Review of Literature
Chapter 2

Review of Literature

This chapter presents an extensive review of literature on outreach and financial performance of microfinance institutions. The chapter begins with an overview of credit market problems. Different approaches pertaining to contradictions between outreach and performance have been described. Based on the literature, the chapter provides a depiction of constructs and their relationship with one another.

2.1. Introduction to Microfinance

Asian Development Bank (ADB) defines microfinance as the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their micro-enterprises (ADB, 2000; Mwenda and Muuka, 2004). Microfinance encompasses microcredit, micro insurance and micro savings (Roth, 2002). Microfinance is “the provision of financial services to low-income and very poor self-employed people” (Otero, 1999). These financial services generally include savings and credit but can also include other financial services such as insurance and payment services (Ledgerwood, 1999). Microcredit is the lending side of microfinance. It helps the poor to accumulate capital and improve their standard of living by making them involved in income generating activities (Littlefield et al., 2003). However, with the passage of time, increased emphasis have been placed on the importance of offering a range of quality, flexible financial services in response to a wide variety of needs of the poor (Wright, 1999). Schreiner and Colombet (2001) defined microfinance as “an attempt to make small deposits and small loans accessible to poor households neglected by banks.” Therefore, microfinance involves the provision of financial services such as savings, loans and insurance to poor people living in both urban and rural areas, who are unable to obtain such services from the formal financial sector. Robinson (2001),
cited in Ejigu, (2009) defined microfinance as: Microfinance refers to small scale
financial services primarily credit and savings-provided to people who farm or fish or
herd; who operate small enterprises or small business enterprises where goods are
produced, recycled, repaired, or sold; who provide services; who work for wages and
commissions; who gain income from renting out small amounts of land, vehicles,
draft animals, or machinery and tools; and to other individuals and groups at the local
levels of developing countries, both rural and urban. Similarly, CGAP (2003) defines
microfinance as “a credit methodology that employs effective collateral substitutes to
deliver and recover short-term working capital loans to micro entrepreneurs.”

The poor, having no or very little income, cannot offer any collateral as required by
banks, have no credit history, banks are too far away to verify and observe their
behaviour (there is little information) and the loans are generally far too small
compared to the cost of transaction (Dokulilova et al., 2009). Here, Microfinance is
an effective tool for these people. Micro-Finance can be a powerful instrument
initiating a cyclical process of growth and development, leading to poverty
alleviation. Mulunga (2010) in his study about Namibia found that the availability of
microfinance services has impacted positively the lives of the poor.

Microcredit in Bangladesh has encouraged women empowerment by increasing their
contribution to the household income and asset accumulation, which significantly
improved the living standard of the family (Khandker et al., 1998). As per Malegam
committee report (2011) too, Microfinance promotes women entrepreneurship, by
providing loans to the poor women to help them engage in productive activities and
grow their tiny establishments. It gives people the means to fight against poverty.
Microfinance can contribute to solve the problem of inadequate housing and urban
services as an integral part of poverty alleviation programmes (Vetrivel and
Kumarmangalam, 2010).
2.1.1. Credit Market Problems

Financial sector efficiency is often considered as a key factor for economic development. Credit is required for working capital financing and fixed capital investment, to overcome sudden, surprising events such as illnesses and, to smoothen consumption when incomes experience seasonal fluctuations (Ghosh et al., 2000). Thus, financial development affects both the country and the poor by boosting aggregate growth and by changing income distribution in favour of the poorest quintile of the population respectively. But the problem lies with credit markets as they often work inefficiently in poor and rural regions. Here the only source of credit for the poor individuals is from the informal sources such as friends, relatives, and local moneylenders. Moneylenders charge interest rates even up to 75% per annum, and sometimes make credit altogether unavailable. Therefore, such loans are used only coping with emergencies and not for productive purposes (Hoff and Stiglitz, 1990). There are some problems on the part of finance providers also. The problems they face may be due to informational asymmetries, which are further exacerbated in poor-country contexts. This problem with regard to lending arises mainly from the lender’s inability to completely observe the borrower’s characteristics and to correctly appraise the borrower’s project for which the loan is taken. This is specifically difficult for a lender who comes from outside the community (Stiglitz, 1990). Further, the lack of widespread information system and proper documentation also means that the borrowers have no means to prove their credit histories, their identities or their collateral (Besley, 1994).

With the poor clients working in the informal sector, determining the riskiness of potential borrowers and monitoring the actions taken by them is rendered difficult (Morduch, 2000). Poor countries characterized by the weak legal environment together with the lack of collateral serve to exacerbate the problems even further.
(Armendáriz and Morduch, 2005). The lack of collateral means no right for the lender to recourse in case of a default by borrower. This is one of the major reasons for credit market inefficiencies in poor countries. (Besley, 1994; Ghatak and Guinnane, 1999; Armendáriz and Morduch, 2005). According to Stiglitz (1990), inadequate legal system to enforce contracts is a major hurdle in the development of institutions in developing countries. The borrower may refuse to repay his loan even if his project succeeded, if he knows about the loopholes of the legal system. Besley and Coate (1995) suggest that the incorrect application of the sections the lender can apply make it impossible for him to enforce repayment or seize collateral. In addition, poor infrastructure (Beck et al., 2007a) and smaller loan size (Morduch, 2000; Ghatak and Guinnane, 1999) also affects the supply of financial services by adding to the cost of transaction. Another problem is the low educational level of the clients as many of them are not literate or numerate (Besley, 1994).

2.1.2. Microfinance as a Solution to Credit Market Problems

Despite the severity of above mentioned problems, microfinance has developed in developing countries around the world. It is noteworthy that microfinance mechanisms enable the lender to cope with the problems of legal environment, poor information, low educational level of the clients and the lack of collateral even though it does not receive any more information about the borrowers, and the other problems remain as it is. There is by now a vast literature on microfinance and the solution it provides to the credit markets problems of poor countries. Out of them, one is the group lending method that is probably the most famous of the lending innovations provided by the microfinance, and its importance should not be understated. But there are several other mechanisms that are employed by successful microfinance institutions in their lending operations.
Stiglitz (1990) did the pioneering work on peer monitoring in group lending, and his work was followed by several authors (Besley and Coate, 1995; Conning, 1999; Ghatak and Guinnane, 1999; Armendáriz and Gollier, 2000; Laffont and Rey, 2003). Many institutions are using individual lending method instead of group lending. Armendáriz and Morduch (2005) also emphasized the importance of other microfinance mechanisms in addition to group lending. In a typical group lending contract, people who know each other and don’t have any collateral, form a group in order to obtain a loan. Each member of the group obtains his/her individual loan, but gives guarantee for a loan jointly. If one member of the group defaults on his loan, each of the other members pays an equal portion of it to the lender. The joint liability in the group lending system “affects group formation, induces group members to influence the way other members select their projects, helps the lender avoid costly audits, and encourages borrowers to repay their loans without the lender imposing costly sanctions” (Ghatak and Guinnane, 1999). The group members’ liability works as collateral and even more important than collateral is the incentive, the members have to monitor the other members (peer monitoring) and the threat of social sanctions the other members are able to exert on the defaulting member (Besley and Coate, 1995; Stiglitz, 1990).

