**BANKING OF THE UNBANKABLE- KEY ISSUES AND CHALLENGES IN THE MICROFINANCE**

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**ABSTRACT**

This paper on “The imperative need of statutory regulations and challenges in regulations in digitalisation in the microfinance sector is based on the descriptive study of the available literature on the subject. It touches on the growth of the microfinance and rationalises the critical requirement of regulations. Further the study focuses on the key issues both the inherent in the system and the contemporary issues. The challenges faced in the digitalisation process is also analysed. Further it tries to explain regulations in the general context and with reference to microfinance and probes at length the reason as to why regulations are essential in the digitalisation and the regulatory processes at global, national and regional context. The existing gaps in the regulatory framework is stratified and presented. Finally, the purpose of the regulators, the rational, the type of regulation and the regulatory intervention is explained also as a functional model.

Keywords- Microfinance, Regulations, Statutory Provisions, Delinquency, Interest caps.

**INTRODUCTION**

The primitive form of microfinance can be traced to the ancient religious texts. The use of the word ‘usury’ figures in many places in the Bible. The koran proclaims that taking interest is against the religious tenants and in the Arthasastra special mentions are made (Sharma,2005). However, the roots of the present day microfinance can be traced to the two pioneers Ella Bhatt who initiated the women’s own SEWA Cooperative Bank at Ahmedabad and Nobel Laurette Mohammed Yunus who not only introduced microfinance in Bangladesh but redefined and put microfinance in in its glorous track to fight the menace of poverty. The United Nations in 2004 announced that 2005 would be declared as “International Year of Microcredit” putting the first stamp of approval of the international community and the comity of nations. The financial services for the so called “unbankable persons everywhere in the world” thus took a new meaning and recognition. Though the official acclaim of this new found hope to alleviate poverty reached the zenith of prestige when Muhammed Yunus and the bank he founded share the Nobel Prize in 2006 there are many who look at it with a skeptic eye. The Norweign Nobel prize committee in its citation wrote “Lasting peace cannot be achieved unless large population group finds ways to break out of poverty”. Long before all this the US President Bill Clinton in 2002 asserted “I” ll keep on saying until the Nobel Prize is given to him. In 2009 President Obama honoured Prof Yunus with the Presidential Model of freedom the highest US Civilian honour for lifting millions from poverty with microloans.

Ever since then microfinance has grown leaps and bounds and has spread in all the continents and struck roots in atmost all countries. The official estimates is that in2018 the client base reached 139.9 million, 80% are women and 65% are rural borrowers. The average growth rate was 11.5% over the past five years. But the growth rate was at a slower pace than in 2000-2010 period. During the same tenure the growth rate since 2012 stood at 7% compared to a rate of nearly 20% in the past decade. Thus revealed a slump in the growth rate. In terms of volume the estimated credit portfolio stood at 124.1 billion and the growth rate +8.5% over the previous year(Microfinance barometer, 2019)

The two current years has witnessed many problems in the microfinance sector more so because of the pandemic covid-19. Two years after Prof Yunus received the Nobel Prize the global financial crisis ribbed the sector. These two are primarily universal problems the former one with a devastating effect newer recorded in human history and the latter a global financial recession. All these have telling effect on the microfinance sector as the clients are poorest among the poor, the unbankable and who do not have any access to any formal credit.

Though widely acclaimed as a panacea to end poverty (Karnani,2009), gradually it has reached a stage of recognition that it is not an alleure prescription to address poverty. There is also a big cohort of skeptic coho singh the chorus against MF.

There is great diversity in the institutions dealing with microcredit to cite an example the case of India reveals different institutions a) Scheduled Commercial Banks (SCBS) Small finance Banks(SFB) and Regional Rural Banks (RRBs) building through business correspondents and SHGs b) Cooperative Banks C) Non banking financial Banks and d) MFIs registered as NBFCs (RBI,2021).

This study has in its heart to make in depth analysis of the various key issues plaguing this vital sector which has been hailed as a major reform and received rapt attention of society, states, countries and comuty of nations. It also try to dissect the challenges faced by the microfinance industry at large, the regulations that have come in this sector and finally the existing gaps and some rational thoughts on the future.

