CHAPTER 2

LITERATURE REVIEW AND THEORITICAL UNDERPINNINGS

2.1 REVIEW OF LITERATURE

2.1.1 Microfinance Scenario- General

Microfinance is a Financial Service, which caters financial help to the poor & economically deprived community. These services are provided by MFIs. They adopt an unconventional method of financing by giving small/micro loans with little/no collaterals. It enforces lending and liability as well encourages pre loan savings. Based on the confidence built by the group, the MFIs will gradually increase the loan sizes and guarantee future loans, when the groups have a good track record of repayment.

Microfinance is part of financial inclusion aiming at providing financial services like savings, credit and insurance to the economically and socially deprived community. It helps to improve the livelihood of these segments (Satyajit Roy 2011).

The formal banking sector faced a set of serious problems. They found it very difficult to classify the risk prone customers from all other customers. For the customers’ with high probability of default, the banks would like to charge higher interest than other customers. In addendum, the customers’ effort to make full payment is unknown for the banks. Lack of
bank support for the poor led them to source money from money lenders, neighbours and other sources (Beatriz Armendariz de Aghion et al. 2010).

Microfinance is different from other source of funds. In general, loans are provided against collateral security. However MF focuses on economically deprived community, and as such funding is not based on collateral security. In general the deprived community members are those who are excluded by formal financial institutions. They are marginal farmers, unorganised sector enterprises, landless labourers, slum dwellers, migrants, senior citizens, tribals, women and socially excluded groups (Thorat 2007). Microfinance enables the aforesaid loan availers / clients of MF to engage themselves in productive, sustainable activities. It also aimed at women empowerment as it funded to those who are excluded by the formal financial system to get access to savings, loans, insurance and remittances (Mahendra Dev 2006).

Microcredit is not a new concept by itself; its emergence shoots up from mid 1700’s (Satyajit Roy 2011). But the concept got much popularized in developing nations as the below the poverty line segment is enormous. MFIs took this as an opportunity to fund this untapped segment. Surprisingly the default in payment was much below 5 percent sometimes to the maximum of 10 percent.

India is second largest country in terms of population with more than 1.2 billion people (World Bank report 2012). The population below the poverty line segment is defined as those who earn less than $2/day and the poorest of poor are those who earn less than $1 dollar. The Planning commission of India has defined the poor as mass below the poverty line segment who earn monthly per capital income less than Rs.972 in Rural India and Rs.1407 in Urban India. The poverty ratio has dipped equally in rural and urban areas over a period of time. In rural areas the poverty ratio got dipped
from 39.6 percent (2009-10) to 30.9 percent (2011-12) and in the urban areas the poverty ratio dipped from 35.1 percent (2009-10) to 26.4 percent (2011-12). 91.6 million People, got elevated out of poverty line (Dr.C.Rangarajan Committee, Planning commission, 2014).

After Independence, in Rural India, the landlords funded 90 percent of rural credit requirements. The banks had mere contribution to an extent of 1 percent and this increased to an extent of 2.4 percent only. Since the nationalization of banks during 1969, Indian government insisted commercial banks to provide priority lending. 40 percent total funds lent by commercial banks focused on priority lending which included agriculture and other rural activity. The Integrated Rural Development Programme (IRDP) was implemented to supplement the above objective but they paved way for corruption and didn’t fulfill the aspiration (Rajarshi Ghosh 2005).

North India recorded the highest of accounts maintained by the people with 43 out of every 100 members. The lowest was recorded in north eastern states with only 19 accounts for every 100 members (Situation Assessment Survey 59th round, National Sample Survey Organisation 2003, Basil Hans et al. 2008). In the case of United States, the Federal Deposit Insurance Corporation 2013 reported that, only 7.7% households were left unbanked. It was mainly due to loss of jobs or income. The scenario was similar with UK with 6.8% unbanked (Leeladhar 2005). This shows that there is lack of outreach of Financial Services in India and emphasizes the need for building this system for economic development (Basil Hans et al. 2008).

