CHAPTER 1
INTRODUCTION

1.1 Problem Statement: India and Bangladesh are two developing countries in the world. The GDP per capita of India, though it has shown improvement in recent years, is only (USD) $1371 as at the end of 2010 [1]. Poverty is the major problem in these countries. In these economies, it is argued that, among others, absence of access to credit is presumed to be the cause for the failure of the poor to come out of poverty. Meeting the gap between demand and supply of credit in the formal financial institutions frontier has been challenging [2]. In fact, the gap has not arisen merely because of shortage of loan-able funds to the poor rather it arises because it is costly for the formal financial institutions to lend to the poor. Lending to the poor involves high transaction cost and risks associated with information asymmetries and moral hazards [3]. Nevertheless, in several developing economies governments have intervened, through introduction of microfinance institutions to provide microcredit to the poor.

Microfinance is one of the ways of building the capacities of the poor who are largely ignored by commercial banks and other lending institutions and graduating them to sustainable self-employment activities by providing them financial services like credits, savings and insurance. The reasons of this neglect are many. Often, such credits are just not profitable enough for banks because of economies of scale. By focusing on small amounts, and easing collateral requirements, microfinance institutions are better equipped to target poor individuals or groups who need resources to finance small scale investments.

To provide microfinance and other support services, MFIs should be able to sustain themselves for a long period.

Some researchers have found the evidence to be not so favourable. Many MFIs seem to have trouble reaching self sustainability at the financial level, even after the set up period. In this case, microcredit becomes more akin to subsidized credit which has a long record in developing countries, but often fails to achieve lasting positive results [4].

Still even if the MFI’s do not reach financial sustainability and fail, therefore, to conform to the “win-win” assumption, they can still be considered valuable if they provide credit facility to poor households who would not be able to find financial resources otherwise. In this perspective, outreach has social value in itself, which may more than offset the cost associated with permanent financial subsidies needed by the MFIs.
In other words, MFIs face double challenge: not only do they have to provide financial services to the poor (outreach), but they also have to cover their cost in order to avoid bankruptcy (sustainability). Both dimensions must, therefore, be taken into account in order to access their performance.

In India microfinance traces its roots to mid 1970s when some prominent Indian NGO’s like Myrada & Pradan started using the Self Help Group (SHG) model. The SHG is used as a platform for social mobilization and finance is one of the various services provided to the grassroots community through this model. It was widely replicated across other developmental NGOs. It is a community driven and managed microfinance model where the NGO plays the role of a facilitator, for instance providing capacity building services to the groups and building relationships with banks.

It is only from last 15 years that the MFIs, using Grameen model or Joint-Liability Groups (JLG), created a pace in outreach and credit growth. With the phenomenal growth recorded by the MFIs in India in recent years, 62% per annum in terms of numbers of unique clients and 88% per annum in terms of portfolio over the past five years i.e. Year 2005 to Year 2010 and around 32 million borrower accounts by March-end 2011, India has the largest microfinance industry in the world. Yet question remains whether it is a sustainable business model or not? Whether outreach affects the sustainability of MFIs? How Indian MFIs, which serve the largest number of poor and contribute around 40 percent of the microfinance delivery, is performing financially?

The financial performance of MFIs may be compared either from its previous year’s performance or from some other countries which are pioneer in the microcredit delivery. Bangladesh being the pioneer in the microfinance space and having similar demographics is the obvious choice for comparison. It can also be observed that the Grameen model promoted by Muhammad Yonus of Grameen Bank and the ASA model promoted by the Association for Social Advancement, both from Bangladesh, found rapid acceptance amongst the newer breed of MFIs in India. This was due to the models’ capability for rapid scaling in terms of client outreach. Also these models are less dependent on donor funds and pass the actual service charges to the clients while retaining a margin for its own growth. These models have proven to be robust revenue models.

The purpose of this study is also to critically evaluate the definition of sustainability which is denoted by OSS (Operational Self Sufficiency) and given by Microfinance Information
Exchange (MIX)\(^1\) USA. Further it suggests a sustainability index to check the overall financial performance of MFIs of any country.

**1.2 Objectives and Hypotheses:** The study is focused on achievement of following three objectives:

1. To analyze the financial performance of Indian MFIs and compare it with the MFIs of Bangladesh.
   a) To compare the financial performance of Indian MFIs and the MFIs of Bangladesh.
   b) To analyze the financial performance of NGO form of Indian MFIs and compare it with NBFC form of Indian MFIs.
   c) To compare the financial performance of Indian MFIs age wise.
2. To establish the trade off between the sustainability and other financial performance indicators like outreach, efficiency, liquidity, and asset quality.
3. To study the models of financial performance of MFIs with a view to suggest a new model for financial sustainability index.

The following hypotheses are created for the first objective and tested using two sample independent Mann-Whitney U tests.

1. H\(0\): There is no difference in the Capital/Assets ratio of India and Bangladesh
2. H\(0\): There is no difference in the growth rate of Number of Active Borrowers of India and Bangladesh
3. H\(0\): There is no difference in the Percent of Women Borrowers of India and Bangladesh
4. H\(0\): There is no difference in the Return on Assets of India and Bangladesh
5. H\(0\): There is no difference in the Return on Equity of India and Bangladesh
6. H\(0\): There is no difference in the Operational Self Sufficiency of India and Bangladesh
7. H\(0\): There is no difference in the Yield on Gross Portfolio of India and Bangladesh
8. H\(0\): There is no difference in the Operating Expense / Loan Portfolio of India and Bangladesh
9. H\(0\): There is no difference in the Number of Active Clients per Staff Member of India and Bangladesh
10. H\(0\): There is no difference in the Portfolio at Risk > 30 days of India and Bangladesh

Similarly, the hypotheses are created for NGO and NBFC forms of Indian MFIs on all

---

\(^1\) 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.
financial indicators mentioned above and tested using Mann-Whitney U test.

