# The challenges of inclusiveness in microfinance



**(Mains GS 3 : Inclusive growth and associated issues/challenges)**

**Context:**

The **Reserve Bank of India** (RBI) in June published a "Consultative Document on Regulation of Microfinance" with the objective of promoting the financial inclusion of the poor and competition among lenders.

**The microfinance:**

- 'Microfinancing' was introduced in India as a solution to poverty and to empower women.
- Microfinance is a type of banking service provided to low-income and unemployed factions of the population.
- The financial institutions supporting microfinance offer services like lending, setting up bank accounts and providing micro-insurance products.
- Microfinance meets the demands of the rural poor and helps small-scale businesses flourish by providing greater financial stability.

**The rate of lending:**

- According to the consultative document RBI suggested that the current ceiling on rate of interest charged by non-banking finance company-microfinance institutions (NBFC-MFIs) or regulated private microfinance companies needs to be done away.
- Document stated that the rate of lending is biased against one lender (NBFC-MFIs) among the many (commercial banks, small finance banks, and NBFCs).

- As per RBI the rate of interest should be guided by the governing board of each agency and believe that “competitive forces '' will bring down interest rates.

**Case study on microfinance:**

- Microfinance is an important loan portfolio specially for poorer rural households.
- The Foundation for Agrarian Studies makes their report on the finding of two villages in Tamil Nadu.
- Findings show that more than half of the total borrowing by households resident in these two villages was of unsecured or collateral-free loans from private financial agencies (SFBs, NBFCs, NBFC-MFIs and some private banks).

**Socio-economic relation:**

- Findings of the study also shows that there is clearly a caste and socio-economic class relation coming out in terms of source and purpose of borrowing.
- The unsecured microfinance loans from private financial agencies were of disproportionate significance to the poorest households.
- The unsecured loans are mostly disbursed to poor peasants and wage workers along with persons from the Scheduled Castes and Most Backward Classes.
- The microfinance loans to these people were rarely for productive activity and almost never for any group-based enterprise, but mainly for house improvement and meeting basic consumption needs.

**Higher cost:**

- The cost of microfinance loans is much higher as the method of repayment creates a cascading problem.
- An “official” flat rate of interest on loans used to calculate equal monthly instalments actually implies a rising effective rate of interest over time.
- In addition, a processing fee of 1% is added and the insurance premium is deducted from the principal.

**Growth of private agencies:**

- The recent phase of growth of financial services in microfinance is mostly privately-owned for-profit financial agencies which are “regulated entities”.
- These entities have been promoted by the RBI and lending by small finance banks (SFBs) to NBFC-MFIs has been recently included in priority sector lending.
- In **Post-COVID-19** period the cost of funds supplied to NBFC-MFIs was lowered but without additional restrictions on the interest rate thus it affected the final borrower.

**Microfinance crisis:**

- Microcredit mostly given by scheduled commercial banks either directly or via non-governmental organisations to women’s self-help groups in the decade of 1990.
- But the scope of high returns and lack of regulation attracted  for-profit financial agencies such as NBFCs and MFIs.
- By the mid-2000s  rapid and unregulated expansion of private for-profit micro-lending leads to widespread accounts of the malpractices of MFIs (such as SKS and Bandhan).
- The microfinance crisis of Andhra Pradesh led the RBI to form a new regulatory framework for NBFC-MFIs in December 2011 on the recommendation of the Malegam committee.
- Laterly,  the RBI permitted a new type of private lender, SFBs having the objective of taking banking activities to the “unserved and underserved” sections of the population.

**Current statistics:**

- As per the RBI’s consultative document, currently 31% of microfinance is provided by NBFC-MFIs along with 19% by SFBs and 9% by NBFCs.
- While the current share of public sector banks in microfinance (the SHG-bank linked microcredit) is 41% which seems to fall sharply.
- Thus the private financial institutions which have grown exponentially over the last few years, garnering high profits.

**Conclusion:**

- The further privatisation of rural credit and  reducing the share of direct and cheap credit from banks makes poor borrowers at the mercy of private financial agencies.
- Thus to meet the credit needs of poorer households stakeholders need to strengthen public sector commercial banks and firm regulation of private entities.

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