India being one of the fastest emerging economies has 135 million people (72 percent of its population) under the economically deprived segment who are out of banking orbit (Lokcapital 2010). To supplement, India being a male dominated society, it further lacks credit schemes for rural women (Karmakar 2002). The low income segment ignored / least bothered by
conventional financiers has become the best opportunity for contemporary MFIs (Kurmanalieva Montgomery & Weiss 2003).

The MF system proved to be much efficient as the clients were given advisory services, training and permitted them to incorporate technology in the occupation they were into. It largely helped in poverty alleviation (Momoh 2005). MF is much more sustainable, as it enables the poor to save, do productive job, as well repay their loans in a more effective manner (Lindvert 2006). The membership in MF has helped to reduce vulnerability. It enabled the economically deprived segments not only to have regular uninterrupted consumption, but also to build on their assets & preserve to have safe future (Zaman 1999). The credit had a large impact on consumption expenditure for women borrowers than male borrowers (Pitt & Khander 1998).

The Bangladesh Microcredit programme concentrated on marginal farmers with less than half acres of land and people doing manual labour. The old members had better household asset value, ie., 112 percent higher than the newer members (Mustafa et al.) and the household expenditure was high by 26 percent. Studies show that the MF had positive impact in reducing poverty in India (Little Murduch & Hashemi 2003).

MF’s main objective is poverty reduction. Four strategies were adopted to reduce Poverty. They are to satisfy the economic needs through catering services like education, health, and housing; to satisfy the basic needs like food, shelter and clothing; to promote rural development and to focus on women, youth and physically challenged people’s livelihood and empowerment (Ogwumike 2002). The clients of MF are those who are denied credit under the conventional methods as it includes much of operational cost and default risk.
In India, SHG financing has become part of rural finance (Rajesh Chakrabarthi 2005). These segments were earlier chained by money lenders financing, who exploited them by charging higher interest rates to an extent of 60-100 percent per annum (Lokcapital 2010). Only 20 percent people had access to formal credit sector and the remaining 80 percent manage fund requirements through informal sources like Zamindars, Chit Funds and Money Lenders (Satyajit Roy 2011). The village money lenders are as old as village whereas the Microfinance institutions exist since the last ten years (Vijay Mahajanand Bharti Gupta Ramola 2003). Small Loans exist way back from 1800’s itself (Saxena 2015). As like West Africa’s “tontines” Chit funds existed in India (Krieger. 2006). In 1951-52, the share of private money lenders Vs cooperative banks was 68.6, 7.3 percent respectively (Lalitha 1998). The money lenders were the main source of informal borrowing and they borrowed to meet up family contingencies and social commitments (Basu Priya 2005). In general, rural borrowers borrowed money to meet up short term eventualities. The major reasons why people have accepted money lenders as a major source of funding is that they need to meet up menial conditions like less or no collateral, quick money and no processing time.

The loss making rural banks revised their strategies. With NABARD as their apex body, these banks funded the SHGs. They worked along with the NGO’s skill development activities (Rajesh Chakrabarthi 2005). During 1986, NABARD with MYRADA, an NGO started to spread its services to rural poor, in the areas where the formal banking system kept the things out of purview. The multiple initiatives led by NABARD along with the capacity building led to a change in mindset of conventional lenders too. They observed that the new segment of quality portfolio with low risk has emerged. However, this has to be catered with marginal increase in operating cost (Erhard Kropp et al. 2002). During 1992, NABARD introduced the Self
Help Group bank linkage programme (SHGBLP) on experimental mode. As formal finance didn’t reach the deprived mass especially the rural poor, they had huge scope for microfinance to bridge the gap. Microfinance was clubbing the feature benefits of both formal and informal sources of funds. It actually twinned the quick money with safe and reliable funds to borrowers (Deepak Barman et al. 2009). The pilot project turned to have best results and grew as one of the major initiatives of all times in developing the deprived community. As of 2005, 560 banks got involved in this initiative in a large way (Rajarshi Ghosh 2005).

By 2009 the CAGR of past five years had an appreciable growth record. The growth counted to 86 percent with reference to number of borrowers and 96 percent in terms of portfolio outstanding. Indian MFIs fostered growth with huge profits and strong Return on Assets (RoA) (Lokcapital 2010).

