Chapter 1

Introduction
Introduction

The aim of this chapter is to provide an introduction to the research undertaken and outline the research themes of the study. It presents the background of the research, evolution of microfinance industry and rationale of the study. In addition, this chapter covers research problem, and research questions. Finally, the outline of thesis is also presented.

1.1. Microcredit and Microfinance

*Microfinance is the provision of financial services to low-income clients or solidarity ups including consumers and the self-employed, who traditionally lack access to banking and related services.*

Microfinance is not just about giving micro credit to the poor rather it is an economic development tool whose objective is to assist the poor to work their way out of poverty. It covers a wide range of services like credit, savings, insurance and remittance. In the literature the terms microcredit and microfinance are often used interchangeably, but it is important to highlight the difference between both the terms. After the great success of Grameen Bank of our neighboring country Bangladesh, the concept of microfinance has gained momentum. Micro credit / microfinance have been defined as the programs that provide credit and other financial and business services (including savings and technical assistance) to very poor persons. Thus, microfinance refers to the provision of financial services to low income households, including the self-employed. These financial services include savings, credit, payment facilities, remittance, insurance and also non-financial services like training, counseling etc. (Ledgerwood, 1999; Wright, 1999; Christen and Rosenberg, 2000). The key features of microfinance are:
• Borrowers are from the low income group
• Loans are of small amount – micro loans
• Short duration loans
• Loans are offered without collaterals
• High frequency of repayment
• Loans are generally taken— for income generation purpose

1.1.1. Gaps in Financial System and Need for Microfinance

According to the World Bank’s global financial inclusion database (global findex) reports, three-quarters of the world’s poor lack a bank account because of poverty, costs, travel distances and the often burdensome requirements involved in opening an account. There are an estimated 2.5 billion financially excluded adults today, with almost 80 percent of those living under $2 per day having no accounts at formal financial institutions. Only 25 percent of adults earning less than $2 a day have saved money at a formal financial institution. Being “unbanked” is linked to income inequality. The richest 20 percent of adults in developing countries are more than twice as likely to have a formal account. This holds back the fulfillment of the World Bank Group’s goals of eradicating extreme poverty by 2030 and increasing the share of income held by the bottom 40 percent of the population.

Microfinance institutions can help in this direction. These institutions not only offer micro credit but they also provide other financial services like savings, insurance, remittance and non-financial services like individual counseling, training and support to start own business and the most importantly in a convenient way. The borrower receives all these services at her/his door step and in most cases with a repayment schedule of borrower’s convenience.
1.1.2. Objectives of the Microfinance

The fundamental objectives of microfinance are the following:

a) To offer cost effective approach to formal institutions for expanding their outreach to the poor.

b) To develop collateral substitutes.

c) To focus on the rural and the urban poor generally and particularly on women.

d) To test other micro-credit delivery mechanisms as alternative channels to the formal banks.

e) To effectively pursue the objectives of microeconomic growth (Yadagiri and Gandadhar, 2008).

f) To bring Social Empowerment through:
   - increased status, participation and decision making powers of women in household, community, village and democratic institutions.
   - breaking cultural barriers for equal development of women.

g) To bring the Economic Empowerment through:
   - greater access to financial resources outside the household.
   - reduced vulnerability of the poor women to famine crisis, and the like.
   - financial self-reliance of women.

h) To promote capacity building (a strategy and an end in itself) through:
   - improvement in functional literacy, innumeracy.
   - better communication skills.
   - better leadership skills.
   - self-help and mutual help.

i) To enhance Political Empowerment through:
   - participation in Panchayati Raj Institution.
   - negotiating political power.
   - accessing political power.
• collective identity (Soundarapandian, 2006).

j) To increase the consumption capacity of the poor (Lal, 2007)

1.1.3. Genesis of Microfinance

The origin of microfinance or microcredit can be traced to the early 1700s with the Irish loan fund system where micro-credit was provided to the rural poor with no collateral requirements. From this seed, larger and more formal savings and credit institutions sprung up in the 1800s in Europe. In the early 1900s, different versions of the European model emerged in Latin America. Beginning in the 1950s, the European model evolved into the microfinance institutions in operation today. The terms, microcredit and microfinance, relatively new terms in the field of development, first came to prominence in the 1970s (Otero, 1999; Robinson, 2001). Prior to then, from 1950 to the 1970’s, the provision of financial services in the form of subsidized rural credit programs by donors or governments was prevalent. These often resulted in high loan defaults, mounted losses and an inability to reach poor rural households (Robinson, 2001). Microfinance programs have been introduced in many developing economies especially during the past 10 years (Niels and Lensink, 2007). Dr. Muhammad Yunus, the former chairman of Yunus Centre, in 1976 developed the pioneer institution of Grameen Bank, Bangladesh. Other important institutions are the Bank of Rokyat of Indonesia, the Bank Kredit Deas of Indonesia, Banco Sol of Bolivia and village banks started by the Foundation for International Community Assistance (FINCA) in Indonesia.