The same study also reported that there are 197 MFIs with a loan outstanding of Rs 227942 crores of this 15 bank account for Rs93,432 crore, 86 NBFC- MFI Rs 70, 196 crore and 8 small finance banks Rs 42,689 crores.

**STATEMENT OF THE PROBLEM**

The growth of microfinance in the last decade of nineties and the early twenty first century was one beyond comprehension. The literature itself was loaded all singing the chorus that microfinance is the way to eradicate poverty. At the pinnacle of recognition started the reality of also associated problems and the cry for low based controls started. This cry became more and more louder just two years after Prof Yunus received the nobel prize in recognition for his work on microfinance when financial crisis gripped the world. The effect of global downturn in Nicargua, Morrocco, Bosnia, the suicides in Andhra Pradesh state of India and in many countries particularly the organ trafficking in Bangladesh not only showcased the fragility of banking for poor but also the imperative needs of comprehensive laws on regulating the industry as a whole. The growth of microfinance institutions in terms of the business and number of beneficiaries continued to grow with all its inherent deficiencies and problems. The diversity of the MFI is another factor as there are big and small in MFIs, for profit, not for profit and a mutual aid provider like credit union again MFIs, for profit, not for profit and a mutual aid provider like credit union again MFIs, formal and informal MFIs are unique and cannot be treated on even platform. All these problems brought in opportunities used with challenges but established one aspect that microfinance needs digitalisation.

A second aspect came in with the laws and rules in place in different countries and core principles and guidelines emerging but never complete with digitalisation becoming a felt need opening a challenge of a big business of the poor and for the poor and most importantly who are both economically and educationally backward. This is the biggest challenge now as it has now opening out a new set of rules of the game accommodating the impoverished and lesser education in a technologically driven environment and is not in a level playing ground.

**METHODOLOGY**

The study being done on the challenges in digitalisation was framework of microfinance. The methodology is based on literature available on the principles, key issues, challenges and policy framework available within the broad realm of microfinance. The secondary literature available was collected from journals, project reports, books, chapters institution home pages, websites, handbooks analysed, conclusions made and categorised under broad subheadings.In essence this is based on a descriptive study relying on seconadary data and hence the reliability and sanctity of the study is based on the truthfulness of the source of literature.

**SCOPE OF THE STUDY**

The diversity of the types of microfinance institutions, the volume of business and the large clientele base are the unique features that reveals the scope of the study. The unbankable poor clients speralling growth has added another dimension the existing challenges where digitalisation is the only answer to add to the systems efficiency and infuse a spirit of confidence. The large outreach and the difficulties of COVID-19 which has brought out restrictions or mobility rendering payments difficult and repayments still are difficult. The reid due to the pandemic infection also and spread can also be minimised, if microfinance is fully digitalised. For effectively streamlining the process, the prerequisites such as key issues and the challenges that is to be overcome with regulation have to be understood and clearly defined. This is an essence the very basic scope significance of the study.

**KEY ISSUES IN MFI**

A critical analysis of growth of MF would reveal that the problems started with the ontogenic transformation of a concept born in ethics of social banking and entrepreneurship to a profit centred commercial approach. Thus, the social entrepreneurship promoting activity changed to commercial business. The late part of the first decade and early part of the second decade of the 21st century brought to fore some external manifestation of this switch over beginning with meltdown reported in countries like Morrocco, Nicaragoa, Pakistan, Bosuia, Mexico, Lebanon India. The worst impact of of this was experienced in suicides in Andhra Pradesh state of India, (Associated Press ,2012), Marikana massacre in south Africa (Bond,2012) and organ trafficking in Bangladesh (BBC,2013). Thus the forces of attention shifted from expansion drive to identifying the key issues. The part ‘micro’ in microfinance is a misnomer which tends to make the target too small ( Bernetein, 2013).

