

The Dynamics of Microfinance – A Brief Review of Existing Literature

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ABSTRACT

Microfinance is getting wider attention these days with the concept of inclusive financing, through its outreach to the rural households. More and more institutions are taking up microfinance to uplift the poor and the marginalized. It is really important to look in to several aspects of microfinance in this regard. In order to find out the efficiency of microfinance programmes in reaching out to the rural poor and analyzing the sustainability of its business operations, a conceptual review has to be made. The article therefore tries to fulfill the same. It provides a theoretical review of microfinance and it brings forth the issues such as modes of lending of microfinance, financial performance, outreach and sustainability of micro finance Institutions and also the recent trends in the microfinance sector.

1. Introduction

It was a shot in arms for microfinance when its founder Prof. Mohammad Yunus won Nobel Prize for peace in the year 2006. He conceptualized the idea of providing credit to the rural poor particularly women in groups. Microfinance is defined as the provision of thrift, credit and other financial services such as money transfer and micro-insurance products for the poor, to enable them to raise their income levels and improve living standards. It has been considered as an instrument for saving the poor from financial isolation by mainstream and formal financial system all over the world. The basic idea of microfinance is that the poor people are ready to pull themselves out of poverty if given access to financial service at lower cost (Shihabudheen, 2014). Microfinance initially emerged as a not for profit effort to establish microcredit services to the poor, with the hope that access to loans would help alleviate household poverty. These programmes have been established in developing economies around the world (Samuelson, 2013). The potentiality of such programmes in uplifting the rural poor is conditioned upon its linkages to the poverty alleviation (Laha & Kuri, 2015). A well-targeted microfinance programme can address gender-specific poverty by expanding economic opportunities to women. In fact, it can be argued that outreach of microfinance is one of the anti-poverty measures that could avoid the problem of wrong targeting and promote the empowerment of rural women (Devi, Prabakar, & Ponnarsi, 2011). The principle of microfinance focuses on equipping the poor people to take an active role economically in their lives through financial and technical support that encourage enterprise development (Hulme & Mosley, 1997). Microfinance programmes in Asia and Pacific countries are found to be successful in extending the services to the poorest and women sections of the population. In these continents, nearly 62 percent of the members covered under such programmes are considered as poor women (Maes & Reed, 2012). It is widely believed that microfinance programme is not a panacea to alleviate poverty from grass root level. The programme is considered only as a means and not an end (Laha & Kuri, 2015). Microfinance is the key to improve access to financial services by the poor people at an affordable cost. In

other words it helps to promote the process of financial inclusion. The main objective of financial inclusion is to ensure access to formal credit for people who depend on informal sources for fulfilling their financial needs at an affordable cost, in a fair and transparent manner and to promote financial education (EY, 2016). The outreach of microfinance programme could play a significant role in facilitating financial inclusion, as they are uniquely positioned in reaching to the rural poor (NABARD, 2008).

2. Microfinance – Modes of Lending

The microfinance programmes generally operates through two types of granting credit to the rural poor. These are Joint Liability Group (JLG) lending and individual based lending. The JLG model functions by providing loans to a group of people. It will be a group of 5-10 borrowers. Individual based lending involves a one to one relationship with the institution and the individual. Currently, most of the borrowers accept loans through group lending programme or we can say that they have prior access to the JLG lending model (Hermes & Lensink, 2007). According to one recent survey of a sample of microfinance programmes, only 16% of these made use of group lending model to provide credit to the poor. Yet, they served more than two third of all borrowers from the microfinance programmes included in the survey (Lapenu & Zeller, 2001). The MFIs can select either of the two modes of lending. Many cases they choose a mode of lending based on their convenience and transaction costs. The sustainability of the MFI depends on the choice of the model and hence it is an irreversible decision. The need for a structural and optimized model is high since the microfinance sector is growing at an abnormal rate (Singh, 2010). Through group lending MFIs focus on using social collateral. The group takes over the underwriting, monitoring and enforcement of loan contracts from the lending institution (Wenner, 1995). The social collateral operates through reputational effects on group members in which they consider loan repayment as a necessity to maintain their social standing in the community (Woolcock, 2001). Group lending not only increases repayment rates and welfare through social collateral but also with peer selection by

members of the lending group (Ghatak, 1999). As per the system of peer review and monitoring, the lenders can charge lower interest rates compared to the conventional lenders and at that rate the expected rate of repayment is higher (Islam, 1995). Although social collateral is widely used, it is not universally accepted by all as the optimal approach. For example, (Mustafa, 1994) concludes that alternate forms of institutional arrangements may be better than credit cooperatives in alleviating poverty.

