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Challenges And Principles To Informal Credit In India And The Appearance Of Micro Finance Institutions

Dr. Vivek Mittal Professor Department of Management, Himalayan University, Ita Nagar (Arunachal Pradesh)

Dr. Sara Kamal Assistant Professor Department of Management Mangalayatan University, Aligarh, (Uttar Pradesh)

Abstract

Microfinance has not yet risen to the top of the priority list in the Indian financial sector. Despite this, India now possesses the necessary knowledge, capital, and technological resources to address these challenges, albeit not yet in a fully coordinated manner. Due to an improved business environment and an increase in economic growth, the delivery of financial services to poor people in India is expected to be particularly exciting in the coming years.When it came to established financial institutions in India and other parts of the world, there was a notable shortage of them. Traders and moneylenders were the only options accessible to the marginalized.As seen by the innumerable success stories of microfinance in India as well as in emerging and developed countries, there is little doubt that microfinance has immense potential to promote both economic and social development among the poor, particularly among the rural and urban poor. Not only does microfinance bring financial stability to those who are in desperate need of it, but it also promotes the idea of credit as a fundamental human right, something that should be available to everyone, regardless of their socio-economic situation.

Keywords: microfinance, informal, credit, India, microfinance institution, etc.

1. INTRODUCTION

Microfinance is now widely recognized as a powerful tool in the fight against poverty and the empowerment of the world's most marginalized people, particularly in developing countries. Case studies have demonstrated that microfinance has the potential to play a role in the development of social capital and the advancement of human development. As the sector continues to grow, there is a greater need for comprehensive analyses of the role and structure of microfinance, as well as its problems and prospects. Through the provision of credit to the poor in order to stabilise their income while also enabling them to invest in income-generating activities, microfinance and specifically micro-credit have the ability to transform people's lives.

Microfinance promotes financial inclusion among those who have never been considered creditworthy or bankable in the past, and it provides the poor with services such as microcredit, microsavings, insurance, and remittances. The economic contribution of microfinance to the eradication of poverty is only one of the many aspects of development that it seeks to address. As a means of promoting social development, microfinance has the potential to empower women and promote gender equality, as well as to provide the poor with sustainable livelihoods and to provide social security and support for the poor, particularly among women.

1.1 The Importance of Microfinance

Access to financial services is extremely important in the economic and social development of individuals. According to the findings of impact assessments conducted in Rajasthan and elsewhere, beneficiaries' income levels have improved, their reliance on money lenders has decreased, they have increased expenditure/investment in children's education, health, agricultural input, increased production and most importantly, they have increased awareness and self-confidence among the poor and are becoming more aware of their own abilities. Microfinance, because of its inherent characteristics of timely provision of financial services and product flexibility, can provide a boost to promising sectors such as animal husbandry, wool and mutton processing, information technology, tourism, and other related industries. Additionally, microfinance aids in reaching out to vulnerable segments of society such as women, people from lower socioeconomic classes, and people from minority groups, who are often left out of the reach of traditional financial institutions and institutions of higher learning.

2. HISTORY OF INFORMAL CREDIT IN INDIA AND THE APPEARANCE OF MICROFINANCE

When it came to established financial institutions in India and other parts of the world, there was a notable shortage of them. Traders and moneylenders were the only options accessible to the marginalised. These loans were given at exorbitant rates of interest to the detriment of the borrowers in this old system, which was sometimes predatory in character. There is a new way of giving credit without establishing the onerous debt cycle that was present in the old system: microfinance. We offer lower interest rates to the underprivileged so they can actually pay back their loans. Because of this, microfinance has played an important role in boosting financial inclusion in India. Indians were slow to accept or adopt microfinance despite its evident advantages over the conventional moneylender system. Factors such as inadequate grant levels to microfinance organisations and an unfriendly policy environment initially slowed down microfinance's rapid development. SHGs of 15-20 members were able to deal with commercial banks for the first time because of government policy support in this area. There are currently over 20 million members in India's self-help group microfinance movement with over 1.4 million self-help groups. This style of microfinance continues to be the most widely used in India today.

National Bank of Agriculture and Rural Development (NABARD) was significantly instrumental for launching India's self-help group microfinance movement. Microfinance in India has also been dominated by cooperatives, Regional Rural Banks (RRBs), Small Industries Bank for Agriculture and Development (SIDBI), and the Housing Development Finance Corporation (HDFC) (HDFC). Sa-Dhan, a network of Indian Microfinance Institutions created in 1999 as the Association of Community Development Finance Institutions, is another prominent player in Indian microfinance. Mission: To help its members and affiliated institutions better serve low-income people, particularly women from rural and urban India, in their quest to establish secure livelihoods and improve quality of life through community development finance. Sa-membership Dhan's has skyrocketed since its inception, making it one of India's most relevant and comprehensive microfinance organisations. The Working Women's Forum in Madras, India, and Mitrabharati – The Indian Microfinance Information Hub are other notable microfinance institutions in the sector.

