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Microfinance: Fostering Inclusive Growth in India

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Abstract

The comprehensive Financial Inclusion plan declared in India by our honourable Prime Minister Shri Narendra Modi has emerged as a major policy objective. The microfinance sector plays a significant role in fostering inclusive growth by offering loans, credit, savings and other basic financial services to borrowers at the bottom of the economic pyramid. Inclusive growth simply means all round growth of the masses. Microfinance and inclusive growth ensure the economic and the financial progress by bridging the gap between the formal financial institutions and the poor sections of the society resulting in balanced and optimal growth.

In this paper, author provides an overview of India's microfinance industry, its position and significance in economic development, prevalent models for the microfinance disbursement, potential for growth of microfinance in India, challenges of microfinance in India and the suggestions to overcome these challenges.

Keywords: Challenges, economic development, financial progress, inclusive growth, India, microfinance.

Introduction

The microfinance sector plays a significant role in fostering inclusive growth by offering credit to borrowers at the bottom of the economic pyramid. The industry has played an important role by providing credit access to 64 million exclusive live borrowers who have historically been out of reach of mainstream financial services. This sector currently has a total lending portfolio of USD 1.785 trillion and loan disbursement is rising by volume at a rate of 20%. This growth is due to the rapid progress of regulatory reforms, the mass adaptation of payments based on UPI, the development of small finance banks and several government and regulatory authorities' initiatives. This sector has not only given the unorganized sector tremendous momentum but is also driving businesses, generating jobs and changing millions of beneficiaries' lives. Government policies have played a major role in canalizing the credit flow to weaker sections of the society by priority sector lending, MUDRA Yojana, credit co-origination and by investments in the private sector.To complement these projects, women are encouraged by giving them convenient access to credit, and support to launch their own projects in business and financial literacy. Schemes like Pradhan Mantri Mahila Shakti Kendra will build an atmosphere favourable for women to reach their maximum potential.

Review of Literature

Most current studies have examined empirically the relationship between microfinance and poverty. Many of these studies suggest that the microfinance has the potential to alleviate poverty and foster inclusive growth by providing basic financial services to the borrowers at the bottom of the economic pyramid (Johnson and Rogaly, 1997; Gibbons and Meehan, 2002; Armendariz and Morduch, 2005; Bakhtiari, 2011). Harper (2002) revealed both benefits and drawbacks of Grameen bank groups and self-help groups. The paper identified and illustrated each group and contrasted its effectiveness, its outreach and effect on the poor and its institutional viability. Ghosh(2005)found that the amount of interest on each loan is one of the big issues resulting from micro-borrowing, thus, same borrowers start looking for loans elsewhere to repay the original loan, thereby creating a risk. Subramanium (2011) investigated whether benefit maximization by MFI undermined its social goals and compared non-profit and profitable MFIs. The results showed the goals of gaining profit by MFIs make them charge exorbitant interest rates or extensively push the debt-payment capabilities to their borrowers. Banerjee et a1.(2015)observed that microfunding has little to no effect on poverty. Amarnani and Amarnani (2015) concluded that microfinance has a positive effect on poor women but that more social and human initiatives are required in order to improve their quality of life and to maintain that change over a period of time. Kapila et al. (2016) showed that micro-credits have greatly enhanced the earnings of women respondents, and their participation in household decision - making has increased. MFI's activities should be made available and affordable to a large number of poor rural people, particularly the poorest(Prathap et al., 2018).Dixit et al.(2019) observed that self-help groups play an important role in providing micro financial services leading to rising savings patterns of poorest society strata and helping to grow the people at the bottom of the economic pyramid in India.

Research Methodology

This study is based on exploratory research and focuses on extensive study of secondary data collected from government websites, various national and international journals, conference papers, government reports, newspapers, magazines which focused on various aspects of microfinance in India.

Objectives of the Study

This paper gives an overview of India's microfinance industry, its position and significance in economic development, prevalent models for the microfinance disbursement, potential for growth of microfinance in India, challenges of microfinance in India and the suggestions to overcome these challenges.

