Microfinance in India - A Comprehensive Analysis of the Growth and Performance of MFI’s

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Abstract

The extraordinary growth recorded by microfinance 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 few years – and around 27 million borrower accounts, India with the largest microfinance industry in the world is suddenly taken the world by surprise with the crises looming large on the very existence of this sector. An industry that grew at 90% on an annual basis from 2002-03 to 2009-10 was reduced to just 7% growth in 2010-11 with its portfolio over the period October 2010 (when the crisis started) to the end of the year 2011 estimated by M-CRIL to fall by around 33%. The objective of the research is twofold first, to analyse the financial performance of independent microfinance institutions (MFIs) in terms of cost efficiency, cash constraints and net portfolio in India providing microfinance services to low income clients secondly, this research helps to understand the role of microfinance in the Indian economy and to focus on the current performance of the sector in relation to financial services in general. The paper concludes that primarily, the regulations improvisation which is caught in the headlights of draconian regulation is uncertain which way to go. This is a dangerous situation that the sector has to deal with and come out successfully. Secondly, the crisis not only had the effect of bringing microfinance in AP (Andhra Pradesh) to a halt, it also caused a sudden rash of prudence in commercial bank lending to MFIs resulting in an increase in lending rates.

Key words: Microfinance, Microfinance Institutions, Financial services, Portfolio, Financial Performance, Cost efficiency, Cash constraints

1. Background and Introduction

Microfinance refers to all types of financial intermediation services (savings, credit funds transfer, insurance, pension remittances, etc.) provided to low-income households and enterprises in both urban and rural areas, including employees in the public and private sectors and the self-employed (Robinson, 2003). Effective, long-term provision of these services occurs through microfinance institutions that adhere to the key principles endorsed by the Consultative Group to Assist the Poorest (CGAP). Microfinance emerged in the early 1990’s to provide credit and savings services to the poor as a possible alternative to conventional bank lending. Many developing economies have developed and have been providing credit to the poor through microfinance schemes. The experience of several Asian, African as well as Latin American countries could be a typical example for this (Meyer 2002). It received further boost with involvement of several non-governmental organizations and microfinance institutions. These efforts led to the formation of Self Help Groups(SHGs), where poor from homogenous backgrounds formed groups of around 20 each and pooled money that was lent to the needy in the group. With huge potential and low NPA’s, several private and foreign banks, unveiled their plans to enter the Indian Microfinance sector. The government and RBI have announced several measures to boost microfinance activities in the country. However, there is lot to be done by the regulator in the light of the recent developments in this sector. The few specific developments worth mentioning here are —The exponential growth, witnessed in the Micro Finance Industry lately, with more and more institutions coming in everyday, secondly with more and more funds required for the established MFI’s to scale up and because of the regulatory prohibition on raising deposits, the profitable MFI’s are offering there equity stakes to bank and FI’s, who are more than willing to put their money in these more or less established and highly profitable MFI’s in return for an Equity stake. Last but not the least, with alternative models, being proposed now to further Financial Inclusion, including agent based banking, Mobile based banking, the next big question would be the “transaction cost”, as to which of the alternative models would have the lowest transaction cost.(Singh 2010)

2. Literature Review

The growth of MFI’s have recorded about 8.5 million clients during the year 2008-09, a growth of 60% over the previous year. More than 50 percent of low income households are covered by some form of microfinance product. Nagesh Naarayana (2009). Poverty is the major problem in most developing economies. 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
challenged (Von Pischke, 1991). In fact, the gap is not aroused merely because of shortage of loan-able fund to the poor rather it arise 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 (Stigliz and Weiss 1981). Microfinance is the provision of financial requirement serves to the poor people with very small business or business projects (Marzys, 2006). Only a small fraction of the world population has access to financial instruments, essentially because commercial banks consider the poor people as unbank-able due to their lack of collateral and information asymmetries. There are a number of studies in the MF industry because it has got the attention of academicians and practitioners as an innovative method of fighting poverty. The studies mostly concentrate on three key areas. The first one is impact assessment of the MF programs on the lives of the poor. It is to mean that whether the provision of financial service mostly of credit and saving has improved the lives of the poor in terms of economic, social and political indicators of poverty. Using much type of quasi experimental designs the studies about the impact of the microfinance in changing the lives of the poor have shown mixed results (Hishigsuren, 2004). Sebstand and Chen, 1996 cited in Hishigsuren, 2004 summarised the key findings from thirty two impact studies and revealed varying degree of positive impact on program participants notably increase in household and enterprise income and assets. Mixed effects were found in employment, children schooling and women’s empowerment. So the evidence on whether Microfinance can alleviate poverty is of highly debated issue.