3. INDIAN MICROFINANCE INSTITUTIONS IN A GLOBAL BACKGROUND

Microfinance has firmly established itself as a vital component of India's socioeconomic development. Microfinance institutions (MFIs) in India are rapidly expanding, with the goal of achieving the so-called "double bottom line" of financial sustainability and socially relevant involvement. From a global viewpoint, a large number of Indian institutions appear on Mix Market's and Forbes' rankings of the world's top microfinance institutions. In 2008, eight Indian MFIs made the top 50 in the Microfinance Information Exchange (MIX) list, with the highest ranking at number four, and seven MFIs made the top 50 Forbes list, with the highest ranking at number two. Except for Bandhan, a Kolkata-based MFI that appears on both rankings within the top 10, no other MFIs appear within the top 50? The causes for this include the evaluators' differing assessment parameters. The criteria employed by MIX market were outreach, efficiency, and openness. Forbes used the scale, efficiency, risk, and return criteria.

The lists, the assessment methodology, the criteria, and the number of higher performing MFIs that are not on the lists are all hotly debated topics. However, the fact that a substantial number of Indian MFIs have made it into both lists despite the sector having the lowest interest rates (in worldwide comparison) is a source of pride for everybody in the industry. The lists were created using data from 2006, and they may need to be updated in order to make conclusions with long-term ramifications. Since then, market conditions have altered dramatically, as have leadership roles (Dr. Prakash D Achari and Dr. Ankur Kumar Agrawal, 2018).

4. MICROFINANCE PRINCIPLES

Microfinance is a technique for socioeconomic development that can be distinguished from charitable giving. Families who are impoverished or so poor that they are unlikely to be able to repay a loan should be the receivers of charity. Financial institutions are the greatest option for others. The Consultative Group to Assist the Poor (CGAP) contained and adopted by the Group of Eight leaders at the G8 Summit on June 10, 2004 some principles that summarised a century and a half of development experience.

- In addition to loans, poor people require savings, insurance, and money transfer services.
- Microfinance must benefit impoverished households by assisting them in increasing their income, accumulating assets, and/or protecting themselves from external shocks. "Microfinance has the potential to pay for itself. Donor and government subsidies are few and unpredictable; therefore microfinance must pay for itself in order to serve large numbers of poor people.
- Microfinance entails the establishment of long-term local institutions as well as the integration of poor people's financial requirements into a country's mainstream financial system.
- Government's role is to assist, not to deliver, financial services.
- Donor funding should complement rather than compete with private resources.
- Donors should focus on capacity building because the main barrier is a lack of strong institutions and management.
- Microfinance organizations should assess and disclose their performance - both financially and socially.
- Interest rate ceilings harm impoverished people by prohibiting microfinance institutions from covering their costs, suffocating the supply of credit.

4.1 Microfinance Challenges

The following are some of the roadblocks or barriers to establishing a viable commercial microfinance industry:

i. Donor subsidies that are not suitable; poor regulation and supervision of deposit-taking MFIs;

ii. a scarcity of MFIs that satisfy the demands of savers, remittances, and insurance;

iii. a lack of management capacity in MFIs; and

iv. Institutional inefficiencies.

v. There is a pressing need for greater awareness and use of rural and agricultural microfinance methods.

Clients with little or no cash income have traditionally been denied access to financial services, such as loans, by financial institutions. No matter how little the sums of money involved in a client account are, banks pay significant expenditures in order to operate the account. For example, although the total gross revenue generated by delivering one hundred loans worth $1,000 each will be comparable to the revenue generated by delivering one loan worth $100,000, it will require nearly a hundred times the amount of work and resources to manage one hundred loans as it will to manage one loan worth $100,000 in terms of time and resources. In order to handle loans of any size, there is a significant fixed cost, which includes the evaluation of potential borrowers, their repayment prospects, and security; administration of outstanding loans, collection from late borrowers, and other tasks that must be completed in all cases. The provision of loans or deposits reaches a break-even point below which banks lose money on each transaction they complete. Poor people are more likely than not to go below the breakeven point. Attempts to provide other financial services to low-income persons are thwarted by a similar equation. Furthermore, most poor people have limited assets that may be used as collateral by a bank to get a loan. In other words, the bank will have limited recourse against defaulting loansUpadhyay et. al, (2017). A result of these challenges, when poor individuals need to borrow money, they frequently turn to family or a local moneylender, whose interest rates might be extremely high. After reviewing 28 studies on informal money lending rates in 14 countries across Asia, Latin America, and Africa, researchers came to the conclusion that 76 percent of moneylender rates exceed 10 percent per month, with 22 percent of moneylender rates exceeding 100 percent per month.

Moneylenders typically demand higher interest rates to poorer borrowers than they do to more affluent ones. Despite the fact that moneylenders are frequently stigmatised and accused of usury, their services are convenient and rapid, and they can be extremely accommodating when borrowers encounter difficulties. It has been impractical to expect them to go out of business in a short period of time, even in regions where microfinance institutions are present. Despite significant progress, the problem has not yet been resolved, and the vast majority of individuals who make less than $1 a day, particularly in rural regions, continue to have no practical access to formal sector finance, despite significant advances. Microfinance is increasing at a rapid pace, with $25 billion in microfinance loans now in operation. It is predicted that the industry will require $250 billion to provide capital to all of the underprivileged people who are in need of financial assistance. Because the sector is expanding at a rapid pace, there have been concerns that the rate at which cash is coming into microfinance could pose a risk if it is not properly handled. As the state of Andhra Pradesh has demonstrated, these systems are susceptible to failure. There are a variety of reasons for this, including lack of use by potential customers, excessive debts, bad operating processes, neglect of responsibilities, and insufficient controls.