In India, microcredit programs are mostly organized by NGOs. Robinson (2001) further states that the 1980s represented a turning point in the history of microfinance in which MFI's such as Grameen Bank began to show that they could provide small loans and savings services profitably on a large scale. They were fully sustainable and
could attain wide outreach to clients with commercial funding and without continuing
subsidies (Robinson, 2001). It was at this time that the term “microcredit” came to
prominence in development (MIX, 2005). The term microcredit is different from the
subsidized rural credit programs of the 1950s and 1960s in the sense that microcredit
insisted on repayment, on charging interest rates that covered the cost of credit
delivery and focusing on clients, dependent on the informal sector for credit. It was
now clear for the first time that microcredit could provide loans to the people
profitably. The 1990s “saw accelerated growth in the number of microfinance
institutions created and showed an increased emphasis on reaching scale” (Robinson,
2001). The year 1990 was referred as “the microfinance decade” (Dichter, 1999).
According to Robinson (2001), Microfinance has now turned into an industry. Along
with the growth of microcredit institutions and when it became clear that the poor had
a demand for these other services, attention changed from just the provision of credit
to poor people (microcredit), to the provision of other financial services such as
savings and pensions (microfinance) (MIX, 2005).

The significance of microfinance in the field of development was reinforced with the
launch of the Microcredit Summit in 1997. The Summit aimed to reach 175 million of
the world’s poorest families, especially the women of those families, with credit for
self-employment and other financial and business services, by the end of 2015
(Microcredit Summit, 2005). The UN declared 2005 as the International Year of
Microcredit.

1.1.4. Grameen Bank Model in Bangladesh

A simple and an effective system is adopted by Grameen Bank. To obtain loans, the
potential borrowers have to form a group of five, and to gather once a week for
meeting regarding loan repayments. This formation of groups is the first necessary
step to receive credit and Loans which are granted by the rest of the members (Ansari,
2007). For effective Grameen bank system, Dr. Mahammad Yunus developed certain principles.

- It is believed in rural areas that poverty is not created by the poor, but by the institutions and policies which surround them. In order to eliminate poverty, appropriate changes have to be made either in these institutions or their policies. Alternatively, new policies have to be created.

- Charity is not an answer to eliminate poverty. It serves only to perpetuate poverty and further create dependency. It takes away the initiative of an individual to break through the wall of poverty. Thus, the only way to overcome poverty is to unleash the energy and creativity in each human being.

- The Grameen system is built on the belief that the ability of a poor person and the other one is the same i.e., there is no difference in the ability of a poor person and any other person. The poor people merely do not get the opportunity to explore their potential and so their abilities remain unutilized or partially utilized. If these people had the opportunity, they would have been able to change their own lives.

- Furthermore, conventional banks start with the principle that the more you have, the more you can get in the form of loans and credit. This provides a spring board for those who are already well off. But the principle of Grameen Bank model has always been to give priority to persons having less.

- A central assumption underlying Grameen’s system success is the firm belief that poor people always pay back. For many of the borrowers, it is for the first time that they are handling money because no one has ever trusted them with these sums of money before. For this reason, they commit to pay back every penny.

- Lending to women is more beneficial for the family than lending to men. If the mother is the borrower, then the children are the immediate beneficiaries. Women have greater long-term vision and are ready to bring about spectacle changes in their lives step by step (Yunus, 2004).
• Policy makers rarely gave an important place to the landless people in their plans for rural investment as the poor with no land or collateral are considered a risky proposition (Lal, 2007).

1.2. Microfinance and Indian Economy

The Economy of India is the tenth largest in the world by nominal GDP and the third largest by purchasing power parity (PPP). The country's per capita GDP (PPP) was $1505 in 2012 and it is ranked as 141st by nominal GDP and 130th by GDP (PPP) in 2012 (International Monetary Fund). Overall GDP of India grew at the rate of 6.88 percent during the year 2011-12. Despite fast economic growth, India continues to face massive income inequalities, high unemployment and malnutrition. India faced unemployment at the rate of 3.8 percent (2011-12) nationwide which rose to 4.7 percent during the year 2012-13.¹ Data on Indian poverty, both in absolute terms and in percent form, shows that the people living in the rural area are poorer in comparison to the urban people (Table 2). Overall there has been a reduction of 10.5 million poor people from 2004-05 to 2009-10. According to the Rangarajan committee, which has retained consumption expenditure as the basis for determining poverty, the total number of poor in the country is 363 million or 29.6 per cent of the population (2014). Against the estimation of Rangarajan committee, Suresh Tendulkar committee stated it to be 269.8 million (21.9 per cent) (2014). Further, C Rangarajan committee on poverty projected the number of India's poor to rise by 100 million (Sharma, 2014). The existence of such an extreme level of poverty and the associated problem of unemployment prevent the economy from realizing its full potential.