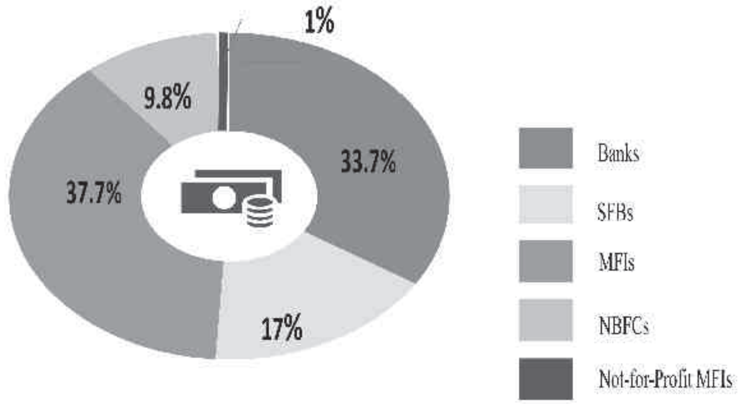
Overview of India's Microfinance Industry

In the early eighties Microfinance began as a global movement to lend low-income families who had restricted access to conventional banking services. Some of the key global concerns for microfinance were the volatile regulatory environment, over indebtness of the borrowers, and absence of an institutional framework. However, the microfinance industry has been transformed considerably in recent years by forming self-regulatory bodies, developing structured guidelines, digital interventions, and using a redefined approach to customer service. This has resulted in a significant increase in the portfolio of loans and, therefore, in the number of borrowers. The global microfinance sector is presently worth more than INR 8.90 trillion and over the past five years the amount distributed in the loan has increased at an average annual rate of 11.5%. Globally, this sector has touched 139.9 million borrowers, with 80 percent being women and 65percent belonging to rural areas. Globally, South Asia is one of the leading markets in microfinance. The year 2018 saw the maximum borrowers, i.e., 84.6 million, rising at a pace of 13.8%. India has a large proportion of these debtors. Loan portfolio grew by 40 percent Year-over-Year, with 63.9 million unique live borrowers in FY 19 in the Indian microfinance sector. Diverse microfinance providers and different microfinance models has fuelled this development.

Microfinance Providers in Indian Lending Ecosystem

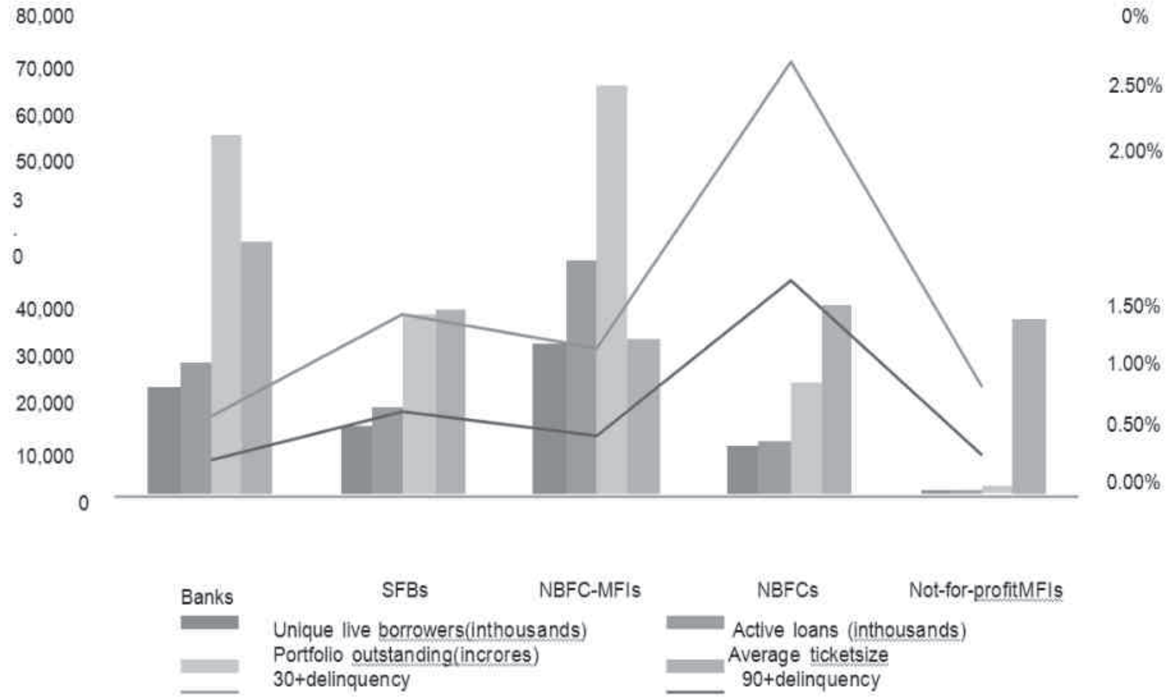
Microfinancing has been facilitated in India by different players, such as banks, SFBs, MFIs, NBFCs and non-profit MFIs. MFIs have a largest portion of the INR 681 billion loan portfolio, comprising 38 per cent of the industry's overall portfolio. This means that borrowers are more likely to obtain loans from MFIs.(Fig. 1).

