Chapter- 1

Introduction

CHAPTER 1

INTRODUCTION

1.1 Background

Growth and social justice have been the basic objectives of the development planning in India. Poverty reduction has been the prime agenda of the successive governments in independent India since the inception of the first five year plan. Lots of efforts have been devoted to the elimination of poverty. Various anti-poverty programmes have been prepared and implemented for the removal of poverty, but all these efforts by the government meted only with partial success[1]. At the beginning of the first five year plan almost half of India's population was living below the poverty line, 80 per cent of which lived in rural areas (GOI, 2001). Though, the absolute poverty in India declined considerably over the years, still large numbers of people are not even able to get certain basic necessities of life.

Poverty is a complex phenomenon. It manifests itself in myriad ways. The poor not only suffers from low income and high unemployment, but also low life expectancy, low levels of literacy and poor health. Rural poverty is even more complex as it is reinforced by social factors. Social and economic factors operate differently in different regions. There have been sustained efforts through Government intervention to deal with poverty. The poverty alleviation efforts in India have adopted a multi-pronged approach to alleviate poverty at the individual level through various anti-poverty programmes. Area development programmes have been introduced at the community and regional level for enabling the poor and enhancing opportunities for the poor in rural areas. To address the compelling needs of time, the existing programmes have been revamped and restructured to make them more people friendly and also trigger the bottom-up initiatives. However, there are evidences to suggest that the present strategy of the various programmes have failed to achieve the desired goals (Narayan, et al. 1988; Gaiha, R. 1990; Ravallion, M. 1991).

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1 The non-poor and poor equally participated in Indian government subsidized credit scheme in the 1980s (Ravallion and Datt, 1995).

Various social, cultural and institutional factors are responsible for the vicious circle of poverty which grip the rural masses. Financial services are the most important inputs for the removal of rural poverty. It is widely recognized that access to financial services can play a critical role in helping poor people widen their economic opportunities, increase their asset base and diminish their vulnerability to external shocks. The role of finance to tackle poverty has been recognized by the government in the early period of independence[2], which prompted the Government to take a series of steps for making banking system more suitable for rural financing. According to committee on financial inclusion (2008)[3]

> *"Access to finance by the poor and vulnerable groups is a prerequisite for poverty reduction and social cohesion. This has to become an integral part of our efforts to promote inclusive growth. In fact, providing access to finance is a form of empowerment of the vulnerable groups. Financial inclusion denotes delivery of financial services at an affordable cost to the vast sections of the disadvantaged and low-income groups. The various financial services include credit, savings, insurance and payments and remittance facilities."*

In past, Government has taken some concrete steps to make the banking system more inclusive. Nationalization of Commercial Banks in late 60's, introduction of Regional Rural Banks, and aggressive efforts to increase the rural bank branches during 70's and 80's are some steps in this direction. Due to these efforts by the Government bank branches in India have grown tremendously over the period. The Government has taken several initiatives to strengthen the institutional rural credit system. The rural branch network of commercial banks has been expanded and certain policy prescriptions imposed in order to ensure greater flow of credit to agriculture and other preferred sectors. The Commercial Banks are required to ensure that 40 per cent of the total credit is provided to the priority sectors out of which 18 per cent in the form of direct finance to agriculture and 25 per cent to priority sector in favour of weaker sections besides maintaining a credit deposit ratio

2 The link between finance and poverty was first articulated in the All India Rural Credit Survey 1951-52 (RBI).

3 GOI in June 2006 constituted a committee to prepare a strategy of financial inclusion. The ten member committee was constituted under the chairmanship of Dr. C. Rangarajan.

of 60 per cent in rural and semi-urban branches. Further, the IRDP introduced in 1979 ensures supply of credit and subsidies to weaker section.

Although these measures have helped in widening the access of rural households to institutional credit, the vast majority of the rural poor have still not been covered. Also, such lending done under the poverty alleviation schemes suffered high repayment defaults and left little sustainable impact on the economic condition of the beneficiaries. Despite vast banking network in the country, a sizable section of the population remains outside the ambit of the formal banking system.

India's formal banking system has not been able to develop sustainable banking services for the poor (IFAD, 2001; Basu & Srivastava, 2005). A recent World Bank- NCAER survey on rural finance indicates that 70 per cent of the rural poor do not have a bank account and 87 per cent have no access to credit from the formal sources. According to RBI over 40 per cent of India's poor do not even have bank accounts. The national sample survey 59th round (2003) estimates reveal a disappointing fact that of the total cultivator households only 27 per cent have received credit from formal sources and 22 per cent from informal sources. The remaining 51 per cent mostly marginal farmers have virtually no access to credit. Formal financial services are not available to poor people because of the high interest rates, collateral requirements, complicated application procedures, and long admissions processing low level of financial literacy (Miki, 2010). Informal sector, moneylenders usually charge excessively high interest rates, tend to undervalue collateral, and often allow racist and/or sexist attitudes to guide lending decisions. The failure of the formal and informal financial sectors to provide affordable credit to the poor is often viewed as one of the main factors that reinforce the vicious circle of economic, social and demographic structures that ultimately cause poverty. Most of the poor in India lack access to the formal financial system and the problem is serious especially in rural areas where most of the poor live. This limits their ability to acquire assets, start businesses, finance emergency needs and insure themselves against illnesses and disasters. The informal alternatives such as family loans, savings or local money lenders are limited in amount, rigidly administered or available only at exorbitant interest rates.