More than half a million SHGs got linked to banks over the years. But the South India accounted to three-fourth of this figure with Andhra Pradesh as a definite leader (Rajesh Chakrabarthi 2005). Andhra could mobilize 80 lakh women in fifteen years. Under NABARD scheme of providing loans to SHGs Andhra benefitted a lot, where it consumed 52 percent of loan disbursement by itself (Marcus Taylor 2011).

India Practices much flexible SHG financing entrepreneurial enthusiasm especially with focus on women have led to risk mitigation mechanism in downtrodden community. (Erhard Kropp et al. 2002). In general, the women clients found to invest their income for good use than men (Ramu Maurya 2011). When well-trained women are given the credit, it led to high productivity in the activities engaged by them. It helped them to get rid of the access to aggressive and costly informal sources of funds (Sylvain Dessy et al. 2006).
In recent times due to exploration of MF business, the intensity and growth of the MF industry became inevitable. The risk grew with the growth of the industry. Competition fueled the intensity of risk. Studies reflected that many a times, the Risk identification and risk monitoring affected the performance of loans offered based on unsecured loans to a greater extent (Gakure et al. 2012). The risk management tools would help the MFI to sustain financial soundness and corporate governance (Ayi Gavriel Ayayi 2011). Weak credit management led to capital erosion and eventual failure. But in turn, a sound and strong credit system provides confident profitability; sustainability as well helped the women in their livelihood and empowerment (Mojisola Oguntoyinbo 2011). Though the industry experienced immense growth, few dissenters viewed it as a bubble (Rozas & Sinha 2010).

World Bank has categorised the credit risk measurement parameters into quantitative and qualitative. ACCION’s CAMEL model learns about Capital adequacy, Asset quality, Management, Earnings and Liquidity. This model had been most widely used risk measurement tool by Banks.

In reality, MFIs which are trying to push the society upwards faces drastic challenges. The operational efficiency and effectiveness had been the key factors influencing the financial performance of the Companies. The researchers have used data envelopment analysis through which they have identified that efficient companies need not be always effective (Chien Ho et al. 2004). Few other studies proved that Return on Assets, Interest Margin and Capital Adequacy had high correlation with customer service quality (Elizabeth Duncan 2004). Many of the studies concentrated more on Asset Liability Management, but more emphasis should be given on nature of risk—return of assets and diversification of the same (Jon Preseley 1992). To have an efficient asset liability management, corporates not only need to maximize
profits but also minimize the risk, but in addendum, have to manage market
perceptions which may affect their asset value during crisis (Arzu Tektas
et al. 2005). Companies with high operating efficiency achieved it through
adoption of various cost reduction techniques like low cost recruitment,
training methods and decentralized branch operations (Radha Rani 2013).

Earlier, factors affecting the financial inclusion had been lower
income and asset holding. In addendum, information barrier, cumbersome
policies and procedures, lack of access to financial products and suitable
products clubbed with lack of financial education also affect the Financial
Inclusion in India (Ramu Maurya 2011).

The massive spread of microfinance institutions has led to serious
effect on Money lenders business. They were compelled to reduce the interest
rate from a range 2-30 percent to 3-5 percent per month on a uniform basis
(Karmakar 1999).

However in recent times, even the Microfinance industry is facing
challenges. The Loan repayment is affected by varied reasons like age of the
client, amount of loan received, income level, number of family members,
education level, occupation etc (Eze & Ibekwe 2007). Non repayment of
Loan is the biggest risk faced by the MFIs (CGAP 2001). The collection rate
of MFIs in Andhra Pradesh pitched to 5 -10 percent (Dinesh Unnikrishnan
2013).

2.1.2 Based on Credit Risk

Over the years, Microfinance industry has grown in a much
intensive way. Risk is central part of any financial intermediation and
management of the risk is still crucial. Except few MFIs all other MFIs have
not adopted methodical risk management which may suit their increased scale
of operations. Few MFIs failed to exercise the fundamental credit risk management which helped them to grow in the past times (Nimal Fernando 2008). Indian Microfinance Industry faced serious default risk due to intense commercialisation, but failed to create equal provisioning to hedge the risk. Variety of credit risk techniques existing in practice are ACCIONs CAMEL (Capital Adequacy, Asset Quality, Management, Earnings & Liquidity; 1993) (Anand Rai & Kanwal Anil), MicroRate and WOCCU’s PEARLS (Protection, Effective Financial Structure, Asset Quality, Rates of Return and Costs, Liquidity, Signs of Growth; 1990, 2011); PlaNet’s GIRAFE (Governance and Decision Making, Information and Management Tools, Risk Analysis & Control, Activities & Loan Portfolio, Funding and Efficiency & Profitability; 1999,) (David Richardson 2002).