5. CHALLENGES TO MICRO FINANCE INSTITUTIONS

Despite the fact that the relevance of microfinance in the process of poverty eradication has been recognised, the sector continues to face a number of challenges. The reason for this is because providing loans to the poor is a time-consuming procedure, and the industry is still in its early stages of development.

- **High costs involved in small transactions/ micro lending:** As a rule, micro entrepreneurs have no collateral to provide to microfinance providers in exchange for loans, no other source of income to supplement their loan payments, and little, if any formal education or training in the field in which they conduct their business. So, commercial banks view micro entrepreneurs as having a significant credit risk and therefore avoid doing business with this sector. Microfinance institutions (MFIs) are forced to compensate for this risk by increasing the interest rates they charge on loans (read 10 determinants of interest rates in microfinance). Fortunately, the concept of collective lending (social collateral against loans), which ensures high repayment rates, can be used to overcome the difficulty of the situation.

- **Small transactions/micro lending is expensive due to the high costs involved:** The tiny size of micro firms raises the transaction costs for microfinance institutions because they are unable to process loans in large quantities (unless good management information systems are in place). Due to the lack of economies of scale, microfinance institutions (MFIs) are compelled to pay their costs by the imposition of high interest rates on loans (read 4 ways to control high interest rates). An ADB analysis found that microfinance providers in the Asia-Pacific area charge interest rates on micro-sized loans ranging from 30 to 70 percent per year, which is significantly higher than the interest rates offered by commercial banks in the region (Fernando, 2006). However, there have been cases in which the interest rates charged were too low to ensure the long-term viability of the MFIs. A viable solution to this problem exists, however: by enhancing the technological model employed by microfinance institutions, their operational expenses can be greatly reduced, and efficiencies can be realised during automated loan processing.

- **Lack of debt and equity funds for MFIs to pass on to the poor:** Because of the tremendous growth in the microfinance sector, which has been spurred by attention from the media and development agencies, capital availability for microfinance is no longer a concern. In spite of the fact that there are numerous financing sources accessible for microfinance institutions, there is a growing lack of funds as a result of the current global financial crisis. Another explanation for this shortage is that MFI managers are not aware of the many funding sources available to them.

- **Difficulty in measuring the social performance of MFIs:** Despite the fact that microfinance is delivering the economic returns that its proponents promised, there are just a few instruments available to quantify the social return of loan programmes for the poor. To compound the problem, the tools make use of proxies to assess the amount of poverty and social change that exists in the area where micro entrepreneurs operate. As a result, rising funding might be difficult since donors may be sceptical about the actual impact of microfinance.

- **Mixing charity with business:** Because lending without strong discipline is nothing more than charity, if microfinance providers fail to safeguard themselves against loan default, they would, in fact, prioritise social objectives at the expense of long-term financial viability Inadequate implementation of corporate governance standards results in improper delinquency management, and both formal and semi-formal microfinance providers are frequently affected by this. The effect will be increased default rates in microfinance transactions as a result of looser supervision over these transactions. Read on to learn more about the challenges of combining charity and business.

- **Insufficient access to customized solutions for the poor:** As a result of MFIs' failure to comprehend the diverse demands of micro entrepreneurs, inadvertently targeting disadvantaged households is a regular occurrence in microfinance programmes. MFIs must spend time in the field with their clients and his or her business, and then use this information to design personalised microfinance solutions for each micro entrepreneur they work with. Generalized solutions may be effective for major corporations dealing with broad homogeneous client groups, but microfinance providers must be able to meet the diverse demands of individuals in each micro market segment.

- **Microfinance training for human resource in microfinance institutions is discouraged:** When compared to the regular financial industry, working in the microfinance sector is a very different ball game. Microfinance officers and volunteers, for example, must be able to communicate in a foreign language, establish long-term relationships with individual micro entrepreneurs, comprehend the specific needs of the poor, assess the borrower's long-term viability, and understand the cultural nuances of the borrower's communities. It should come as no surprise that microfinance providers require specialised training to guarantee that they do not encounter problems such as intimidating or underserving customers.

6. CONCLUSION

As seen by the innumerable success stories of microfinance in India as well as in emerging and developed countries, there is little doubt that microfinance has immense potential to promote both economic and social development among the poor, particularly among the rural and urban poor. In spite of the fact that microfinance does not specifically target the most impoverished of the poor, it has had a transformative effect on individuals who are economically active and have the ability to flourish through self-employment. Not only does microfinance bring financial stability to those who are in desperate need of it, but it also promotes the idea of credit as a fundamental human right, something that should be available to everyone, regardless of their socio-economic situation. This organisation advocates social development by empowering women and advocating for gender equality. It also works to develop leadership and social capital among members of local communities.

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