¹ http://m.financialexpress.com/news/unemployment-rate-jumps-to-4.7-as-slowdown-bites/1171982/
According to just released inter media survey (2014), only 6% of India’s residents are aware about mobile money and only 0.3% have accessed such services (Banerjee and Rana, 2014). Mere 48% of India has bank accounts, but only 25% of these accounts are active. Access to credit has long been considered a major poverty alleviation strategy in India. The RBI recognized the problem of financial exclusion in its annual policy statement in 2005 and since then it has taken several policies initiatives aiming at promoting financial inclusion of especially self-employed, the pensioners and those employed in the unorganized sector (Mehendra, 2006).

1.2.1. Coverage of Financially Excluded Population by Microfinance Service Providers

The Table 1.1 displayed below depicts the state-wise picture of microfinance penetration. The state-wise picture, is however, much less optimistic. The states have been arranged in descending order by the extent of microfinance coverage of their financially excluded families.
## Coverage of financially excluded population by microfinance service providers

<table>
<thead>
<tr>
<th>States of India</th>
<th>Population (million)</th>
<th>Poverty rate (based on MPI)</th>
<th>Calculated rate of financial exclusion</th>
<th>Financially excluded families (mn)</th>
<th>SHGs</th>
<th>MFIs</th>
<th>Total</th>
<th>% coverage of excluded families&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Andhra Pradesh</td>
<td>84.7</td>
<td>44.7%</td>
<td>52.4%</td>
<td>10.10</td>
<td>22.87</td>
<td>7.48</td>
<td>30.54</td>
<td>334.0%</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>72.1</td>
<td>32.4%</td>
<td>38.0%</td>
<td>6.23</td>
<td>2.75</td>
<td>5.47</td>
<td>13.22</td>
<td>235.8%</td>
</tr>
<tr>
<td>Kerala</td>
<td>33.4</td>
<td>15.9%</td>
<td>18.7%</td>
<td>1.42</td>
<td>2.41</td>
<td>0.94</td>
<td>2.74</td>
<td>215.1%</td>
</tr>
<tr>
<td>Goa</td>
<td>1.5</td>
<td>21.7%</td>
<td>25.5%</td>
<td>0.08</td>
<td>0.13</td>
<td>0.13</td>
<td>0.13</td>
<td>167.7%</td>
</tr>
<tr>
<td>Karnataka</td>
<td>61.1</td>
<td>46.1%</td>
<td>54.1%</td>
<td>7.51</td>
<td>3.41</td>
<td>4.47</td>
<td>7.89</td>
<td>116.6%</td>
</tr>
<tr>
<td>Orissa</td>
<td>41.9</td>
<td>64.0%</td>
<td>75.1%</td>
<td>7.15</td>
<td>4.52</td>
<td>1.91</td>
<td>6.44</td>
<td>100.0%</td>
</tr>
<tr>
<td>West Bengal</td>
<td>91.3</td>
<td>58.3%</td>
<td>68.4%</td>
<td>14.19</td>
<td>6.77</td>
<td>4.21</td>
<td>10.98</td>
<td>85.9%</td>
</tr>
<tr>
<td>Himachal Pradesh</td>
<td>6.86</td>
<td>31.0%</td>
<td>36.4%</td>
<td>0.57</td>
<td>0.34</td>
<td>0.34</td>
<td>0.34</td>
<td>66.4%</td>
</tr>
<tr>
<td>Maharashtra</td>
<td>112.4</td>
<td>48.1%</td>
<td>56.4%</td>
<td>14.42</td>
<td>3.14</td>
<td>1.76</td>
<td>4.90</td>
<td>37.8%</td>
</tr>
<tr>
<td>Uttarakhand</td>
<td>10.1</td>
<td>40.3%</td>
<td>47.3%</td>
<td>1.09</td>
<td>0.25</td>
<td>0.10</td>
<td>0.35</td>
<td>35.6%</td>
</tr>
<tr>
<td>Northeast region</td>
<td>45.0</td>
<td>57.6%</td>
<td>67.8%</td>
<td>6.91</td>
<td>2.01</td>
<td>0.11</td>
<td>2.12</td>
<td>34.1%</td>
</tr>
<tr>
<td>Chhattisgarh</td>
<td>25.5</td>
<td>71.9%</td>
<td>84.4%</td>
<td>4.89</td>
<td>0.85</td>
<td>0.55</td>
<td>1.40</td>
<td>31.7%</td>
</tr>
<tr>
<td>Jharkhand</td>
<td>33.0</td>
<td>77.0%</td>
<td>90.3%</td>
<td>6.78</td>
<td>0.98</td>
<td>0.37</td>
<td>1.35</td>
<td>32.1%</td>
</tr>
<tr>
<td>Gujarat</td>
<td>60.4</td>
<td>41.5%</td>
<td>48.7%</td>
<td>6.68</td>
<td>1.01</td>
<td>0.29</td>
<td>1.29</td>
<td>21.5%</td>
</tr>
<tr>
<td>Bihar</td>
<td>103.8</td>
<td>81.4%</td>
<td>95.5%</td>
<td>22.53</td>
<td>2.63</td>
<td>0.90</td>
<td>3.52</td>
<td>17.4%</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>72.6</td>
<td>69.5%</td>
<td>81.5%</td>
<td>13.45</td>
<td>0.85</td>
<td>1.21</td>
<td>2.06</td>
<td>17.0%</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>68.6</td>
<td>64.3%</td>
<td>75.3%</td>
<td>11.74</td>
<td>1.22</td>
<td>0.51</td>
<td>1.73</td>
<td>16.4%</td>
</tr>
<tr>
<td>Haryana</td>
<td>25.3</td>
<td>41.6%</td>
<td>48.0%</td>
<td>2.81</td>
<td>0.26</td>
<td>0.08</td>
<td>0.35</td>
<td>13.7%</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>199.6</td>
<td>69.9%</td>
<td>82.0%</td>
<td>37.20</td>
<td>2.89</td>
<td>1.45</td>
<td>4.34</td>
<td>13.0%</td>
</tr>
<tr>
<td>Punjab</td>
<td>27.7</td>
<td>26.2%</td>
<td>30.7%</td>
<td>1.94</td>
<td>0.15</td>
<td>0.00</td>
<td>0.15</td>
<td>8.7%</td>
</tr>
<tr>
<td>Jammu &amp; Kashmir</td>
<td>12.5</td>
<td>43.8%</td>
<td>51.4%</td>
<td>1.46</td>
<td>0.03</td>
<td>0.00</td>
<td>0.03</td>
<td>2.2%</td>
</tr>
<tr>
<td><strong>All India</strong></td>
<td>1,210.0</td>
<td>55.4%</td>
<td>65.0%</td>
<td>175.69</td>
<td>64.62</td>
<td>31.93</td>
<td>96.56</td>
<td>61.1%</td>
</tr>
</tbody>
</table>