Fig 1. Market Share of Financial Institutions in Outstanding Portfolio



Source: SIDBI & Equifax Microfinance Pulse report, June 2019

Fig 2. Snapshot of players in the Indian Microfinance Industry



Source: SIDBI & Equifax Microfinance Pulse report, June 2019

Banks have seen stable growth with easy access to funding, greater ticket sizes for loans and low crime ratios among microfinance players (Fig. 2). However, while MFIs hold the largest proportion of the loan portfolios, their growth is negatively affected by limited supply of funds, high cost of acquiring customers and servicing incurred by operations in remote areas. Consequently, for larger NPFC-MFIs, rates for MFIs will range from 24% and 35%-45% for smaller MFIs, leading to systemic inaccessibility for final customers and large NPAs for microfinancers. In addition to the banks and MFIs, SFBs provide high ticket loans and have a lead over NBFCs and MFIs. Thus, SFBs are the emerging players of the current microfinance sector. In FY19, NBFC and MFIs disbursed an average ticket size of INR 25,850 per customer while that paid-out by SFB's was INR 30,780.With the market share of SFBs growing by 17 percent, they are expected to expand further and provide borrowers attractive offerings. With the involvement of many microfinance players with their distinctive strengths and weaknesses, a collaborative strategy for greater growth is required. In this sense, the RBI allowed for the co-origination of banks' and NBFC's/MFI's loans requiring a joint credit and risk sharing agreement between the both. With a large portion of the credit risk carried by the participating bank, Co-lending is expected to reduce lending risks for the NBFCs. In addition, the comprehensive network provided by NBFC/MFIs' also will be beneficial for the banks as the task of procurement of loans and thereby the monitoring and maintenance of these loans under this scheme will also be taken care of.

