Chapter-1

INTRODUCTION

“Poor people are like bonsai. They have all the capabilities to rise up like big trees, but the problem is they are planted in flower pots.”

Muhammad Yunus, Nobel laureate, Chairman, Grameen Bank, Bangladesh.

1.1 Introduction:

Prior to the early 1980’s, financial services were essentially unavailable to the world’s impoverished populations. Without access to financial services, such as small business loans and interest based savings programs, there are few means by which poor populations can make themselves better off. According to Uy and Cuevas (2004), numerous studies have confirmed that “poor families with access to financial services eat better, keep their children in school longer, receive better medical care, and live in safer housing” than families that do not have access to such services. Essentially, access to financial services allows poor populations to solve their own problems and create their own futures. Bearing this in mind, microfinance institutions (MFIs) around the world have attempted to provide these crucial services to the poor, overcoming the barriers that have stopped formal banking institutions from doing so.

There are very few reliable aggregate data available for the Indian microfinance market and no comprehensive database or directory of microfinance institutions. However, India presents an obvious scope for microfinance in general and housing finance in rural India. Urban sector has
traditionally been less attractive to the microfinance institutions as compared to the rural areas:

1) High migration in urban areas increases the default risk of microfinance portfolio, unsecured.

2) MFIs operating in urban area suffer comparison with commercial banks on interest rates.

3) Various methodologies of group formation and peer pressure are not as successful in urban areas as in rural areas.

4) Urban population mostly have a tendency of service or organized employment as compared to self employment in rural areas thereby increasing the probability of loan being utilized for consumption purposes in urban areas.

In spite of various challenges, some MFIs are now accelerating their expansion in urban areas.

Micro entrepreneurs (the self employed poor) have little access to the formal financial system in developing economies. At best, formal financial institutions reach the top 25 percent of the economically active population, which leaves the bottom 75 percent without access to formal financial services.

Asia pacific region has six micro finance giants. Out of which only Reserve Bank of India is a commercial bank. There are other regulated institutions, which provide financial services to micro entrepreneurs such as rural banks and credit union. The commercial banks undertook microfinance lending only because their governments required it. These commercial banks can be
classified as Government subsidized lending programs, government mandated lending targets.

The analysis done on the basis of high portfolio quality and significant scale of outreach to the poor showed that government mandated lending commercial banks were failures. They must have well designed products for micro enterprises, which can be encouraging and profitable. An appropriate regulatory and prudential framework by the government may encourage the commercial banks to become involved in microfinance.

There has been a wide recognition among the academicians, bankers, researchers and policy makers regarding the need for deepening and widening the financial services to the rural poor. The Bangladesh Grameen Bank Model and the Microfinance Programs of BRAC and ASA in Bangladesh have been studied and the microfinance experience of Philippines has been familiarized with and though they represent the "path breaking and innovative efforts" they have been used in some form or the other in India; The most talked about experience appears to be that of Brazil. "The Brazilian model is largely technology driven and uses kiosks or Automated Teller Machines (ATMs) by such agents to accept payment, opening of accounts, without a cheque book, collection of small deposits, provision of micro credits, selling of savings bonds and insurance". Another initiative indicated is that "Post Offices network and Post Office staff to deliver banking services through Banco Postal". It is also worth mentioning here that the "Brazilian Central Bank extended microfinance program by allowing banks to draw on 2% of the reserves deposited with them and lend it to individuals and small businesses at concessional interest rates". 
The international experiences indicate that micro savings are important for micro-credit. BURO Tangail ah MFI of Bangladesh uses a unique saving product "Contractual Saving Agreement". Kenya has developed the "Jijenge Savings Account" a contractual saving’s Product. Further there is the facility of mobile subscribers making micro payments made possible by the Commercial Bank of Africa.

In India the existing credit institutions and the initiatives taken by the authorities have not helped the rural poor to improve their standard and welfare. With regard to the provision of credit there seems to be a big gap between the requirement of rural people and their convenience. The outreach of banking-institutions, undoubtedly, has seen a rapid progress with 48% of their branches catering to a population of 23,000 per branch, 31% of their deposit accounts and 43% of their borrowed accounts in the rural areas (Banking Statistics, RBI, 2003). The statistics show the availability of banking services only to the tune of 18.4% of the rural population (Rural Population, India, Census 2001) through savings/accounts and a still lower percentage of 17.2% of the rural households through loan accounts.

The unfavorable situation of low productivity, deficiencies of other credit agencies and inaccessible banking sector services have led the rural areas into doldrums looking up to the expensive and exploiting money lenders for loans. The purpose of this article is to emphasize that there is need for a more prominent role to be played by the banking institutions through devices that could improve the rural lot. In recent times there have been frequent discussions and deliberations going on with regard to the importance of microfinance facilities and services by the banks in the rural areas.
Microfinance is the supply of loans, savings and other basic financial services to the poor and low income group—Consultative Group to Assist the Poor [CGAP]; the lending microfinance think tank housed at the World Bank.