The key issues can be broadly classified as

1. Those inherent to the system
2. Small volumes of business and large number of clients entered too (Nobel Peace Prize,2006, Microfinance Information Exchange, Microfinance Barometer 2019)
3. Diversity of micro enterprises too large for specialised intervention and back-to-back support subjects or beneficiaries are the poor or chronically poor (Yunus,2001,2003)
4. Most of the clients/ beneficiaries are illiterate or financial literacy.
5. Large number of MFIs in operation
6. Risks to large as it is not based on collateral opportunities and danger combined (Adams, 2002, Bernstein, 2013), Sustainability warrants a shift from its mission approach to atleast a sustainable approach.
7. In comparison to the formal banking sector microfinance is more ignored ( Dennis, 2011).
8. MFIs often too small or remote for effective regulation (IRIS,2006)

**CONTEMPORARY ISSUES**

Some of the issues gaining momentum and importance are the

1. Large credit requirement(Nasir,2010)
2. Insolvency concerns as a result of unrestricted rapid expansion ( Rozers, 2009).
3. Transformation from a donor driven setup to direct links with international capital (CGAP, 2010).
4. MFIs turning out as global setup with cross border funding ( CGAP, 2010)
5. Commercialisation of MFIs with sole target of maximising profits.
6. A one-time investment to need to integrate ICT to have efficient governance
7. Liquidity issues in the context of covid-19 pandemic.
8. Large delinquency rates due to lockdowns, restrictions, mobility issues and low business returns due to the pandemic.(Nawai , Sharif 2013)
9. Resorting to unfair practices like coercive collection and abusive tactics (Fernando,2010)
10. Rising level of indebtness due to multiple loans (Fernando, 2010)
11. Exchange rate risk due to foreign currency funding (CGAP,2010)

**CHALLENGES**

The challenges faced by the MFIs are too many some that demand immediate attention and others that need to be viewed from the point of sustainability, some that needs local and regional thrusts while others that needs to

CGAP (2009) further explains that regulations could be categorised as

Self-Regulation- Regulation an or supervision that effectively controlled by the bodies being regulated or supervised in a predetermined criterion

Prudential Regulation- Regulation aimed to protect the financial system as a whole as well as protecting the safety of small deposits is in individual institutions- such as BASEL principles and CAMELS rating

Non-Prudential Regulations -Outside the central bank purview covering “ Fit and Proper”, “Dos and Don’ts” accaintained by various mechanisms by government body, industry association, audit firms, disclosure rating tools etc

Enabling Regulations- Regulations having a positive outlook such as removal of external barriers in the business. IMF (2002) made it very clear that all financial institutions are subject to two forms either the prudential regulations the distinction and choice is normally based on the “pros and cons” of provisions.

Why regulation is required in digitalisation in MFIs

IMF (2002) has broadly outlined why regulation is required in digitalisation. The reasons

* Protection of interest of depositors
* Protection of borrowers- consumer centric
* Protection of the financial system
* Promotion of the MFI sector and
* Protection of public funds

There is no “fit for all” recipe for regulation in digitalisation. A variety of factors has to be weighed and reviewed in determining how best to regulate and there is nothing like a standard approach or one called appropriate ( Chanes and Gonsoles-Vega, 1994; Ledgerwood , 1998; Van Grenning etal 1998; Mutenda 2001; wright , 2000 and Gallardo(2001).

The challenges faced in the digitalisation processs are

* Large outreach and clientele base (A
* The high interest rates that are at times variable (Maimbo and Gallegos; 2014, RBI 2021, AFPI 2021 ( Ferari etal, 2018)
* The large delinquency crisis of repayment (FRB, 2007;ADB 2016; Mehnaz and Bilal, 2018.
* Helpelessness the present context of pandemic weakness
* A restricted capital base and asset base.
* Making the microfinance loans strictly purpose oriented by focusing on payment for the microenterprise
* Provision for mid term corrections including restructuring of debts.
* Buffering of risks (both external and internal)
* The high competition between MFIs and multiple loan being issued for same purpose and to the same person

**REGULATION IN MICROFINANCE**

The lexical meaning of the world regulation is an official rule that controls how something is done. On the otherhand a regulation from the standpoint of law is the rule of order having the force of law, prescribed by a superior competent authority, relating to actions of those under the authoritys control. Regulations are normally issued by governments enacted by legislatures/ parliament/ congress to carry out the extent of legislation. Financial regulation as defined by Ertugal(2020) is a type of supervision monitoring or regulation which leads financial institutions to some kind of laws, rules, requirements, guidelines and restrictions that aims to maintain the soundness, stability and integrity of the financial system at large. There are large number of definition on regulation.