World Bank has categorized parameters in CAMEL model as quantitative variables (47%) and Qualitative variables (53%) which measures credit risk through 21 indicators; PEARLS is 100% quantitative measures of credit risk measured through 45 indicators; GIRAFE measures credit risk through quantitative variables (43%) and Qualitative variables (57%); as well Microrate is more quantitative than Qualitative (CGAP 2001). Counter balancing this issue, Morgan Stanley’s methodology is exclusively designed to assess credit risk for MFIs. It identified Quantitative factors like Loan portfolio; Profitability, Sustainability and Operating Efficiency; Asset-Liability Management; and Qualitative factors like Management Capability and Strategy; Internal Systems and Reports; Operational Procedures and Controls and Growth Potential. The above stated 7 factors are measured through 23 indicators of which 11 are Quantitative and 12 are Qualitative. They are measured in a 1-6 point scale (Miguel Arvelo et al. 2008; Mojisola Oguntoyinbo 2011). Adoption of proper risk management tools enhances sustainable financial
soundness and good corporate governance. The MFIs adopt almost similar type of risk management techniques than the suitable ones. Credit risk determines the success and survival of micro finance banks. Weak credit management leads to capital erosion and eventual failure. A sound credit risk management system guarantees profitability, sustainability and helps in up-liftment of the deprived community and women empowerment. The shareholders, board and management found to be crucial for the sound management of the MFB. The credit risk identification, assessment as well sound corporate governance is very vital to ensure sustainability of MFBs (Mojisola Oguntoyinbo 2011).

2.1.3 Based on Financial Sustainability

MF accentuates lending loans at subsidized rate to the poor (Robinson 2001). Hence financial sustainability becomes tough for the MFI as it serves the under privileged segment of the society. It’s difficult to have twin objectives of serving the poor as well generating profits out of the business operations. However MF is finding the middle ground of the social and commercial mission (Simanowitz & Walter 2002). PaR 30, Capital Asset Ratio, Operational Self Sufficiency, Borrower per staff member, Operational Expenses / Loan portfolio is used to measure the financial performance of MFIs based on ACCION’s CAMEL model (Anand Rai & Kanwal Anil 2011). Weights are assigned for each parameter and a questionnaire with rating scale is used for data collection.
Table 2.1  Indicators used in CAMEL rating model for analysing financial sustainability

<table>
<thead>
<tr>
<th>Indicators</th>
<th>Scale in %</th>
<th>Standards/ Benchmarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio At Risk &gt; 30 days</td>
<td>0 - 100%</td>
<td>≤ 10%</td>
</tr>
<tr>
<td>Capital to Asset ratio</td>
<td>0-100%</td>
<td>≥ 8%</td>
</tr>
<tr>
<td>Operational Self Sufficiency</td>
<td>0-α</td>
<td>Above 100 %</td>
</tr>
<tr>
<td>Borrower per staff members</td>
<td>0-α</td>
<td>More than 200</td>
</tr>
<tr>
<td>Operating expense/ Loan portfolio</td>
<td>0-100%</td>
<td>≤</td>
</tr>
</tbody>
</table>