<sup>a</sup> Assumes 10% of all excluded families are destitute and, therefore, ineligible for microfinance debt.

Source: M-CRIL Microfinance Review 2012
Andhra Pradesh had, by far, the highest coverage of 334% – for every excluded family (eligible for microcredit), more than three microfinance loans were outstanding as on March 2011. All the other main southern states – Tamil Nadu (290%), Kerala (236%) and Karnataka (117%) along with Orissa (100%) and West Bengal (86%) also had high coverage ratios. This indicates the concentration of the MFIs on the southern area of India. On the other hand, the northern states like Jammu and Kashmir (2.2%), Punjab (8.7%) and Haryana (13.7%) had the lowest coverage ratios. Furthermore, all over India, 61.1% of the total excluded families are covered by microfinance service providers. It shows that 39.9% of the deprived ones are still out of the range of microfinance efforts.

1.2.2. Key Players in the Micro Finance System

i) National Bank for Agricultural and Rural Development (NABARD)

NABARD is an apex institution, accredited with all matters concerning policy, planning and operations in the fields of credit for agriculture and other economic activities in rural areas in India. NABARD was established in 1982 as a Development Bank, in terms of the Preamble of the Act, “for providing and regulating credit and other facilities for the promotion and development of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas and for matters connected therewith or incidental thereto”. The corporate mission set by NABARD for making available microfinance services to the very poor envisaged coverage of one third of the rural poor through one million Self Help Groups by the year 2006-07. In November 1998, a high-powered Task Force on Supportive Policy and Regulatory Framework for Microfinance (henceforth referred to as the Task Force) was set up by NABARD at the
instance of RBI. The objectives of the Task Force were to come up with suggestions for a regulatory framework that brings the operations of the Microfinance Institutions into the mainstream, to access the possible role of self-regulatory organizations and to explore the need for a separate legal framework for micro finance.

ii) Reserve Bank of India

The earliest reference to micro credit in a formal statement of monetary and credit policy of RBI was in former RBI President Dr. Bimal Jalan’s monetary and credit policy statement of April 1999. The policy attached importance to the work of NABARD and public sector banks in the area of micro credit. The banks were urged to make all efforts for provision of micro credit, especially forging linkages with Self Help Groups, either at their own initiative or by enlisting support of Non-Government Organizations (NGOs). The micro credit extended by the banks is reckoned as part of their priority sector lending, and they are free to devise appropriate loan and saving products in this regard (Reddy and Manak, 2005). Considerable work has been done by RBI in this sector since 1991. In 1991-92 a pilot project for linking up SHGs with banks was launched by NABARD in consultation with the RBI. In 1994, the RBI constituted a working group on SHGs.