The inadequacy of the formal banking system paves way for the emergence of the microfinance not only in India but worldwide. Microfinance addresses the

problems faced by the formal banking system in serving the poor through some innovative approaches (Armendarize & Morduch, 2010). There has been a surge in interest in microfinance in the recent past, particularly in the context of reaching poor families in a more effective and sustainable way. The availability of financial services allows people to take advantage of opportunities and better utilization of their resources. Microfinance emerges as an effective tool for poverty alleviation. The poor, like the rest of society, need financial products and services to build assets, stabilize consumption and protect themselves against risks. Microfinance serves low-income population excluded from the traditional financial system and seeks to fill this gap and thereby alleviate poverty. Microfinance loans help low-income population in many ways by (1) providing working capital to build businesses (2) infusing credit to smooth cash flows and mitigate irregularity in accessing food, clothing, shelter and education; and (3) cushioning the economic impact of shocks such as illness, theft, or natural disasters. Access to flexible, convenient, and affordable financial services empowers and equips the poor to make their own choices and build their way out of poverty in a sustained and self-determined way. Loans, savings, and insurance help smooth out income fluctuations and maintain consumption levels even during lean periods. The availability of financial services acts as a buffer for sudden emergencies, business risks, seasonal slumps, or events, such as a flood or a death in the family that can push a poor family into destitution (CGAP, 2003)[4]. The increasing role of microfinance in development is due to several key factors (United Nations, 2000):

- The poor need access to resources of which appropriate financial services are a key resource, in order to improve their conditions.
- There is a high demand among the poor for credit and saving services, because provision of these services by the commercial sector is limited.
- The poor can save, repay loans and effectively utilize resources towards income generation, provided that the instruments are appropriate to their needs.

Microfinance is a relatively new concept that has grown exponentially in the last decade as investors, donors, and banks realize the potential for capital that can be made by banking to the poor. In the past it was assumed that poor people were unbankable due to lack of collateral. Grameen Bank in Bangladesh, the first to start

4 CGAP (Consultative Group to Assist the Poor) is consortium of public and private development agencies to expand access to financial services for the poor in developing countries.

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banking to the poor, proved that not only the poor are bankable, but microfinance in the informal sector can be quite profitable. Since then microfinance institutions have sprung up all over the world and reached millions of poor people (Simanowitz & Walter, 2002).

1.2 Microfinance and Poverty

1.2.1 Concept of Microfinance

During recent years microfinance is the most researched area. Still there is no universally accepted definition of microfinance[5]. Various authors and agencies have defined microfinance in different ways. Some of these are given below:

A definition of microfinance provided by Robinson (1998) *"Microfinance refers to small-scale financial services for both credits and deposits — that are provided to people who farm or fish or herd; operate small or microenterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and local groups in developing countries, in both rural and urban areas".*

According to ADB (2000), Microfinance is 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 microenterprises. Microfinance services are provided by three types of sources:

- Formal institutions, such as rural banks and cooperatives;
- Semiformal institutions, such as nongovernment organizations
- Informal sources such as money lenders and shopkeepers.

Institutional microfinance is defined to include microfinance services provided by both formal and semiformal institutions.

Task Force on Supportive Policy and Regulatory Framework[6] for microfinance setup by NABARD defines microfinance as:

5 The terms Microcredit and Microfinance are often used interchangeably, but there are differences between them. Microcredit is a component of Microfinance in that it involves credit to the poor, but microfinance also involves additional non credit financial services such as saving, insurance, pensions and repayment services.

6 In 1998 NABARD setup a high powered task force on supportive policy and regulatory framework for microfinance. Key stakeholders such as GOI, RBI, NABARD, banks and NGOs were represented on the task force. The objective of the task force, inter alia were to suggest a regulatory framework that created an enabling environment for MFIs to improve their operations.

"Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban or urban areas for enabling them to raise their income levels and improve living standards."

The Task Force emphasizes that microfinance will cover not only consumption and production loans, but also include other credit needs such as housing and shelter improvement, while other financial services like savings and insurance are also included under it. Microfinance is very often accompanied by non-financial and other business services like capacity building, forward and backward linkages, etc., provided either by the same or by some other institutions, mainly for enhancing the productivity of credit.

Concept of microfinance is so diverse and evolving that defining it is difficult. Some key characteristics of microfinance (World Bank, 2007) are as follows:

1. Small transactions and minimum balances
2. Loans for entrepreneurial activity
3. Collateral-free loans
4. Group lending
5. Targeting of poor clients
6. Targeting of female clients
7. Simple application processes
8. Provision of services in underserved communities
9. Market-level interest rates

1.2.2 Linkage between Microfinance and Poverty

Theories of development advocate that financial development creates enabling conditions for growth through either a 'supply-leading' (financial development spurs growth) or a 'demand-following' (growth generates demand for financial products) channel. The early literature on the subject focused on the need to develop an extensive financial system that could tap savings and then channel the funds so generated to a wide spectrum of activities (Gurley & Shaw, 1955). The modern development theory perceives the lack of access to finance as a critical factor responsible for persistent income inequality as well as slower growth (Greenwood & Jovanovic, 1990). A large body of empirical literature suggests that developing the financial sector and improving access to finance may accelerate economic growth

along with a reduction in income inequality and poverty (World Bank, 2007; Karlan & Morduch, 2009). Without an inclusive financial system, poor individuals and small enterprises have to rely on their own limited savings and earnings to invest in their education and entrepreneurship to take advantage of growth opportunities (World Bank, 2007). Operational holdings in India are small and marginal and are not economically viable. The condition of poor in nonfarm activities is also precarious. Lack of adequate credit has remained the major constraint in the upliftment of poor (Chavan & Rajkumar, 2002; Vitta, 2003).