Like other methods, the group lending method is not without its drawbacks like the group might decide to collude against the borrower and together default on their loan, or an individual member can be allured to declare default because the other members will then repay for his part (Besley and Coate, 1995; Laffont and Rey, 2003). Group lending has also proved unsuitable for wealthier borrowers. As a result of this, many renowned institutions such as Grameen Bank in Bangladesh and BancoSol in Bolivia started offering individual loan contracts to their better-off clients. ACCION International network programs also started to turn towards individual lending
(Armendáriz and Morduch, 2000). Some borrowers might prefer independence to the security provided by the group and don’t want to be obligated to others.

Though group contracts are preferred when borrowers are very poor and the effect of monitoring dominates. But above some level of wealth, the borrowers prefer individual loans as the effect of risk imposed by joint liability dominates the effect of monitoring. Distance barrier makes it costly to attend group meetings and to do peer monitoring (Armendáriz and Morduch, 2005) and then this cost imposes risk on the borrowers (Madajewicz, 2004). Some other shortcomings of group lending method are cited by Rai and Sjostrom (2004) in their work. As individual lending contract is short of the incentive effects of group lending, some individual lending contracts require the borrowers to pledge collateral, but many use other innovative mechanisms to ensure payment of their loan. For example, staff members in some cases visit applicants’ businesses and homes to acquire information instead of just relying on business documents. Local knowledge can be exploited by requiring loan applicants to obtain a witness from a member of the local community. Some programs, such the Association for Social Advancement (ASA) in Bangladesh, have altogether abandoned the joint liability method, but still meet with clients in public group meetings, this way take advantage of the threat of social stigma (Armendáriz and Morduch, 2005). Madajewicz (2004) solved this dwindling situation between group lending and individual lending by concluding that borrowers may be benefitted when the lender offers small group loans for the poorest borrowers and larger individual contracts for the wealthier ones.

Besides joint liability contracts, some other repayment incentive mechanisms have been developed in order to fine tune loan contracts to meet the specific needs of the area of operation (such as sparsely populated rural areas) or the clients (e.g. mature, wealthier clients). These mechanisms comprise of regular and public repayments, dynamic incentives (the promise of future loans for diligent repayers), targeting
women as clients and collateral substitutes (e.g., forced savings or pledging personally valuable items as collateral). In addition, some microfinance institutions provide additional services such as direct food aid or educational services to the clients in order to improve the abilities of the borrowers, thus improving their repayment abilities as well. Armendáriz and Morduch (2005) have extensively described these kinds of innovative loan contract beyond group lending system.

2.1.3. The Ultimate Promise of Microfinance

The credit market problems described above illustrate the reasons for the exclusion of the poor from credit. As credit services could have important income generating effects for the poor, there is clearly a need for improvements in financial markets to suit the needs of poorer borrowers. In many cases, this has been read as a justification for market intervention by the state, and at the central level, considered as a poverty alleviation strategy through subsidized credit in many developing countries from the early 1950s through the 1980s. These measures resulted in loan repayment rates below 50%, huge subsidies costs to the governments, and also the diversion of credit away from the intended recipients to politically powerful non-poor groups (Morduch, 1999). Stiglitz (1990) suggested that “although governments have recognized the problem, they have paid insufficient attention to its root causes. If informational problems are the barrier to the development of an effective capital market, then there is no reason to presume that governmental lending agencies will be in a superior position to address these problems.” Microfinance achieved success in this, and it increased the repayment rates of several renowned programs upto 95 percent. Microfinance has provided a promising way to provide financial services to the financially excluded people through a market-based solution. Thus, the ultimate promise of microfinance has been large-scale poverty reduction through sustainable institutions (Morduch, 1999; Cull et al., 2007).
2.2. **Best Practices in Microfinance Institution Management**

This section describes the concept of best practices for microfinance institutions. The term *best* practice is used in a general framework, and best practices vary and change continuously as the microfinance fields mature (Dunford, 2000). Due to the nature of MFIs’ clientele and the changing environments in which MFIs operate, best practices must be adjustable as per the requirement of the specific area in which the institution operates. A study by Bhatt and Tang (2001a) highlights the importance of research to develop sound practices of MFI design and management. Bhatt and Tang (2001c) discussed MFI technologies, vehicles, and performance assessments and concluded that the future success of microfinance will depend on MFI design tailored to the specific needs of the clients.

The primary topics covered within the context of MFIs’ best practice literature include the determination of an optimal interest-rate to charge borrowers, commercialization of MFIs, whether to lend to groups or to individuals, credit scoring, aspects of loan size and growth, and lending relationships with customers. For the setting of interest rates in a for-profit financial institution, the criterion of shareholder wealth maximization is used for the determination of interest rates. However, MFIs face unique issues in setting an appropriate rate of interest. If MFIs charge rates that are too high, they may hinder their ability to help the poor in pulling themselves out of poverty. Excessive interest rates may also lead to MFIs’ losses, as borrowers cannot pay and thus lead to the default on loans, and, in the case of group lending, they would bog down their solidarity groups. On the other hand, due to the involvement of small principal amount with microcredit, it is difficult to cover fixed costs because of the existence of diseconomies of scale in the lending process. Moreover, MFIs operate with very high administrative costs per dollar lent relative to formal financial institutions. Thus, to achieve financial self-sufficiency, MFIs have to
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charge comparatively high interest rates. Conning (1999) constructs a theoretical model for the contract design problem facing MFIs that want to maximize welfare impact and simultaneously achieve financial self-sufficiency. Using data from 72 MFIs, Conning concluded that sustainable MFIs that target poorer borrowers can have higher staff costs, charge higher interest rates, and be less leveraged than those targeting less poor borrowers. In contrast, Hollis and Sweetman (1998) analyzed mid-19th century Irish loan funds and found that MFIs were able to lend to the poor at competitive interest rates without depending on subsidies. These Irish MFIs combated enforcement and informational problems while operating at a surplus in the market that formal sector banks would not serve. Indirect evidence where the poor may not mind paying high interest rates can be drawn from Perry’s (2002) work where MFIs’ clients borrow funds to become moneylenders, presumably successfully lending at rates higher than their MFI’s charges. The poor who are unable to have MFI membership are thus willing to pay rates higher than that charged by the MFI. Robinson (1996) also argues that interest rates charged from microfinance borrowers should cover all costs and that the working poor can afford these rates which are relatively low as compared to other alternatives. Last but not the least, Fafchamps (1997) used simulation methodology to show that in India, interest rate subsidizations have little impact on the poor people investment in non-divisible and irreversible profitable projects.