On its recommendations, SHGs would be reckoned as part of their lending to weaker sections and such lending should be reviewed by banks and also at the State Level Bankers’ Committee (SLBC) level, at regular interval. Banks were also advised that SHGs, registered or unregistered, which engaged in promoting the saving among their members, would be eligible to open savings bank accounts with banks irrespective of their availment of credit facilities from banks.

iii) Self Help Groups
The origin of SHGs is the brainchild of Grameen Bank of Bangladesh, which was founded by Mohammed Yunus. SHGs are started and formed in 1975. The establishment of SHGs can be traced to the existence of one or more problem areas around which the consciousness of rural poor is built and the process of group formation initiated. SHGs are considered a new lease of life for the women in villages for their social and economic empowerment. SHGs are suitable means of the empowerment of women. Since SHGs have been able to mobilize savings from persons or groups who were not normally expected to have any ‘saving’ and also to recycle effectively the pooled resources amongst the members, their activities have attracted attention as a supportive mechanism for meeting the credit needs of the poor (NABARD, 2004 cited by Singh, 2009). The main characteristics of SHGs are as follows:

- The ideal size of an SHG is 10 to 20 members. (In a bigger group, members cannot actively participate).
- The group need not be registered.
- From one family, there can be only one member. (More families can join SHGs this way).
- The group consists of either only men or only women. (Mixed groups are generally not preferred).
- Women’s groups are generally found to perform better.
- Members have the same social and financial background. (Members interact more freely this way).
- Compulsory attendance by all the members is required to have larger participation.

Functions of SHGs

The following are the main functions of SHGs:
• The amount may be small, but savings have to be a regular and continuous habit with all the members. ‘Savings first – Credit later’ should be the motto of every group member.

• The savings are to be used as loans to members. The purpose, amount, rate of interest, etc. are to be decided by the group itself. It enables the SHG members to attain loans from banks, and repaying the same.

• In every meeting, the group discusses and tries to find solutions to the problem faced by the members of the group.

iv) Non-Government Organizations (NGOs)

The Non-Government Organizations involved in promoting SHGs and linking them with the Formal Financial Agencies (FFAs) perform the following functions:

• Organizing the poor people into groups.

• Training and helping them in the organizational, managerial and financial matters.

• Helping them to access more credit and to link with formal financial agencies.

• Channelizing the group effort for various development activities.

• Helping them in availing opportunities, widening the options available for economic development.

• Helping them in sustaining the group effort independently even after withdrawal of the NGO.

v) Micro Finance Institutions (MFIs)

Amongst the financial terminology, the concept of microfinance institutions has assumed greater importance in the recent years. The institutions having microfinance as their main operation are known as micro finance institutions. These are relatively small financial institutions that have traditionally granted small loans (microcredit) to low income clients with the objective of helping them to engage in productive
activities or microenterprises (Hassen and Sanchez, 2009). They give poor people particularly small businesses and women, access to financial services. Micro finance institutions differ from traditional financial institutions in the manner that they provide services to low income customers and often provide loans without the conventional form of collateral. They also impart skill-based training to enhance productivity and organizational support, and consciousness-building training to empower the poor. Such institutions provide financial services to the poor through innovative approaches such as progressive lending, group lending, regular repayment schedules, and collateral substitutes.

A number of organizations with varied size and legal forms offer microfinance services. These institutions lend through the concept of Joint Liability Group (JLG). A JLG is an informal group comprising of 5 to 10 individual members who come together for the purpose of availing bank loans either individually or through the group mechanism against a mutual guarantee. The reasons for existence of separate institutions i.e. MFIs for offering microfinance are as follows:

- **High transaction cost** – generally micro credits fall below the break-even point of providing loans by banks.
- **Absence of collaterals** – the poor usually are not in a state to offer collaterals to secure the credit.
- **Loans are generally taken for very short duration periods.**
- **Higher frequency of repayment of installments and higher rate of Default**

Today, there are more than 10,000 institutions engaged in these activities and serving the poor.² A range of institutions in public as well as private sector offers the micro-

finance services in India. Based on asset size, MFIs can be divided into three categories:

a) Non-Banking Finance Companies (NBFCs).
   - 5-6 institutions which have attracted commercial capital and scaled up dramatically during last five years.
   - The MFIs which include SKS, SHARE and Grameen Style program but after 2000, converted into for-profit, regulated entities mostly Non-Banking Finance Companies (NBFCs).
   - Around 10-15 institutions with high growth rate, including both new and recently formed for-profit MFIs. Some of MFIs are Grameen Koota, Bandhan and ESAF.

b) The bulk of India’s 1000 MFIs are NGOs struggling to achieve significant growth. Most of them continue to offer multiple developmental facilities in addition to microfinance and have difficulty in accessing growth trends. Private MFIs in India, barring a few exceptions, are still fledging efforts and are therefore unregulated. They secure micro finance clients with varying quality and use different operating models.

These different types of MFIs together account for about 42 percent of the microfinance sector in terms of loan portfolio. Furthermore, the MFI channel is dominated by NBFCs which cover more than 80 percent of the total loan portfolio through the MFI channel.

