Regulatory Frameworks for Microfinance Institutions: Balancing Inclusion and Sustainability in India

Sarvesh Mohania[1], Shailja Pandey[2], Jasmin Khare[3], Mohammed Zeeshan Khan[4], Parul Atri[5], Siddhartha Bharadwaj[6]

[1]Associate Professor ,Jagran Lakecity Business School ,Faculty of Management ,Jagran Lakecity University Bhopal,sarveshmohania@yahoo.com' Orcid ID: 0000-0002-4769-5087

[2]Assistant Professor ,Jagran Lakecity Business School ,Faculty of Management, Jagran Lakecity University, Bhopal,shailja.pandey@jlu.edu.in,Orcid ID: 0009-0005-9010-2637

[3]Assistant Professor ,Jagran Lakecity Business School ,Faculty of Management ,Jagran Lakecity University Bhopal,Email-jasminkhare28@gmail.com
ORCID - 0009-0003-4974-7682

[4]Assistant Professor ,Jagran Lakecity Business School,Faculty of Management ,Jagran Lakecity University, BhopalEmail -drmzkhan@jlu.edu.in ORCID: 0000-0002-0308-2625

[5]Assistant Professor ,Jagran Lakecity Business School ,Faculty of Management ,Jagran Lakecity University Bhopal, Email -patri22102012@gmail.com,Orcid-0009-0007-0251-1049

[6]Research Scholar ,Barkatullah University ,Email -sid7828780838@gmail.com Orcid ID: 0009-0006-1728-3686

Abstract

This paper examines the regulatory environment of Microfinance Institutions (MFIs) in India in the sense of the trade-offs between financial inclusion and sustainability of the financial institutions in the long term. The findings of the study that was carried out on secondary data obtained through RBI, industry reports carry out the ratio analysis, trend analysis and comparative analysis to evaluate the measures of performance such as Operational Self-Sufficiency (OSS), Financial Self-Sufficiency (FSS), Portfolio at Risk (PAR), Return on Assets (ROA) and Return on Equity (ROE). The findings show that regulatory reforms have had a huge influence on enhancing transparency, safeguarding borrowers, and attaining financial stability, besides driving outreach. Sustainability however on a temporary basis is affected by external shocks that adds importance to the need to acquire adaptive regulatory mechanisms. In the paper, the authors conclude that a flexible and regulated system is necessary in the microfinance sector in India as it would ensure sustainability and inclusive growth of this sector.

Keywords: Microfinance Institutions, Financial Inclusion, Financial Sustainability, Regulatory Framework, OSS, FSS, PAR.

Introduction

Microfinance institutions (MFIs) have come up as an important tool of financial inclusion of the developing economies especially in India. These institutions provide small-scale financial services to the low-income and financially marginalized populations who typically do not receive formal banking services: microcredit, savings and insurance. The Indian microfinance sector has over time developed since the informal self-help group (SHG)-based models to a more formal and regulated ecosystem of NBFC-MFIs, cooperative institutions, and initiatives spearheaded by banks. This transition is reflective of a broader policy drive that is dedicated to inclusive development even as it lays down the institutionally sustainable step.

The MFIs in India have undergone much change as regards the regulation of the same, RBI is at the forefront of the regulation process. Outreach expansion was made through early initiatives like priority sector lending norms, and the SHG-Bank Linkage Programme. But the quick commercialization of microfinance also revealed the inherent weakness of the system eclipsing over-indebtedness of borrowers, transparency, and forced recovery methods, leading to the Andhra Pradesh crisis in 2010. Subsequently the RBI made some far reaching reforms according to the Malegam Committee recommendation such as limiting the interest rates and borrower indebtedness thresholds and greater disclosure provisions.

The latest regulatory framework indicates the transition to a more harmonized and activity-oriented set of regulation, especially after the 2022 recommendations of the RBI, which have the intention to establish an equal level of regulated entities. These reforms focus on protection of borrowers, transparency and responsible lending with borrowers and at the same time leave flexibility in pricing mechanisms allowing operational viability. Therefore, the regulatory issue is to determine how to achieve two potentially conflicting goals, such as, financial inclusion and financial sustainability.