There are different arguments concerning how to evaluate the performance of microfinance institutions. Meyer (2002), Citing from Zeller and Mayer (2002), indicated that there is what is called “Critical Microfinance Triangle” that we need to look at it to evaluate Micro-Finance institutions based on their objective. Here, the corners of the triangle represent outreach to the poor, financial sustainability and welfare impact. And “Performance criteria are required for each objective and all three must be measured thoroughly to evaluate micro-finance performance”, noted Meyer (2002). Navajas et al (2000), similarly indicated that there are six aspects of measuring outreach: depth, worth of users, breadth, length and scope. Where, depth of outreach refers to “the value the society attaches to the net gain from the use of the micro credit by a given borrower”, Navajas et al. (2000). The microfinance institutions participation in several developing economies is escalating from time to time. Various studies on different countries on the performance of the MFI’s confirm this (Adongo and Stork 2005, Zeller and Meyer 2002, Meyer 2002, Robert Cull et al. 2007) Microfinance services are provided with different methods in India (Sadhana 2005, Basu and Srivastava 2005). Delivery models can be divided into two broad categories: group models and individual models. Group models include Self Help Groups (SHG), the Grameen model and joint-liability groups (JLG). The individual model corresponds to individual banking. In the SHG model, the institution lends to groups of 10-20 individuals, mostly women who have created a SHG. A SHG is a solidarity group. It is a very flexible structure, formed by economically homogeneous women who share generally the willingness to improve their living conditions. It is a place of empowerment of members and a “channel” for microfinance services. Usually a SHG has a single account with the MFI, and individual members make their transactions through the unique SHG account (Nair 2005). The Grameen model corresponds to the lending method initiated by Yunus in Bangladesh. With this model, the institution lends to 4 to 6 individuals, based on the mutual guarantee of each other’s loans. Members of a joint liability group are generally engaged in the same activity and they are not forced to save. With the individual banking model, the MFI gives directly loans to clients as a standard bank. There is a bilateral relationship between the MFI and the borrower, but requirements such as collateral are less stringent than in standard banking contracts. It is in the SHG model that the group plays the largest role in decisions. In the two other group models (Grameen and JLR), the group mainly serves as a substitute for material guarantees.

3. Research Objective

The objective of the research is twofold first, to analyse the performance of independent microfinance institutions (MFIs) in terms of cost efficiency, cash constraints and net portfolio in India providing microfinance services to low income clients. Secondly, this research helps to understand the role of microfinance in the Indian economy and to focus on the current performance of the sector in relation to financial services in the country in general.

4. Methodology

The study is an exploratory study. The study tries to relate the growth, efficiency and the performance parameters towards the contribution of MFI for the financial inclusion through microfinance. The data used for the research is supported by NABARD, M-CRIL and RBI. Also, Interviews with experts in the area of micro finance is conducted. These interviews are semi-structured. Semi-structured interviewing starts with more general questions and topics relevant to Micro finance especially related to the moral, ethical and governance implications of Commercial Microfinance in India. In some cases due to the sensitivity of the issue and special request of the interviewee the names of the interviewee are kept confidential.

4.1 Decline of Cost Efficiency

The cost incurred by MFIs in servicing loan accounts is very low in comparison with the global benchmark of $139 of the MIX. Even when compared with other Asian MFIs, the cost per borrower (Rs. 716, $15.90) amounts to just 26% of the East Asian median of $61 and is also substantially lower than the median for low end MFIs internationally ($64). The trend in the average cost per borrower for the delivery of micro-loans in India shows a sharp 33% increase over the past year (Exhibit 1). This is attributable to the high “growth at all costs” pursued by MFIs in the first half of the year as the larger ones chased the chimera of an IPO, while the latter half of the year was spent in “fire-fighting”, trying to persuade borrowers in AP( Andhra Pradesh) to repay and those elsewhere to
maintain their payments. But over all it can be concluded that the cost per borrower has increased thus declining the cost efficiency.