1.3. Present Scenario of MFIs in India

Indian microfinance industry has undergone a major process of transformation in the last decade. The following tables and figures demonstrate the MFIs outreach as per legal form, regional spread of microfinance and the distribution of MFI branches.
1.3.1. Progress and Performance of MFIs

Table 1.2. Progress of MFIs

<table>
<thead>
<tr>
<th>Particulars</th>
<th>2010</th>
<th>2011</th>
<th>Growth Rate (%)</th>
<th>2012</th>
<th>Growth Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of MFIs Reporting</td>
<td>264</td>
<td>170</td>
<td>--</td>
<td>167</td>
<td>--</td>
</tr>
<tr>
<td>Customer Outreach (Million)</td>
<td>26.7</td>
<td>31.8</td>
<td>19.1</td>
<td>26.8</td>
<td>-15.7</td>
</tr>
<tr>
<td>Outstanding Loans (Rs. Billions)</td>
<td>183.44</td>
<td>215.56</td>
<td>17.5</td>
<td>209.13</td>
<td>-3</td>
</tr>
</tbody>
</table>

Source: Data from Sa-Dhan’s ‘The Bharat Microfinance Quick Report-2012’.

As per the data made available by Sa-Dhan, the total client outreach of the MFIs was recorded at 26.8 million with a gross loan portfolio of 209.13 billion (Table 1.2). Both the client outreach and loan portfolio registered negative growth in 2012. There was negative growth in client outreach; the number of clients declining by 15.7 per cent in the year 2011-12. However, the gross loan portfolio fared marginally better with a smaller decline of 3 per cent. Customer outreach has recorded a relatively higher deceleration in growth rate as compared to the loan outstanding. The MFIs have been unable to retain their customers on account of the liquidity crisis, which affected the MFIs during the second half of the year 2011-12. A further problem might be the loss of clients in Andhra Pradesh who could not be substituted easily by the MFIs.

1.3.2. Regional Distribution of MFIs

The regional distribution of outreach and loan portfolio estimates based on the Sa-Dhan Bharat Microfinance Quick Report-2012, revealed that the dominance of the southern region still continues.
Figure 1.1. Regional Distribution of Outreach

Source: Sa-Dhan Bharat Microfinance Quick Report 2012.

Figure 1.2. Regional Distribution of Loan Portfolio

Source: Sa-Dhan Bharat Microfinance Quick Report 2012.
The Southern region accounts for the almost 50 percent in both outreach (Figure 1.1) and portfolio (Figure 1.2) followed by the Eastern region (25 per cent). The outreach share of the Northern region remains below 5 per cent.

1.3.3. Comparison of Market Share of Different Regions

<table>
<thead>
<tr>
<th>Region</th>
<th>Share of Clients 2010-11 (%)</th>
<th>Share of Clients 2011-12 (%)</th>
<th>Share of Loans 2010-11 (%)</th>
<th>Share of Loans 2011-12 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>North</td>
<td>4.8</td>
<td>4.2</td>
<td>3.7</td>
<td>4.2</td>
</tr>
<tr>
<td>North East</td>
<td>3.2</td>
<td>4.2</td>
<td>3.6</td>
<td>6.1</td>
</tr>
<tr>
<td>East</td>
<td>17.9</td>
<td>25.1</td>
<td>18.1</td>
<td>23.3</td>
</tr>
<tr>
<td>Central</td>
<td>16.7</td>
<td>9.6</td>
<td>14.3</td>
<td>9.7</td>
</tr>
<tr>
<td>West</td>
<td>12.1</td>
<td>7.2</td>
<td>11.4</td>
<td>7.6</td>
</tr>
<tr>
<td>South</td>
<td>45.3</td>
<td>49.7</td>
<td>48.9</td>
<td>49.1</td>
</tr>
</tbody>
</table>

Source: MIX Market

When compared to the previous year the Southern region registered an increased share both in terms of client outreach (4.4%) as well as loan portfolio (0.2%) (Table 1.3). The share of North East and Eastern regions has registered impressive growth while the Western region lost its share significantly.

1.4. Regulation of the Microfinance Sector

1.4.1. Crisis in Microfinance
Commercialization of microfinance has increased the interest of the both investors and practitioners in the microfinance activities. Efforts were made across the country to expand the MFIs’ activities. Unfortunately most of the efforts were aimed to develop methods and tools to ensure that investments create sustainable microfinance ventures rather than ascertaining the welfare impact of the microfinance activities. This approach created a situation of unregulated growth contributing to high interest rates, providing loans largely for unproductive purposes and multiple agencies lending to the same household, thus contributing to the high level of indebtedness which ultimately led to a crisis in the MFI sector. The recent microfinance crisis in Andhra Pradesh is only a tip of the iceberg. It is said that the current stalemate in Andhra Pradesh is only a continuation of the 2006 episode that was out in Krishna District of Andhra Pradesh. It was alleged then that the coercive debt recovery methods used by the microfinance institutions (MFIs), and the explosive growth rates of some MFI operations since the beginning of the decade, had led as many as 200 borrowers to end their lives (Nair, 2011). Several branches of MFIs were made to close their operations in Krishna district. According to Andhra Pradesh Government, more than Rs.25,000 crore has been lent over to 80 lakh poor families i.e. on an average each family owes Rs.30,000. And most of MFIs charge 27 per cent interest on loans. Some MFIs appear to use strong – arm tactics in loan recovery. What is seen in Andhra Pradesh is only forerunner of what is happening in other parts of the country. Even then, most MFIs claim that they have lent for income generating activities. In reality, most lending has been for consumption purposes. According to a recent survey conducted in Andhra Pradesh, households use less than 2.5% of all micro loans to start new ventures and 10% go into buying stocks. The survey also reveals that most of the spending is done on agricultural inputs, repayment of old debts, health and other consumption. The customers use bulk of their borrowings as bridge finance rather than to create new business. While such uses can bring much needed relief during financial stress, they
cannot lead to sustained reduction in poverty. Thus, indiscriminate lending and to some extent irresponsible borrowing is responsible for the crisis in MFIs in India.