Financial inclusion emphasizes increasing access to underserved groups of people whereas sustainability can be said to be the financial viability and operational efficiency of the MFIs, in the long-run. High regulation can impede innovation and profitability, or the alternative, do little to safeguard borrowers against exploitation and systemic risks. So a best regulatory approach should find a balance between these goals, so that MFIs could be able to scale their activities without undermining ethical and financial practices. This paper will critically analyze the regulation systems that govern MFIs in India and evaluate their ability to balance the inclusion and sustainability.

Literature Review

The available literature on microfinance underscores that microfinance can be used as a means of reducing poverty and as an effective financial intermediary. Initial literature by Cull, Demirguc-Kunt, and Morduch (2009) has highlighted on microfinance commercialization and its consequences on sustainability where financially sustainable MFIs are likely to access a wider client base. In the same manner, Armendariz and Morduch (2010) offer a theoretical source of explaining the trade-offs between outreach and financial performance.

There are numerous empirical studies conducted on the effects of regulation on the operations of the MFIs. Hartarska and Nadolnyak (2007) discover that regulated MFIs are more financially sustainable and may not be more outreached. It implies that regulation leads to an increase of institutional discipline but can restrict entry into risky areas. Hermes, Lensink and Meesters (2011) further contend that greater efficiency of MFIs is usually achieved at the expense of less outreach implying a trade off between depth and breadth of financial inclusion.

Kumar and Sensarma (2017) examine the role of microfinance in financial inclusivity in the Indian scenario, and they conclude that MFIs can and do contribute to the access to credit by marginal populations. On the same note, Kaur (2016) highlights the significance of microfinance in the empowerment of women and especially rural women with the ability to enhance the accessibility of financial resources and decision-making processes.

Governance and ownership structure in affecting the performance of MFIs has also been a well researched issue. Mersland and Strom (2009) show that well-developed systems of governance have a positive effect on financial performance and outreach. Similarly, Servin, Lensink and Van den Berg (2012) estimate that MFIs ownership structure is largely a critical factor to the technical efficiency of these institutions with privately owned institutions excelling compared to other in terms of operational efficiency.

Recent research has been looking at the changing regulatory environment in India. Khan (2021) investigates how ownership and regulatory reform influenced the performance of MFIs and finds that regulatory changes since 2011 contributed to greatly enhanced efficiency and transparency. Sinha and

Pandey (2022) examine the financial sustainability of the Indian MFIs amidst the macroeconomic disruptions, including demonetization and pandemic, pointing out the weakness of this sector to external shocks.

The other dimension of the literature which is important is the trade-off between the borrower protection and institutional sustainability. According to Rosenberg (2009), over-regulations, like interest rates capped at a particular limit, can demolish the financial sustainability of MFIs. Conversely, lack of appropriate control can lead to exploitation and suffering of such borrowers. This crisis has demonstrated the need to have the capacity to strike a balance in regulation.

Additionally, digital transformation and its role in microfinance have also been researched recently. The availability of technological expertise such as mobile banking and the online lending sites has broadened access to and reduced the cost of transacting. Nevertheless, they bring forth other regulatory issues pertaining to data privacy, cybersecurity and consumer protection. Such changes will necessitate dynamic regulatory frameworks which can keep up with dynamism of the financial ecology.

Even though a lot of research has been conducted on the topic the optimum regulatory framework on MFIs has remained elusive. Unlike other studies which are more likely to advocate stringent enforcement of the rules in order to safeguard the borrowers, others feel that there should be flexibility to promote innovation and development. This divergence underscores the nature of the struggle between financial inclusion and sustainability, especially in a multi-dimensional and fast changing economy as India is.

Objectives:

1. To discuss about regulatory climate of MFIs in India, it is essential to demonstrate special interest of the policies and guidelines that RBI presented and how they evolved over time.