Reserve Bank of India’s task Force on Microfinance has defined it as “provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban or urban areas, for enabling them to raise their income levels and improve living standards”.

As the Financial Services of microfinance usually involve small amount of money—small loans, small savings etc. The term “microfinance” helps to differentiate these services from those which formal banks provide. These services are not limited to credit but include savings, insurance, and money transfers.

1.2 Credit barriers in rural market:
Credit markets in developing countries have traditionally been defined by high transaction costs and information asymmetries. The risks of both voluntary and involuntary default on loans in rural markets are amplified by conditions specific to the rural environment. Risk of voluntary default, defined by Ray (1998) as a situation in which an individual has the means to repay a loan but does not see it in his or her best interest to do so, is higher due to the lack of well-functioning legal systems to enforce repayment or determine retribution in the case of default. Risk of involuntary default, or default because of an inability to repay, is increased due to a number of factors present in rural markets. Income in rural markets is often largely based in agricultural production, thus the threat of drought and other unforeseeable natural occurrences can lead to an inability to repay loans,
forcing individuals to default who would have otherwise repaid. The prevalence of disease in developing countries also often leads to involuntary default, creating situations in which individuals are unable to work and earn income because of sickness and are thus unable to repay loans. In many cases the risks associated with lending in rural markets are greater than the benefits that larger banks and formal financial institutions would receive in the form of interest gained on loans in these markets. Because the loans needed by individuals in poorer, more rural areas are usually much smaller than those desired by more wealthy borrowers, the interest that banks would receive on such loans is significantly less. Thus, in most cases it is simply not in the best interests of larger banks to loan to poorer people because such loans are relatively risky and the payoffs to taking such risks are relatively small.

Because of both a lack of any documented credit history and an inability to provide proper collateral as backing for loans, potential borrowers are often forced to borrow in a more informal market. Informal credit markets have a number of advantages over more formal institutions when it comes to serving rural markets, and thus have controlled the majority of lending therein. First, informal lenders are able to accept more “exotic” forms of collateral than traditional credit institutions, such as plots of land or time in the form of labor. Second, informal lenders often have better access to information regarding the activities and characteristics of their clientele (Ray 1998). Members of the rural community, such as landlords and business owners, may be more inclined to loan to individuals because they have the ability to directly monitor the borrower’s use of funds. In the case of a store owner-patron relationship the store owner can easily supervise the spending
of a patron, whereas a commercial bank may not have the ability to do so. If they were to do so it would be much more costly for them than for the store owner. However, while the informal sector may be more efficient in terms of access to information and monitoring costs, local lenders cannot realistically satisfy the needs of all potential borrowers within the poor, rural market.

Without access to any form of credit, the self-employed majority in rural markets will have to reduce consumption when faced with a reduction in output, and thus the entire economy of the given area suffers. Not only will the self-employed suffer as a result of fluctuations in income, a reduction in their income will cause them to consume less which will consequently hurt producers of goods that one would consume when profits are normal. Thus, credit is an integral part of rural markets, creating economic stability through consumption smoothing in both the formal and informal sectors of the economy. Yet the informal lending that once controlled rural markets did not seem to lead to economic sustainability, that is, the ability of individuals to generate income and live without relying upon assistance from financial institutions. Thus, in an attempt to provide the credit necessary for sustainable rural economies while mitigating the power that informal lenders have in the market and overcoming the traditional information barriers, MFIs have evolved over time as a solution to the problems that have plagued rural credit markets.

There are significant reasons why rural people remain outside the realm of banking services. The high transaction cost to be incurred by the banks, the complex formalities involved, lack of suitable and ideal products, hassles of
the formal system and the general impression of indifferent attitude of the banks deserve special mention.

In the present day context of the credit deposit ratio of banks having gone up to more than 100% and with the growth of the untapped rural potential there is plenty of scope for the banking sector to play a lead role in the extension of financial services to the rural demanders of credit for various purposes which would also help the banks to increase their business besides spreading their risk. There has been wide recognition of the fact that there is a very good opportunity for banks to do retail loan business. With the growth of the NGOs and SHGs and their linkage with the bankers, there is ample scope to facilitate micro financing activities in the rural areas. On these lines the Union Budget 2005 - 06 contains the Finance Minister's request to the RBI to examine the issue of allowing banks to adopt the “agency model” by using the infrastructure of civil society organizations, rural kiosks and village knowledge centers, to provide credit support to rural and farm sectors. The Finance Minister has also stated that commercial banks may appoint MFIs as “banking correspondents” to provide transaction services on their behalf.

1.3 Evolution of Microfinance:

Microfinance, loosely defined by Woller and Woodworth (2001) as programs that extend small loans to poor people for self-employment projects that will generate income, was first attempted with the creation of the Grameen Bank in Bangladesh in 1983. Since that time the microfinance movement has gained both momentum and success, with thousands of MFIs operating in almost every county in the world (Woller and Woodworth
2001). Following the lead of the Grameen Bank, FINCA International, another MFI, was developed in Washington DC in 1986. Within ten years of its creation, by 1996, FINCA had introduced the methodology of microfinance in fourteen countries, serving more than sixty-five thousand of the poorest families in rural Latin America, Africa, and Asia (Kelly 1996). Today, tens of millions of people have been on the receiving end of microfinance loans, with billions of dollars of outstanding loans at any given time.