Microfinance was once considered as the poster child for poverty alleviation. Hailed as an alternative to dangerous ‘loan sharks’ money lenders, it quickly gained momentum due to support from governments and NGOs alike. But later on the glitter of the Microfinance has been wearing off and this once globally praised idea has come under severe criticism. Some governments encouraged their citizens not to pay back their dues, causing lenders to experience a drop in payback. The Government of Andhra Pradesh blamed the MFIs for farmers’ suicides calling MFIs ‘Profiteering loan sharks’. The economists analyzing the MFIs in India with particular focus on Andhra Pradesh observed that the politicians are looking at the MFI crisis from a political angle rather than from moral or economic perspective. Apart from India, microfinance has come under severe criticism in Bangladesh which is considered to be its birth place, but also in Latin American countries such as Nicaragua and Bolivia.

1.4.2. Response to the Crisis

The crisis in MFIs resulted in quick and desired response from both Government of Andhra Pradesh and the Reserve Bank of India. Andhra Pradesh Government brought an ordinance called ‘Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010’, which was subsequently enacted into the State legislature while the Reserve Bank of India constituted a Sub-committee under the chairmanship of Malegam. The report of the committee is now available in the public domain. They both attempted to provide solutions to the crises in the MFIs from different perspectives. The AP Act, among other things, requires the registration of MFIs themselves, and prevents lending in cases where loans are already outstanding. It allows only loans with monthly repayments and demands for
the display of interest rates charged by the MFIs. Subsequent to the enactment of this Act, on December 15, 2010 there was a sharp drop in repayments to MFIs – that is reportedly 15 per cent or 20 per cent across the state.

**Recommendations of the Malegam Committee:**

a) The creation of a separate category of NBFC – MFIs. The NBFCs should hold more than 90 per cent of their total assets as qualifying assets.

b) 75 per cent of the loans should be for income generating purposes.

c) Individual loans should not exceed Rs.25,000 and the borrowing households’ annual income must not be more than Rs.50,000.

d) The tenure of the loan is recommended as 12 months for amounts less than Rs.15,000 and 24 months for others.

e) The interest cap is fixed at 24 per cent for all personal loans. The margin gap varies based on the outstanding loan portfolio of MFI’s. For Rs.100 Crore or more the margin gap is 10 per cent and below that, is 12 per cent.

f) The cost of the loans will have over three components – Processing fee (less than 1% of the loan amount), interest, and insurance premium.

g) No individual household should be provided access to micro loan from more than two MFIs.

It is evident that while AP Act is more concerned about the clients and households, the Malegam Committee recommended from the view point of the MFI institutions and their sustainability from a bankers perspective.

**1.5. Rationale for Studying Outreach and Financial Performance of Microfinance Institutions**

The study aims at examining the trade-off between outreach and financial performance of microfinance institutions. The microfinance industry has been recognized as an important tool for poverty eradication and social upliftment of the
poor people. The financial services provided by the microfinance providers are meant to help the poor in undertaking economic activities, mitigating vulnerabilities to income shocks, smoothening consumption, increasing savings and supporting self-empowerment. Indian microfinance industry is witnessing great competition with more than 3000 microfinance companies playing pivotal roles in the development of India. Few major MFIs like SKS, Grama Vidiyut, Asmitha microfinance, Cashpor microfinance, Trident microfinance and Samridhi microfinance are reaching to the 70% of the poor districts of India. Increased competition amongst the different MFIs ensures the signs of revival by registering a 30% growth in gross loan portfolio in 2013 till September over the same period of the previous year. The amount of loan disbursed rose by 50% in second quarter of 2014 over the same period of the previous year. Alok Prasad, chief executive officer, MFIs’ Network (MFIN) expected the MFI industry to grow by atleast 55% by the end of 2014 due to a favourable business environment. Besides all this favourable results, Indian economy has been facing massive poverty and unemployment. According to UN Report (2013), a third of the world’s poorest people live in India. Also, banks are reluctant to provide loans to the poor or landless people. About half of the Indian population still doesn’t have a savings bank account and they are deprived of all banking services. Poor also need financial services to fulfill their needs like consumption, building of assets and protection against risk. Microfinance institutions serve as a supplement to banks and in some sense a better one too. In order to serve the poor people and to maintain their market share, microfinance institutions are continuously required to improve their performance. But serving the poor people and maintaining sound financial performance seems to be contradictory. Thus, microfinance institutions are facing immense difficulties in their outreach to the poor and financial sustainability.