3. Microfinance Institutions

Microfinance Institutions (MFIs) provide a range of financial services to poor households. MFIs focus on providing credit to the poor who have no access to commercial banks, in order to reduce poverty and to help the poor with setting up their own income generating businesses. This focus is generally described as outreach in the literature (Hermes, Lensink, & Meesters, 2011). Among other things MFIs try to concentrate more on financial sustainability and efficiency because of the number of developments that have taken place in the microfinance sector such as the increasing competition among MFIs, the commercialization of microfinance, technological change implemented in microfinance and financial liberalization and regulation policies of the government (Rhyne & Otero, 2006). Commercialization of microfinance means the interest of commercial banks and investors to finance MFIs. Large banks such as Citigroup, Deutsche Bank and HSBC, for example, have separate microfinance divisions, supporting activities of MFIs (Hermes, Lensink, & Meesters, 2011). The interest of multinational banks is due to the concept called "double bottom line" of financing and supporting MFIs. It allows banks and investors to show their corporate social responsibility, while at the same time these investments provide attractive risk-return profiles (Deutsche Bank, 2007). MFIs worldwide growth in numbers has had a positive impact by providing the poor with loans, savings products, fund transfers, and insurance facilities (Haq, Skully, & Pathan, 2010). Today there are thousands of MFIs providing financial services to an estimated 100-200 million of the world's poor (Brau & Woller, 2014). As we know the microfinance industry is growing rapidly as more and more institutions are coming in to the fore. Between December 1997 and December 2005 the number of microfinance institutions increased from 618 to 633. The number of people who received credit from these institutions rose from 13.5 million to 113.3 million (84% of them being women) during the same period (Harris, 2006). The dominant product offered by MFIs was loans for enterprise formation and development (Nourse, 2001). They have developed over the period of time and now such institutions are called 'credit+ providers' since they offer additional products, such as savings, consumption or emergency loans, insurance, money transfer, remittances and business education. (Centre for Micro Finance, 2006)

4. Microfinance Institutions in India

Micro finance Institutions perform a crucial function of facilitating financial inclusion goals in developing countries through the provision of microfinance services. Microfinance services include –

- Micro credit facilities to the extent of Rs.5lakhs (or Rs.10 lakhs if so specified by the RBI),
- The collection of thrift,
- Pension,
- Insurance services and
- The remittance of funds to individuals within India subject to prior approval by the RBI (CIER, 2013).

The MFI sector in India is highly heterogeneous and only a few of the MFIs have significant outreach with substantial volumes of credit. The microfinance sector was severely affected by the Andhra Pradesh crisis in 2010, the then Government of the state declared an ordinance to curb the activities of microfinance companies. The crisis had created a strong response from the RBI and in the years that followed, the sector has registered a turnaround and has evolved into a more mature market. Moreover, the Government as well as the RBI has tried to create a conducive policy and regulatory environment for MFIs to expand the financial inclusion agenda in India (EY, 2016). According to (Karmakar, 2008), MFIs in India are registered as one of the following five types of entities:-

- NGOs engaged in microfinance (NGO-MFIs) comprising of societies and trusts
- Cooperatives registered under the state level Mutually Aided Cooperative Societies Act
- Section 25 Companies (not for profit)
- For profit NBFCs and NBFC – MFIs

The Indian microfinance industry is dominated by NBFC-MFIs with an 88% market share. According to data from MFIF, there are 12 small MFIs (loan book less than INR 1 billion), another 22 medium sized MFIs (loan book between INR 1 billion and INR 5 billion) and 22 large MFIs (loan book above INR 5 billion). Large MFIs account for ~90% of the industry's Gross Loan Portfolio (GLP), client base and debt funding (EY, 2016). Despite the significant growth of microfinance institutions and its active borrowers, the penetration of microfinance lending services to the poor households in India is observed to be limited. (Laha & Kuri, 2015) made an attempt to analyse the role of microfinance in alleviating poverty across the states of India. The result shows that out of 27 states and Union territories, only in seven states (Kerala, Andhra Pradesh, Tamil Nadu, Goa, Himachal Pradesh, Tripura and Karnataka) outreach of microfinance programme has made a significant impact on the reduction of poverty (Laha & Kuri, 2015).