The first and foremost objective of microfinance has been outlined to be poverty reduction. It is generally believed that microfinance programmes will raise incomes and broaden financial markets by principally providing credit, among other services, to small scale entrepreneurs (Aghion & Morduch, 2000). Microfinance specifically allows households and enterprises to benefit from financial service in seven distinct but related ways:

1. Facilitating economic transactions: poor people often travel long distances and wait in line to make transactions, which is time-consuming and risky. Microfinancial services can both save time and reduce risk.
2. Managing day-to-day resources: Low-income families can use credit and savings to tap into past or future income, helping them to both take advantage of immediate opportunities or, for example, to survive the annual 'hungry season.'
3. Accessing services that improve quality of life: Financial services give families access to education, healthcare and other necessities that improve quality of life, through such tools as school fee loans, health insurance and home-improvement loans.
4. Protecting against vulnerability: Savings, credit and insurance provide sustainable and low-cost coping strategies. If a household loses a source of income, it might not have to withdraw a child from school, sell a valuable asset, or fall deeper into poverty.
5. Making productivity-enhancing investments: Clients can improve their businesses using credit or savings for investments such as sewing machines, refrigerators or farm tools.

6. Leveraging assets: The poor own assets, but without recognition of the formal sector, they cannot leverage them. Allowing poor households, particularly the women who run them, to borrow against these assets helps them capture the existing financial value, facilitating long-term investments.
7. Building economic citizenship: Financial services foster independence. Microfinance can help clients to grow more self-confident and, with that economic citizenship, to step out and become involved in local government, garnering the respect of their communities.

In terms of classic economic mechanisms, we can think of the direct effects of access to financial services (Matin, et al., 2002) as coming through:

I. The ability of near-poor households, with expected income levels above the poverty line, to insure themselves against a variety of shocks that could bring their consumption levels below the poverty line, whether temporarily or permanently. In addition to directly insulating against income declines, insurance could have the indirect effect of making households sufficiently confident to engage in riskier high yield economic activities, thereby increasing their productivity and mean income. For low income groups, liquid and secure savings media are at least as relevant here as formal insurance products.

II. Access to credit, through which a poor household may acquire capital (physical or human) yielding (in combination with pre-existing resources) a rate of return in excess of the cost of credit and thereby enhancing income.

III. A reduction in the cost of making small payments locally, nationally, and internationally on a secure basis.

ADB (2000) illustrates the connectivity between microfinance services and poverty reduction, as well as the beneficial impact (Table 1.1).

Microfinance is one way of fighting poverty in rural as well as in urban areas. It puts credit, savings, insurance and other basic financial services within the reach of poor people. Through MFIs such as credit unions and some NGOs, poor people can obtain small loans, receive remittances from relatives working abroad and safeguard their savings. Accessing small amounts of credit at reasonable interest rates gives people with the willingness and know-how an opportunity to set up a small business.

Records show that poor people are a good risk, with higher repayment rates than conventional borrowers.

Table 1.1 Financial Services and Their Impact

Financial Service	Results	Impact on poverty
Savings Facilities of MFIs	• More financial savings • Income from savings • Greater capacity for self-investments • Capacity to invest in better technology • Enable consumption smoothening • Enhance ability to face external shocks • Enable purchase of productive assets • Reduce distress selling of assets • Improve allocation of resources • Increase economic growth	• Reduce household vulnerability to risks/ external shocks • Less volatility in household consumption • Greater income • Severity of poverty is reduced • Empowerment • Reduce social exclusion
Credit Facilities	• Enable taking advantage of profitable investment opportunities • Lead to adoption of better technology • Enable expansion of microenterprises • Diversification of economic activities • Enable consumption smoothening • Promote risk taking • Reduce reliance on expensive informal sources • Enhance ability to face external shocks • Improve profitability of investments • Reduce distress selling of assets • Increase economic growth	• Higher income • More diversified income sources • Less volatile income • Less volatility in household consumption • In increase household consumption • Better education for children • Empowerment • Reduce social exclusion
Insurance Services	• More savings in financial assets • Reduce risks and potential losses • Reduce distress selling of assets • Reduce impact of external shocks • Increase investments	• Greater income • Less volatility in consumption • Greater security
Payments/Money Transfer Services	• Facilitate trade and investments	• Greater income • Higher consumption

Microfinance allows poor people to protect, diversify, and increase their sources of income, the essential path out of poverty and hunger. The ability to borrow

a small amount of money to take advantage of a business opportunity, to pay for school fees, or to bridge a cash-flow gap can be a first step in breaking the cycle of poverty. Similarly poor households will use a safe, convenient savings account to accumulate enough cash to buy assets such as inventory for a small business enterprise, to fix a leaky roof, to pay for health care, or to send more children to school. Microfinance also helps safeguard poor households against the extreme vulnerability that characterizes their everyday existence. Loans, savings, and insurance help smooth out income fluctuations and maintain consumption levels even during lean periods. The availability of financial services acts as a buffer for sudden emergencies, business risks, seasonal slumps, or other events- such as a flood or a death in the family- that can push a poor family into destitution.