Digitalisation of microfinance has mimeua benefits also many challnges (Rayetal, 2018). Some of this regulation with respect to digitalisation

1. Inequality in the digitalisation – The number of active clients are with a single credit officer is large for the big MFIs. When compared to smaller MFIs (Sa. Dhan 2017). If the technology interventions really happen this will effect the balance of efficiency. The large MFIs need and can meet the cost level the small MFIs will find the exercise a costly affair leading to a projected case- those who can and those who cannot leading to another problem the digital divide in the microfinance.
2. Trust/ Distrust- Over the counter activities and face to face contact always build up confidence. The basis of MFI is that its founded on ethics and build on robust platform to serve the poor where the element of ‘human touch’ has maximum significance. As operations get digitalised this aspect is lost. Social belief, trust is an unaccounted basis of the MFI (Bergreen and Burzynska, 2014). Ray (2018) reported that networks built over trust is critical to the efficiency of firm’s operation. The Basel Committee on Bond Supervision(2016) also reinforces the concept of trust in Principle 25 operational risk.
3. Facilitating role of supervisers avoided- The field workers directly act to overcome clients reluctance to participate, bring a check on delinquency ( fisher and siriram, 2002 and Sewaleand Ditchie, 2012)
4. High initial cost of infrastructure support- lack of investment.
5. Risk – The clients perception of risk is an important aspect. Though cyber security rules are in force, lacking of accounts and theft cannot be overruled disrruptions from inadequate security and stability are two aspects that needs to be counterbalanced.
6. Capacity development particularly in the process of digitalisation.
7. Operational challenges- Digitalising transaction starts at the level of ICT and tech readiness and ends with acceptance and adoption by both MFIs and clients.
8. Lack of vision clarity or awareness for clients to switch on form liquid cash to digital.
9. Confusions and competitions created by Digital financial services and the growing number of regulatory changes
10. Broadly the regulations have to apply differently to the two sets of MFIs the one that takes deposits and the other that do not accept deposits the former not requiring any form of prudential regulation but both requiring complete transparency.
11. Weak consumer protection and redressal of complaints.
12. Online redressal of complaints and immediate answers to queries is an issue that needs to be given equal priority.

**SETTING REGULATIONS STANDARDS AT GLOBAL NATIONAL AND REGIONAL LEVEL**

Regulatory and supervisory protocols and statutory procedures were mostly done at the national level but with the growth of microfinance crossing geographic boundaries and cross border funding involving foreign currency a paradigm shift has become imperative. Further some of the websites also reveal a peer to peer cross border micro-lending. Another point of concern and a big challenge is that regulation and isolation cannot be seen in isolation level only two sides of the same coin. A third aspect is the conversion of foreign currency (CGAP,2010 and kline and sandhu, 2015). All this can be and is possible at one stroke only if that fair practices are promulgated at global level and the rules of the game framed are at a level playing ground. Sehwarcz (2011) has also opined that legal framework also needs immediate attention.

At the global level the world bank particularly through its aren the Consultative Group to Assist the Poor (CGAP) launched in 1995. The CGAP in its is now reviewing the MFI sector based on the contemporary issues such as the notes published by them in the face of COVID-19(CGAP ) with a number of governments making financial inclusion (GPFI) came into existence in the G20 social summit in 2010 as a mechanism for financial inclusion Action Plan and a platform for peer learning knowledge sharing, policy advocacy and coordination among G20 policy makers (GPFI,2011). In addition to the Basel committee on Banking standards (BCBS) other bodies engaged with GPFI include the committee on payment and Market Infrastructures (CAMI) the financial Action Task force (FATF), the financial stability Board, (FSB), the International Association of Deposit Insurers, the International Association of Insurance Supervisers and the International Organisation of security commissions(GPFI, 2016). The Basel Committee initially established by the central bank governors of group of ten countries in 1974.