In order to analyse age-wise performance of Indian MFIs, three categories are created namely ‘Young’, ‘Mature’ and ‘Old’. Kruskal-Wallis One Way ANOVA is used to find out which category has done better than the other two categories on different financial performance indicators as mentioned above. Following hypotheses are created relating to One Way ANOVA:

1. H0: Means of Capital/Asset ratio of Young, Mature and Old MFIs of India are same.
2. H0: Means of growth rate of Number of Active Borrowers of Young, Mature and Old MFIs of India are same.
3. H0: Means of Percent of Women Borrowers of Young, Mature and Old MFIs of India are same.
4. H0: Means of Return on Assets of Young, Mature and Old MFIs of India are same.
5. H0: Means of Return on Equity of Young, Mature and Old MFIs of India are same.
6. H0: Means of Operational Self Sufficiency of Young, Mature and Old MFIs of India are same.
7. H0: Means of Yield on Gross Portfolio of Young, Mature and Old MFIs of India are same.
8. H0: Means of Operating Expense/Loan Portfolio of Young, Mature and Old MFIs of India are same.
9. H0: Means of Number of Active Clients per Staff Member of Young, Mature and Old MFIs of India are same.
10. H0: Means of Portfolio at Risk > 30 days of Young, Mature and Old MFIs of India are same.

In order to achieve the second objective following hypotheses are created.

1. H0: Number of Active Borrowers does not affect OSS of Indian MFIs.
2. H0: Capital/Assets ratio does not affect OSS of Indian MFIs.
3. H0: Yield on Gross Portfolio does not affect OSS of Indian MFIs.
4. H0: Operating Expense/Loan Portfolio does not affect OSS of Indian MFIs.
5. H0: Portfolio at Risk > 30 days does not affect OSS of Indian MFIs.
6. H0: Debt Equity ratio does not affect OSS of Indian MFIs.
7. H0: Percent of Women Borrowers does not affect OSS of Indian MFIs.
8. H0: Inception date does not affect OSS of Indian MFIs.
9. H0: Number of Active Borrowers does not affect OSS of the MFIs of Bangladesh.
10. H0: Capital/Assets ratio does not affect OSS of the MFIs of Bangladesh.
11. H0: Yield on Gross Portfolio does not affect OSS of the MFIs of Bangladesh.
12. H0: Operating expense/loan portfolio does not affect OSS of the MFIs of Bangladesh.
13. H0: Portfolio at Risk > 30 days does not affect OSS of the MFIs of Bangladesh.
14. H0: Debt Equity ratio does not affect OSS of the MFIs of Bangladesh.
15. H0: Percent of Women Borrowers does not affect OSS of the MFIs of Bangladesh.
16. H0: Inception date does not affect OSS of the MFIs of Bangladesh.

1.3 Significance of the Study:
This study and its outcome will be a tool for the MFIs:
 a) To have a clear view about its current performance and risks (strengths and weaknesses).
 b) To facilitate decision making through the identification of improvement areas.
 c) To motivate the entire institutions towards performance improvement.
 d) To follow up its development, assess progress in achieving sustainability.
 e) To compare to its peers.
 f) To present itself to potential funders.

It might be a tool for a donor or a supporting NGO:
 a) To better know the performance / level of sustainability of its partner.
 b) To better understand the kind of support its partner is asking for.
 c) To easily follow-up the evolution of its partner.

It might be a tool for investors:
 a) To identify potential investments.
 b) To follow-up the MFIs they are investing into.

1.4 Limitations of the Study: The microfinance sector in India is still in its nascent stage and not well regulated. The financial data is not available for most of the MFIs. Therefore, the financial data is taken only from Microfinance Information Exchange (MIX) (USA) and Sa-dhan\(^2\) (India). Second limitation is relating to sample size. Only 88 companies from India have reported data to MIX in the year ended March 2010 (financial year) and 69 companies had reported data in the year 2007-08. In case of Bangladesh, the scenario is worse as only 28 companies have reported data as on 31\(^{st}\) December, 2009. In the year 2007, only 31

\(^2\) **Sa-Dhan** is the Association of Community Development Finance Institutions Founded by SEWA Bank, BASIX, Dhan Foundation, FWWB, MYRADA, ROVN, SHARE and PRADAN in 1999. Its mission is to help its member and associate institutions to better serve low-income households, particularly women, in both rural and urban India.
companies had reported data to MIX. Since the study has taken the last five years data therefore, sample size could only go up to maximum 40 companies for India and 26 companies for Bangladesh.

The third limitation is relating to sampling technique. The stratified random sampling is done on the basis of the age of the microfinance institutions. The average age of the MFIs of Bangladesh is much higher than Indian MFIs therefore we do not find any company who is young in Bangladesh as per the life cycle approach which categorises MFIs on the basis of age.

Time horizon is another area of limitation. The data older than the year 2003-04 of most of the MFIs has either not been reported to or made available by the agencies like MIX or Sadhan to make a proper trend analysis.