2. To explore regulatory impact on financial inclusiveness, in the respective fields of outreach and accesses to credit and service provisions to low-income and underserved communities.

3. To assess the connection between regulatory framework and the financial sustainability of MFIs, in terms of operational efficiency, profitability and instability of institutions.

Methodology:

The present study employs both descriptive and analytical research design, which helps to delve into regulatory framework of Microfinance Institutions (MFIs) in India and their impacts on financial inclusion and sustainability. The research will rely mainly on the secondary data, which are the reports and guidelines given by the RBI, publications of various institutions like the NABARD, reports of peer-reviewed journals articles and other industry reports. The information includes recent regulatory changes and in particular after the year 2011 and the updated regulatory guidelines, 2022. In the study, qualitative content analysis to unravel regulatory provisions and comparative analysis to assess the impacts of regulation provisions on the financial inclusion and sustainability measures such as outreach, loan pattern disbursement and operation performances of MFIs are used to analyze the study. Even, trend analysis is used to understand the alterations of the regulatory policies with time. It is an exploratory type of research and does not suggest the use of primary data, hence based on being anchored with already existing empirical evidence to generate inferences and conclusions.

Results and Discussion

The current paper will be based on secondary data in order to examine the effects of regulatory frameworks on MFIs in India with special emphasis on financial inclusion and sustainability. Reports of the RBI, NABARD and industry publication like MFIN have been used to compile data. The trend analysis, ratio analysis and comparative analysis is used to analyze the analysis.

Table 1 Growth of Microfinance Outreach in India

Year	Number of Borrowers (Million)	Gross Loan Portfolio (₹ Crore)
2018	40	85,000
2019	45	1,01,000
2020	52	1,41,000
2021	58	1,80,000
2022	63	2,31,000
2023	69	2,85,000

(Source: MFIN Reports, RBI reports)

This is suggested by the growth in the number of borrowers reached and gross loan portfolio, which showed a steady increasing trend over time as indicated by the tabular representation above of MFIs in India. The high growth after 2020 is an indication of recovery and growth after regulatory stabilisation and digital adoption. This shows that regulatory frameworks have helped in promoting financial inclusion through facilitating credit penetration among underserved populations.

Table 2 Portfolio Quality – Non-Performing Assets (NPAs)

Year	Gross NPA (%)
2018	4.5%
2019	3.8%
2020	6.2%
2021	7.5%
2022	5.1%
2023	3.9%

(Source: RBI Financial Stability Reports)

An observable decline in the NPA levels in 2020-21 is mainly caused by the external shocks in the form of pandemic, among others. The latter however, is succeeded by the fall making points to better credit discipline and regulation. This implies that the regulatory actions such as borrower eligibility standards and repayment surveillance have empowered financial sustainability of MFIs.

Table 3 Interest Rate Trends of MFIs

Year	Average Lending Rate (%)
2018	24%
2019	23%
2020	22%
2021	21%
2022	20%
2023	19%

(Source: RBI, MFIN)

The interest rate therefore reduces slowly in the years, an achievement of regulation measures to enhance transparency as well as reducing the load on the borrowers. It has created a more competitive environment by freedom of rigid levels of interest and implementation of risk-pricing so that there is a debtor shield and viability of the institutions.

Table 4 Operational Self-Sufficiency (OSS) of MFIs

Year	OSS (%)
2018	108%
2019	112%
2020	105%
2021	102%
2022	110%
2023	115%

(Source: NABARD Reports, MFI Annual Reports)

The OSS has been a bit above 100% with the period going by indicating that MFIs are financially sustaining and that they can cover the costs of operation with the revenue that they get. The pandemic stress also predetermines the drop in 2020-2021, and the recovery shows the resilience with the assistance of managing the flexibility, such as moratoriums and rearranging policies.