Due to disturbances in international currency and banking markets particularly the failure of Bankhacy Herstat in Germany. The committee headquartered at the bank for International settlements in Basel Expanded from G10 to 45 institutions and is now known for series of standards for bank regulation particularly with reference to capital adequacy ratio known as Basel I (1988) , Basel II 2004, Basel III (2010) .The Basel III post crisis reforms were completed in 2017 with publication of new standards for calculation of capital requirements for credit risks, credit evaluation adjustment risk and operational risk. The final reforms provide a regulatory foundation for a resilient banking system including the microfinance sector. It also set into motion the 2006 core principles an Banking which was later revised in 2012 with a major revision focused on bank risk management. The BCBS come up with 29 core principles and later in 2016 came up with a slenth of guidance measures for 19 of the 29 core principles in their application to regulation and supervision of the financial institutions engaged in reaching the financially unserved and undeserved. Meanwhile IMF continues its active role by rolling out working paper of particular aspects within the broad realm of Microfinance and public policy. A series of discussion have also been initiated and documented thereafter following the horror set off by the COVID-19 pandemic. Recent meetings the 21st International conference of Banking Supervisors was focused in digitalisation of finance and evolution of banking models (BCBS, 2020) and the later on the changing role of a banking supervisers (Roers, 2021). Each principle is important and starts with principle1- Responsibilities objectives and powers. A key component is the use of technology to assist supervisers and financial institutions in gathering transmitting and processing data and information. The principle 15 on Risk Management, process, 16 on capital adequacy, 17 on credit risk, 18 on problem assets, provisions and reserves, 24 on liquidity risks, 25 on operationalised risk and 28 on transparency and 29 on Aberses is basically oriented on regulations of these aspects in an technology driven and governed environment.

At each country level there is yet another regulator which works on country specific issues and regulations. The broad parameters of regulations are thus under such banks which act as the regulator like the Reserve Bank of India, the Nepal Rastra Bank, the bank of Ethiopia, bank of Zambia etc.

The state versus the central regulatory jurisdictions in a third tier of operation because there is no clarity regarding central and state regulatory jurisdiction. The typical example of this is during the 2010 and 2011 Andhra Pradesh and Gujarat states in India passed legislations barring specific practices within the state (Kline and sadhu, 2015).

Thus there are three tier of operation one at the global level, the national level and yet another at the state level, stability and confidence level will elude this sector unless and until such regulatory ambiguity is resolved.

**GAPS IN REGULATION**

The gaps on the regulation front look like that all the work till now a regulation policy of on aspects beginning from the licensing and one aspects like risks, indebtness, multiple lending repayment delinquency, auditing, transparency reporting lend the missing link in regulation of digitalisation in the microfinance. Within this there are again areas to be defined where regulation is required.

1. Haves and Have not- Small MFIs and the not for profit MFIs do not generate income to build a strong robust infrastructure that is finally computerised. Hence regulations should primarily ensure where it should be ICT enabled. If governments want all the MFIs to the ICT enabled the small MFIs have to be necessarily supported by the respective governments of countries.
2. Categorisation of MFIs to be regulated- It has to be made mandatory by statutory provisions of volume of business, clientele base and audited balancesheet. Such MFIs with a turnover is threshold value needs to be necessarily computerised.
3. Regulation on auditing on monthly basis- Digitilisation opens out a new way for protection of borrowers, depositors and MFI.