PREVALENT MICROFINANCE DISBURSEMENT MODELS

Table 1: Prevalent Microfinance Disbursement Models

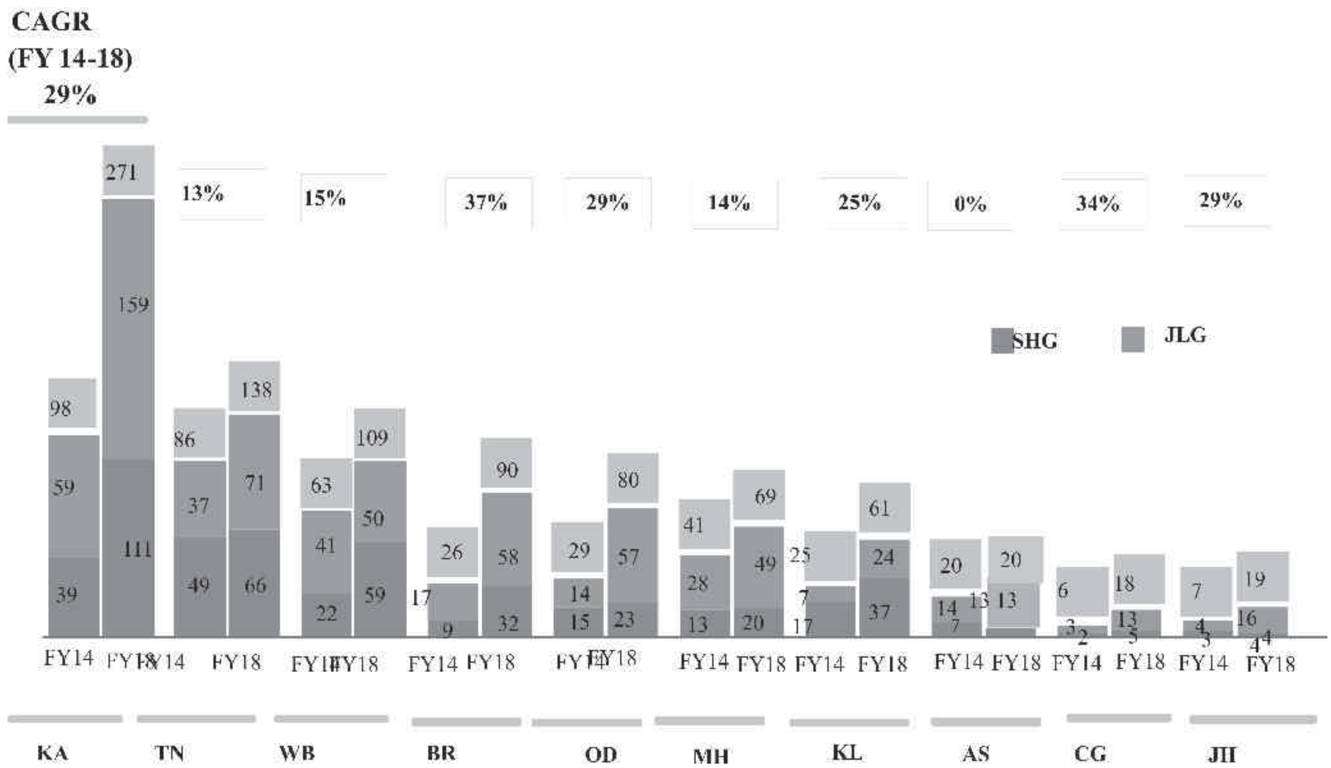
Parameters	SHG's	JLG's
Underlying strategy	Greater focus on savings generation	Greater focus on credit generation
Scalability	SHGs are lessscalable whencompared to JLGs	JLGs have a faster turnaround and are more scalable
Average group size	10–20 members per group	3–10 members per group
Associated NPA's	NPAs vary from 7–8% for SHGs	NPAs are less than 1%, which is quite low compared to SHGs
Future landscape	Capacity building for partner institutions	NBFC-MFIs prefer JLG model as it is more commercially viable and scalable

The Joint Liability Group (JLG) or the Self-help Group (SHG) model are the two prevalent models used by microfinance players in India to disburse loans.

SHG MODEL vs JLG MODEL

The preference of a disbursement model solely relies on the feasibility of the institution's process and organizational strategy. With restricted funding exposure, Non-Banking Financial Corporations-MFIs embrace a more flexible JLG model with faster turnaround, lower NPAs (less than 1 per cent compared to 7 to 8 per cent for SHGs) and shared responsibility that eliminates default costs, rendering it financially feasible to meet the increasing consumer base. Overall, the number of JLGs from FY18 to FY19 has risen by 46 per cent, with SFBs and commercial banks supporting JLGs via NABARD MoU's. The SHG share is also expected to decrease in the future relative to that of JLGs as a shift of NBFC-MFIs towards the JLG model. It is apparent from the historic pattern of SHG's allocation to the overall portfolio of MFIs in select states.

