

Issues and challenges of microfinance: A conceptual framework

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ABSTRACT

India is one among the fastest and most emerging economy in the world. Even after achieving 7 to 8% of GDP growth, major part of countries population is still affected by poverty, and other huge social evils. In order to address issues like poor infrastructure, lack financial sources to poor and unemployment, Government of India and other financial agencies have initiated inclusive programs through micro finance and SHG bank linkage program. Micro finance refers to small savings, credit and insurance services extended to socially and economically vulnerable segment of society. Micro finance institutions have made remarkable progress during the last two decades in innovating services and technologies to deliver financial services to poor on sustainable basis. Increased operation and rapid growth of micro finance industry have come across with lots of challenges and problems like lack of funds, fraud, language barrier, regional disparity etc. This study discuss the concept and importance of microfinance initiatives and focus on the issues and challenges of micro finance institutions.

1. Introduction

Microfinance is one of the most visible innovations in anti-poverty policy in the last half-century, and in three decades it has grown radically. The most important benefit of microfinance in India is that it helps long-term financial independence in these poverty-stricken areas. Microfinance help sustained impact by educating recipients on how to create their own businesses and how to properly manage and grow their money. There is a rapid growth in the strength of microfinance in India and several other countries. Undoubtedly it has been successful in bringing formal financial services to the poor. Microfinance institutions (MFIs) have created a massive social infrastructure uniquely positioned to reach millions of clients on a regular basis.

2. Microfinance: An Overview

Micro Finance may be defined as "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban or urban areas, for enabling them to raise their income levels and institutional initiatives of rural credit and to the improve living standards". At present, a large part of micro finance activity is confined to credit only. Women constitute a vast majority of users of micro-credit and savings services. Microfinance is the supply of loans, savings, and other basic financial services to the poor. As these financial services usually involve small amounts of money - small loans, small savings, etc. - the term "microfinance" helps to differentiate these services from those which formal banks provide. The poor rarely access services through the formal financial sector. They address their need for financial services through a variety of financial relationships, mostly informal.

Microfinance is provided through Microfinance Institutions (MFIs). To be sustainable, MFIs ultimately have to: Organize their own resources through savings and equity, enhanced by other domestic resources.

3. Microfinance Institutions

A microfinance institution is an organization that offers financial services to low income populations. The Micro Finance Institutions (MFIs) accesses financial resources from the Banks and other mainstream Financial Institutions and provide financial and support services to the poor. Among the Indian institutions offering microfinance services, there are Non-Government Organizations (NGOs), Private Foundations/Trusts, Cooperatives, Commercial Banks, Regional Rural Banks (RRBs), Local Area Banks (LABS) as well as specialized Non-Banking Financial Institutions (NBFCs). Currently India is considered to be the largest emerging market for microfinance. It has been growing in India at a steady pace over the past decade.

The reasons for existence of separate institutions i.e. MFIs for offering micro finance are as follows:

- High transaction cost – generally micro credit fall below the break-even point of providing loans by banks.
- Loans are generally taken for very short duration periods.
- High frequency of repayment of instalments and higher rate of default.
- Absence of collaterals – poor is not in a state to offer collaterals to secure the credit.

4. Objectives of the study

1. To study the concept of microfinance and its goal in poverty alleviation and uplifting living standard of the poor people.
2. To understand the challenges and issues of microfinance institutions.
3. To recommend measures to tackle the challenges.

5. Research Methodology

The present study is conceptual in nature. This study is mainly based on secondary data, which is obtained from the existing literature in the form of research articles and report.

6. Review of Literature

1. **NasirSibghatulla (2013)**; this study focuses on the issues and challenges of Microfinance in India. The study found that MFIs played an important role in poverty alleviation and enhancing living standard of the poor. This study also indicate that, if MFIs overcome the problems like regional imbalance, regulatory issues, language barriers, and proper management of loans can lead to positive result and enhance the greater efficiency in improving the living standards of the thousands of poor.
2. **Dey Sanjeeb Kumar (2015)**;this study focuses on the Issues and challenges of MFIs and its present context, and also studies the sustainable development through microfinance. This study revealed the MFIs suggestive measures to tackle those challenges faced by MFIs. The measures like proper regulation, field supervision, transparency of interest rate, and alternative source of fund. These measures can lead to positive result and obtain a growth, development, and diversification in rural economy.
3. **MahajanRuchika (2017)**; this study focuses on challenges of microfinance institutions and it also studies the strategies to be implemented to overcome the challenges. The challenges like financial illiteracy, lack of information, inability to generate funds, and weak governance are the measure challenges of micro financial institutions. These strategies to overcome the challenges can give a good result in future.