SANDWITCH MODEL OF PROVISIONS FOR REGULATION OF DIGITILSATION

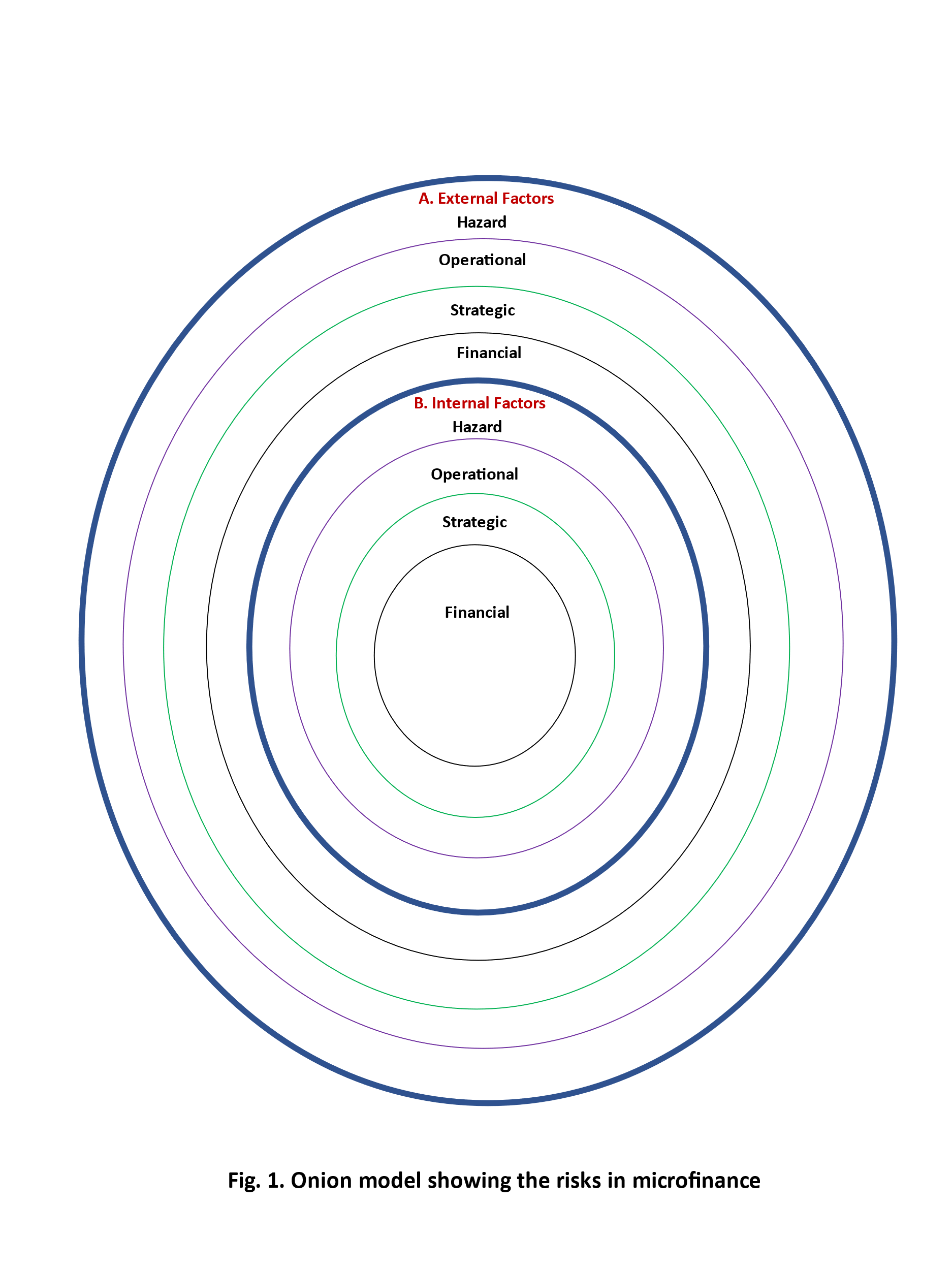
Removing the supervisors who act as the middle level persons who connect the beneficiaries/clients to the MFIs. A Second aspect is that MFI clients are both educationally and financially illiterate and needs either full support or handholding to rise up to the level of digitalisation

* Regulatory provision ensuring privacy of Accounts- Regulations should ensure the privacy of the accounts and should not had to reputational risks both for the client and MFI.
* Regulatory frame for risk elimination and digitalisation- Cyber security laws and provisions for computerisation has to be made in case of lacking of accounts or false withdrawals. Avoiding operational risks have also to find a place in the provisions.
* Regulatory provision for effective controls on digitalised Accounting- The tech readiness and facilitating conditions need to be geared that accounting is totally digitalised and clients have a feedback with a click.
* Digitalisation leading to total transparency- Regulatory provisions of digitalisation should lead to total transparency in all sets of processes, procedures, governance and management.
* Regulatory provisions for Enabling/ Empowerment- Provisions for empowerment of both the staffs and clients aimed towards a fully digitalised environment should be aim and regulatory provision made to ensure the same and finally.
* Provisions for digitalised redressal of grievances/ anomalies/ Claims- The health of financial institutions lies in addressing all the problems/ anomalies. This has to be ensured by regulatory provisions for having it inbuilt in the system.