Once primarily cooperatives and non profit organizations, MFIs around the world are now professionalizing, in hopes of creating sustainable, or even profitable, institutions to provide banking options for the poor. Commercial funding for MFIs has greatly increased in recent years, enhancing their ability to provide both financial and non-financial services to their clientele. Non-financial services, which have become an integral part of the MFI framework, primarily consist of improved access to, and funding for, education and healthcare in areas where such resources were previously out of reach. The quest for commercial funding has also led to increased competition between MFIs, forcing competing institutions to create innovative products and increase employee productivity. Various savings plans, some aimed at saving for the education of borrower’s children, have been introduced in a number of programs as one form of innovation. Human Resource Management firms have been employed by MFIs to monitor and enhance worker productivity. A number of incentive based pay programs have been included in the framework of MFI employee policy, most offering increased pay and stock options in return for increased productivity. According to Godquin (2004) success is based in these innovative systems
of incentives and non-financial services that are inherent in the MFI framework. Others have attributed the success of MFIs to their primarily group-based lending models and the use of women as primary borrowers. Anderson, Locker, and Nugent (2002) credit the success of MFIs partially to their ability to increase social capital within a region. Anderson et al also make the argument that the success of MFIs may be more deeply rooted in social factors than economic factors. That is, pre-existing social linkages and a heightened sense of communal dedication seen in poor, rural communities, combined with the theology of hard work and determination engrained in the MFI framework, create an environment conducive to MFI success.

1.4 Problem:
While MFIs have evolved greatly over time and vary vastly in form and function from nation to nation and institution to institution, it is possible to create a broad framework of elements that have affected and will affect the growth, stability, and overall success, defined by economic sustainability and repayment rates on loans, of MFIs across the board.

The diverse range of core functions affected by a market led approach present a significant problem for Microfinance Institutions and indeed corporation operating in almost every industry worldwide. A market led approach, by definition, affects almost every aspect of the business, and thus the Marketing Director needs to be a master of networking, alliance building and collaborative working within the organisation.

1.5 Driving Factors Behind Successful MFIs:

1.5.1 Endogenous Factors:
1.5.1.1 The Model:

The theory behind MFI lending models is based primarily on two concurrent strands of thought positive assortative matching and peer monitoring. Positive assortative matching suggests that self-selection of members within lending groups, under the Solidarity Group Model which will be discussed later in depth, will eventually drive the more risky borrowers out of the market for credit. Essentially, positive assortative matching suggests that both good and bad borrowers would want to team up with good borrowers. If the good borrowers can manage to distinguish bad borrowers from other good borrowers, groups of only good borrowers would, in turn, be formed. If a bad borrower has been denied from one group, their chances of being accepted into another group are greatly reduced. Thus, rather than the lending institution bearing all the risk, it is dispersed among group members. If they chose a bad borrower who in turn defaults on a loan, the remaining group members will not only be held responsible for repayment but will also encounter difficulty in obtaining larger loans in the future (Ray 1998). The positive assortative matching associated with MFI group lending models also reduces the transaction costs for lenders. Costs that MFIs would otherwise incur, because of imperfect information, are passed on to group members.

According to Ray, while positive assortative matching assumes that all borrowers are either intrinsically good or bad, peer monitoring theories account for the fact that group members may be able to monitor, if not influence, the choices of individuals within the group. While individuals may not fully take into account the risks associated with borrowing projects, when the costs of such risks are borne by a group the members therein are
much more likely to discourage risky endeavors. While this is generally good for the outcome of loans, leading to both more successful projects and higher repayment rates, it can also have the negative effect of leading to increasingly un-risky projects and lower returns for both borrowers and lenders. Because group members most often take into account both the social costs of default and the cost of being denied access to future credit, there is a tendency of groups to be “over conservative” in the projects that they choose (Ray). The question then is whether the costs associated with the peer monitoring aspects of the group model outweigh the benefits, or vice versa. Based upon the wide spread success of MFIs, the majority of whom employ some form of group lending model, the assumption has been made that the benefits linked with peer monitoring are greater than its costs.

1.5.1.1.1 Lending Models:

The model of lending employed by MFIs has proven to be a very important determinant of success and sustainability over time. Most importantly, the lending model established tends to have a large effect on loan repayment rates. MFI lending can be broken down into three common models: The Village Banking Model, the Solidarity Group Model, and the Individual Model. Under the framework of the Village Banking Model, loans are made to entire villages for projects such as community gardens and water systems. Villages as a whole are then expected to repay the loan over time, from community funds rather than the pockets of individuals.

