

## **ABSTRACT**

**Title of the Thesis:** Cost Structure and Financial Sustainability of Microfinance

Institutions: A Study of Select MFIs in Assam

**Researcher:** Pinky Dutta

**Supervisor:** Dr. Debabrata Das

Professor, Department of Business Administration

Tezpur University, Napaam, Assam, India Pin- 784028

**Period of research:** The study covers a period of 2010 to 2016

**Statement of the Problem:** The financial sustainability of an Microfinance Institutions (MFIs) is defined as its capacity to generate income from its operations to cover all its expenses and a margin to support its growth. The cost structure which includes the operating expense, financial expense and loan loss expense, reflects the financial self-sufficiency of the institutions, which is a necessary condition for institutional sustainability. The microfinance in Assam, India, is still at an early stage of development, facing severe constraints, including limited funding, lack of experience, inappropriate legal forms, and high operational costs. In addition, the new guidelines issued by the Reserve Bank of India (RBI), curtailed the profitability of the MFIs and forced them to reduce their costs at various fronts. Under such conditions in-depth studies on the issues of cost and factors which effect costs are important. Hence, identifying the cost factors and quantifying them will help the MFIs in reducing their cost. The study also provides insight into the cost borne by the borrowers in procurement of credit from MFIs in Assam.

**Objectives of the Research:** The objectives of the study are

1. To identify and analyze the cost structure of the selected MFIs operating in Assam.
2. To examine the effect of various factors on the cost of the selected MFIs.
3. To study the cost of borrowing from microfinance borrowers' perspective.
4. To derive strategies for financial sustainability of MFIs through improving cost management practices.

**Scope and Limitation of the study:** The study in this thesis covers both supply side and demand side of the leading MFIs in Assam. To collect data from supply side perspective, the eight selected MFI head offices and 64 branch managers, 81 field officers were interviewed. The demand side data were collected from 571 microfinance borrowers covering seven districts of Assam viz. Kamrup, Jorhat, Barpeta, Sonitpur, Goalpara, Darrang and Morigaon. Detailed analysis of three cost components for the MFIs namely, operating cost, financial expense and loan loss expense are carried out in this thesis. For microfinance borrowers' perspective transaction cost and financial cost components are studied.

In spite of several studies on cost structure of MFIs, the number of research papers focused on MFIs of Assam seems to be drastically less. The present study makes an attempt to analyse the cost structure of MFIs in Assam.

**Research Methodology:** The study is primarily based on field survey carried out through interview method. Primary data for the study was also collected from the select MFI head offices for the period of five years (FY 2009-10 to FY 2013-14). The research work in this thesis is empirical in nature. To fulfill the objectives of the study survey method and interview method was adopted. A sample survey of 61 branch offices and 571 microfinance borrowers was conducted in seven districts of Assam. The survey included two research instruments. A questionnaire prepared for the MFI branch offices and an interview schedule prepared for the borrowers of the respective MFI branch offices.

*Parameters:* Three broad categories of MFI cost are considered for study: operational cost, loan loss reserve and cost of funds. The cost components considered for the borrowers are financial cost, and transactions cost. Effects of various factors such as the size of loan, number of clients, number of employees, mode of delivery, area of operations, outreach and capital structure on operational and financial cost of MFIs. Similarly, variables which have impact on the sustainability of the MFIs were identified and analyzed.

Regression analysis is used to test the significance of the independent variables on the sustainability of the MFIs in Assam. The study also provides insight into the borrowing costs of the borrower. The borrowing costs were estimated using the activity cost based method.

**Findings of the study:** From the above analysis, it is observed that the microfinance industry in Assam has emerged as a market consisting of small or medium NGO-MFIs, dominated by a few large NBFCs. The MFIs are currently operating in twenty two districts of Assam, with a network of 199 branch offices. In spite of the Andhra Pradesh crisis in microfinance sector during 2011, the MFIs in Assam have focused on their growth. The client outreach grew by 33 percent and loan outstanding grew by more than 100 percent in five financial years from 2009-10 to 2013-14. The average loan outstanding per borrower increased by 42 percent from FY 2009-10 to FY 2013-14. The eight MFIs have a staff strength ranging from 20 to 560, with a total of 1052 employees in the FY 2013-14 and an increase of 21 percent in last five financial years. There were only nine percent of women employees in the non-managerial level of the MFIs at the end of the financial year 2013-14. The number of active borrower per staff for the MFIs in Assam is 321 in the year 2013-14, which is higher than the all Indian MFIs average of 294 borrowers per staff member. However, the gross loan portfolio per staff is lower than average gross loan portfolio per staff of the all Indian MFIs as reported in Sa-dhan. Hence, there is a scope for the MFIs in Assam to increase their loan size. The MFIs in Assam are funded through a combination of external debt, equity financing and internal cash generation. In the last few years, Developmental Finance Institutions are the major source fund for the MFIs in Assam, represented 54 percent of the total funding, and followed by banks. Debt funding grew by 14 percent into the sector from FY 2012-13 to FY 2013-14, compared to the previous FYs. The median leverage ratio of the MFIs in the FY 2013-14 was 5.6, higher than that of the all Indian MFIs. The Net owned fund of the MFIs increased by 177 percent in 2013-14 from the financial year 2009-10. The Capital Adequacy Ratio for the NBFCs remained above the level of 15 percent, fixed by RBI.