7. Issues in microfinance in India

1. **Low Outreach:** In India, Micro Finance Institution (MFI) outreach is very low. It is only 8% as compared to 65% in Bangladesh. Data show the great potential of MFIs in increasing their outreach and scale of operations. It has been observed that, Micro Finance (MF) programmes focus a great deal of attention on women. It has been argued that women are better clients as they are more inclined to save than men, they borrow smaller amounts than men and their repayment better than men. These characteristics of women clients constitute evidence in support of the inclination of MFIs to cater to the needs of women. Women may be better and more reliable clients, but in order to increase their outreach MFIs cannot ignore men as clients.
2. **High Interest Rate:** MFIs are charging very high interest rates, which the poor find difficult to pay. It has been argued that MFIs are private entities and hence need to be financially sustainable. They do not receive any subsidized credit for their lending activities and that is why they need to recover their operational costs from borrowers. In the process, the basic reason for their existence and their primary

objective is being lost. It is important that these NGOs should be willing to operate at narrow margins and to bear a low effective interest rate so that they can maintain a balance between their dual objectives of commercial viability and serving the poor.

3. **Negligence of Urban Poor:** It has been noted that MFIs pay more attention to rural areas and largely neglect the urban poor. Out of more than 800 MFIs across India, only six are currently focusing their attention on the urban poor. However, the population of the urban poor is quite large, amounting to more than 100 million. With increasing urbanization, this number is expected to rise rapidly in the coming years. In this situation, MFIs need to pay equal attention to the urban poor because they too need financial assistance for various activities.
4. **Client Retention:** Client retention is an issue that a problem in growing the MFIs. There is about 28% client retention in the MFIs. This occurs because people are not properly informed and educated about services and products provided by the institutions.
5. **Loan Default:** Loan default is an issue that creates a problem in growth and expansion of the organization because around 73% loan default is identified in MFIs. Lack of understanding on the part of the clients, they also cannot correctly utilise the loans given to them. As a result, they are not able to pay back the loan.
6. **Low Education Level:** The level of education of the clients is low. So it creates a problem in the growth and expansion of the organization because its percentage is around 70% in MFIs. Target population of MFIs is people of rural areas and they have no or less education level.
7. **Language Barrier:** Language barrier makes communication with the clients (verbal and written) is an issue that creates a problem in growth and expansion of the organization because around 54% language barrier has been identified in MFIs. As the education level of clients is low so it is difficult to communicate with them. For this reason it is also difficult for the MFIs employees to make the clients to understand the policy and related details.
8. **Late Payments:** Late payments are an issue that creates a problem in growth and expansion of the organization because late payments are around 70% in MFIs. This usually occurs because clients are uneducated and they don't know how to manage their debt. They are unaware of the fact that late payment increases their loan payments.
9. **Internal Environment High Transaction Cost:** High transaction cost is a big challenge for microfinance institution. The volume of transactions is very small, whereas the fixed cost of those transactions is very high. It cannot vary with the size of the loan. The higher a producer's fixed costs in the proportion of his total cost, the element of risk increases in the same proportion. Moreover, if the demand for the product falls or the marginal costs increases, it becomes very difficult to adjust the cost by cutting output. This cut will reduce revenue out of which he has to pay

principal amount as well as interest on the loan. This needs to be rationalized.

10. **Lack of access to Funding:** Another factor contributing to the lack of growth in MFIs is that requisite financial support has not been provided to MFIs by concerned agencies. Around 68% of MFIs response was in favour of that government and SBP don't support them to meet the funds requirement as MFIs cannot alone remove the poverty from the country.
11. **Loan Collection Method:** Loan Collection Method is found an issue that creates a problem in growing the organization. Around 55% of MFIs agrees that due to weak law and legislation they are not able to make their loan collection system as effective as they want to do so.
12. **Fraud:** Fraud is an issue that creates a problem in growth and expansion of the organization because its percentage is around 67% in MFIs. Mismanagement of loans on the part of the clients creates the problem of fraud and financial embezzlement on the part of clients.

8. Challenges faced by micro finance

Poor people do not live in a static environment of poverty. Many millions of people get out of poverty by successfully embracing new farming technologies, investing in new business opportunities, or by locating new jobs. At the same time, large numbers of people fall back into poverty due to financial setbacks, health problems, and other shocks. If available at critical moments, effective tools for savings, payment, credit, and insurance can help households capture an opportunity to climb out of poverty or a crisis or emergency without falling deeper into poverty.

Microfinance is gathering momentum to become a significant force in India. Some challenges faced by micro finance in India are:

1. **Financial illiteracy:** One the major challenge in India towards the growth of the microfinance sector i.e. illiteracy of the people. This makes it difficult in creating awareness of microfinance and even more difficult to serve them as microfinance clients.
2. **Lack of information:** There are various sources of credit information in India, but none of these focuses on small, rural borrowers. Credit information on such borrowers is difficult to obtain because the majority of the rural poor rely on moneylenders and other informal lenders, and it is not in the interest of such lenders to pass on a borrower's good credit repayment record to other providers of finance.
3. **Inability to generate funds:** MFIs have inability to raise sufficient fund in the microfinance sector which is again an important concerning challenge. Though NBFCs are able to raise funds through private equity investment because of the for profit motive, such MFIs are restricted from taking public deposits.
4. **Heavy dependence on banks:** MFI's are dependent on borrowing from banks. For most of the MFI's funding sources are restricted to private banks & Apex MFI's. In these banks available funds are

typically short term i.e. maximum 2 years period. Also there is a tendency among some lending banks to sanction and disburse loans to MFI,s around the end of the accounting year in pursuit of their targets.