The choice between offering group loans or individual loans is another main issue explored in detail in the existing MFIs’ best practice literature. An MFI often relies on social collateral within loan groups to secure their loans (Woolcock, 2001). Gomez and Santor’s (2001) study provide empirical evidence of the importance of social collateral. They conducted an empirical study with 612 group borrowers and 52 individual borrowers in Canada, and in their study, they reported that group lending and the presence of neighbours keeps a positive correlation with self-employment
earnings. It states that borrowers with higher earnings will not face any difficulty in servicing their microloans. Bhatt and Tang (2001a) discussed group lending under the frameworks of incomplete transactions cost theory and information theory. Based on their research, they offered recommendations for setting-up and managing an MFI. The issue of group-lending design is also addressed by Woolcock (1999). Analyzing five cases of MFI failures in Bangladesh, Ireland, and India, he concluded that group performance depends on MFIs’ cost structures, lending policies, nature and extent of social relations among group members, and the MFIs’ staff. Although, bulk of microloans are made with the group lending mechanism, yet individual lending is significant in some areas and is gaining popularity. Armendáriz and Morduch (2000) considered microfinance beyond group lending in context of Eastern Europe, Russia, and China. They described the mechanisms of regular repayment schedules, direct monitoring, and the use of non-refinancing threats to allow MFIs to successfully penetrate new segments of credit markets.

An MFI with sound management practices is getting importance day by day. Milgram (2001) presented the case of a Philippines MFI that attempted to achieve self-sufficiency too quickly, resulting in targeting not-so-poor people already running their operating businesses. She argued that the MFI's hurry to become self-sufficient forced it to betray from its original mission of targeting the very poor and facilitating the creation of microenterprises. Bhatt and Tang (2001b, 2002)'s study focused on the importance of social, administrative and financial intermediation on the determinants of repayment rates in US microenterprise programs. Park and Ren (2001) showed contrast implications of microfinance services provided by non-government MFIs versus the Chinese government. Their test indicated that non-government microfinance showed positive results in client targeting, sustainability, and impact assessment in comparison to the government programs. The data supported the notion
that efficient management of an MFI contributes significantly to accomplish microfinance objectives.

In articles that address more specific areas of loan structure, Schreiner (2001) and Painter and MkNelly (1999) analysed factors that drive loan size and loan growth respectively. Painter and MkNelly showed that these factors vary across loan cycles. Schreiner identified seven aspects of loan size and their impact on MFIs’ depth of outreach and profitability. Churchill (2000), Schreiner (2000), and Norell (2001) all addressed attempts to incorporate existing banking practices into MFIs. Churchill discussed the impact of customer loyalty, similar to the relationship lending literature in mainline finance (e.g., Petersen and Rajan, 1994; Berger and Udell, 1995; Cole, 1998) concluded that customer loyalty is key to MFIs’ success. Schreiner discussed the role of credit scoring in MFIs and argued that scoring can add value to the MFIs’ process. Norell discussed techniques that MFIs can use to reduce arrears, which include following-up quickly on loans in arrears, forming strong solidarity groups, updating and enforcing credit policies, and concentrating on the scope of lending. Woller (2002) reviewed the costs and benefits of MFIs’ commercialization and its impact on mission drift. He concluded that the benefits of commercialization outweigh the costs, but recommends that MFIs should remain poverty alleviation focused.

2.3. Measurement of the Performance of Microfinance Institutions

The main objective of microfinance is to improve the standard of living of the poor and bring them out of poverty. Yadagiri and Gangadhar (2008) stated that microfinance has become a significant poverty alleviation program as it provides the necessary capital to the poor for starting their own ventures. To carry out this objective, a microfinance institution needs to perform well. Performance measurement of a microfinance institution is about examining its progress and
determining whether the goals of microfinance have been met. However, according to Schreiner (1996), the performance of microfinance differs as par the perspective of the borrowers, society, donors, the microfinance institution’s staff and investors.

On the basis of the Consultative Group to Assist the Poor (CGAP) guidelines, five core areas are needed to be taken into consideration when measuring the performance of microfinance institutions: (i) Outreach, (How many clients are being served?); (ii) Client poverty level (How poor are the clients?); (iii) Collection Performance (How effective is the microfinance institution in collecting its loan?); (IV) Financial sustainability (Is the microfinance institution profitable enough to maintain and expand its services without continued support from subsidized donor funds?); (v) Efficiency (How well does the microfinance institution control its administrative costs?) (CGAP, 2007). Rosenberg (2009) used five parameters to gauge the performance of MFIs. These are: outreach (breadth), outreach (depth), loan repayment, financial sustainability (profitability) and efficiency.

For evaluating the performance of microfinance institutions, Meyer (2002) suggests that microfinance institutions must be evaluated on the basis of their objectives. He has mentioned “Critical Microfinance Triangle” consisting of: outreach to the poor, financial sustainability and welfare impact. However, there is a trade-off in meeting the objectives of reaching the poorest and achieving financial sustainability, and, at the same time, ensuring a positive impact on the borrowers. Some studies focused on both financial performance and outreach for measuring the performance of microfinance institutions. (Cull et al., 2007; Kereta, 2007; Park and Ren, 2001)

2.3.1. Measuring Outreach

Outreach means the number of poor served, including the number of women clients. How well does a microfinance institution reach the poorest and the variety of
financial services, it makes available, also explains the outreach. Outreach is defined as the ability of an MFI to provide high quality financial services to a large number of clients (Martin and Frederic, 1999). Outreach is “a social benefit of microfinance” aiming at improving the well-being of the poor (Schreiner, 2002). Depth of outreach is the value that society attaches to the net gain of a given client (Schreiner, 2002) or "the value the society attaches to the net gain from the use of the micro credit services by a given borrower," (Navajas et al. 2000). The loan size is usually taken as a proxy for the depth of outreach (Bhatt and Tang, 2001a; Cull et al., 2007; Schreiner, 2002; Lensink et al., 2008). The assumption is that the smaller the loan size, the deeper the outreach, or the poorer the client; the smaller the amounts or shorter times, indicate better depth. Accordingly, it is believed that poorest clients are served if the majorities are female and the average loan size is smaller (Bhatt and Tang, 2001a). An alternative proxy to the depth of outreach of microfinance is the percentage of women borrowers. The SPTF report (2009) cited by Zerai and Rani (2012) also showed that women outreach is considered an important indicator in the various social performance measurement and assessment tools used.

