Chapter I
INTRODUCTION

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1.1 Introduction

Microfinance refers to providing entire range of financial services such as savings, remittances, insurance, production and investment credit to low income clients (Karmakar 36). It is considered to be an integral part of the financial sector; which extends financial services to low and moderate income businesses or households (Robinson 9). It is an effective means to combat poverty and economically empower the poor by financing income generating activities. Microfinance helps to develop the institutional capacity of a financial system, by providing cost effective loans to the poor households (Mordoch 617). The institutions actively involved in microfinance are referred as microfinance institutions (MFIs) (Mershland and Storm 28). They act as financial intermediaries, with a focus on poverty alleviation and outreach along with financial sustainability (Mordoch 617). In due course of time microfinance has evolved into a global industry, with thousands of MFIs serving more than 205 million clients around the world (Maes and Reed 3). It has changed the established ideas of the formal financial sector by proving poor as bankable (Brua and Woller 4).

Globally, the microfinance sector has been recognized as a tool for poverty reduction and financial inclusion (Leikem 6-7). At the same time it has also emerged as a profitable venture for private equity investors. The potential for profitability and increase in access to capital has prompted a large number of MFIs to adopt for-profit business model (SKS microfinance) (Lauer 1). It has increased the access of capital and financial services for both lender and borrower. However, the for-profit model is alleged for its negative impact for charging exorbitant interest rates and encouraged over-borrowing and multiple lending (Mader 55-56; Harper 564).

Moreover, MFIs adopted the practice of offering loans at high interest rates to cover all their expenditure. MFIs defend the charges of high interest rate, on the plea that the operating costs are very high in microfinance sector in comparison to traditional formal financial institutions. The high operating costs are due to high cost of delivering services to the poor. Therefore, MFIs argue that insufficient interest may lead to unsustainability (Mordoch 617 and Littlefield and Rosenberg 39). Some researchers believed that by adopting for-profit model MFIs can manage their costs more efficiently (Pollinger et al. 39). But the issue of achieving sustainability became questionable due to the various practices adopted by the MFIs. For instance, higher interest rates, larger loan sizes, multiple lending, over borrowing and coercive recovery practices were some of the means used by the MFIs for achieving sustainability. For example, the Andhra Pradesh (AP) crisis in India during 2010 was the effect of commercialized coercive practices adopted by the MFIs to remain sustainable (Shankar and Asher 8).

The AP crisis (in 2010) slowed down the growth of Indian microfinance sector substantially. Prior to the crisis, during the period from 2005 to 2010 the microfinance sector recorded phenomenal growth with 62 percent per annum in terms of numbers of unique clients and 88 percent per annum in terms of portfolio over the five years (M-CRIL viii). The growth was supported by funding availability and potential demand for microfinance in the sector (CARE 3). The growth was concentrated to some parts of Southern India (especially Andhra Pradesh), which leads to major crisis in the Indian microfinance sector (Mader 49) (discussed in detail later in this chapter in section 1.4). The crisis not only damaged the viability of the MFIs but also severely impacted other stakeholders such as the clients, banks, etc. Further, the position of the Indian microfinance sector in the global context in terms of overall microfinance business, environment and regulatory framework and practices declined during 2010-11 (see Economist Intelligence Unit report in 2012). In response to AP crisis, a series of reforms were introduced by the Government of AP and Reserve Bank of India (RBI) during 2010-13. Following the AP Ordinance, in 2010 RBI formed a committee, viz. the Malegam Committee, to look into the issues related to the sector (RBIa 1-54). Based on the recommendations of the committee, RBI issued prudential and non-prudential guidelines for the MFIs in December 2011, which were implemented by the MFIs from April 2012. Various studies have reported that the new regulations restrained supply of funds in microfinance sector of India (IFMR 1-42; Phuzhendhi 141 and Srinivasan 63). Consequently, the operational and financial performances of the MFIs were adversely impacted during 2011-12 (Das and Dutta 5). The impact of the crisis was much more severe in southern part of India. However, the impact was also visible in other regions of the country. The microfinance industry in North East Region (NER)[i] was also effected with a lesser level of impact. The NER of India suffered from funding problems, which in turn hindered the operations, recruitment and expansion plans of the MFIs in the region (Das and Dutta 209). For instance, in some areas of Assam the borrowers waited for three or more months to get the loan amount after sanction of the loan. Funding problem also led to closing of branches of some of the MFIs. However, with stable and supportive policy environment from RBI, the sector has regained its growth and potential to serve the poor (Microfinance Barometer 2).