5. **Weak governance:** Many MFI's are not willing to convert to a corporate structure. Hence they trend to remain closed to transparency and improved governance, thus unable to attract capital. MFI's also facing a challenge to strike a balance between social and business goals. Managements need to adapt business models based on changing scenarios & increased transparency; this will enable attracting capital infusion and private equity funds.
6. **Interest Rate:** MFIs are charging very high interest rates, which the poor find difficult to pay. MFIs are private institutions and therefore require being economically sustainable. They do not get any subsidized credit for their lending activities and that is why they need to recover their operational costs from borrowers.
7. **Regional Imbalances:** There is unequal geographical growth of Microfinance institutions and SHGs in India. About 60% of the total SHG credit linkages in the country are concentrated in the Southern States. However, in States which have a larger share of the poor, the coverage is comparatively low. Main reason for this is the state government support, NGO concentration and public awareness.

9. Measures to overcome challenges

The following are some measures to overcome the challenges faced by MFIs in providing microfinance services to have a sustainable development

1. **Proper Regulation:** When the microfinance was in its nascent stage and individual institutions were free to bring in innovative operational models, the need for a regulatory environment was not a big concern. However, as the sector completes almost two decades of age with a high growth trajectory, an enabling regulatory environment is needed that protects interest of stakeholders as well as promotes growth.
2. **Field Supervision:** In addition to proper regulation of the microfinance sector, field visits can be adopted as a medium for monitoring the conditions on ground and initiating corrective action if needed. This will keep an eye on the performance of ground staff of various MFIs and their recovery practices. This will also encourage MFIs to abide by proper code of conduct and work more efficiently. However, the problem of feasibility and cost involved in physical monitoring of this vast sector remains an issue in this regard.
3. **Encourage Rural Penetration:** It has been seen that instead of reducing the initial cost, MFIs are opening their branches in places which already have a few MFIs operating. Encouraging MFIs for opening new branches in areas of low microfinance penetration by providing financial assistance will increase the outreach of the microfinance in the state and check

multiple lending. This will also increase rural penetration of microfinance in the state.

4. **Complete Range of Products:** MFIs should provide complete range of products including credit, savings, remittance, financial advice and also non-financial services like training and support. As MFIs are acting as a substitute to banks in areas where people don't have access to banks, providing a complete range of products will enable the poor to avail all services.
5. **Transparency of Interest Rates:** As it has been observed that, MFIs are employing different patterns of charging interest rates and a few are also charging additional charges and interest free deposits (a part of the loan amount is kept as deposit on which no interest is paid). All this make the pricing very confusing and hence the borrower feels incompetent in terms of bargaining power. So a common practice for charging interest should be followed by all MFIs so that it make the sector more competitive and the beneficiary gets the freedom to compare different financial products before buying.
6. **Technology to Reduce Operating Cost:** MFIs should use new technologies and IT tools & applications to reduce their operating costs. Microfinance institutions should be encouraged to adopt cost-cutting measures to reduce their operating costs. Also initiatives like development of common MIS and other software for all MFIs can be taken to make the operation more transparent and efficient.
7. **Alternative sources of Fund:** In absence of adequate funds the growth and the reach of MFIs become restricted and to overcome this problem MFIs should look for other sources for funding their loan portfolio. Various alternative sources of fund for the MFIs may be by getting converted to for-profit company i.e. NBFC, Portfolio Buyout, and Securitization of Loans etc.

10. Findings

1. Outreach of microfinance in India is just 8% as compared to 65% in Bangladesh.
2. Micro Finance Institutions are charging higher interest rate to maintain a balance between the dual

objectives of commercial viability and serving the poor.

3. Micro Finance need to pay attention to urban poor to maximize the outreach.
4. Low education levels, language barrier, unethical practices of employees are the major issues faced by the MFIs.
5. Lack of information among rural poor about the Micro Finance Institutions, financial illiteracy is one among the challenges of MFIs.
6. Inability to generate fund, heavy dependence on bank, weak governance are the other major challenges of MFIs.

11. Suggestions

1. Micro Finance Institutions must adopt technology based services to reduce the operating cost.
2. Micro Finance Institutions must find alternative sources of fund to finance their business.
3. Government agencies should come up with proper regulation to protect the stakeholders.
4. Ensure the uniform distribution of micro finance services in both rural and urban areas of each states of India.
5. Proper training for the clients should be organized in an efficient way so that they could utilise the borrowed fund for the purpose.

12. Conclusion

In the globalised era, the sustainable devolvement and continuous growth can be assured by delivering diversified services to the people increased innovations resulting outoff competition in the financed market stressing the significance of delivering low cost financial services. Low out reach of micro finance institutions and the expensive interest rate, the loan default and fraudulently activities are disturbing financial health of institutions. Financial illiteracy weak governance, regional imbalance is posing significance challenges for the MFI's. In this background MFI's take local initiatives and downer support to maximize the delivering of savings and credit service to the needy. Identification of alternative sources of fund can be used for skill development among rural poor and training them towards income generation activity.

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