Exhibit 1. Cost Per Borrower

![Graph showing cost per borrower from 2000 to 2011 with different lines for All MFIs, L-10, and 2002 prices.]

Source- M-CRIL

4.2 Indian MFIs Reliance on Commercial Bank Funds

The distribution of sources of funds for microfinance, presented in Exhibit 2, shows that the share of debt in MFI finances climbed sharply. The current level of debt, amounting to 69.2% of total funds raised by the leading MFIs represents a reduction from the highest level of around 80% reached in 2008. The extent to which commercial debt continues to dominate the financing of Indian microfinance is apparent. Indeed, the domination of commercial bank funds in Indian microfinance is under-played in this since it excludes off-balance sheet financing via portfolio sales and securitisation of portfolios undertaken by some of the leading MFIs to the commercial banks. A separate compilation of the portfolio managed by MFIs for others – securitised portfolios that are not on MFI balance sheets – shows that the amount added some 10.5% of the portfolio to the MFIs’ managed portfolio.

Exhibit 2. Sources of Funds for Microfinance Operations

![Bar chart showing sources of funds for microfinance operations from 2003 to 2011.]

Source- M-CRIL

4.3 Cash Constraints

The allocation of funds by Indian MFIs has conformed fairly well to international best practice norms in recent years. However, the exceptional circumstances of the current year have resulted in exceptional measures. Of the total resources of `25,000 crore ($5.5 billion) deployed in microfinance by the sample MFIs, over 80% was deployed in loans to clients at the end of March 2011 (Exhibit 3). Last year this was 69% which was below the portfolio allocation level of the MIX international median of 76.8% largely because of the prevalent practice in India of lenders making substantial
disbursements of loans to MFIs in the last week of March (the end of the financial year). As indicated earlier, the effect of the crisis resulting from the AP ordinance spread much more widely than the state of Andhra Pradesh. This effect was not due to any delinquency contagion reaching clients outside the state but rather due to the drying up of bank funds to MFIs. Thus, the manifestation of political risk that they saw in the form of the AP ordinance, resulted in banks reducing their sanctions in the last quarter of the financial year to a minimal level. This affected MFIs all over the country and is the primary reason for the low (25%) growth in net portfolio of the leading MFIs during the year. Since there is a limit to the equity it is possible to raise and equity takes longer to mobilise, while deposits are not an option, MFIs were forced to limit their portfolio growth.

Exhibit 3
Use of funds by Indian MFIs, 2011

| Source | M-CRIL |

4.4 Improved Prudential Management

For ensuring prudential management, banks in India are expected by the RBI to maintain Capital Adequacy Ratios (CAR - net worth as a proportion of risk weighted assets) of 9% and NBFCs of 12% (until March 2010 increasing to 15% by March 2011). While equity was a constraint in the early years of Indian microfinance, the earlier equity constraint eased considerably and, though investors became very cautious after October 2010, the weighted average for Indian MFIs is now in excess of 25% – well ahead of the banking sector. The slowdown and reversal of portfolio growth in the last months of the financial year has been largely responsible for this increase from the 18% weighted CAR of March 2010. While securitization may offer a short-term solution to the capital problem, it does not resolve the issue in the long term. For commercial banks, as discussed above, it provides the benefit of inclusion in the priority sector lending requirement (though that is now being re-assessed by the Reserve Bank of India in the context of the crisis). A surfeit of lending funds leads MFIs to
- induct clients without due care and relationship building
- lend beyond the capabilities and means of their clients
- resort to coercive practices when the clients’ express an inability to pay.

The emergence of client protection issues and the related political risk in Andhra Pradesh and Karnataka (and, by extension, elsewhere in India) can largely be attributed to this phenomenon. In this context, the reduction in the proportion of the managed portfolio from 53% of the owned portfolio in the 2005 to 10.5% now is a welcome development. It is worth remembering, however, that until March 2010 the absolute amounts had increased to such an extent that the proportions become meaningless from the perspective of an over-heated economic sector.
4.5 Decline in Financial Performance

Exhibit 4. India Financial performance Index.... March 2003=100

Source- M-CRIL

FINEX – the M-CRIL India Financial Performance Index is a composite index of the performance of microfinance institutions in India. It uses information on the portfolio at risk (>30 days) and the return on assets of 24 leading MFIs (based on financial information self-reported by the MFIs to the MIX) FINEX has declined to -466 (March 2003=100 in the figure above) compared to the 40% increase in 2008-09 and a 10% increase in 2009-10.