It intended to measure the variables like Outreach using Number of active borrowers; Number of women borrowers; Portfolio Quality using Repayment rate or Portfolio at Risk, Arrears Rate, Loan Loss rate, Loan Loss provision, Productivity using Number of loan per credit officer, Amount of loan/ credit officer, Operational efficiency, Administrative efficiency, Sustainability using Operational sustainability, Functional sustainability and Profitability using Return on Assets, Return on equity, Yield on Portfolio (Anand Rai & Kanwal Anil 2011). Among all the variables, the Return on Assets, Operating Efficiency, Asset Utilisation and Size are major factors in determining the financial performance (Kifle Tesfamariam Sebhatu 2011). The financial sustainability is measured through Cost of capital and Operating Self-Sufficiency through operating income against accumulation of operating expenses and provision for loan losses (Saundarajya Borbora & Gopal Kumar Sarma 2011). Increase in Operating Self Sufficiency implies the viability of MFIs (Kemonou Richard & Senami Segun and Anjugam 2013). Unsustainable MFIs provides higher cost to poor than the gains relished by them. Sustainability helps to maximise Social values than the Social Cost (Sergio Navajas et al. 2000). Sustainability creates much difference in value and cost offered (Sergio Navajas et al. 2000, Saundarajya Borbora & Gopal Kumar Sarma 2011). It affects the outreach to a large extent which is
measured through Depth; Worth to users; Cost of users; Breadth; Length; Scope. In general, the four pillars for financial sustainability are strategic and financial planning, Income Diversification, Sound administration and Finance and own income generation (Patricia Leon 2001). In general, the growth is affected by multiple factors like poor savings culture, Weak governance and Institutional capacity, hindering regulatory framework and capital constraints, lack of innovative differentiated products and intense competition. MFI serving the poor could be profitable and sustainable only when they charge higher interest rates or expand their scale of operations (Woller 2000). Increasing Outreach will help reduce cost (Merssland & Strom 2009).

The other models like WOCCU’s PEARLS, GIRAFE and MicroRate are hybrid models which use both quantitative and qualitative data, but it is not available for public use (Pankaj Agarwal & Sinha 2010).

2.1.4 Based on Solvency

Solvency risk speaks on the capital strength of the financial Institutions. Adequate amount of equity measured through the equity to total assets, allows the institutions to absorb shocks. Higher the capitalisation, lower the insolvency risk (Marijana Curak et al. 2012). Lack of Liquidity will lead to insolvency (Pandey IM 2010). In Business Bankruptcy prediction model of Altman’s suggests revised Z score (Sanobar Anjum 2012) with 5 ratios namely $X_1 \rightarrow$ Working capital / Total assets (0.717); $X_2 \rightarrow$ Retained Earnings / Total assets (0.847); $X_3 \rightarrow$ EBIT / Total assets (3.107); $X_4 \rightarrow$ Net worth (book value) / Total liabilities (0.420); $X_5 \rightarrow$ Sales / Total assets (0.998). It also suggests REVISED MODEL for non-manufacturing companies as $X_1 \rightarrow$ Working capital / Total assets (6.56); $X_2 \rightarrow$ Retained Earnings / Total assets (3.26); $X_3 \rightarrow$ EBIT / Total assets (6.72); $X_4 \rightarrow$ Net worth (book value) / Total liabilities (1.05).
Table 2.2  Solvency position based on Altman’s revised model for manufacturing and non-manufacturing companies

<table>
<thead>
<tr>
<th>Solvency position</th>
<th>REVISED MODEL Z Scores</th>
<th>REVISED MODEL for non-manufacturing companies Z Scores</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankrupt</td>
<td>&lt; 1.23</td>
<td>&lt; 1.10</td>
<td>High probability of failure</td>
</tr>
<tr>
<td>Non bankrupt</td>
<td>&gt; 2.90</td>
<td>&gt; 2.60</td>
<td>Financially Healthy</td>
</tr>
<tr>
<td>Gray areas</td>
<td>=1.23 - 2.90</td>
<td>=1.10 - 2.60</td>
<td>To be watched carefully</td>
</tr>
</tbody>
</table>

(Source: Edward I Altman et.al – Managing Credit risk)

The results of new model have been 90.0 % success rate in predicting bankruptcy.