1.6. Research Problem

Poverty is the major problem in most developing economies. In these economies, absence of access to credit is presumed to be the main cause of the failure of the poor to come out of poverty. Meeting the gap between demand and supply of credit in the formal financial institutions frontier has been challenging (Von, 1991). Banks have been reluctant to provide financial services to the people in the rural areas because of high risks and high transaction costs. This lack of access can create persistent poverty traps and income inequality (Beck et al., 2007; World Bank, 2008).

Microfinance has therefore been considered as one of the most important tools for poverty reduction as its innovative loan contracts have made it possible to extend the small loans to the poor and to increase the loan repayment rate even upto 100% (Armendáriz and Morduch, 2005). But these high repayment rates have not turned into profits. Many of the microfinance institutions are still dependent on subsidies for their survival and are unable to fulfill their ultimate promise of serving the poor in a profitable way (Morduch, 1999). Serving the poor and being financially self-sufficient seems to be contradictory, due to the involvement of high transaction cost, high clients’ turnover and frequency of transactions. A debate regarding the profitability of microfinance institutions, being emerged in 1990s, still remains unsolved. Generally it is argued for self-sufficient microfinance institutions that they should be able to cover their costs from the revenues they generate. As microfinance institutions become financially sound, they would be able to borrow more and more from the commercial market and reduce their dependency on donations and subsidies. This calls for a more commercial approach to microfinance practices. This opens the way for microfinance institutions to have access to a larger asset base to finance their operations and to serve an absolutely large number of poor people (Morduch, 2000; Bruck 2006; Ghosh and Van Tassel 2008). The other side of the debate fears that when microfinance institutions go for commercialization, they will end up serving the
The debate on these two contradictory aspects of microfinance institutions’ practices still remains unsettled, and there is a clear need for representative empirical studies that attempt to identify the patterns of profitability and outreach of microfinance institutions. It is not possible to conclude precisely on outreach and financial performance as mutually exclusive goals. First analysis was performed by Cull (2007) where he explicitly studied the determinants of mission drift with a dataset of over 100 microfinance institutions. Even then, this study does not offer a representative picture of the microfinance industry, as it was based on a special subsample of leading institutions. Mersland and Strom’s work (2010) was an improvement over Cull’s analysis as they worked on panel data analysis, but it, too, suffered from the same lack of representativeness. Thus, it is difficult to presume that outreach is a constraint to sustainability and vice versa (Paxton and Fruman, 1997). India too, has the largest microfinance base in the world. Yet the question remains whether it is a sustainable business model or not? Whether outreach affects the profitability of MFIs or vice versa? How Indian MFIs, which serve the largest number of poor and contribute around 40 percent of the microfinance delivery, are performing financially? To address the above issues, the present study examined a broader question of the contradiction between the financial performance and outreach of microfinance institutions. In particular the study aims at examining:

- The effect of outreach on financial performance of the Indian microfinance institutions.
- The effect of financial performance on the outreach of the Indian microfinance institutions.
As mentioned earlier, microfinance institutions are required to be profitable enough to serve the needs of the poor people without having any dependence on the subsidies. But, attaining profitability is a serious issue as there are a number of factors having impact on the profitability of the microfinance institutions. In this concern, the study aims at finding:

- The impact of different factors on the financial performance of the microfinance institutions.

1.7. **Organization of the Study**

The study is organized into five chapters. These are as follows:

**Chapter I** provides an introduction to the study including the rationale of the present study, statement of the problem, the research questions and their significance.

**Chapter II** reviews the literature and endeavors to build the theoretical background on which the research is based. The concept of microfinance, credit market problems and their solution by microfinance are introduced in this chapter. It presents a detailed view on the performance measurement of microfinance institutions along with it comparison with the benchmarks. Various model for performance evaluation is studied. The chapter also includes discussion on the areas of microfinance institutions’ products and services, impact of microfinance institutions and two different approaches to microfinance. Proponents and disputants of trade-off between sustainability and outreach and the key factors affecting performance and outreach are also the part of this chapter.

**Chapter III** details the research methodology including justification of the choice of the research paradigm and the reasons behind the choice of the research methodology.
It also explains the sampling technique chosen and describes how the data was gathered. It includes methods of analysis of each of the research objective.

**Chapter IV** presents the data analysis and results. It provides the interpretation and discussion of the results of data collected from the microfinance institutions of India.

**Chapter V** concludes the study. It provides the recommendations and implications for practical use of the findings in outreach and financial performance. It also mentions the limitations of the study along with the suggestions for future research.

### 1.8. Summary

The chapter introduces the concept of microfinance, microfinance institutions and a brief description about the history of microfinance. It gives a brief description of the present trends in the microfinance industry in Indian economy. The chapter justifies the selection of studying outreach and financial performance of microfinance institutions in the context of Indian economy. It discusses the research problem. Finally the organization of the study has been presented.