The Solidarity Group Model is similar to the Village Banking Model in the cooperative sense, yet on a smaller scale. Under the Solidarity Group Model loans are given to groups of five or six community members, chosen on the
basis of societal reputation, and often composed only of women. In this scenario, each member backs the loans of the other members of the group, thus if one member of the group fails to repay their portion of the loan the remaining members are held responsible. While solidarity groups most often do not all use the funding for a common project, but rather individual business endeavors, they meet as a whole to provide support and guidance for one another. Finally, under the Individual model, as the name implies, loans are given to individuals for personal business endeavors. The individual alone is held responsible for repayment of the loan; however they do still maintain some level of group support in the form of business development classes and guidance provided by lending institutions.

The Solidarity Group Model is the most common framework for lending, attributed to its ability to reduce a number of the information asymmetries that are present in other models. Group members are chosen and approved by their peers, thus people who would be likely to default on loans are less likely to be involved in the system. The K-rep program in Nairobi is based in a group lending model that has evolved over time to fit the specific needs of the local clientele. The Juhudi program, which operates under the umbrella of the K-rep program, is modeled after a similar group-based system employed by the Grameen Bank. Groups, made of five to seven members, receive two months of training on group dynamics and the importance of savings and are then issued loans.

While the group-based lending system reduces the risks associated with imperfect information and adverse selection, in the case of exogenous shocks this approach can often leave the lending institution worse off. In the case of a drought or natural disaster, most often if one of the group members
defaults on the loan the entire group, facing similar predicaments, will have to default on the loan. Individual loans also reduce the free rider problem seen in the group model, particularly in cases in which there is a peer monitoring system in place (Zaman 2004). In these cases, individual loans will often better serve the lending institution.

**1.5.1.1.2 Loan Officers:**

Theory behind MFI selection of local loan officers over commercial bankers is similar to that behind group based lending programs. While there are risks associated with employing inexperienced local loan officers, the benefits that come with doing so often exceed the costs. It is assumed that, similar to the role of one’s peers in group lending models, local loan officers are able to provide enough information on potential borrowers to significantly reduce the risks associated with lending to individuals with no viable collateral or formal lending history. While commercial bankers may have more experience and a better understanding of the dynamics of banking systems, theory suggests that their ability to relate to MFI clientele is often limited compared to that of local loan officers and that their relative inability to decipher good borrowers from bad borrowers adds greatly to the transaction costs faced by MFIs.

MFIs have had varying success in replacing commercial bankers with local loan officers. In many programs, MFIs have chosen to employ loan officers from the local community rather than employing loan officers from within their organization. Employing a local loan officer, who already has an extensive knowledge of the people within the community, allows MFIs to spend less time and effort researching and ensuring that potential borrowers
will repay loans to the best of their ability. While local loan officers cannot help much in situations of involuntary default, in which case the inability to repay would be unforeseen by both borrower and lender, they have proven to be extremely helpful in deciphering those who would be more likely to voluntarily default from more reliable borrowers.

However, certain incentives have to exist in order to encourage local loan officers to sort potential borrowers to the best of their ability. Without proper incentives, it is possible that local loan officers could team up with potential borrowers, offering loans to borrowers who would then intentionally default, take the money, and give a portion of their profits to the loan officer for his efforts. Thus, incentives, such as increased pay in return for high repayment rates, are necessary to keep local loan officers in align with the MFI mission. These incentives have been, in more successful MFIs, ingrained in the MFI framework under the realm of necessary employee monitoring practices.

These employee monitoring practices do not only apply to local lenders or village intermediaries. There are also certain risks associated with employing outside individuals as loan officers. Yet, accompanying these risks are certain benefits as well. Many MFI’s have chosen to use individuals within their organization as loan officers, rather than employing individuals from the community in which loans are being issued. In doing so, MFI’s often chose individuals with a background in banking or some other form of formal experience. It is then assumed that in hiring more skilled individuals, MFI lending will be carried out with more ease. For a number of MFIs, such as K-Rep in Kenya, the choice to use more experienced loan officers has led to near failure. It is often seen that employing outside individuals as loan officers or intermediaries leads to significant mission drift.
bankers working as loan officers have often been found to be less sympathetic to the needs of microfinance clients, focusing more on conventional practices and a strict adherence to procedural rules and regulations (Nyerere). Without the flexibility to deal with MFI borrowers, who are most likely not familiar with formal financial institutions, commercial bankers may have trouble providing the necessary services for their clients.

1.5.1.2 Outside Assistance:

Underlying the role of outside assistance in the success of MFIs, theory would suggest that, to a certain extent, some form of outside assistance, most often in the form of financial aid, would be necessary in the early stages of MFI creation. Without help from donors and other outside aid organizations, it would be difficult for MFIs to build up a financial base from which to provide loans and other services to borrowers. However, noting that successful MFIs are defined in part by their ability to eventually, provide sustainable financial services to the poor, their reliance upon donor organizations should be limited to the beginning stages of development. At some point, it can be assumed that successful MFIs develop sufficient profits from interest gained on loans, allowing them to provide loans and other services from such profits rather than relying upon donors for such funding. Successful MFIs must strike a balance between realizing the need for outside assistance in initial capacity building, and overusing aid, in turn becoming reliant upon the help of outside donors.