2.1.5 Based on Determinants for Return on Average Assets (ROAA)

ROA reflects the profitability of the bank. It is a ratio of two variables Income and total asset (Khrawish 2011). It measures the ability of the bank management to generate income by utilizing company assets at their disposal. In other words, it shows how efficiently the resources of the company are used to generate the income. It further indicates the efficiency of the company in generating net income from all the resources of the institution (Khrawish 2011). ROA is influenced by efficient utilization of resources (Wen 2010). Various variables like spread, operating expenses, provision and non-interest income (Subhendu Dutta et al. 2013) were used to test the determinants of Return on Assets. Regression results showed that all the above had significant impact and Correlation results showed that the spread had positive impact and all other variables like operating expenses, provision...
and non-interest income had negative impact. Operating expense ratio, personnel productivity ratio, write off, cost per borrower ratio & debt equity ratio determines ROA (Dissanayaka & Anuranga 2012). ROA has positive correlation with personnel productivity and negative correlation with the remaining variables which are mentioned above. Regression was carried on with ROA as the dependent variable and operating expense, personnel productivity ratio, write off, cost per borrower ratio & debt equity ratio, deposit to loan, Capital Adequacy ratio (CAR), non-interest income, provision and portfolio at risk as independent variables. Result shows that write off, cost per borrower ratio & debt equity ratio, CAR and portfolio at risk were significant predictor variables. Two sets of variables that determine the profitability of banks are as follows. One is bank specific variable and the other one is industry and macro-economic variable. The Bank Specific variables like Asset Structure, Asset Quality, Capitalization, Financial Structure, Size and Revenue Diversification was included and for Industry and macroeconomic variables, Industry Concentration, Economic growth, inflation and Interest Rate were considered for analysis. External factors like inflation, interest rate and GDP has a positive impact on ROA (Khrawish 2011). Profitability is measured majorly by the internal factors (Athanasoglou, Brissimis & Delis 2008). The researcher has concluded that loans and deposits from the customer base constituted a major portion of Spanish banks’ economic and financial structure and that characteristic enhanced bank profitability, in terms of both ROA and ROE (Antonio Trujillo-Ponce 2012). Providing financial services was relatively costlier for MFI’s model (YSP Thorat 2006). In an analysis of 36 top MFIs (Jindal & Sharma 2001) it was found that 89 percent of MFIs were highly dependent on subsidies and only 9 could cover 80 percent of their cost. Second major problem faced by MFI was lack of capital. No reliable mechanism was found in meeting up the equity requirements.
2.1.6 Based on Andhra Pradesh Crisis

Andhra Pradesh, a South Indian state outnumbered the national average. It ranked first in terms of loan portfolio and outreach (Saxena 2015). During 2010, client outreach was 31.4 million and the gross loan portfolio level was Rs 207 billion. It recorded 18% growth rate in client outreach and 56% in the loan portfolio which was just 13.1% during 2010-11 (Source: S-Dhan; Sangeetha & Chitra- d). Andhra Pradesh crisis started during the year 2006. Government compelled to close 57 branches of two giant MFIs SHARE and Spandana Sphoorty in Krishna District. The government took actions on them for multiple reasons like coercive recovery, usurious interest rates, poor governance and adoption of excessive profiteering methodology (CGAP, 2010). As a part of scale of expansion, double loans were provided to poor with no collateral assets, who failed to repay their outstanding loans due to low income generating capacity. Coercive recovery practices exhibited by the MFIs led to commitment of suicides in the districts of Andhra Pradesh. This set a saturation stage for MF in the state (Ghate 2006). The problems which arose out of crisis was intensified further by the political motivation to develop the Pavalavaddi Scheme , a interest subsidy scheme to reduce the financial burden of Self Help Groups run by the AP government. On an average the MFIs loan debt outstanding per household of pan India remained at Rs.7700, whereas it was Rs.65000 at Andhra Pradesh during the same time period (Prabhjot Kaur & Soma Dey 2013). The inability led to 57 suicides in short span. The government came out with AP ordinance bill. Almost all the AP MFIs operations came to standstill. SA-Dhan, Association for MFIs, a national level player took some mutilation mechanism to restore and sustain the operations of MFIs (Vijay Mahajan 2006; Sylendra 2006). MFIs were
compelled to charge to an extent of 21-24 percent only. They were insisted to follow and enhance good corporate governance. Banking Sector was seriously affected by this crisis. One third of total loan portfolio (Rs.21000 crores) was left unpaid by the MFIs’ to the banks. Banks lost the trust on the MFIs. Banks which financed the MFIs, decided not to fund them, as the MFIs Networth was turning negative. Thereby the MFIs were handicapped and could not issue fresh loans to its clients (Financial Express, Nov 2010). Borrowings by MFI became costly. In addendum, the MFIs found it difficult to raise money for the strategic growth. During the year 2011-12, with pressure building up, the Operating Self Sufficiency slashed from 150 percent to 40 percent (MicroScape 2012). In the state of sector report 2012, it was recorded that only 18 percent of MFIs recorded positive RoA ie., 15%. The Bharat Microfinance Quick Report 2012 - Microfinance - Growing against All Odds reflected the Andhra Pradesh crisis. The following table highlights gloomy scenario prevalent in Andhra Pradesh.