Figure 3: Overall MFI segmentation into SHG and JLG (INRbillion)



Source: NABARD, Sa-Dhan, PwC analysis

Potential for Growth of Microfinance in India

India represents an immense opportunity for the microfinance sectorwith numerous players in the microfinance landscape and established microlending models andthe fact that a large portion of India's population belongs to the low-income category. For almost 67% of India's rural population access to micro-credit has been increased via Government schemes and developed financial institutions. The major geographical concentration of MFIs in a few districts of India has risen (34% of districts with a microfinance presence contributing 80% to the portfolio) suggesting potential for higher microfinance penetration. Potential of microfinance to achieve financial inclusion and overall development of microfinance industry is attributed to the fact that a large chunk of the Indian population borrows from informal sources such as moneylenders or relatives due to lack of access to formal sector finance. To realize this potential for development, it is important for the sector to recognize and assess emerging needs within the sector and address them through appropriate growth-optimizing initiatives.

71% of financial institutions claim that, due to the relative concentration in the southern markets, Eastern India provides the highest growth potential in future.

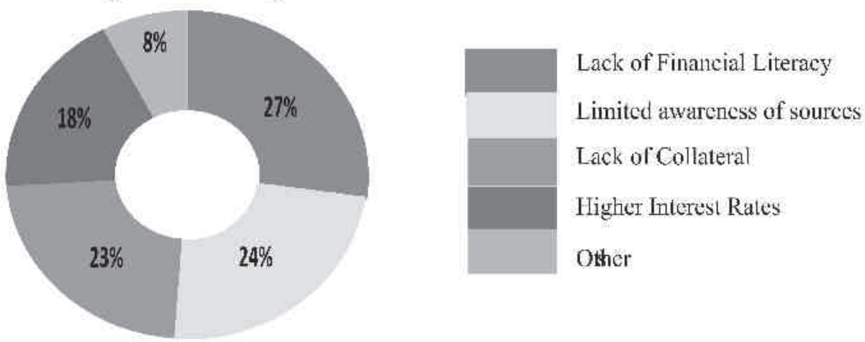
Microcredit should be in a position to turn the path of the borrower from that of a job seeker to a job maker. It is important to exploit funds to build a sustainable and competitive ecosystem for borrowers as the sector progresses through better regulation and capital inflows.

Challenges of Microfinance in India

The microfinance industry has its own challenges, ranging from restricted access to low-cost funding for microfinance institutions (MFIs), competition for more creative and consumer-oriented goods, lack of collateral, a laborious customer acquisition process, and low technical and financial literacy among targeted lenders, over-borrowing, and lack of structured credit history. There are also threats relating to consumer data security and privacy, along with financial and liquidity threats, which present a major challenge to organizations that aspire to remain sustainable. While the RBI has introduced a range of initiatives, such as data localisation, a public credit registry (PCR), a cap on multiple lending and a regulatory sandbox aimed at formalizing credit and enabling the sector to conceptualize an automated underwriting mechanism and to make decisions based on essential data points, a comprehensive risk management system is yet to be developed for the microfinance sector. The Government of India has also recently increased the micro-loan ceiling for borrowers to INR 1.25 lakh with a view to increasing the reach of microfinance sector. It is also expected that RBI measures such as co-originating of lending by banks and NBFCs (non-bank financial companies)/MFIs would reduce the risk of lending to NBFCs with a large portion of the credit burden accepted by participating institutions.

Mature risk and regulatory framework: The microfinance industry is currently in a phase of expansion, with a strong reliance on macroeconomic factors and changing demand from consumers. As the industry expands, related threats may emerge in the form of fraud, credit risk, safety, asset and liability threats and inefficiency that will call for effective management of portfolios and fraud detection by lenders (PwC's Microfinance Lenders Survey 2019).

