparation of questionnaire to evaluate the governance aspects in the functioning and sustenance of MFI’s was used as source of primary data. Through the structured questionnaire, the relevant information has been sought from the respondents. Field survey type of research is undertaken for collecting the primary data. Questionnaire Administration and tabulation has done in the light of the research objectives. To establish relationship with the variables like determinants, influencing factors and independent factors relevant inferential statistical techniques have been applied to test the hypothesis.

1.14.7 PERIOD OF THE STUDY

The primary data relating to the perceptions of Micro finance institutional respondents towards the governance practices, regulatory framework followed were collected during April 2015 to December 2015. The primary data related to the opinion of beneficiaries towards their experiences of the MFIs in transparency, following of RBI guidelines and the need for regulatory frameworks in MFIs are collected from March 2016 to September 2016 from the respondents selected in the selected districts of Karnataka.

1.15 LIMITATIONS OF THE STUDY

Any research work is not out of limitations. It is the responsibility of the researcher to mention those in the following points.

1. This research work is confined only to selected MFIs of Karnataka and not for the entire MFIs operating in Karnataka. The results of the study may or may not be applied for other parts of Karnataka.

2. The major limitation was review of literature as at the time of commencing the study the literatures available on the governance of MFIs were very limited.

3. The sample which is selected is less compared to other studies, the reason being the non-availability of registered MFIs. As part of study on governance it was important to find only the MFIs and not the SHGs. Sincere attempt is made to increase the sample base. But it is only restricted to 37 MFIs who have registered under AKMI of Karnataka. But the respondents of 10 selected MFIs across Karnataka have been increased to 500.

4. The institutional respondents while answering were quite hesitant and avoided selecting certain answers. The informal responses collected were tested with the
help of articles, annual reports and financial statements and modified to suit the need of the analysis.

5. It is difficult to collect responses from the institutions than the individual responses as the MFI authorities do not find the need of sharing information for the purpose of research.

1.6 CHARTERISATION SCHEME

The present study has been divided into following 5 chapters

<table>
<thead>
<tr>
<th>CHAPTER NO</th>
<th>TITLE</th>
</tr>
</thead>
<tbody>
<tr>
<td>CHAPTER - 1</td>
<td>INTRODUCTION</td>
</tr>
<tr>
<td>CHAPTER - 2</td>
<td>REVIEW OF LITERATURE</td>
</tr>
<tr>
<td>CHAPTER - 3</td>
<td>CONCEPTUAL FRAMEWORK</td>
</tr>
<tr>
<td>CHAPTER - 4</td>
<td>ANALYSIS AND INTERPRETATION OF DATA</td>
</tr>
<tr>
<td>CHAPTER - 5</td>
<td>SUMMARY OF FINDINGS, SUGGESTIONS, AND CONCLUSIONS</td>
</tr>
</tbody>
</table>

CHAPTER 1: INTRODUCTION:

This chapter covers the introduction to Microfinance, the meaning of Micro Finance and Micro Finance Institutions, governance of MFIs, Regulations on MFIs, Relevance of the study, need for the study, objectives of the study scope and limitations of the study, Research Methodology, Hypothesis of the study. The chapter also emphasizes on the issues present in the microfinance sector and developments in the field of service delivery and the quality of service to the poor.

CHAPTER 2: REVIEW OF LITERATURE:

This chapter deals with review of literature from various books, articles and journals covering earlier studies related to microfinance, Microfinance Institutions, Governance, regulations, the role of NGOs, NABARD and RBIs efforts in channelizing the finance and administration of MFIs, need for MFIs in providing financial services to the rural poor and the problems prevailing in the Micro finance sector. The review of literature provides an insight into the research gap and the need for the present study.
CHAPTER 3: CONCEPTUAL FRAMEWORK:
This Chapter provides a bird’s eye view of the topics surrounding the Micro Finance like, meaning, evolution of micro finance and MFIs, governance in MFIs, area of study etc.

CHAPTER 4: ANALYSIS AND INTERPRETATION OF DATA:
This chapter deals with analysis of the data collected and interpretation of the same with the help of statistical tools on the basis of formulated hypothesis. The data analysis chapter presents the results obtained in the form of tables and graphs based on the primary data collected and tested with the help of statistical tools like mean, median, percentage and frequencies. Testing of research hypotheses, accepting or rejecting of the same is discussed in this chapter.

CHAPTER 5: SUMMARY OF FINDINGS, SUGGESTIONS, AND CONCLUSIONS:
This chapter is dedicated to record the summary of findings based on the analysis and the interpretation of data for drawing a conclusion on the study undertaken. This chapter highlights various findings of the study, major as well as general and suggestions for the delivery of better services for the next generation of borrowers. The chapter also records the scope for further research in the field of micro finance and limitations or myths surrounding the MFIs.
This chapter includes the summary and conclusions of governance issues of MFIs in Karnataka drawn on the basis of information collected and analysis made on the subject matter.