Cost competitiveness:

Sustaining in a market with capital and regulatory constraints has become a challenge for the All Indian MFIs. It is observed that to remain sustainable, the All Indian MFIsare making efforts to reduce costs or reallocate costs (Guntz 20). Cull et al. (167-192) and Mahajan (1) argued that for the sustainability of microfinance operations the cost-covering interest rates are necessary. Ek (13) stated that, MFIs should make an effort to become more efficient and reduce their transaction costs as much as possible to ensure that the poor are not being exploited by high interest rates. However, the new RBI regulation[1] imposed stipulation of minimum net owned funds, introduction of the concept of "qualifying assets", strict capital adequacy norms; cap on operational income, compliance to credit bureau checks curtailed the profits of the MFIs. With new regulations and constrains, to remain sustainable in the market is a challenge for the All Indian MFIs.

Hence, identifying the cost factors and quantifying them will help the MFIs in reducing their cost. The cost structure reflects the financial self-sufficiency of the institutions, which is a necessary condition for institutional sustainability (Brau and Woller 6). For this reason, the issues effecting the cost components of the MFIs and

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[1] Master Circular - 'Non Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions (2015) https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=9012

their impact on overall cost structure of the MFIs have drawn substantial research interest.

However, there seems to be no unique set of factors that determine the cost structure of the MFIs of a country or region. For instance, Muhammad and Waweru (8) observed that the cost structure of certain MFIs in Bangladesh were influenced by the source of fund, transferable cost, subsidy, cost of delivery and administrative cost of the MFIs in that country. Khan (1-30) found that the cost of capital, administrative costs, and loan losses as the major cost components. Their study was based on data from the MFIs reporting to Microfinance Information Exchange (MIX). Fernando (1-18) and Rosenberg, R.; Gonzalez, A. and Narain, S. (2) observed that the cost structure of an MFI depends on the cost of funds, the MFI's operating expense, loan losses, and the profits needed to expand their capital base and fund required for future growth. Guntz (16-17) segregated the costs into financial services cost and functionally separate costs (direct and indirect costs). Identification of the important cost components of the MFIs operating in Assam, India, is one of the objectives in this thesis.

The cost of lending strongly determines the viability of the organization and its ability to reach the poor. Information on cost helps MFI managers to streamline processes, and to raise the awareness of the cost components of different products, including hidden costs (Cracknell and Sempangi 2). The greatest challenge of the MFI business model is to reduce its operating expense (operating expenses are the main component of interest rates) in order to reduce the cost of service borne by the borrowers (Gonzalez 37 and Kneiding and Mas 1-4). MFIs are reducing their costs by adopting innovative methods, new technology and improved internal operational policies and infrastructure (Fernando 10). Hence, identifying the cost factors and quantifying cost will help the MFIs in reducing their cost.

The microfinance in North East Region of India is still at an early stage of development and is largely limited to Assam and some parts of Manipur and Tripura. In Assam, microfinance is a relatively new concept, but it has around 0.3691 million clients with loan portfolio of Rs 246.752 million (Sa-dhan 40-56). The existing MFIs are facing severe constraints due to a number of factors, including limited funding, lack of experience, inappropriate legal forms, high operational costs and moderate human resource quality. Further, the challenging environment viz. the tough geographical terrain, inadequate infrastructure and higher associated costs effect the operating expense of the MFIs (SIDBI 31 and Nair 60). Under such conditions in-depth studies on the issues of cost and factors which effect costs are important.

In spite of several studies on cost structure of the MFIs, number of research papers focused on MFIs of Assam seems to be drastically less. The present study identifies the factors and tries to discuss the impact on the factors of the financial sustainability of the selected MFIs in Assam. The reduction in operational cost can be transferred to the clients by reducing the interest rate on loan products; thereby the financial services for poor households can contribute to the achievement of Millennium Development Goals[2].

The scope of this research is to find and test empirically which cost factors influence the achievement of financial sustainability of the MFIs operating in Assam.

1.2 Theoretical framework

1.2.1 Conceptualizing microfinance

The term microfinance refers to "Small, Short and Unsecured" (Srinivas 1). Generally microfinance is defined as small loans to low-income households for self-employment projects, with a mission to reduce poverty and to empower the people to help themselves (Mershland and Storm 28; Bogan 1045 and Ledgerwood 1).