Nearly all successful MFIs have benefited from some form of outside funding or assistance during the course of their existence. The extent to
which MFIs are reliant upon this outside assistance, however, varies greatly. Some MFIs, such as the CrediAmigo wing of Banco do Nordeste in Brazil, are almost entirely reliant upon funding from outside sources and powerful donors. After a number of near failures because of over lending within the CrediAmigo network, the World Bank issued the program a loan of $50 million to support a five-year expansion plan. According to Christen (2004) in his analysis of the role that the World Bank played in the success of the CrediAmigo program, “multilateral donors can play a catalytic role in microfinance development” if they 1) adopt policies individualized for the needs of specific countries rather than creating a universal model, 2) encourage MFIs to develop management capacity for growth before funding expansion, 3) encourage MFIs to take advantage of up to date technological advancements, and 4) ensure that workers on both the donating side and the receiving side are “grounded in the basic elements of sustainable microfinance.” This framework for relationships between donors and MFIs is relatively constant across institutions and countries. Most importantly, the hope is that in receiving foreign aid MFIs will not suffer from mission drift, and will thus be able to use the donated funding to support the original mission of sustainable financial services for the poor.

1.5.1.3 Employee Monitoring:

As in any business, proper employee monitoring techniques are an integral part of the MFI framework. Without proper employee monitoring and incentive programs, shirking and other inefficient behavior will often be seen on the part of employees. In the face of such obstacles, employers often institute incentive based pay schemes and other mechanisms aimed at both encouraging hard work and discouraging shirking. The hope of moving up
within an organization over time provides one such incentive for employees, encouraging both loyalty and efficiency. MFIs face the additional challenge of not only hiring dependable, efficient individuals, but also individuals who will remain loyal to the goals of the MFI mission. In this, screening mechanisms and incentives within the MFI framework must be tailored to the innovative goals of the MFI mission.

As mentioned above, a number of MFIs have attempted to use members of the community in which they are issuing loans as loan officers. While the cost of training these individuals is higher, their knowledge of the people to whom they are issuing loans reduces the risk of adverse selection that arises when borrowers are indistinguishable from one another. K-Rep, a MFI in Nairobi, Kenya, attempted to combine both systems, hiring traditional bankers to run certain functions and NGO staff to carry out other tasks. However, according to Nyeere (2004), this combination created “culture conflicts and personality clashes” which eventually slowed operations to a near fatal pace. While the NGO staff members were sympathetic to the needs and situation of their poor clientele, the commercial bankers focused more upon conventional banking methods and a strict adherence to rules and regulations. To resolve the problem, K-Rep sent the conventional bankers into the field to learn more about microfinance itself, while the NGO staff members underwent training as bank tellers and clerks.

Other MFIs have set limits on lender to borrower ratios, ensuring equal attention for all sectors of the client base. Bank Rakyat Indonesia (BRI) has set similar benchmarks: one credit officer for every 400 borrowers, one teller for every 200 daily cash transactions, and one bookkeeper for every 150 daily transactions (Maurer 2004). Not only does this system ensure
individual attention for borrowers, it also ensures that BRI employees are not over worked and are thus more efficient in the work they do. The Kazakhstan Small Business Program (KSBP) has used “incentive-based pay schemes,” similarly, to encourage efficiency. Loan officers in the KSBP program are often promoted within the system to senior positions and are even occasionally hired by competitors, creating an environment of competition in which hard work and dedication to the MFI mission are rewarded (Terberger and Lepp 2004). While methods may vary, MFIs ultimately share the goal of employee efficiency and dedication to the mission at hand.

1.5.1.4 Female Centered Lending:

Theory behind the decision of many MFI’s to loan primarily to women is two-fold. It is thought that MFI’s benefit from this framework because women are more likely than men to use loans for non-risky, income generating projects, and are thus a less risky investment. The income generated from interest on these loans satisfies the MFI goal of providing financial services to the poor without the help of donors and subsidies. It is also thought that both educating women and granting them access to capital leads to not only female empowerment but also tends to be more successful in alleviating poverty than providing these services to men may. This also satisfies goals embedded in the MFI mission. According to Weighton (2005), women are often characterized by poverty; they are often less educated, unskilled, and have limited access to productive resources, information, and technology when compared to men in similar situations. This indicates that simply providing women access to capital and training them to use that capital effectively can greatly reduce poverty levels. For
example, the Strategic Development Plan in Ghana, aimed at improving the social, economic, legal, political, and cultural conditions of women and children, suggests that when women are given the tools needed to be successful, their children, and ultimately everyone, will be better off (Weighton).