Breadth of outreach simply involves the number of poor people served by an MFI and is measured as the total number of active borrowers. It can also be assessed in relation to the increase in branch network and staff hired over time. Breadth of outreach is the number of users or the number of credit clients (Schreiner, 2002). Meyer (2002) defined outreach as a multidimensional concept. He mentioned different dimensions of outreach measurement like the number of people now served that were previously denied access to formal financial services, number of women served, depth of poverty and the variety of financial services provided.

Similarly, Navajas et al. (2000) indicated six aspects of measuring outreach: worth to users, depth, breadth, cost to users, length and scope. This measure is to identify the poor clients as the poor are the ones who fail to get access to credit from
formal financial institutions since they fail to prove that they can pay back their loan (Conning, 1997). Worth of outreach to users refers to "how much a borrower is willing to pay for a loan,"(Navajas et al., 2000). Similarly, "cost of a loan to a borrower, is referred as cost of outreach to user" (Navajas et al., 2000). These costs to the users might consist of prices like rate of interest and various charges that they have to make such as loan related transaction costs like transport, expenses on documents, food, taxes, etc. (Navajas et al., 2000). Time frame in which a microfinance institution produces loans is known as length of outreach," and "scope of outreach is the number of type of financial contracts offered by a microfinance organization," (Navajas et al., 2000). It is argued that length of a loan matters, because if the microfinance institutions support the poor only in the short run it will hamper their growth in the long run. If a microfinance institution’s client knows that he/she will not receive additional loan in the future, it discourages them repay their existing loan (Navajas et al., 2000). Meyer (2002), also, noted that the poor needed to have access to financial services on long-term basis rather than just a onetime financial support. Bitye (1997) analyzed the outreach through the value of loans disbursed and number of clients served and concluded a decline in outreach. Hermes et al. (2008) suggested average loan balance per borrower (ALB); percent loans below US$300; percent woman borrowers (WOMAN); Average savings balance per saver (US) (ASB); percent clients below poverty Line; percent clients in bottom half of the population, as the outreach indicators.

2.3.2. **Measuring Financial Performance**

Financial performance analysis is used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. According to Schreiner (1996), financial viability helps an MFI in better resource
mobilization. Assessment of MFIs’ financial performance also helps to assess whether they are financially sustainable or not (Kereta, 2007).

Financial sustainability stands for the degree that an institution is capable of generating sufficient revenue from the offered services to meet full operating costs. According to Foster et al. (2003) and Meyer (2002), there are two levels of financial sustainability: operational self-sustainability and financial self-sustainability. Operational self-sustainability is the sufficiency of an institution to cover its operational costs like salaries, supplies, loan losses, and other administrative costs from its operating income. And financial self-sustainability (which he referred as high standard measure) is its ability to cover the cost of funds and other forms of subsidies received when they are valued at market prices. As per the MIX market definition, the term Financial Self Sustainability (FSS) is defined as having an operational sustainability level of 110% or more, while Operational Self Sustainability (OSS) is defined as having an operational self-sufficiency level of 100% or more. However, "measuring financial viability requires that MFIs maintain good financial accounts and follow recognized accounting principles and standards that provide full transparency for income, expenses, loan recovery, and potential losses" (Meyer, 2002).

The first level of financial sustainability is achieved when “the organization earns sufficient income from its own earned revenue sources to cover all administrative or operational expenses but relies wholly or partially on subsidized capital base” (Forster et al., 2003). A commonly used indicator is the operational sufficiency index.

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\text{Operational self-sufficiency} = \frac{\text{Total operating income}}{\text{Total operating expenses}} \text{ (including administrative expenses, interest expenses, and loan loss provision)}
\]
The second level of financial sustainability is achieved when the organization earns sufficient income not only to cover all its operational expenses but also covers the cost of inflation, its loan losses and the market cost of funds. In other words, at this level of sustainability, an organization earns positive net income independently of donor support and can offer positive returns to its investors (Forster et al., 2003). A commonly used indicator, accounting for institutional scale, is the adjusted return on assets.

**Adjusted return on assets (equities) = Net operating income (adjusted / net of taxes, inflation and subsidies)/ average total assets**

Sarma and Borbora (2011) measured the sustainability of MFIs by using the indicators like Financial Self Sustainability (FSS), Subsidy Dependence Ratio (SDR), Subsidy Dependence Index (SDI). Sustainability is also measured by return on assets and return on equity. The return on assets (ROA) ratio indicates how well an MFI is using the institution’s total assets to generate returns. Studies such as Olivares-Polanco (2004) and Cull et al. (2007) have used return on assets for measuring sustainability or profitability. There are various indicators to analyse the financial performance like provision expense ratio, portfolio at risk, operating expense ratio, write-off ratio, risk coverage ratio, cost per client, credit officer productivity, personnel productivity, funding expense ratio, cost of funds ratio and loan loss reserves (Cull et al., 2007; Nieto et al., 2004; Tucker, 2001). A study by Aggarwal and Sinha (2010) discussed different dimensions to analyse the financial performance of various microfinance institutions and concluded that the difference in MFIs performance is due to the adoption of different business models. Crombrugghe et al. (2007) suggested that a better targeting of the interest rate policy or increasing the number of borrowers per field officer especially in collective delivery models could lead to the performance improvement. Khandker et al. (1995) pointed out the loan
repayment (measured by default rate) as another indicator for measuring financial sustainability of MFIs; because, low default rate helps to realize future lending. Operational cost and portfolio yield are the important variables to measure the financial performance (Christen, 2000).

A workshop report (2006) on Micro insurance suggested different ratios like net income ratio, incurred expense ratio, incurred claims ratio, renewal rate ratio, solvency ratio, promptness of claims settlements, claims rejection ratio, growth ratio, coverage ratio and liquidity ratio to measure the financial performance of micro insurance practitioners. Sarma and Borbara (2009) measured the sustainability by using the ratios like Subsidy Dependence Index (SDI) and Subsidy Dependence Ratio (SDR). A few experts are of the view that financial performance can be analysed from different angles like sustainability / profitability; assets / liability management; portfolio quality; efficiency / productivity (CGAP, 2003). Similarly, Ledgerwood (1999) stated the following parameters for measurement of MFIs’ financial performance: portfolio quality indicators, productivity and efficiency ratios, financial viability indicators, profitability indicators and leverage and capital adequacy ratios.