1.3 Microfinance Models in India

There are two broad approaches for delivering microfinance to the poor clients in India

1. SHG-Bank Linkage programme
2. Microfinance Institutions (MFIs)

1.3.1 SHG-Bank Linkage Programme

Due to the inadequacies of the formal financial system to cater the financial needs of the rural poor, NABARD launched an action research project in 1987 through an NGO called MYRADA. NABARD provided a grant of Rs. 1 million ($22,222) to MYRADA for an R&D programme related to credit groups. Encouraged by the results of field level experiments in group based approach for lending to the poor, NABARD launched a Pilot Project in 1991-92 in partnership with Non-governmental Organisations (NGOs) for promoting and grooming self-help groups (SHGs) of homogeneous members and making savings from existing banks and within the existing legal framework. Steady progress of the pilot project led to the mainstreaming of the SHG-Bank Linkage Programme in 1996 as a normal banking activity of the banks with widespread acceptance. A microfinance scenario in India is dominated by SHG-Bank linkage programme due to its adoption by state owned financial institutions like Commercial Banks, Regional Rural Banks and Cooperative Banks (Singh, 2008). SHG-BLP is the largest microfinance service programme, involving around 5,000 NGOs, and covering about 50 million families

through 3.4 million SHGs (EDA Rural, 2009). According to RBI "A Self-Help Group (SHG) is a registered or unregistered group of micro entrepreneurs having homogenous social and economic background voluntarily, coming together to save small amounts regularly, to mutually agree to contribute to a common fund and to meet their emergency needs on mutual help basis. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment thereof. In fact, peer pressure has been recognized as an effective substitute for collaterals". There are three different methods or models of forming and financing SHGs under SHG-Bank Linkage Programme

1. Model-I: Banks as self-help promoting institutes. Under this model groups are formed by banks and also financed by the banks.
2. Model-II: Under this model group are formed by NGOs and finance by banks.
3. Model-III: NGO forms SHGs and also perform the financial intermediation role as on the lender to SHGs after sourcing loans from Banks.

The second model is most prevalent model of SHG-Bank Linkage Programme in India. Under this model, groups are promoted by self-help group promoting agency (SHPA) and linked to the banks by opening the groups' savings account. The SHPA (an NGO or government agency) promotes the groups, but is not part of its funding chain. SHG-Bank Linkage Model has been actively promoted by NABARD since the early 1990's. This model involves formation of participative groups of 10-20 poor persons, which open a group savings account in banks. They regularly pool small amount of savings and group use these savings to lend member of the group. After around six months group bank gives credit to the group to augment its resources for lending to members (Sinha, 2007). The SHGs are informal voluntary associations of people formed to attain collective goals. People are generally homogeneous with respect to social background, caste or occupations and work together for a common cause to raise and manage their collective savings for the benefit of all the group members.

SHG-Bank Linkage Model Grows tremendously over the period both in terms of number of groups and amounts of loans disbursed and it becomes the largest microfinance model not only in India but in the world. The SHG-Bank Linkage Programme has passed through three main phases. During the pilot testing phase

(1992-1995), a small number of SHGs were organized in different parts of the country to test the efficacy of the linkage concept. Following the success of the pilot phase, the mainstreaming of the concept was undertaken during 1996- 1998. The expansion phase, starting from 1998, has propelled the SHG-BLP to give it the shape of a microfinance movement. According to NABARD in 2007-08 around 45 million clients were being served by this model.

1.3.2 Microfinance Institutions

This second model of microfinance in India is mainly a private sector initiative. Semi-formal institutions that undertake microfinance services as their main activity are referred as microfinance institutions (MFIs). MFIs are an extremely heterogeneous group comprising Non-Banking Finance Companies (NBFC), Societies, Trusts and Cooperatives. They are provided financial support from external donors and apex institutions including the Rashtriya Mahila Kosh (RMK), SIDBI Foundation for Micro Credit and NABARD and employ a variety of ways for credit delivery (Batra, & Sumanjeet 2011). Task Force on Supportive Policy and Regulatory Framework for microfinance (1998) setup by NABARD define MFIs as:

"Microfinance institutions (MFIs) are those which provide thrift, credit and other financial services and products of very small amounts mainly to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards".