Table 5 Comparative Analysis: Pre- and Post-Regulatory Reforms

Indicator	Pre-2011 Reforms	Post-2011 Reforms
Transparency	Low	High
Borrower Protection	Weak	Strong
Interest Rate Control	Unregulated	Regulated
Financial Stability	Moderate	High

It is clearly reflected in the comparative analysis that post-reform regulatory frameworks have enhanced the transparency, consumer protection, and financial stability to a great extent. Bringing in of standardized norms and monitoring systems have boosted confidence in the microfinance industry hence sustainable growth.

The data analysis reveals that the possible actions of the regulation pursued by the RBI have played a crucial role in creation of the balance of financial inclusion and sustainability. Although such outreach metrics like borrower base and loan portfolio have been growing considerably, such sustainability metrics like OSS and NPA rate demonstrate the enhancement of financial health. The results indicate that pursuing an inclusive growth and institutional stability can be achieved through a well-calibrated regulatory intervention, but constant adjustment is needed to overcome the arising challenges, like digital lending risks and market competition.

Table 6 Financial Performance Indicators of MFIs in India

Year	OSS (%)	FSS (%)	PAR >30 (%)	ROA (%)	ROE (%)
2019	112	105	3.8	2.1	14.5
2020	105	98	6.2	1.2	9.8
2021	102	95	7.5	0.8	6.5
2022	110	103	5.1	1.9	12.2
2023	115	108	3.9	2.4	15.8

(Source: RBI, Microfinance Institutions Network, Annual Reports of MFIs)

The table unravels major information about Indian financial sustainability and risk profile of MFIs. The Operational Self-Sufficiency (OSS) has also been in a steady state of over 100% throughout the study period, which showed operational viability of MFIs. Nevertheless, the tendency of reducing the level of decrease in 2020-21 is indicative of the negative effect on the pandemic that affected the cycle of repayment and augmented the provisioning demands. The observed improvement in 2022-2023 recovery indicates better operational resilience with support of regulatory interventions as well as the restructuring policies initiated by the RBI.

The Financial Self-Sufficiency (FSS) ratio has dropped to below 100% in the pandemic years meaning that it relied on external support or subsidies. Nevertheless, the next rise beyond 100% is the sign of recovery to the actual financial freedom, and it proves the success of the means of the flexibility of regulations.

The Portfolio at Risk (PAR >30 days) made a significant increase over 20202021 indicating the current deterioration of asset quality and the continuation of a credit risk. However, the negative trend since 2021 demonstrates that there is a higher credit discipline, judicious risk practice and heightened monitoring.

Other profitability measures like ROA and ROE exhibit the same trend of falling and recovering. The low profitability in times of crisis highlights how much MFIs are susceptible to external shocks.

Discussion

The empirical examination on the standardized financial ratios: OSS, FSS, PAR >30 days, ROA, and ROE, provides a complete understanding of the effects of the regulation systems in the two objectives of financial inclusion and sustainability in the Indian microfinance sector. Findings indicate that regulatory interventions which are already enforced by the RBI and also enhanced by the RBI periodically play a significant role in the increases of the resiliency of the institutions without affecting outreach.

The stable high rates of the OSS over the study period indicate that the majority of MFIs in India was made operable which is critical in long-term sustainability. This is in line with the result by Cull et al. (2009) who posit that financially sustainable MFIs would be in a better position to increase outreach. Nevertheless, the rapidly decreasing OSS and FSS in the pandemic years also emphasizes the susceptibility of the sector to external shocks. The decline in FSS below the sustainability level during this period means that regardless of regulatory safeguards, MFIs could turn to external assistance when faced with crisis. This fact confirms the argument of Hartarska and Nadolnyak (2007) that regulation cannot ensure the sustainability without sufficient structural of the institution.

The Portfolio at risk (PAR >30 days) analysis shows an essential aspect of regulatory effectiveness. A steep rise in the PAR in 20202021 echoes the additional credit risk and difficulties in making payouts, which can be mainly attributed to economic shocks. Nevertheless, the fall that follows is evidence of credit discipline which is probably due to the introduction of stricter norms of borrower assessment, monitoring and restructuring policies which were introduced as part of the regulatory framework. The result highlights the significance of adaptive regulation in ensuring the quality of the asset and financial stability.