2.3.3. Welfare Impact

The measurement of the welfare impact of the services of microfinance institutions on the borrowers is essential in determining the success of microfinance programs. A report given by World Bank (2001) view poverty as lack of money, lack of adequate food, shelter, education and health resulting in the vulnerability of the poor to ill health, economic dislocation and natural disaster. According to Meyer (2002) this perspective of poverty can be used to assess the impact of the MFIs on their beneficiaries.
Hermes et al. (2009) concluded a positive relationship between MFIs’ efficiency and domestic financial development. A study by McKernan (1996) conducted in the context of Bangladesh stated that program participation can positively influence the self-employment profits. Similarly, program credit has a significant impact on the welfare of poor households, especially when it is targeted to women clients (Pitt and Khandker, 1998). Seven other studies in Bangladesh done by (Schuler and Hashemi, 1994; Hashemi et al., 1996; Goetz and Gupta, 1996; Schuler et al., 1997; Schuler et al., 1998; Steele et al., 2001) focused on the aspect of female empowerment. It was found that participation in microfinance program has a statistically significant impact on one or more aspects of female empowerment, such as contraceptive usage or intra household decision-making. The sole Bangladeshi impact study failing to find significant impact is done by Goetz and Gupta (1996) who found that significant portions of the women’s loans were administered by male relatives, thereby limiting the women’s ability to develop meaningful control over their investment activities. However, they found no clear evidence of the impact of microfinance in poverty reduction and women empowerment, as assumed by the PRONAFIM programs (Gonzalez-Vega, 1998; Armendariz and Morduch, 2005). Schreiner (1999) and Bhatt (1999) support the view that microfinance may not be an effective poverty alleviation tool in the US. Schreiner analyzed US micro enterprise programs and found that some programs can move some people from welfare to self-employment, but it only works one percent of the time. Meyer (2002) also mentioned the assessment of impact of the MFIs on their clients as a very difficult and controversial way of evaluating the institutions’ performance.

Many researchers measured the performance of microfinance institutions on the basis of welfare impact on the borrowers (business, household and individual); for example, Bolnick and Nelson (1990) in Indonesia, Barnes et al. (1999) in Uganda, Coleman (1999) in Thailand, Wydick (1999a; 1999b, 2002) and Kevane and Wydick...

Bolnick and Nelson (1990) found that MFI participation has a positive impact on enterprises that were typically small, labor intensive and growing, although the impact was far from uniform across sectors and target variables. Copestake et al. (2001) found that borrowers who were able to obtain two loans, experienced high growth in profits and household income compared to a control sample, but borrowers who never qualified for the second loan were actually worse off due to MFI collection mechanisms. Wydick (1999a) found that upward class structure mobility increases significantly with access to credit. Using the same Guatemala data set in a subsequent study (2002), Wydick also found that rapid gains in job creation after initial credit access were followed by prolonged periods of stagnant job creation. Dunn (2001) found that program clients’ enterprises performed better than non-client enterprises in terms of profits, fixed assets, and employment. Finally, Anderson et al. (2002) analysed 147 MFIs and found that microfinance participation increased environmental awareness and common pool resource stewardship.

In Bangladesh, Khandker et al. (1998) found that program participation has positive impact on household income, production, and employment, particularly in the rural non-farm sector, and that the growth in self-employment was achieved at the expense of wage employment, which implies an increase in rural wages. Woller and Parsons (2002) estimated that a microfinance program in Portoviejo, Ecuador contributed $480,000 per year in direct and induced economic benefits to the local economy. Other impact studies address trade-offs that need to be considered when performing
microfinance impact assessments. Mosely and Hulme (1998) studied 13 MFIs in seven countries (Bolivia, Indonesia, Bangladesh, Sri Lanka, Kenya, India, and Malawi) and constructed an "impact frontier" describing the inverse relationship between outreach (depth of poverty reached) and impact.

2.3.4. Comparison with Benchmarks

An attempt can be made to compare the performance of the MFIs with the industry benchmarks. Comparison with benchmarks can alert management and those who fund MFIs about how well or poorly an MFI is performing. By revealing weaknesses, benchmark measure can be used as a guide to focus resources and upgrade management practices. In a study done by Ejigu (2009), he analyzed that the MFIs are poor performers on depth of outreach, ratio of GGLP to assets and not using their debt capacity properly. In context of outreach, he found that institutions are good at breadth of outreach, in managing the cost management and charge low interest rates.

Aggarwal and Sinha (2010) concluded that there exists a similarity between the firms’ performance in the areas like risk coverage, debt equity ratio, productivity, cost per borrower, operational self-sufficiency etc. Bassem (2008), through the use of non-parametric DEA, found that the eight MFIs were relatively efficient and had a notable level of average efficiency. Lindsay (2010) concluded that legal status of an MFI determines its effectiveness. Further, he found that non-profit institutions are most effective in fulfilling the purpose, they intend to fulfill. Tucker (2001) found that commercial banks and the non-regulated MFIs’ performance exceeded the performance of regulated MFIs in terms of growth in assets, growth in portfolio, and growth in equity. In context of outreach, Mersland and Strom (2009a) found that average loan has neither increased over the time nor there is a tendency towards more individual loans and higher proportions of lending to the rural customers.
Lafourcade et al. (2006) found that MFIs in Africa are dynamic and perform favourably as compared with their counterparts in other global regions. Mersland and Strom (2007) recommended the change in board structure to improve the overall financial performance. He suggested the changes like splitting the roles of chief executive officer (CEO) and chairman, having a woman chief executive officer (CEO), and granting the loans to individuals. In case of outreach, he assessed that outreach increased with the higher group lending. Thus, it can be inferred that his opinion in context of financial performance and outreach is contrasting as one focused on individual and other on the group lending. MFIs in South Asia and Middle East and North Africa tend to be less efficient than the others (Nawaz, 2008). A study revealing non-sustainability of Nepalese MFIs is done by Sharma (2008). Farrington (2000) suggested the measures like an increase in loan officer productivity and improving portfolio quality will help to increase the profitability by the reduction in total administrative and provisioning expenses. On the basis of the existing literature, we expect the outreach and financial performance of microfinance institutions varies significantly, and proposes the following hypotheses:

1. **H1**: There is a difference in the outreach and financial performance of microfinance institutions on the basis of different peer groups.
2. **H1.1**: There is a difference in the outreach and financial performance of microfinance institutions on the basis of their legal status.
3. **H1.2**: There is a difference in the outreach and financial performance of microfinance institutions on the basis of their profit status.
4. **H1.3**: There is a difference in the outreach and financial performance of microfinance institutions on the basis of their regulation.
2.4. **Performance Evaluation Models for MFIs**

During the 1990s, there was an increasing interest on the part of financial institutions in microfinance. As a result, several performance evaluation indicators in the form of different models emerged in relation to different areas of management considered as the most important in evaluating an MFI’s performance. Some evaluation models were accepted in general and have been currently adopted by institutions to monitor and evaluate the business performance. Each of these models focused on specific profiles of analysis. These models contribute to raising the level of informative transparency with regard to the process of credit management of MFIs. **CAMEL Model (1993)** from ACCION International\(^1\) defined capital adequacy, asset quality, management, earnings and liquidity as the performance indicators out of the 21 indicators that are currently utilized by North American banks to evaluate performance, focusing principally on the financial aspects of management. **PEARLS Model (1990)** from the World Council of Credit Unions specified the following indicators for evaluating the performance of credit unions: protection, effective financial structure, asset quality, rate of return and costs, liquidity and the sign of growth.