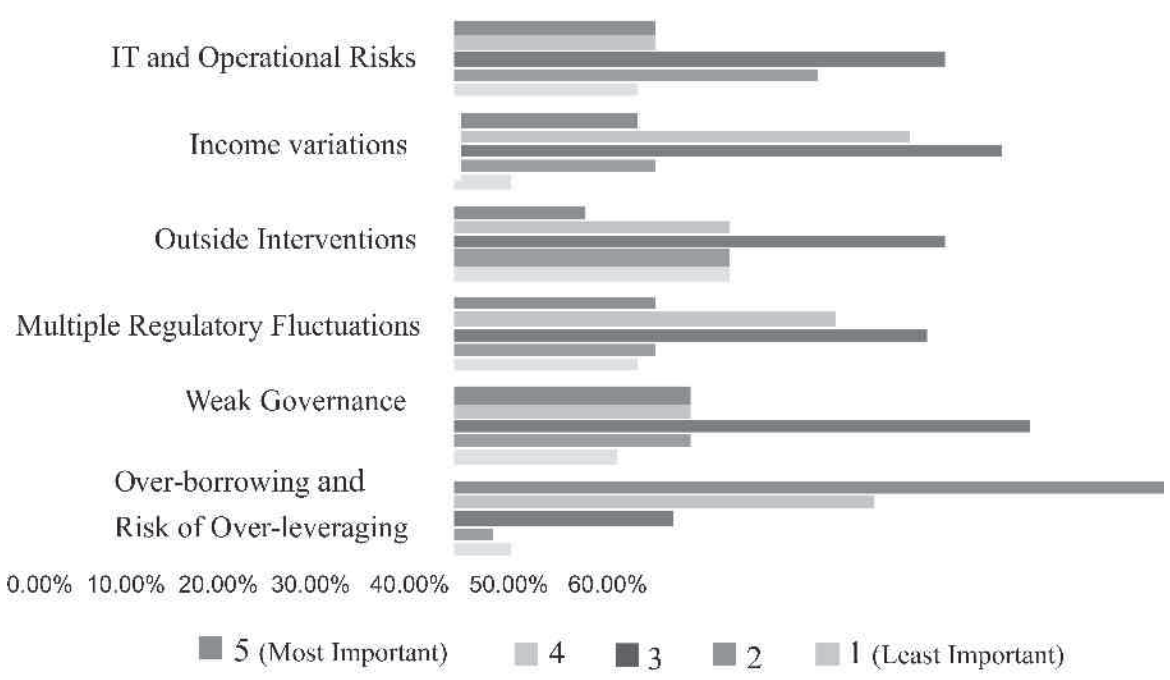
Fig. 4: Challenges in accessing credit from the formal sector



Source: PwC's Microfinance Lenders Survey 2019

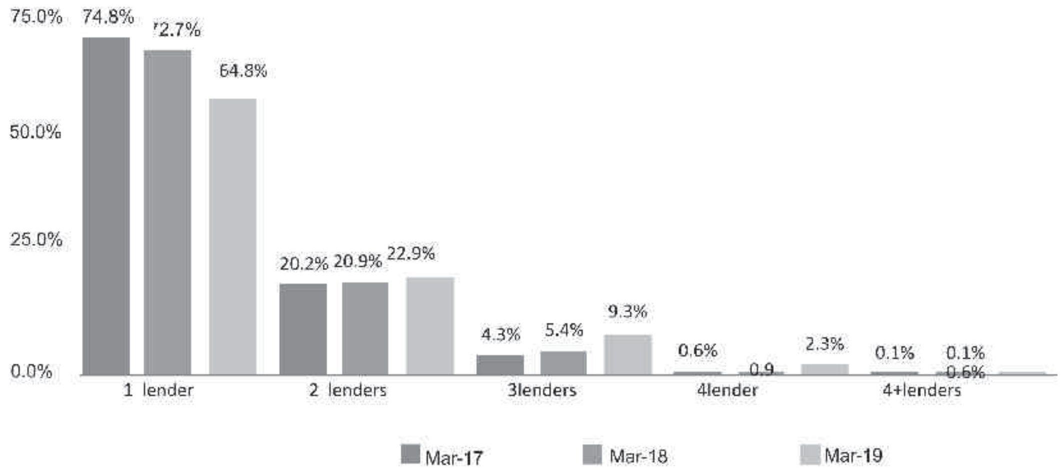
Risks in the microfinance sector: Over-borrowing is one of the main threats of microlending, with approximately 35% of borrowers having access to two or more lenders. The concern over keeping a stable NPA level is inevitable with increase in borrowing and the introduction of new-to-credit borrowers(PwC's Microfinance Lenders Survey 2019).