Table 2.3 Performance of AP based MFIs for the year 2011 and 2012

<table>
<thead>
<tr>
<th>AP MFIs (Criteria)</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2011</td>
</tr>
<tr>
<td>Loan Portfolio (Amount Rs. In crores)</td>
<td>19180</td>
</tr>
<tr>
<td>Debt funds loans (Amount Rs. In crores)</td>
<td>4844</td>
</tr>
<tr>
<td>Return on Assets (RoA)</td>
<td>2%</td>
</tr>
<tr>
<td>Return on Equity (RoE)</td>
<td>2%</td>
</tr>
<tr>
<td>Operating Self Sufficiency (OSS)</td>
<td>111%</td>
</tr>
</tbody>
</table>

(Source: Sa-dhan 2012)
Upto 2010 – AP MFIs had peak performance

October 2010 – Introduction of AP MFI ordinance bill

December 2010 - Introduction of AP MFI ordinance bill enacted

January 2011 – Malegam Committee report

May 2012- MF bill cleared by the cabinet

May 2012 – Bill introduced in Parliament

(Source: Microsave, Ballem et.al.-Access to Credit in Andhra Pradesh Post the Microfinance Crisis)

Figure 2.1 Aftermath of MFI crisis – A Snapshot

Table 2.4 Portfolio at Risk of AP versus Pan India for the years 2009 - 2012

<table>
<thead>
<tr>
<th>Year</th>
<th>PaR 30</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>AP MFIs (%)</td>
</tr>
<tr>
<td>2009-10</td>
<td>0.4</td>
</tr>
<tr>
<td>2010-11</td>
<td>44</td>
</tr>
<tr>
<td>2011-12</td>
<td>62</td>
</tr>
</tbody>
</table>

(Source: Microscape 2012, Prabhjot Kaur & Soma Dey)
2.2 THEORETICAL UNDERPINNINGS AND TERM DEFINITIONS

2.2.1 Microfinance

Microfinance and Microcredit are generally confused. Microcredit is small loans provided to unsalaried people with little or no collaterals. Microfinance in addition provides financial services which encompass credit, savings, insurance, money transfer and other financial products which target the deprived people. It aims at poverty alleviation and empowerment of the society. Microfinance was generally emphasized to rescue the deprived community people from the money lenders. It is providing small scale financial services to deprived community / unbanked people of the society (Hartarska 2005). To provide financial services like payments, insurance, deposits, loans and money transfers to poor or low income households aiming at improvement of their livelihood (Asian Development Bank 2000; Mwenda&Muuka 2004). Beyond the above said services, few MFIs provide social middling and support services like building self-confidence, training on management capabilities and creating financial knowledge, formation of clusters proposed to do good to the groups (Ledgerwood 1999).

Microfinance is a Financial Service, which caters financial help to the poor & economically deprived community. These services are provided by MFIs. They adopt an unconventional method of financing by giving small/micro loans with little / no collaterals. It enforces lending and liability as well encourages pre loan savings. Based on the confidence and good track record of repayment built by the group, the MFIs gradually increase the loan sizes and guarantee future loans.
2.2.2 Microfinance Clients

MF clients are those who do not get formal access to financial products and services. Generally they are small retail groups, small & marginal farmers, rural artisans, cottage workers, manufacturers of snack items, herbal products, honey making, cosmetics, as well beauticians and people from economically weaker sections.