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\(^1\) ACCION International is a private, non-profit organization providing “micro” loans, business training and other financial services to poor men and women who start their own businesses.
**GIRAFE model (1999) from Planet Rating** is an instrument of qualitative and quantitative evaluation of performance and of the risks borne by the MFI. The qualitative analysis focused on the success of the strategy verifying the quality of management processes and the efficiency of the information system with the objective of guaranteeing the internal control functions. It focused on government and decision making, information and management tool, risk analysis and control, activities and loan portfolio, financing: equity and liability, efficiency and profitability as the performance indicators for MFIs. Similarly, the 8 broad parameters included in the **Microfinance Information Exchange model** are institutional characteristics, financial structure, outreach indicators, macroeconomic indicators, overall financial performance, revenues and expenses, efficiency, risk and liquidity. Women’s World Banking has categorized performance indicators into quantitative and qualitative parameters. The emphasis is here on those MFIs which achieve minimum agreed performance standards and take significant incremental steps to improve their performance.

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2. Planet Rating, headquartered in Paris, France, is a specialised microfinance rating agency offering evaluation and rating services to microfinance institutions (MFIs), using the GIRAFE and the Social Performance methodologies. Planet Rating was created in 1999 as a department of the international NGO PlaNet Finance in order to accompany the tremendous development of microfinance services and bring the transparency that was needed to harness the growth of the sector.

3. MIX Market is a global, web-based, microfinance information platform. It provides information to sector actors and the public at large on microfinance institutions (MFIs) worldwide, public and private funds that invest in microfinance, MFI networks, raters / external evaluators, advisory firms, and governmental and regulatory agencies.
2.5. **Institutionalist and Welfarist Approaches to Microfinance**

There are two schools of thought-welfarists and institutionists for the measurement of performance of MFIs. Welfarists argue that MFIs can achieve sustainability without achieving financial sustainability (Brau and Woller, 2004). Welfarists tend to emphasize poverty alleviation, place relatively greater weight on depth of outreach relative to breadth of outreach and gauge institutional success according to social metrics. This is not to say that breadth of outreach and financial metrics don’t matter. Welfarists feel that these issues are important, but they should not be achieved at the cost of depth of outreach (Brau and Woller, 2004). On the other hand, today when the microfinance industry is ruled by an institutionist paradigm, studies by Morduch (2000) and Woller et al. (1999) stated that an MFI should be able to cover its financing and operating costs with program revenues. Institutionists argue that unless we build sustainable MFIs that are capable of running independent of subsidies, the promise of MFIs, of eradicating world poverty will not be met. They argue that a sustainable MFI helps to expand outreach and reach more poor people. The research work of the rural finance program at the Ohio State University provides conceptual foundations to the institutionist paradigm. Gonzalez-Vega (1994) analyzed that the primary cause of the unsuccessful rural credit agencies established by several less developed countries’ (LDC) governments during the 1960s and 1970s had been the “lack of institutional viability”. Rhyne (1998) considered the two goals of MFIs-financial performance and outreach to be win-win situation, stating that MFIs following the principles of good banking would also be those that alleviate the most poverty. Markowski (2002) as cited by Wrenn (2005) stated that they have a dual mission: a social mission “to provide financial services to large numbers of low-income people to improve their welfare”, and a commercial mission “to provide these financial services in a financially viable manner”. It has been observed that MFIs are not fulfilling their social mission to the extent needed to meet the demands of the
poor for financial services. Simanowitz and Walter (2002) argued that microfinance is a compromise between this social mission and commercial mission. With the greater emphasis on financial and institutional performance, opportunities for maximizing poverty impact and depth of outreach have been compromised. They call for a balancing of social and financial/commercial objectives because the current focus on financial objectives means targeting fewer of those who are in utmost need of the microfinance services. To do this they argued “it is now time to innovate and design services that not only, maintain high standards of financial performance, but also set new standards in poverty impact” (Wrenn, 2005).

The debate between institutionists and welfarists is referred as the “microfinance schism” (Morduch, 2000). Generally it is thought that there exists a trade-off between financial self-sufficiency and depth of outreach (Von Pischke, 1996). But there is much disagreement about the nature, extent, and implications of this trade off. Nonetheless, as suggested by the existing little evidence that those MFIs that have achieved true financial self-sufficiency have also tended to loan to the borrowers, who were either slightly above or slightly below the poverty line in their respective countries (Navajas et al., 2000). These MFIs are able to attain economies of scale by extending larger loans to the marginally poor or non-poor. This limited evidence leads many to think that if financial self-sufficiency is desired, then the very poor will not be benefitted by MFI services. That is, the MFI would not be able to achieve enough depth to reach those who need credit most desperately.

2.6. Trade-off between Sustainability and Outreach?

Microfinance institutions predominantly originated with a mission of “poverty reduction”. However, during the last two decades or more, there has been a major shift in emphasis from the social objective of poverty eradication towards the economic objective of sustainable and market based financial services. Indeed, MFIs
have been increasingly pressurized to adopt more “business” practices and to become more self-sufficient (Ledgerwood, 1999; Morduch, 2000). The shift in emphasis of Microfinance Institutions into viable financial institutions with maintaining greater outreach to the poor has given rise to a debate over trade-off between financial sustainability and outreach to the poor. Different authors have given their opinion either in favour of this trade-off or against the trade-off. However, it is not possible to conclude exactly on outreach and sustainability as mutually exclusive goals.