Fig 5: Risks in the microfinance sector



Source: PwC's Microfinance Lenders Survey 2019

Fig 6: Over-borrowing pattern in microloans



Over-borrowing considerations: With borrowers' credit requirements increasing, the possibility of lending from numerous lenders is imminent. Although the RBI has established guidelines to avert over-borrowing, borrowers still rely on local money-lenders, co-operatives, peers, and other channels of informal financing to meet their growing needs. Microfinance companies should execute rigorous analysis of current loans of borrowers in order to strike a balance between crediting for sustainable business development and reducing threats that could result from over-borrowing.

Suggestions to Overcome the Challenges

Availability of alternative sources of capital financing: With the growth of the microlending market, the need to venture into new investment channels is increasing, particularly for smaller MFIs with lower credibility and a smaller product portfolio. The microfinance sector needs to establish alliances with private donors such as foundations, NGOs, development communities, venture capital and sustainable conscious investing through funds from corporate social responsibility, global trust funds and other funding sources. INR 17.17 billion of NSE-listed companies' CSR funds were left unspent in FY18. The microfinance industry should establish collaborations with private companies to funnel unused CSR funds to enable the industry. To access low-cost funds, microlenders may pursue new-generation fundraising tool, such as social impact bonds (SIBs). Like SIDBI's Prayaas initiative, institutes with access to low-cost funds may channel these funds via well-regulated intermediaries to micro-borrowers. Thus, alternative sources of capital financing and new business models will provide access to cheaper capital for micro-financers, generating incentives for a better gross loan portfolio, expanded customer scope and improved product offers and services.

Customer centricity: Financial inclusion is not limited to people who have access to bank accounts. This is their opportunity to navigate a multitude of applicable financial goods and services consistent with the changing trends of the consumer market. Microfinance companies should provide tailored financial solutions based on customer needs such as crop insurance and machinery leasing facilities in terms of financing for particular agricultural development and production cycles. For example, microinsurance is intended to cover a variety of risks, including natural disasters, credit risk, consumer risk and safety disasters. For higher acceptance, the move to consumer-centric goods and services should be made possible by rigorous customer identification focused on attitudes, characteristics, occupations and habits. The resulting exposure to diversified assets will help borrowers to increase their income potential and avoid over-borrowing risks.

Last-mile access: Various government programmes, private and trust fund projects have been introduced to provide and determine access of needy people to financial services. Government of India's Ministry of Finance unveiled the Financial Inclusion Index to assess access, use and quality of financial services on September 2018.In addition, the Department of Financial Services (DFS) has launched Jan Dhan Darshak, a mobile app, to help people locate related financial services near them. Microfinance companies should look to exploit government initiatives and enter into new alliances to accelerate attempts at financial inclusion in order to deliver last-mile services in unpenetrated geographies.