The total expenses of the MFIs, which include operating expense, financial expense and loan loss expense, in Assam exhibit an increasing trend. The operating expense comprised 47 percent, financial expenses contributed 51 percent and loan loss expense contributed 2 percent of the total expense of the MFIs in Assam, in the FY 2013-14. The average operating expenses seems to be decreasing and financial expenses seems to be increasing for the MFIs in Assam during FY 2009-10 to FY 2013-14. The personnel expense seems to be the largest contributor to the MFI operating expense. The salary and incentive of the staff comprises of

68 to 87 percent of the total personnel expense. The major contributors of administrative expenses were rent and traveling expenses. There are a number of determinants of the operating expense of an MFI; out of which the form (legal structure) of the MFI, its lending model, number of active borrowers and the number of borrowers per staff were the key determinants of operating expense. The operating expense of NBFCs was much higher than that of the NGO-MFIs, since most of the NBFCs were in growth phase and invested in their expansion. Operating expense of the institutions following SHG model is lower than that of the MFIs following JLG model.

The yield on gross loan portfolio of the MFIs in Assam seems to be improving slowly from 2011-12 to 2013-14. The yield and OER seems to be close to each other, reflecting that the MFI borrowers in Assam are gaining from the higher efficiency in the form of lower interest rates. The ROA and ROE for the MFIs in Assam for the FY 2013-14 is lower than that of the All Indian MFIs.

The MFI borrowers incurred transaction cost and financial cost while availing loan from the MFI. The documentation comprises 59 percent and transportation cost comprises 22 percent of the total transaction cost. As obvious, the total borrowing cost decreased with the increase in loan amount. The transaction cost for the borrowers in the subsequent loan cycle is lower than the same cost in the first loan cycle. This is because some of the costs, especially initial costs, were one time costs and non-recurring in nature. For the MFIs in Assam, the opportunity cost appeared to be negligible.

The important factors in determining financial sustainability of microfinance institutions in Assam are the institutional factors, financing structure, revenue generated and efficiency. The institutional factor indicates that, NBFC are more sustainable than the NGO-MFI and the JLG lending model help the MFIs to achieve sustainability. The financing structure implies that various combination of capital improve the financial sustainability of the MFIs. However, more the MFI is debt financed compared to other sources of finance, the more they are deficient in their sustainability. It is important for the MFIs in Assam to maintain their debt to equity ratio below 5.6. As obvious, it is observed that MFIs are required to maintain a

striking balance between the number active of borrowers and the number of staff to reduce their operating expense. The MFI can achieve sustainability, either by increasing their yield, or by decreasing their expenses. Hence, with efficient utilization of resources the MFI can minimize the expenses and enhance their revenue. The MFIs in Assam had to resort to different cost cutting measures to remain sustainable.

**Suggestions:**

- (a) ***By improving productivity and efficiency:*** MFIs can attain sustainability by decreasing their cost per borrower and number of active borrowers per staff. It is observed that MFI branch offices with 500 to 600 borrowers per staff or 1500 to 1800 active borrowers are able to reduce their cost effectively. Further, by efficient management of operating expense MFIs can achieve sustainability. Such as utilizing the same premises for both area and branch offices can reduce the cost, extending higher loan size to the existing customers.
- (b) ***Use of technology:*** Cost can also be reduced by using technology in their operations. Printing expenses can be reduced by minimizing paper work in loan application and processing. Further, use of palmtops can reduce the costs and increase the operational efficiency of the MFI. Disbursement of loan directly to the account of borrowers can reduce the time and effort of both the MFI field staff and the borrower.
- (c) ***Management of financing mix:*** It is suggested that the MFIs should maintain DER below 5.6 levels. Higher leverage ratio of the NGO-MFIs adversely impacted their sustainability. Hence, it is important for the NGO-MFIs to increase their equity capital to bring down their leverage ratio. This can be done either by tapping clientele capital (by issuing equity capital to their members) or by increasing their revenue, which can be reinvested in the institution. To attain sustainability, it is important for the NGO-MFIs to increase the proportion of loan portfolio and defer any increase in its fixed assets.
- (d) ***Managing borrowers cost:*** MFI borrowers' transportation cost may be reduced by providing all the services at the doorstep of the borrowers. Similarly, in order to reduce the documentation cost, the photograph of individual member as well as identity certificates can be digitized electronically at the MFI so that borrowers need

not to incur the expenses on these items again and again. This will also reduce the documentation cost for the MFIs. Borrowers' awareness about loan products and features can increase the efficiency of the loan process. MFIs can use innovative methods like pictorial representation or aids, to communicate and advertise the information more efficiently.

The study extends following recommendations to the policymakers. There is a need of suitable regulations to be enacted for the NGO-MFIs.

***Contribution to the body of knowledge:*** The present study documents the scenario of microfinance in Assam, the operational and financial performance of the MFIs in Assam during the period from 2009-10 to 2013-14. The key contributions to knowledge made by the study are, this is a first attempt to determine the factors effecting financial sustainability of the MFIs in Assam, India. The study reveals the factors which have impact on the operating expense, financial expense and financial sustainability of the MFIs. The study on cost from MFI borrowers' perspective unveils the cost components borne by the MFI borrowers. The study identified the factors which require considerable attention by the MFI manager's to maintain financial sustainability.

***Scope for further research:*** The emergence of payment bank and small finance bank might have impact on the MFIs in terms of cost of finance and operating costs. This may be one of the important areas for further research. While carrying out the current work, it was observed that corporate government aspect and Social performance of the MFIs Assam can also be studied in future.