5. Financial performance and outreach of MFIs

The success of the microfinance programme is the sustainability of its business operations. Microfinance activities are costly due to high transaction and information costs (Hermes & Lensink, 2007). In the 1990s, the importance of financial sustainability of MFIs gave rise to an important debate between the financial systems approach and the poverty lending approach (Robinson, 2001). The former focuses on the significance of financially sustainable microfinance programmes where as the latter deals with providing credit to the poor which will help them to overcome poverty by way of granting credit at subsidized interest rates (Hermes & Lensink, 2007). The two approaches are contradictory to each other as the subsidized interest rates cannot go along with the

sustainability of the microfinance programme. But the advocates of the financial systems approach claims that there is no such empirical data which shows there is negative correlation between the financial sustainability of the institution and the poverty levels of the clients (Hermes & Lensink, 2007). (Morduch, 2000) reports a rough estimate that only 1 percent of MFIs are currently financially self sustainable and that no more than 5 percent would ever be. Two different thoughts on the financial sustainability of MFIs have come up, which are as follows :- One school of thought called 'welfarists' states that MFIs should be sustainable with donor funds, and the other called 'institutionists' states that they should meet their costs with the revenue that they have generated as they cannot depend on donor funds (Brau & Woller, 2014). Welfarists take odds with intuitionists over the issue of sustainability. Welfarists argue that MFIs can achieve sustainability without achieving financial self sufficiency (Morduch, 2000), (Woller, Dunford, & Woodworth, 1999a). Their opinion is that donors can be considered as social investors since the donations they provide serve as a form of equity. The difference between social investors and private investors is that the latter invest in securities of a publicly traded firm to obtain monetary benefits whereas the former does not expect financial benefits from investment in MFIs, rather they expect a social or an intrinsic return of not investing in firms they find offensive (Brau & Woller, 2014). (Hibako Rai, 2009) in his study states that competition among Micro finance Institutions reduce wide outreach or loan size per borrower but it does not affect the financial self sufficiency of those institutions. The negative impact of competition on outreach declines as MFIs increase their experience. In other words, the above mentioned impact gets reduced as the institutions prosper over the years. In order to increase the loan size per borrower, socially motivated Micro finance Institutions take advantage of external subsidies and cross subsidies. Cross subsidy is the use of gains from profitable borrowers to subsidize loans to unprofitable borrowers (McIntosh and Wydick, 2004). Two recent developments have helped MFIs to improve their sustainability and efficiency. First, new banking technology such as charge cards, ATMs, the use of cell phones, and the internet has begun to enter the microfinance business, helping to reduce costs and improve the delivery of services (Kapoor, Ravi, & Morduch, 2007). Second, several developing countries have recently liberalized financial markets, while at the same time installing regulations to help in improving the stability of the microfinance business. These changes of financial market policies may also contribute to improving the sustainability and efficiency of microfinance (Hartarska & Nadolnyak, 2007).

6. Recent trends in MFI lending

Microfinance Institutions form a key part of the RBI's inclusion drive. It tries to reach the unbanked population. Banks were earlier hesitant to expand in to remote areas due to high operational costs, but with technological advancements they became more cost effective and they are entering the micro finance sector either with their own units or with existing

providers through partnerships. While MFIs are more knowledgeable at the community level, banks have the advantage in greater access to capital and existing infrastructure. Deposits are increased as a source of funding with the integration of banks and Micro finance Institutions (Micro Capital Team, 2005). Large Microfinance Institutions are converting into banks (e.g: the largest MFI, Bandhan has converted into a universal bank and 8 other MFIs are on the verge of becoming small finance banks). Commercial banks were reluctant to finance small and medium sized MFIs earlier but they recently become more liberal in providing funds to the same (EY, 2016). Most of the MFIs have got high repayment rates (e.g:- more than 90 percent in many cases) and hence they can tap the world capital market through instruments such as commercial bank loans, bond financing, commercial paper, or through the bundling and securitization of MFI loans (Brau & Woller, 2014). If capital markets can be tapped to give MFIs the needed funds to be self-sufficient and if investors can earn returns proportionate to the risk that they have beard, the vision of a poverty alleviation mechanism that pays for itself may be realized in greater proportions (Brau & Woller, 2014).

7. Conclusion

It has been quoted by Prof. Muhammad Yunus that poor people are like bonsai and that they have all the capabilities to rise up like big trees although they are planted in flower pots. The phenomena of poor always remain the same. But with the advent of microfinance, catalytic changes have taken place in the lives of financially excluded people. MFIs have emerged as an alternative to provide financial services to low income clients, who are otherwise excluded from formal credit channels. A marked improvement has been observed in the standard of living of many individuals living below the poverty line. The efficiency and sustainability of Micro Financing Institutions (MFI) are important issues to be tackled. Those firms which are efficient and sustainable have significant reach to the rural poor.

The article was meant to look into the several important aspects of microfinance. It has addressed the issues such as modes of lending of microfinance, financial performance and outreach of micro finance institutions and the recent trends in the microfinance sector. It would definitely help the finance researchers to identify the different issues in microfinance and provide a platform for them to take up other dimensions of microfinance such as microfinance products, different models of microfinance etc.

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