Financial and Digital Literacy among borrowers: Training programs on financial literacy can be designed to sensitize the advisors of Financial Literacy Centers (FLCs) and branch managers of rural banks so that they can provide basic financial literacy at ground level.In addition, to ensure financial literacy private institutions may partner with local authorities or government-sponsored institutes such as RSETI "Rural Self-Employment Training Institutes". Trained staff from these organizations can help borrowers build portfolios, access government savings and insurance policies. The sharing of information among borrowers can be further guided by field agents who can be trained to develop their analytical skills, skills in technology, and knowledge of regulatory mandates and the latest product offerings. SHG members can be used as field agents. 85% of SHGs consist solely of women. Such influencers can reach out to women borrowers who earlier could not be reached due to lack of awareness and socio-cultural divides thus enabling higher generations of leads. Technology should be made readily available to all types of microfinance customer groups. Taking into account the high prevalence of cell phones and the inexpensive cost of internet access, micro-loans should follow a mobility-based approach to daily transactions, tracking repayments and providing value-added services to individual borrowers, especially those with lower literacy levels. In turn, successful tracking of the use of loans by digitally driven third-party alliances for direct transfers to recipient accounts, according to daily household needs, should be carried out. Finally, players should make comprehensive use of analytics models to forecast evolving consumer demands and develop customer-oriented borrowing solutions.

Streamlined processes of customer-facing staff: Customer-facing staff, such as loan officers, play a vital part in the acquiring of potential clients, the marketing of goods and the delivery of training to borrowers. However, the lack of a reliable development network, inadequate training and high operating costs impede workers earning capacity in rural areas, resulting in minimal consistency of staff processes, which also impacts customer support and ultimately leads to higher turnover. Such a situation underlines the need to streamline the activities of customer-facing employees by comprehensive use of technology and ensure that the acquisition of customers is backed up by appropriate data insights.

Robust credit risk assessment mechanisms: Since most borrowers come from low-income families, they often lack a credit background that poses difficulties in creating efficient underwriting process and collection models. Lack of robust customer data, fragmented sources of information, and reliance on borrowers' information disclosure hinders forming of consumer credit profiles. Furthermore, the absence of structured documentation also hampers the implementation of fraud detection and NPA monitoring systems with significant consequences for the costs of enforcement and the organization's reputation. In order to build comprehensive consumer credit profiles for deeper analysis of market patterns and understanding the borrowing patterns of customers there is a pressing need is to develop extensive partnership between credit rating agencies, govt. agencies and microlenders.

IT and operational considerations: Several technical and organizational challenges have resulted from the advancement of digital technologies which were created by a growing number of technology collaborations. Under the Government Data Localisation Guidelines and the proposed Data Protection Bill, country is likely to store all confidential customer related data for safety. In addition, microlenders can formulate preventive strategies to manage fraudulent lending activities. These practices should be tracked by demographic analysis, with red flag identification mechanisms at various lending value chain touch points.

Enabling touch for 'high-touch' industry: Although technology is being used to enhance transactional processes, the need for the hour is to exploit technical solutions to create deeper customer relationships and motivate current customers. Technological solutions will deliver door-to - door services to consumers, thus reducing average response time, funding costs for lenders and credit usage costs for borrowers. The same should be made possible by the creation of a comprehensive consumer data management policy and stringent privacy requirements to ensure the organization's accountability on the use of consumer data and process integrity.

Women emancipation and the creation of an entrepreneurial environment: There is a growing need to provide women with credit access, information access, and rights to make financial decisions and assistance in broad range of entrepreneurial activities considering the fact that about 85% of microfinance borrowers are women. Women-driven entrepreneurial ventures will not only guarantee timely repayments for microfinance lenders, but will also create a broad channel of influence in the form of women entrepreneurs for greater credit penetration.

Conclusion

By 2025, India intends to reach a 5 trillion dollar economy and the microfinance industry will be instrumental in raising the lives of millions of low-income households and enabling them to make a significant contribution to the economic growth of our country. Effective governance and stringent regulatory practices is need of the hour to meet the prevailing challenges in the microfinance sector.

The future growth of this sector will depend on creating new alliances, exploiting technologies that meet customer needs, developing new products and by venturing into new investment channels by the numerous players in the microfinance landscape.

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