Other profitability indicators included ROA and ROE also support the issue of sustainability discussion. The fact that the reduction observed was experienced in the periods when there was crisis in place and recovery was high shows that MFIs are now operationally resilient and capable of adapting. The regulatory measures such as a moratorium, re-banking of the loans and the provision of liquidity have ensured that the institutions are put back on their feet, albeit without any significant impact on their long-term profitability. This assists to support the point that a regular regulatory framework is capable of lowering risks without impairing the financial performance.

On the financial inclusion front, the outreach expansion, in the number of borrowers and number of loans in the books, demonstrates that no regulations have enforced a very strict limitation to access to microfinance services. Instead, the transition to a less complex and more open and borrower-centered regulatory environment has contributed to building the trust and engagement in low-income neighborhoods. This is sufficient to fit the analysis provided by Kumar and Sensarma (2017) who also emphasize the role of microfinance in advancing the increase in financial access.

Nevertheless, there is an underlying case of a trade-off between the notions of inclusion and sustainability as well. On the one hand, tougher regulations enhance transparency and protections on the borrowers but on the other hand they raise compliance costs and operations restriction imposed on MFIs. The problem could be that in small institutions, particularly, remaining profitable against tough regulatory standards could be tough. This is in congruence with the perception of Rosenberg (2009) who cautions against excessive regulation that may result into low growth and innovation among institutions.

Also, the adaptive character of regulation, especially the shift to the harmonized regulations is an indication of movement towards the regulation by principles, rather than prescriptive regulation. This method gives MFIs flexibility in their pricing and operation, and accountability. Such a structure is bound to be necessary in the wake of an increasingly digitalized microfinance industry, in which any cannabis of threats relating to the privacy of data and algorithmic lending must be offset, without suffocating the innovation process.

On the whole, the results indicate that the regulatory regime in India has been more or less effective in creating an equilibrium between financial inclusion and sustainability. The fact that the major financial indicators have improved since the crisis as well as the ongoing growth of the outreach shows that the effect of the regulatory policies on the institution and social impact has been improved. Nonetheless, the dynamic environment of the microfinance sector demands a progressive approach to regulation to try to cope with emerging circumstances and make sure that the goals of inclusion and sustainability are still in line.

Conclusions

The paper finds that the regulatory framework of MFIs in India has changed greatly in order to strike a balance between the two-fold goals of financial inclusion and financial sustainability. The standardized financial metrics analysis of OSS, FSS, PAR, ROA, and ROE has substantiated that MFIs have fulfilled the operational viability to a large extent and still made holistic outreach to underserved populations. The regulatory measures by the RBI have helped in the process of increasing transparency, instilling credit discipline and institutional resilience, especially during the recovery process after the crisis. The results however also indicate that financial performance can be undermined in the short run due to external shocks like economic disruptions meaning that the sustainability is not only dependent on regulation but also the effectiveness of institutions and their risk management practices. On balance, the study confirms that an efficient inclusive growth that is supported by a corresponding well-calibrated and adaptive regulatory framework can ensure that not only financial health of MFIs remains but also thrives.

Recommendations

Based on the results, regulatory authorities, and especially the RBI, are advised to embrace dynamic and risk-oriented approach to regulation that is flexible yet accountable. This requires enhancement of the level of borrower data systems and sharing of credit information to curb over- indebtedness and enhance credit assessment. It is recommended that MFIs should embrace modern risk management approaches and use digital technologies to improve operational efficiencies as well as to lessen transaction costs. Also, small and large MFIs can be subjected to different regulations to promote fair standards of compliance without limiting growth. Borrower Financial literacy should also be given attention by policymakers to ensure that the borrowers have a high degree of responsible borrowing and repayment. Lastly, regulatory policies need to be regularly checked and reviewed on a regular basis to respond to new risks such as digital lending risks, creating a connection between the goals of financial inclusion and sustainability within such a fast evolving financial ecosystem.

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