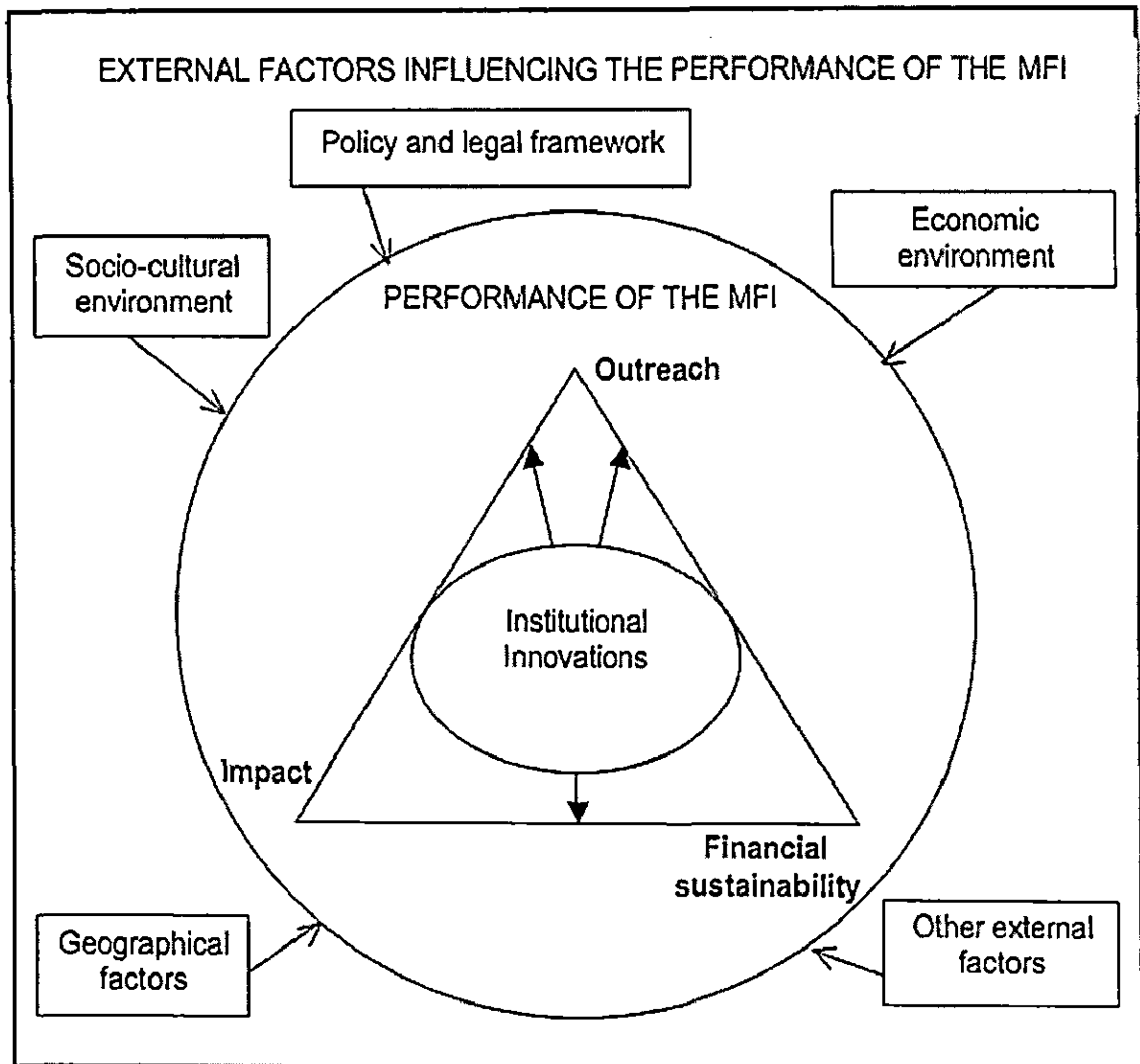
1.4 Statement of the Problem

Three goals are generally pursued by MFIs: outreach to the poor, sustainability of the institution and impact on clients (Zeller & Meyer, 2002). *Outreach* can be distinguished into the breadth and depth of outreach. Breadth is defined as the total number of active clients and is important because demand for credit by the poor is likely to exceed the funds available for lending to the poor (Schreiner, 2002). The objective is therefore to reach as much of the under-served as possible with the given funds. However, a large client base does not necessarily mean that the poorest are served. For that reason it is critical to consider the institutions' depth of outreach, which refers to the poverty level of clients. *Sustainability* relates to the viability of institutions in the future. It is an important criterion for successful MFIs as only permanent institutions can assist future generations and improve the

situation of poor borrowers in the long-term (Woller et al., 1999). Persistence of the MFI is often related to its financial performance. A financially sustainable MFI is independent of donor subsidies. Finally, *the impact* is the sum of all positive and negative changes that take place in the clients' and their families' lives, in their enterprises and in their communities due to the services provided by the MFI. To justify allocation of scarce donor funds, there is a need of strong evidence that MFIs have positive effects on poverty reduction (Navajas et al., 2000).