**CONCLUSION**

The word microfinance is a typical example of oxymoro implying that it require to be regulated . The evolution of the conservative microlending or microcredit is enshrined on a social ethics and towards social entrepreneurship to its present stage reveals that it as come of age but has transformed to one with many faces initially it did not involve savings at all and this is referred to as walking on one leg “ since without savings microfinance is not microfinance at all but microcredit. This was based on a misconception that the poor are too poor to save and that growth of the sector as well as associated problems and then came the need for standardised leading to the Basel standards which Rogers (2021) has like credit to a two legged football game the banking institutions seek to negotiate the global agreement. The present scenario can be compared as a “ three legged race “ with one leg representing the standards and the other individual third leg symbolising each country but running with the ultimate objective of having mutually acceptable legitimate regulatory standards in place.

There are optimistic and pessimistic views raised on the need of regulations on digitalisation in microfinance but the ground reality is a large picture of the great digital divide in the finance and world bank 2015 the IMF reports (IMF 2002) the basel standards , the UNCITRAL laws UNCITRAL, 2021 governments speak from the heart on regulations and point to the need of digitalisation principles there is no real attempt on regulatory principles on digitalisation of microfinance and that is the biggest challenge to regulatory intentions in digitalisation. Its probably an innate character of being cautions or extra cautions and lead us to the oft quoted words of the first Prime Minister of India Jawaharlal Nehru. “ Being too cautious in the biggest challenge to risk itself.



**The functional model of regulation in Microfinance**

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| --- | --- | --- | --- | --- |
| **SLNO** | **Purpose** | **Rationale/Reason** | **Type of Regulation** | **Regulatory Interventions Required** |
| 1 | Protection of borrowers | To protect from market factors like market process, pricing, volatility. | Business conduct rules and regulation | Fair practices rules and regulation, Micro finance schemes and policies. Investing temporary and providing. |
| 2 | Protection of depositors | Though small the clients are products as they are recourse poor and have to say or control on MFIs | Prudential regulation | Provisions for credit, profession of liquidity, enforcing governance and management standards |
| 3 | Protection from associated risks | a) External Risks – like drought, floods, pandemics  b) Systemic risks | Pre- planned preparations and No additional regulation  Systemic Regulation | Fit and proper practices Do’s and Don’ts and adoption of fair practices.  Regulated and procedures lending, adopting regulations in accepting deposits, strict monitoring and financial discipline. |
| 4 | Protection of the Financial System | Awareness and perception of the clients | Prudential regulation | Improving financial literary. Adoption of well laid out practices such as BASEL Committee principles – Auditing, Reporting and Transparency. |
| **5** | Protection of MFI | To reach the poor and financially impoverished. Building trust and confidence | Both self and prudential regulations | Promotional strategies like formation of SHG / JLG’s Handholding and capacity building measures as provided in Basal core principles. Regulations required |
| 6 | Protection of Public funds | To protect the capital base and Asset base of MFI and to enable more information of public funds. | Enabling Regulation and Non prudential regulation | Enforcing strict financial discipline monitoring, Auditing, Reporting and transparency is required. |
| 7 | Protection of growth access and sustainability | Reducing all costs, reducing nonperformance loss cutting down expenses. | Enabling Regulation | Recovering all farms of barriers and enabling easy access to both all clients. |
| 8 | Enhancing efficiency of management, Governance and Financial discipline | Reducing non- performing loans, Reducing unwanted overheads, cost cutting exercises and improving profitability | Enabling Regulation through Digitalisation on all fronts | A new regulatory provision for Digitalisation with directive principles starting from Licensing to the final steps of Auditing and reporting ensuring toal transparency. |