A number of MFI’s have focused the majority, if not all, of their funds and efforts on women. It is thought that the sense of duty and obligation that women feel toward their families is much greater than that of males, and thus it is believed that women use funds much less selflessly than their male counterparts. In doing so, their investments are often much more successful and in turn more beneficial for the individual, the family, and the MFI. This trend in MFI’s, like many trends, evolved from the women only policy of the Grameen Bank. Contrary to social norms in a primarily Islamic culture, the founders of the Grameen Bank chose to focus their efforts on women, offering financial independence to women who were previously not allowed to be seen in public. According to Cain (1979) Bangladesh is characterized by a “set of social relations with a material base that allows men to dominate women.” While constantly challenged by angry husbands and tribal leaders who felt that encouraging women to create businesses, thus affording them greater independence, would destroy any chances of reaching heaven, the Grameen Bank remained loyal to its promise of providing financial services to poor women in Bangladesh. In a society in which the female sphere of existence is restricted to the household, empowerment can be seen in simply offering women access to interactions outside of the household, along with the ability to acquire the skills, knowledge, and confidence that come with such interactions.
Hashemi (1996) developed an “empowerment index” aimed at examining the extent to which access to financial services led to the empowerment of women who were granted such access. According to Hashemi and colleagues, “contributing to a woman’s household’s income is a significant factor in contributing to her own empowerment”. Further confirming these findings, Amin’s study of 36 Bangladeshi villages found that involvement in microfinance programs had a positive effect on a woman’s “decision making role, her marital stability, her control over resources, and her mobility.” Because such resources and opportunities have been withheld from many women in developing nations, it is thought that their appreciation for such assets will encourage them to repay loans on time so as to receive future loans, furthering their own economic independence. Thus, a large part of the success of MFI’s has been attributed to the decision to target women as primary borrowers; it has led to both increased repayment rates and greater economic sustainability for borrowers and their families.

1.5.1.5 Interest Rates:

While there is an obvious compromise to be reached, in that overly amplified interest rates will deter potential borrowers while artificially low interest rates will leave MFIs reliant upon subsidies, it has been suggested that relatively high interest rates play a crucial role in MFI success. Theory would suggest that setting relatively high interest rates would deter borrowing in cases in which borrowers had access to institutions offering credit at lower interest rates. However, in the case of those borrowing from MFIs, access to formal financial institutions is limited, if available at all. Thus, because borrowers do not have alternative sources from which to draw these financial services, MFIs are able to set interest rates above formal
sector interest rates and still maintain a strong client base. Formal institutions would not have the ability to do this. Faced with competition from neighboring institutions formal banks must set lower interest rates in order to remain competitive.

According to a study by the Consultative Group to Assist the Poor (CGAP) MFIs are increasingly charging interest rates that cover the real cost of delivering quality financial services to the poor. With the ultimate goal of financial self-sufficiency, MFIs are using income generated by higher interest rates to develop the institutional capacity necessary to operate independent of donor and government subsidies. The CGAP focus study looked at 11 MFIs issuing loans of, on average, US $200 to US $400. It concludes that all fully self-sufficient programs charged interest rates high enough to cover all of their costs. Colombia’s Corposol program charges a real interest rate of 52%, the highest in the study, yet their client base remains relatively large and repayment rates are comparable to those of the other programs. Because of their ability to charge a higher interest rate while maintaining both a large clientele and high rates of repayment, CorpoSol has become a completely self-sufficient lending institution. The extent to which interest rates are raised is dependent upon the costs specific to various MFIs, most often determined by exogenous factors such population density and regional geography. According to Christen (2004) high interest rates are not only necessary to attain financial independence, but also to cover the relatively high cost of issuing very small loans sustainably. Setting above formal sector interest rates has given MFIs the ability to mitigate the high costs associated with administering small loans, in turn creating financial viability.
1.5.1.6 Repayment Incentives:

Aside from the repayment incentives associated with the peer monitoring aspects of the group model, such as a sense of duty to the group and the social stigma that may come with voluntary default, there exists a need for individually based incentives to similarly discourage default. Without such incentives, it can be assumed that rates of default would be much higher. Taking into account the fact that MFI borrowers have neither a credit history to tarnish nor collateral to be re-possessed, without innovative repayment incentives logical borrowers would have no reason to repay loans. Because repayment plays an obvious role in MFI sustainability and success, such innovative incentives have been developed and incorporated in the MFI framework over time.

Repayment rates for many MFIs are often greatly spurred by the benefits that borrowers may realize with repayment over time. The framework of most MFIs dictates that as a borrower proves herself through repayment, the size of loans at her disposal will increase. The hope of larger loans in the future creates an incentive for borrowers to pay back existing loans in a timely manner. The K-rep bank of Kenya employs a primarily group based lending program, however over time they offer individual loans to clients who have grown successful businesses, have some form of savings, and have a minimum of three years successful repayment experience with K-rep (Nyerere 2004). Prior to the scaling up seen in K-rep that led to their ability to issue larger loans, such clients would have had to seek loans from commercial financial institutions. In most cases such borrowers would have still been considered an unnecessary risk in the eyes of commercial institutions. However, in offering larger loans to successful clients both K-
Microfinance in India: An Analytical Study of its Financial, Human Resource and Managerial Aspects of Selected Institutions

rep and their clientele are able to reap benefits. K-rep clients are able to develop a reputation for reliability and in turn benefit from that reputation, in that they are given access to larger loans. K-rep itself benefits financially from the increased interest paid on the larger loans, while also reducing the transaction costs of obtaining information and monitoring clients in that through the scaling up of loans clients have a strong desire to establish their own reliability.