The concept of microfinance has come to be influenced by two major schools of thought: The Institutionalist School (also known as a financial sustainability approach) and Welfarist School (also known as a poverty lending approach). Though both schools agree that the ultimate goal of microfinance is poverty alleviation, they are of different opinion on how the institutional structure of MFIs should be. Institutionalist school focuses on building financially sustainable MFIs in order to serve poor but Welfarist School pays more attention to the outreach and impact of the programme. Institutionalists advocate "win-win" proposition which suggests that following the principle of good banking MFIs will also serve their mission of poverty alleviation. In their opinion, MFIs should totally discard subsidies, donor funds in order to achieve financial sustainability. Financial sustainability will allow MFIs to extend financial serves to larger population of poor on a long term basis. Welfarists on the other hand believe that commercial orientation will reduce focus on reaching the poorest. Shifting the emphasis toward financial sustainability has raised concerns with respect to the consequences of this shift for the outreach of microfinance, that is, the number (breadth) and socioeconomic level (depth) of the clients that are served by MFIs. As was discussed above proponents of the poverty lending approach claim focusing on financial sustainability goes at the cost of lending to the poor. Lending to poor borrowers can be very costly, which means that outreach and sustainability goals are conflicting (Herms & Lensik, 2011)

Figure1.1. External Factors Influencing the Performance of MFI



Source: Zeller, M. and Meyer, R.L., 2002

The empirical evidences on the impact of microfinance on poverty are mixed. Some impact evaluation studies have found that access to credit by the poor has a large positive effect on living standards. However, other studies have found that poverty is not reduced through microfinance; poor households simply become poorer through the additional burden of debt. Since more money for microfinance in practice means less money for other programmes with similar aims, it is extremely important to carefully evaluate whether or not "small loans for poor people" in fact works.

1.5 Objectives

Specifically, the research sets following objectives:

1. To examine the trends and pattern of microfinance in India.

2. To assess how well the microfinance programme reaches the poor, i.e. the poverty targeting of the Microfinance Institutions.
3. To assess the extent the microfinance reduces poverty of the recipient clients in India, i.e. to measure the impact of microfinance on poverty.
4. To examine the trade-off between financial sustainability and outreach to the poor in India.
5. To suggest policy implications on the design and modification of the microfinance.

In India there is a diversity of approaches to microfinance, involving banks, government agencies and NGOs. This study deals with MFIs who are providing financial services whilst building their own financial sustainability.

1.6 Hypotheses

1. Microfinance does not reach to the poor.
2. Microfinance does not make a significant impact on the poverty.
3. There is no trade-off between financial performance and outreach to the poor.

1.7 Scope and Importance of the Study

It is generally argued that microfinance emerged as one of the most innovative tool for fighting poverty. Such enthusiasm behind microfinance is only due to its holistic objective of poverty reduction. But there is a belief in the academic circle that we still know little about the depth of outreach and the impact of microfinance on poverty. Answering these questions is critical for justifying large scale subsidies and investment of public funds. Answering these questions requires some rigorous quantitative method, as naïve approaches give biased results. Conclusions drawn on the basis of the result of such naïve approaches are generally misleading.

A growing body of evidence suggests that very poor households are excluded from accessing microfinance programmes (Hulme & Mosley, 1996). It is generally believed that extremely poor people are dropping out of credit programmes after having failed to keep up with repayment installments. Some critics also question the efficacy of microcredit in reaching extremely poor people. They argue that, while micro-credit has contributed positively to the wellbeing of poor people in general, it has failed to reach the poorest of the poor. Most microfinance institutions tend to

serve not the poorest of the poor, but rather those near the poverty line. One of the prime reasons behind the failure of the various antipoverty programmes in India is mis-targeting. It has been found that large sections of the poor were not covered under these programmes. Integrated Rural Development Programme (IRDP), the biggest credit delivery programme in the world was also not an exception. So accessing the targeting efficiency of MFIs is of extreme importance as the whole mission of microfinance is directed towards the objective of providing financial services to the lower strata of the society and thereby reducing poverty.

Analysing the targeting efficiency of microfinance institutions is important as the impact of the programme can be diluted if the programme does not reach the intended population. A key objective of microfinance programmes is to provide financial services to poor people who are excluded from such services by the formal banking system. It is in this perspective that governments, development partners and donor agencies continue to provide support to such institutions, to enable them to deepen their outreach.

Large numbers of impact evaluation studies have been carried out in countries like Bangladesh, Pakistan, and Thailand etc. by using rigorous statistical method. There is, however, little research on quantitative evaluation of the micro-credit programme impact. Most of evaluation studies, simply describe the implementation and the output of the programme. Questions on the causal impact of the programme have remained unanswered so far. Information on the quantitative assessment of a programme can be of interest for two main reasons. Firstly, it is very helpful in determining whether the programme should be expanded or terminated. Secondly, the impact assessment can provide useful information for improving the programme. Detailed quantitative assessment, e.g. not only on causal impact but also on poverty targeting, can provide suggestions for modification of the programme. There are only few studies available in India on this particular aspect, despite the tremendous growth of the sector during some past years.

Since 1990s, the commercialization has become the mainstream approach on microfinance practices. It is said that the success of MFIs to serve poor people hinges on their ability to implement sound financial practices, operational efficiency, and profitability. If MFIs cannot cover operational costs, their capital base would soon be depleted, and the sustainability of MFIs to serve the poor will be in a state of doubt

(Nugroho & O'hara, 2008). As mentioned, increased focus toward commercialization may also divert the original mission of MFIs. From a policy making perspective, it is very important to know whether there is a trade-off between sustainability and outreach. Given that there is hardly any solid evidence on the existence of a trade-off, there is much room for expanding our knowledge on this issue (Gulli, 1998; Hermes & Lensik, 2011).