2.6.1. Proponents of Trade-off between Sustainability and Outreach

The developments and the resulting emphasis on sustainability and efficiency of MFIs may go at the cost of their outreach, because it is argued that the unit transaction costs for small loans to the poor are high as compared to unit costs of larger loans (Hulme and Mosley, 1996). Barry et al. (1996) argued that despite the success of microfinance institutions, only about 2% of world's roughly 500 million small entrepreneurs are estimated to have access to financial services. Also, the financial sustainability of microfinance institutions has come under suspicion. Thus, there may be a trade-off between efficiency and outreach, implying that the shifting focus towards increasing sustainability and efficiency reduces the scope for the more traditional aim of many MFIs, which is, lending to the poor. It is impossible for a microfinance institution to achieve financial sustainability and, at the same time, reach higher numbers of the poorest (Hartarska, 2005; Lianto, 1997; Zeller and Meyer, 2002; Park and Ren, 2001). Hartarska (2005) also stressed that there is no “win-win” situation for microfinance institution between achieving outreach and financial sustainability. The microfinance institution either reaches only the poorest, charges low interest rates and is subsidized or reaches not-so-poor borrower, charges higher interest rates and achieves financial sustainability. In policy circles there has been a hefty debate on this issue between the welfarists and the institutionalists. Related to the issue of trade-off between financial performance and outreach, we find
surprisingly few rigorous testing of the issue. The most comprehensive study done by Ylinen (2010) on 487 MFIs suggested that increased profitability tends to worsen outreach. Further, he concluded that the institutional form and operation method, lending method, cost structure and operational environment determine this trade-off. His viewpoint is supported by Sarma and Borbara (2009); Nawaz (2008), Servin et al. (2011), Christen (2000), Hermes et al. (2008), Ejigu (2009) and Armendariz and Szafarz (2009).

However, Christen (2000) argued that there seems to be no compelling argument that represents this mission drift. Rather, larger loan sizes could simply be the function of different factors, such as choice of strategy, period of entry into the market, or natural evolution of the target group. Further Armendariz and Szafarz (2009) used a model to pin down the situation where profit maximising MFIs can deviate from their mission. They concluded that country specific factors like cost and weightage given by MFIs to the poor, affect their mission. Makame and Murinde (2006) analyzed the trade-off between outreach and sustainability using a balanced panel dataset for 33 MFIs in five East African countries for the period 2000-2005, using different measures of the breadth (number of borrowers) and depth (loan size) of outreach. In their study, they found strong evidence for the trade-off between outreach and sustainability and efficiency. Lensink et al. (2008) studied the trade-off between outreach to the poor and efficiency of microfinance institutions using stochastic frontier analysis (SFA) on a sample of more than 1300 observations, where they found the negative correlation between outreach and efficiency of MFIs and indicate that MFIs can improve their efficiency by focusing less on the poor and/or reduce the percentage of female borrowers. Hermes et al. (2008) even found that efficiency of MFIs is higher if they focus less on the poor and by reducing the percentage of female borrowers. It is a challenge for the microfinance industry to serve the very poor and attain sustainability simultaneously. Gonzalez and Rosenberg (2005) stated the
circumstances in which the two objectives would conflict. First is the existence of potential borrowers who are extremely poor, have no reliable source of income from which a loan repayment can be made, and lack the opportunity (not just the capital) to start a micro business. It would be unprofitable to lend to such kind of people. Secondly, cost to serve the people residing in remote and sparsely populated areas would be extremely high.

Cull et al.’ (2007) study argued that a trade-off emerges between profitability and serving the poorest when disaggregation by lending type is done. Along with it, they found that institutional design and orientation matters importantly in considering trade-offs in microfinance. In support of Cull’s findings, Bassem (2012) recognized the existence of trade-off between financial performance and the depth of outreach (social performance). But, it does not mean that achieving the double bottom line, the ultimate promise of microfinance is impossible although it is difficult to achieve. Though Luzzi and Weber (2006) found that some trade off exists between outreach and sustainability but this is not the case for every year. Navajas et al. (2003) do not directly analyse the existence of the trade-off, but their study may have implications for outreach versus sustainability. They concluded that due to increased competition, MFIs changed their lending technologies and the borrowers on which they focus their activities. On the other hand, outcomes of a study done by Gonzalez (2008) revealed that most MFI are more efficient in pursuing sustainability (performing loan portfolio size) rather than breadth of outreach (no of clients) or haven’t met either goal successfully. Mersland and Strom (2009) showed that an increase in average profit and average cost tends to increase average loan size and the other drift measures. Thus from the study of different literature we expect a contradiction between the simultaneous achievement of the two different goals of social performance and the financial performance.
2.6.2. Disputants of the Trade-off between Sustainability and Outreach

The poorest people can benefit from microfinance from both an economic and social well-being point-of-view, and this can be done without jeopardizing the financial sustainability of the MFI (Morduch and Haley, 2002). An efficient microfinance institution leads to the sound economic development by bringing financially disadvantaged people within the sphere of financial services. A study in this regard is done by Hermes et al. (2009) where they found a positive relationship between MFI efficiency and domestic financial development. Chua and Linato (1996) stated that “Banking with the poor” can be a very profitable option. The key is finding the right combination of factors to meet credit and savings needs. In contrast to this study, the results of the studies done by Kereta (2007); Crombrugghe et al. (2007); Kailthya (2009) found no evidence of trade-off between outreach and financial sustainability, rather positive correlation between the two is found. Kailthya’s results are confirmed by Dacheva (2007) where he found no association between the commercialization factors and loan sizes.

According to Christen et al. (1995), Otero and Rhyne (1994) cited in Meyer (2002): outreach and financial sustainability are complimentary. This is because as the number of clients increases, MFIs enjoys economies of scale and hence reduce costs which help them to become financially sustainable. Crombrugghe et al. (2007), also, analyzed that better targeting of the interest rate policy and increasing the number of borrowers per field officer help the MFIs to improve their financial performance. Haq et al. (2010) found that the non-governmental MFIs particularly under production approach are most efficient in the fulfillment of dual objectives. To attain the dual objectives simultaneously, Conning (1999) suggested that MFIs must charge higher interest rate, have higher staff costs per dollar loaned and make less use of leverage. Bassem (2012) didn’t find a justified mission drift. On the other hand, Kar (2010) in his study regarding the trade-off used a unique panel database containing 4-9 years
observations from 253 MFIs in 69 countries. He found a positive significant association between self-sustainability and the height of outreach, suggesting some extent of vulnerability of mission drift over time for individual–based lenders. However, he concluded that mission-drift phenomenon works differently in different developing regions in the world. It can be concluded that MFIs can achieve their double objectives and fulfill their ultimate promise. On the basis of these studies following hypotheses were established.

5. **H2:** There is a positive impact of financial performance on the social performance of the microfinance institutions.

6. **H3:** There is a positive impact of social performance on the financial performance of the microfinance institutions.

### 2.7. Key Factors Affecting Performance and Outreach

The performance of all the microfinance players is not the same. There are a lot of factors which affect the performance of these players. Some MFIs are performing well on some parameters and others on other ones. There are different studies reporting different factors responsible for the performance difference of Microfinance players.