While the perceived size of future loans is very important to repayment rates, the expected availability of future loans, of any size, can have an even greater impact on repayment rates. If borrowers are under the impression that, in the future, loans will not be available to them, their incentives to repay are greatly reduced. If not planning to issue additional loans to clients over time, MFIs lose a certain amount of power over borrowers. In 1991 and 1992, in the face of tight monetary policy and a consequential shortage of funds, the management of BRI in Indonesia imposed a halt on lending. Due to the halt, loan repayment within the BRI units deteriorated (Maurer 2004). Without the guarantee of continuous access to credit over time, the incentives for BRI’s borrowers to repay their loans declined. Essentially, without a credit history to ruin or any real property to apprehend, access to future credit is one of the few proverbial aces up the sleeve of most MFIs. In this, MFI success and growth are dependent upon the ability of institutions to at least convince borrowers that they will have access to continuous, if not increasing, amounts of credit over time.

1.5.1.7 Non-financial services:
In addition to the benefits associated with access to capital, the poor can greatly benefit from appropriate education and health-related services.
Theory suggests that in providing such services, MFIs will not only be bettering the lives of their borrowers but will also increase repayment rates overtime. Creating a more educated and healthy population of borrowers also creates a population of individuals with a greater capacity to earn money and in turn repay loans. Theory behind nutritional wages states that an individual’s ability to do sustained work is in large part based upon their nutritional intake. According to Ray undernourished individuals are easily fatigued and more likely to exhibit both lower intellectual capacity and a lack of motivation. Ray goes on to argue that while low income can obviously lead to low nutrition, low nutrition can also lead to low income. Applying this to the MFI model, without access to health and nutritional services, individuals would be unable to generate the necessary income to repay loans. Similarly, increasing the education available to individuals also increases one’s income generating abilities. It is thought that with education individuals are not only better able to carry-out existing business endeavors, but are also often more innovative and efficient in future endeavors. Again, this leads to higher repayment rates for MFIs, leaving both borrower and lender better off.

A number of MFIs offer low cost health care and education to their clients in an attempt to encourage economic sustainability and increased repayment rates. It is assumed that healthier individuals will be able to work more often and more efficiently, and would thus have the ability to pay back loans with ease, as compared to individuals who may fall ill and will thus be unable to earn income. Similarly, offering educational services to individuals is also thought to increase sustainability and repayment. Educated individuals are able to operate more successful and sustainable businesses in
most cases and thus have a more reliable flow of income with which to pay back loans. With the ultimate goal of helping alleviate poverty in the areas being served, a number of MFIs also offer funding for the education of borrower’s dependents. The Grameen bank, for example, has developed a scholarship program providing a secondary education for young women, and a loan program for tertiary education (Zaman 2004). The goal of these programs is to encourage future sustainability for borrowers and their families, so that eventually loans can be repaid in full and the process of saving can begin. It is also thought that through building a relationship beyond just that of borrower and lender the sense of duty felt toward MFIs will increase, and thus repayment rates will simultaneously increase.

1.5.1.8 Savings Generation Services:

While currently MFIs tend to focus outreach efforts on providing credit services to the poor, the hope is that eventually efforts will enable borrowers to start saving. It is thought that achieving long-term financial sustainability in developing areas is not only dependent upon access to capital, but also the ability to save a portion of funds generated through the use of given capital. According to Solimano et al (1994) ensuring an adequate savings level is crucial for development in its ability to finance capital accumulation over time. A Consultative Group to Assist the Poor (CGAP) study, aimed at developing deposit services for the poor, found that access to such services allowed the poor to better manage emergencies, smooth consumption, meet demands for larger amounts of cash, such as school fees, and take advantage of future investment opportunities.

In providing savings services to the poor MFIs are not only increasing the welfare of those they serve but also reducing the risk of involuntary default
on the part of borrowers. In making borrowers better prepared to deal with adverse shocks, such as sickness or drought, such shocks are less likely to make an individual unable to repay existing loans. If faced with a severe drought, farmers who have been given access to, and taken advantage of, savings institutions will still have the funds to repay at least a portion of loans, as compared to a farmer with no savings who would be forced to default. Once MFIs have successfully developed the institutional capacity to become independent of donor and government subsidies, savings generation theory would suggest that adding savings institutions to the already existing MFI framework will benefit both lenders and borrowers, leaving both parties better off than in the absence of these institutions.

1.5.2 Exogenous Factors:

1.5.2.1 Geography:
Geographically, lending to rural markets has proven very costly for formal lending institutions. Low population density and weak infrastructure often characterize rural credit markets, making it very difficult to exchange resources and information from one place to the next. This, in turn, increases the already high transaction costs faced by formal institutions in providing services to rural, poor markets. Attempting to serve a large area of clients may bring in more income in the form of interest, however the transaction costs associated with doing so would be astronomical. Because of this, a more localized form of financial institution can more efficiently serve the needs of poor, isolated clientele. By working in a limited, local area MFIs can overcome the high costs associated with transferring information in sparsely populated, geographically diverse regions, while simultaneously
becoming better acquainted with borrowers and gaining a deeper understanding of the challenges faced by individuals from region to region.