1.8 Database and Methodology

1.8.1 The Data

As the microfinance sector in India is still in infancy, the sources of statistics related to the sector are also scattered. The study is based on secondary data collected from various sources. The main Sources of aggregate level data are MIX MARKET[7], various publications of SADHAN[8] (Bharat Microfinance Report), Publications of NABARD, SIDBI, Microfinance India- State of The Sector Report published by Access Development Services, Annual Reports of Microfinance Institutions, Micro-Credit Ratings International Limited (MCRISIL)[9], Various issues of State of the Microcredit Summit Campaign Report and many other publications by individual researchers and agencies.

First objective requires aggregate (Country) level data of both SHG-Bank Linkage Model and MFIs. Information about the trends and progress of SHG model is collected from various publications of NABARD mainly from various issues of 'Status of Microfinance in India' and Annual Reports. There are two major sources of information of MFIs, viz. Bharat Microfinance Report published by SADHAN and online database of MIX market, which are utilized for the purpose. For accessing the depth of outreach of MFIs and measuring the impact of microfinance on recipient clients the study needs household level information of clients and non-clients. The study uses the survey data collected by EDA for fulfilment of these two objectives.

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7 The MIX Market ™ is a global, web-based (www.mixmarketorg) 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.

8 SADHAN is a voluntary association of MFIs in India.

9 Micro-Credit Ratings International Limited is one of the pioneers of financial performance ratings and the worldwide pioneer of social rating for MFIs. It is the world's leading specialist microfinance rating agency

For understanding the trade-off between financial sustainability and outreach to poor study uses the online database of MIX Market

For assessing impact of microfinance and depth of outreach of MFIs, the study uses household level data (baseline) collected by the EDA rural system for the Small Industries Development Bank of India (SIDBI) as a part of SIDBI's longitudinal impact assessment study in 2002-03. The sample covers 20 microfinance institutions across the States of Andhra Pradesh, Tamil Nadu, Karnataka and Kerala in the Southern India and Uttar Pradesh, Rajasthan in North and Assam and Manipur in the Northern & North-Eastern India. The original Sample provides the cross sectional household level data of 5327 households which includes both clients (3908) and non-clients (1419).

At each MFI, 2-6 clusters (villages or urban areas) were randomly selected from lists representing typical operational areas in terms of rural/urban location, development context, and women/men clients – and having at least 20 clients. All MFI clients within a cluster were surveyed for a client sample size of at least 130 per MFI. The sample covers 83 clusters in nine states: 71 rural clusters, 12 urban clusters. The rural clusters reflect varying market contexts, categorized as accessible, remote and semi-rural/semi-urban. The urban clusters are located mainly in slum areas of cities – smaller cities such as Tirupati and Guntur in the South, and the larger ones such as Kanpur, Jodhpur and Howrah in the North and North-East. The cluster profile is summarized in Table 1.2 below.

Table 1.2: Sample Clusters – by Region and Market Context

Region	States	Districts	Clusters	Distribution of Clusters by Market context			
				Rural Accessible	Rural Remote	Semi-Rural/Market Town	Urban/City
Total	9	41	83	50	12	9	12
South	4	25	52	37	6	3	6
North/East	5	16	31	13	6	6	6

A comparison group

At each MFI, non-client households were sampled in the same clusters[10] in a ratio to clients of 1:3. These households are a 'quasi-experimental' comparison group, purposefully selected to match the client sample primarily in terms of wealth rank, and secondarily, as far as possible, in terms of other features (main livelihood, social group).

Matching of wealth rank serves to address to some extent the difficult issue of sample selection bias[11] and self-selection and enables a direct comparison between clients and non-clients of the same wealth rank.

The major source of the data for examining trade-off between financial performance and outreach is the Microfinance Information Exchange Programme (Mix Market). Unbalanced panel of 55 microfinance institutions covering period 2005-2009 is taken for the study[12]. Selection of MFIs is based upon the availability of data. Only those MFIs are selected for the study for which data of at least 3 years is available. For various institutional characteristic variables like credit delivery methods used by MFI, location of MFI etc., study uses other sources like Bharat Microfinance-Quick data as well as annual reports and audited financial statements of various MFIs. 46 observations are missing and hence total observations available for study are 229.

1.8.2 Methodology

The methodology used for three core objectives of the study is as follows:

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10 In theory, non-clients are best selected from a cluster area where there is no microfinance programme, since it is possible that non-clients can be indirectly affected by a programme (positively or negatively). In two MFIs, nonprogrammer clusters were selected for non-client sampling. In the other MFIs, non-clients were sampled in the programme clusters. In general it is difficult to match clusters, and in the south India, especially, where development programmes (NGO or government) are quite widespread it becomes practically impossible to find clusters without some form of microfinance intervention. In fact, it is not always easy to find 'non-client' households entirely without some membership in a savings group. Eleven per cent of the non-client sample (14 per cent of the southern sample) have membership in a group, and 2 per cent have taken a microfinance loan in the previous two years.