5. Conclusion

The financial viability of rated microfinance institutions in India, apparent in the 2005, was under threat in 2007. While this situation was dramatically reversed in 2009-10, the current crisis in Indian microfinance has caused a substantial moderation. This is apparent in considering the returns MFIs earn net of all costs – operating and financial. The significant moderation of the past year has been caused by the substantial write offs necessitated by the collapse of microfinance in Andhra Pradesh. The high efficiency (low OER) of Indian MFIs played a key role in their profitability as did the significantly increased portfolio yield since 2007. However, current write-offs have increased the total expense ratio quite significantly and caused the weighted average return on assets for 2010-11 to fall to 3.0%. The crisis not only had the effect of bringing microfinance in AP to a halt, it also caused a sudden rash of prudence in commercial bank lending to MFIs (at the same time as a hardening in inflationary conditions in the country) resulting in an increase in lending rates.

Given the actions of the Government of Andhra Pradesh and the collapse of portfolio quality in AP as a result, it is quite likely that the write-off and provisioning expenses of MFIs with operations in the state will increase even further. At the same time, M-CRIL expects another decline in portfolio yield on account of the limits set by the RBI on lending rates for the purpose of classification as priority sector portfolios.

The implications of this for the long term future of financial inclusion are still difficult to predict. It has already resulted in a substantial decline in capital – both debt and equity – available for microfinance and, as discussed in the research paper, has slowed down and even reversed the financial inclusion effect of MFI operations. What Indian MFIs need is a stable environment in which to deliver microfinance services – deposits, remittances, insurance as well as micro-credit – in a responsible manner. Whether or not MFIs can continue to contribute to financial inclusion in India is now dependent on the passage of the draft Microfinance Bill by the Indian Parliament. Until such time, however, most low income families in AP have been thrown back into the not-so-benevolent arms of moneylenders. Many low income families outside AP have also suffered collateral damage as the drying up of on lending funds from commercial banks has caused a reduction in MFI operations throughout the country.

6. Recommendations

Proper training to be provided to the employees of MFI’s especially in disbursing loans and collection of the loan amount so that the cost per borrower can be more efficiently managed.

Greater engagement with the political economy of the regions in which the MFI’s operate so that bureaucracy, politicians and media are all kept aware and sympathetic to the MFIs’ operational practices and goals.

A very conscious effort to ensure that there is a diversity of sources of funds not just in terms of numbers of lenders/investors but also the type of such fund providers – commercial banks, development banks, social equity investors, private equity investors and, equally, clients as depositors. Wherever the deposit option is available it’s been experienced that it provides an additional anchor of stability to the micro financial system.

7. Limitations
The whole research is conducted based on the views and reviews of the microfinance practitioners and microfinance researchers. Hence scope for further research is to understand the sentiments and preferences of clients of microfinance.

References:-

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Glossary:-
APR Annual percentage rate (APR) Expected earnings from a loan portfolio based on the stated terms of the financial institution’s loan products.
CAR Capital Adequacy Ratio (CAR) Ratio of net worth to risk weighted assets (Risk weights: 100% for all assets except fixed assets & interest bearing deposits: 50%; cash 0%).
FCR Financial cost ratio (FCR) Total interest expense for the year divided by the average portfolio
OER Operating expense ratio (OER) Sum of staff, travel, administration costs, other overheads and depreciation charges of the MFI divided by average loan portfolio.
OSS Operational Self-Sufficiency (OSS) Ratio of total income to total expenses for the Year
PAR30 Portfolio at risk (>=30 days)(PAR30) Ratio of the principal balance outstanding on all loans with overdues greater than or equal to 30 days to the total loans outstanding on a given date
TER Total expense ratio (TER) Ratio of total financing expenses, loan loss expenses and operating expenses to the average loan portfolio
Yield - Yield on portfolio Interest and fee income from loans to clients divided by the average loan portfolio for the year

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