A number of MFIs face serious challenges because of both the political climate and geographical hurdles. MFIs in Bangladesh, the Grameen Bank and BRAC in particular, struggle with the weak infrastructure of the country, difficulty in communicating between geographically diverse regions, and high monitoring costs due to this diverse topography (Matin 2004). Because of this these MFIs have had to work especially hard at establishing strong linkages between a number of satellite offices in more isolated regions and main offices in more accessible regions. Similar networks of onsite offices have been employed in a number of MFIs in an attempt to reduce the transaction and monitoring costs associated with transferring information from remote areas to more centralized locales where a type of head office may exist. These satellite locations have also allowed lenders to become better informed about the people to whom they are issuing loans, in turn reducing some of the information asymmetries that exist in traditional rural credit markets.

1.5.2.2 Political Climate:

As for any organization, MFI’s are more successful in the presence of a supportive political regime. After the widespread success and acclaim seen in a number of MFIs around the world, many governments have fallen in line with the goals of the MFI movement. Theoretically, a political climate that includes relatively low restrictions upon NGOs and other organizations allows the freedom necessary for the innovative tactics engrained in the MFI framework. In conjunction with this, governments that not only limit
restrictions upon MFIs but also support and are willing to aid in the MFI mission play a large role in MFI success. Because of their proven ability to reduce poverty within a region, MFIs are often backed by both foreign and domestic governments on the grounds of reducing world poverty. The extent to which governments play a role in MFI success varies from place to place, yet without some sort of political support MFIs often falter.

According to Taber (2004), a strong political economic emphasis on macroeconomic policies in which interest rates fluctuate very little will create the environment most conducive to MFI success. Taber’s discussion pertains to MFIs in Mexico, discussing laws that have recently been passed providing for “the gradual incorporation of all non-bank savings and credit institutions into a new legal and regulatory framework” (2004). The government also plays a role in the success of MFIs to the extent that many governments have offered subsidies for financial institutions to increase technological capacity and efficiency. In Madagascar, political liberalization led to the lifting of a number of restrictions on the creation of cooperatives, allowing MFIs more ease in creation and expansion. Similarly, the government of Madagascar has realized a need to improve conditions for its poor, especially those in the most isolated rural areas. Thus as in Mexico, the government of Madagascar has employed policies aimed at assisting in the implementation of successful and sustainable institutions for the poor (Martinez 2004). The government of Bangladesh also played a significant role in creating an enabling environment for MFIs. According to Zaman (2004), the government of Bangladesh has “maintained a balanced approach towards regulating and supervising the activities of the NGO sector”. Zaman feels that this approach has been critical in that it ensures “the operational
flexibility that is the cornerstone of service delivery by NGOs.” Thus, as illustrated by the examples of Mexico, Madagascar, and Bangladesh, a supportive political climate is crucial to MFI success.

1.5.2.3 Social Capital:

Social capital, as defined by Anderson et al (2002), refers to the institutions, relationships, attitudes and values that govern interactions among people and contribute to economic and social development. While the role that existing social capital plays in MFI success has been extensively researched, the role that MFIs play in creating new social capital is less apparent. MFIs use existing social capital, in the form of social linkages and an established hierarchy, to lower the information and transaction costs that plague more traditional credit markets. These pre-established linkages and hierarchies allow both MFIs and borrowers to distinguish between reliable and non-reliable borrowing candidates. Along with employing existing social capital to reduce costs, according to Anderson et al MFIs tend to increase social capital in a given region over time. Both the Solidarity Group Model and models that target women as the primary borrowers are thought to be beneficial for communities over time in the sense that they encourage and strengthen social linkages through group meetings, investments in education and business oriented training programs.

The Group Solidarity Model and the group meetings that it entails are thought to increase social capital over time in that they, according to Anderson et al, create a sort of corporate culture or cultural habit. These habits, when combined with strengthened relationships between borrowers and their families, “reduce incentives to behave in ways detrimental to the
common good” (Anderson et al). The Grameen Bank, and many other MFIs of a similar structure, requires its members to repeat the same behaviors every week. The development of weekly habits, reciting both the requirements for membership and the mission statement in the case of the Grameen Bank, is thought to facilitate “communication, knowledge about fellow borrowers, common understanding about the incentive structure, and a trust prerequisite to collective action” (Ostrom, 1994). These advancements, in turn, benefit MFIs in that with increased education and training borrowers are more able to borrow-and repay-larger loans. Simultaneously, the information and transaction costs incurred by MFIs are greatly reduced in that the peer monitoring systems that develop require less direct involvement and monitoring on the part of lending institutions. The use of existing social capital, which leads to the creation of new social capital, and in turn strengthens social linkages used by MFIs to reduce information and transaction costs creates a self perpetuating, Pareto optimal outcome in which both the lender and borrower are better off.