11 Selection bias may be introduced into the sample if the 'treatment group' (client households) possesses some intangible attribute (e.g. entrepreneurial ability, greater freedom for women), which makes it not entirely similar to the 'comparison group'. Analysis based on comparison of these two groups will erroneously attribute client impact to the 'treatment' (microcredit) when, in fact, the other attributes may also be responsible for the change. See Mosley (1997) for a detailed discussion on this issue.

12 Data accessed on 10-October-2009.

Depth of Outreach of MFIs

To analyse depth of outreach of MFIs in India, we have used both parametric and non-parametric methods. First Probit model of participation has been estimated by including various wealth rank categories among various other covariates. There are four different wealth rank categories- very poor, poor, borderline and non-poor. By including dummies for last three categories we have tried to explore differential probability of participation of three included categories with respect to base category- very poor. To support finding of parametric analysis and also to check robustness of findings we have also applied non-parametric method (local weighted regression) for estimating probability of participation.

Impact of Microfinance on Poverty

The Impact of any intervention (Microfinance) on target group is the difference between current outcome with the intervention and current outcome without the intervention. In ex-post impact evaluation though the current status of the individual after being treated is known it is impossible to observe the same individual without the intervention at the same point of time. Hence for valid assessment we need to know what would have happened to the individual without intervention. This issue known as counterfactual in literature makes the task of impact assessment a tedious exercise. The problem of evaluation is that while the programme's impact (independent of other factors) can truly be assessed only by comparing actual and counterfactual outcomes, the counterfactual is not observed. So the challenge of an impact assessment is to create a convincing and reasonable comparison group for beneficiaries in light of this missing data. The matching method is a non-parametric approach to the problem of identifying the treatment impact on outcomes. The Propensity score matching method has been applied on cross sectional survey data of control and treatment group for estimating impact of microfinance on participant households.

Trade-off between Financial Performance and Depth of Outreach

To explore the trade-off between financial performance and depth (Poverty) outreach of MFI of India, study adopted panel data regression framework for understanding the relation between financial performance and depth of outreach. The Study relied mainly on Hausman Taylor framework for the fulfilment of this

particular objective. Two different measures of financial performance (Operational self-sufficiency & Return on assets) as well as of depth of outreach (Average Loan Balance per Borrower & Per cent of Women Borrowers) have been used. Although the study relied mainly on the Hausman Taylor model due to the inclusion of time invariant regressors which makes fixed effect model inapplicable, also assumptions underlying random effect model are not fulfilled, other plausible models (pooled OLS, fixed effect & random effect) are also reported to check the sensitivity of the estimated coefficients for different estimation framework.

1.9 Limitations of the Study

1. As mentioned above there are two microfinance models in India viz. SHG-Bank Linkage Programme and Microfinance Institutions. As the Study deals mainly with MFIs, the findings of the study may not be generalized for SHG-Bank Linkage model.
2. There are various levels (client level, household level, Community level, enterprise level etc.) at which impact of microfinance could take place. The study analyses the impact of microfinance at household level.
3. As the primary survey for proper impact assessment is not feasible for individual researcher in terms of time and cost involved, the study relies on secondary data for fulfilment of two major objectives of the study.
4. The Study uses cross sectional data for measuring impact. As the literature suggests that longitudinal and panel data gives more robust results, the findings of the study may have less robustness.
5. For exploring trade-off between depth of outreach and financial sustainability of MFIs the study uses sample of 55 MFIs based on the availability of data over the period 2005-2009. Though, the included sample represents heterogeneity quit well, it is difficult to generalize findings of the study.

1.10 Overview of Chapters

The study has six chapters and it is organized as follows:

Chapter 1 provides background of the study, discusses linkage between microfinance and poverty, a statement of the problem, objectives of the study, hypotheses, importance of the study, data source, methodology and limitations of the study.

Chapter 2 gives a review of literature of past studies keeping objectives of the current study in perspective. By reviewing past literature we have tried to find research gap and develop a proper framework and methodology for this study. The chapter has been divided into three broad sections. First section reviews past studies focused on poverty outreach of microfinance institutions. Second section reviews some selected impact evaluation studies conducted in the past and in the last section, we considered those studies which tried to explore trade-off between financial performance and poverty outreach of MFIs.

Chapter 3 tries to look microfinance sector in India from a macro perspective. In the first part, the role of the formal financial system in serving poor and adequacy of formal finance has been discussed in detail. The next section discusses evolution of microfinance as an alternative financial system. The chapter provides a detailed discussion on two different approaches of microfinance in India viz. SHG-Bank Linkage Programme and Microfinance Institutions.

Chapter 4 analyses depth of outreach of MFIs and impact of microfinance on household poverty by using large survey data at all India level. The first section tries to understand poverty outreach by applying parametric (Probit model for the probability of participation) and non-parametric (local weighted regression) methods on household level data. In the next section propensity score matching method has been applied to quantify impact of microfinance on household poverty. Separate models have been estimated for rural and urban markets and also for various models of microfinance prevalent in India.

Chapter 5 attempts to explore the trade-off between financial performance and poverty outreach of MFIs. Using data of sample of microfinance over the period 2004-09 we tried to apply Hausman Taylor model for panel data set Beside Hausman Taylor model various other possible models have also been applied for the same purpose to check the sensitivity of Hausman Taylor framework.

Chapter 6 concludes findings of the study and suggests some policy implications.