Ejigu (2009) found that the use of debt financing and the age of the MFIs’ (CGAP, 2009) make firms more efficient and productive. Again, Qayyum and Ahmad’s (2006) study revealed size of the MFI as an important factor in determining both Technical Efficiency (TE) and Pure Technical Efficiency (PTE) levels. Similarly, Mahendra (2008), using regression analysis, concluded that size of MFI is an important factor in the determination of MFIs’ efficiency. In contrast to this, Bassem (2008) found that the size of MFIs had negative effect on their efficiency.
Ruben and Schers (2007) found the membership base, MFI loan size and political constituency as the general critical determinants for performance. Gutierrez-Nieto et al. (2007) found the country effects on efficiency and effects that depend on non-governmental organization (NGO)/non-NGO status of the MFI. A research done by Ylinen (2010) in Uganda concluded that the, non-governmental organizations (NGOs) and group lenders are often the least profitable relative to their other counterparts. Country specific factors like cost and weightage given by MFIs to poor affect the mission of MFI, as assessed by Armendariz and Szafarz (2009) in their study. Martinez-Gonzalez (2008) found average loan size, performing portfolio to assets ratio, scale of operations, ratio of payroll to expenses, age, board structure, for-profit status of MFI, percent of FINAFIM funds as the determinants of difference in efficiency of microfinance institutions.

Hassan and Sanchez (2009) in their study revealed that Technical efficiency is higher for formal MFIs than non-formal MFIs and also, efficiency depends upon the region of the concerned institution. The results of the work done by Kailthya (2009) reported operational efficiency, leverage (risk) and institutional structure as the significant factors affecting the financial performance of microfinance institutions. The study conducted by Hermes et al. (2009) discussed the surprising results saying the type of the loans, an MFI provides, also affects its efficiency. Arsyad (2005) concluded that good performance and sustainability have been very much influenced by the institutional environment. Chua and Linato (1996) found performance to be dependent upon the nature of the organization, internal financial policies and systems and procedures.

Hoque and Muhamamd (2011) held that equity financing and increased use of commercial debt lowers productivity for client-maximizing MFIs because of the lower conversion of savers to borrowers or the yield rate. Chua and Linato (1996) argued that deregulation and very low capital requirement by lending investors have
contributed to the sustainability of pawnshops. MFIs’ transformation into regulated financial institutions doesn’t lead to improved financial results and outreach (Hartarska and Nadolnyak, 2007). Omri and Chkoundali (2011) found the average loan size and the number of outstanding loans per woman as the important factors for the increase in commercial viability of the non-governmental organizations. Oral and Yolalan (1990) linked the profitability of bank branches with their service efficiency. Their viewpoint is supported by Sufian (2006).

Kinde (2012) in his study in context of Ethiopia followed a quantitative research approach using a balanced panel data set of 126 observations from 14 MFIs over the period 2002-2010. His study found that microfinance breadth of outreach, depth of outreach, dependency ratio and cost per borrower affect the financial sustainability of microfinance institutions in Ethiopia. However, the MFIs’ capital structure and staff productivity have insignificant impact on financial sustainability of MFIs in Ethiopia for the study periods. Coleman and Osei (2007) showed the critical role of governance in the performance of MFIs. They also stated that the independence of the board and a clear separation of the positions of a CEO and board chairperson have a positive correlation with both performance measures. Therefore, the study of various literature shows that the effect of different variables on the financial performance is not alike. Some variables affect the performance positively; others in negative directive and the rest affect it not at all. Based on this, following hypothesis is established:

7. **H4: There is no significant correlation between the financial performance and factors affecting the financial performance.**
2.8. **Gap in the Previous Studies**

Having scanned the existing literature, it was evident that no specific study has been conducted on outreach and financial performance of microfinance institutions in Indian context. Even though a study has been conducted on the outreach and financial performance but that was in context of Uganda economy. Research has shown that the performance and outreach of microfinance institutions vary on the basis of their legal status, profit status, regulation and sustainability (Lindsay, 2010; Tucker, 2001; Lafourcade et al., 2006; Nawaz, 2008). With the problems in implementation of the poverty-alleviation and government sponsored schemes by banks and the generation of more NPAs than the other schemes made the rural banking institutions unable to cope with the requirements of the changing rural credit requirements. It also made them helpless to come up with systems and credit / savings instruments as required by the rural clientele (Karmakar, 2008). Under these pathetic and discomforting conditions, that the rural poor were facing, microfinance institutions has come into force as the savior to redeem them from the clutches of the poverty and unemployment. However, the question that how far different micro finance programs have been really benefiting the beneficiaries’ still remains to be answered (Reddy, 2012). There is a dearth of studies pertaining to the analysis of the outreach and financial performance of microfinance institutions to track the extent of their contribution towards poverty reduction and women empowerment. Another major gap in the earlier studies is that there are hardly any studies on the impact of sound financial performance on outreach of MFIs and the impact of greater depth of outreach on financial performance simultaneously. Earlier studies have focused on either the impact of financial performance on the depth of outreach or the impact of depth of outreach on financial performance (Lianto, 1997; Park and Ren, 2001; Zeller and Meyer, 2002; Morduch and Haley, 2002; Kereta, 2007; Crombrugghe et al., 2007). Different studies have stated the different factors affecting the performance of
microfinance institutions. But only a few of them have been conducted in the context of Indian economy and that too was based on studying limited factors affecting the performance.

2.9. Need for the Present Study

To address the above issues the present study intends to check the chances of contradiction between the financial performance and outreach of microfinance institutions. It would help the microfinance institutions to trace out the ways in which they could achieve their dual objective of social and financial performance side by side. This study and its outcome would be a tool for the MFIs to also have a clear view about its current performance and outreach.

It would facilitate decision-making through the identification of improvement areas and motivate the entire institutions towards performance improvement. It would also provide tool to follow up its development, assess progress in achieving profitability and compare to its peers and present itself to potential funders. From a donor or a supporting NGO perspective, it would help to know the performance and the level of outreach of its partner and to better understand the kind of support its partner is asking for. It might also be the tool for investors to amend their portfolio regarding investment in Indian MFIs and to follow-up the MFIs they are investing into. A salient feature of this study is to assess the significance of correlation between the financial performance and the variable affecting the financial performance.

2.10. Summary

The existing literature discusses the various approaches that underpin the explanations of MFIs’ outreach and financial performance. The problems of credit markets and then their solution by microfinance have been presented. Different
models of performance evaluation have been studied. Performance measurement via measuring outreach, financial performance and assessing welfare impact has been done. Different approaches to microfinance together with the views in favour of the trade-off between financial performance and outreach have been presented. The chapter further investigates the major factors affecting the performance of MFI s. After scanning the literature, the major gaps in the study have been depicted, putting forward the need for the study.