2.2.3 Microfinance Institutions

MFIs are the financial intermediaries consisting of Banks, NGOs’ and Refinance institutions. They lend money to SHGs, who deposit their savings or raise money from the fore said parties for product investments with an intention to improve standard of living (Nadarajan & Ponmurugan 2006). MFIs are instruments to mitigate poverty by offering finance and financial services. These institutions do harmonize with formal banking sector (Basu et al.) The underlying principle of providing finance is to empower the unbanked people and the poor class through income generating capacity and get rid of unforeseen events (Davis et al. 2004).

2.2.4 Self Help Group (SHG)

SHGs gather the savings for their own use. Then the savings may be given as loans to individuals or used as group investment. The objectives of SHGs are continuous access to credit and financial services. It enhances the bargaining power and provides the wisdom of dignity. (Karri Srinivas 2013).

2.2.5 Self Help Group Bank Linkage Programme (SHGBLP)

This programme was started with an intention to overcome poverty. The research project was commenced during the year 1989. Based on the outcome of this research, a pilot project was initiated. The pilot project was a
partnership model between the Self Help Groups, NGOs and Banks. SHGs smoothens the progress of decision making and enabled the access to doorstep banking. NGOs focused on capacity building and empowerment of the underprivileged people. Banks provided the financial resources. This programme gained impetus and became stronger after the arrival of MFIs (Reddy 2005). During 2005, the International year of Microcredit, the growth was fuelled by the policies of Government of India and RBI. MFIs were made to concentrate on 3 aspects to improve the status from just financiers to social engineers. They should enable accessibility, sustainability and accountability in their operations (Basil Hans 2009). The success of MF could be measured only if there exists increase in income levels, household expenditure and reduction in economic and social vulnerability (Rajesh Kumar Shastri 2009). The SHG is quite famous than other models like NGO and MFI led microfinance. The main drawback of Joint Liability Group (JLG is a group of 5 members, in which the group will take joint responsibility making the payment of dues when a group member could not make the payment) is the size of loan amount offered to a SHG. The group doesn’t want to bear risk, if the group member defaults. So the group is not willing to take large amount of loan. Many prefer individual liability loan contract than joint contracts (Amit Kundu 2009).

2.3 Major Risks to Microfinance Institutions

Risk means possibility of aberration from desired outcome (Gallati 2003; Kenny Adedapo Soyemi 2014). Financial Institutions face some risks whether they are regulated or not. They are grouped as Default/ credit risk, market risk, Operational risk, Legal risk and Strategic/ Governance risk which are classified further as Financial Risks, Operational Risks and strategic risks.
2.3.1 Financial Risks

The Financial risk covers default risks, liquidity risk and Interest rate risk. Most of the MFIs built new methodologies to minimize the credit risk. These institutions used the savings deposits of the SHGs to lend loans.

2.3.1.1 Credit risk

Credit risk means Delayed or Non-payment / default of loan commitments by the borrowers for a certain period of time. It comprises of pending loan cumulated due to loss of principal amount and the inability to collect the interest outstandings. Credit risk has 2 components quantity and quality of risk which means size of loan pending and probability of default by the client (Raghavan 2003).

2.3.1.2 Market risk

Change in market interest rates are termed to be Market Risk which has the reflection in Asset and Liability of the MFIs (Raghavan 2003). MFIs face huge market risk, as the funds are borrowed from Banks. If the interest rate charged by banks is high then the MFI will face high level disadvantage of charging high interest rates to its customers. This may affect the margins of the MFIs and in turn its Assets and Liabilities.

2.3.2 Operational Risks

Operational risks are those arising due to Faults from human or computer in delivering products and services. It may include lack of HR, fraudulent activities of employees, lack of technology etc. It is a possible loss incurred by the firm due to disruption in daily operations. It may arise due to lack of feeble policies, laws and regulations. It comprises frauds and forgery too (Njogo 2012).
2.3.3 Strategic Risks

Poor ineffective governance and leadership may lead to improper decision making. In general, bankers form part of MFI board. But they hesitate to implement the commercial tools which will ensure profitability and sustainability of MFIs. It covers the untapped opportunities and uncertainties excluded by the strategic objectives (Armoghan Mohammed & Richard Sykes 2012).