The term microfinance has its roots of microcredit, which evolves from last three decades. Till 2000s microfinance was defined as a scheme designed to provide credit and saving services to thousands of poor (Rhyne 6 and Morduch 617).

The task force on supportive policy and regulatory framework for microfinance[3] states microfinance as “Provision of thrift (saving), credit, and other financial services and

[2] For more detail see http://www.undp.org/mdg/

[3] http://www.gdrc.org/icm/country/india-mftaskforce.html

products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards.”

Leikem (7), has stated microfinance as availability of loans to rural people without obtaining collaterals for income generating purposes in order to reduce the poverty levels. Reserve Bank of India (2) referred to microfinance as an economic developmental tool which encompasses a range of financial services and assists the poor to move out of poverty.

The difference between microfinance and mainstream finance is that the former targets borrowers who have no access to formal or mainstream finance and are engaged in informal sector for income generation. In 2002, the world leaders at the United Nation’s Monterrey Conference on Finance and Development adopted a consensus recognizing the link between the provisions of microfinance services and attainment of the millennium development goal of reducing extreme poverty by fifty percent by the end of 2015.

From the above definitions of microfinance, it is observed that initially, microfinance was considered as a medium to provide small scale financial services such as savings and credit facilities to poor customers. Later, a broad range of financial services such as deposits, loans, payment services, money transfers and insurance were extended to poor and low-income households through the MFIs. Further from the definition of RBI, it is observed that microfinance is considered as a tool for economic development. Extending further the scope of microfinance Ledgerwood included social intermediation along with financial intermediation while defining microfinance (1). Increasing employment, reducing poverty, reduced income vulnerability among the beneficiaries is considered as evidence of significant impact of the microfinance sector (Mahjabeen 60). At the same time, microfinance is established as an idea of providing cost-effective financial services to the poor people who were earlier considered non-bankable by the financial institutions (Brau and Woller 4).

Furthermore, microfinance movement empowered women and helped them to enhance their household income and family wellbeing (Littlefield, Mordoch and Hashemi 1). Following the success of microfinance, 2005 was celebrated as the international year of Microcredit by the United Nations (Pollinger et al. 24). According to CGAP (2) the main objectives of microfinance are:

- *To help the poor and the needy to meet their basic requirements and reduce risks.*
- *To improve their economic conditions through small loans and savings products.*
- *To provide self employment opportunities, especially to women.*

In addition to the above mentioned objectives, the Microcredit Summit Campaign identified four core goals for microfinance: reaching the poorest, ensuring a positive measurable impact on the lives of clients and their families, building financially self-sufficient institutions, and reaching and empowering women. Marakkath (3) summarized four main objectives of microfinance as financial inclusion, poverty reduction, women empowerment and sustainability. Microfinance is extended through the MFIs, which act as financial intermediaries, with a focus on poverty alleviation and outreach along with financial sustainability (Brau and Woller 4; Haq et al. 64). MFIs aim to provide opportunity to save and invest in the income generating activities. They play vital role in providing financial services to low income and rural population. Tauheed (1) mentioned that MFIs with certain characteristics are able to reach economically backward areas. These characteristics are

- Ready Access to an established client base,
- Experience in cash management,
- Established internal audit and monitoring system,
- Resources to help build an effective Business Correspondent[ii] channel,
- Client insight for new product development, and
- Client relationship management.

These characteristics enable the MFIs to act as potentially viable tool to eliminate poverty for many and reduce its severity for many.

1.2.2 Institutional arrangement for Microfinance

MFIs gradually replaced the informal money lenders and are recognized as extended arms of banks to provide banking services in the remote areas. Asian Development Bank categorizes the MFIs into formal, semiformal and informal categories based on governmental regulation. Consequently, MFIs can be classified on the basis of their organizational structure (such as cooperatives, solidarity groups, village banks, individual contracts, and linkage models) or according to their legal status (viz., NGOs, cooperatives, registered banking institutions, government organizations, and projects). The categorization varies from country to country. For instance, in India MFI under the Microfinance Institution (Development and Regulation) Bill, 2012 includes the following entities: (a) a society registered under Societies Registration Act, 1860; (b) a company registered under section 3 of the Companies Act, 1956; (c) a trust established under any law for the time being in force; (d) a body corporate; or (e) any other organisation, which may be specified by the RBI if the object of the institution is the provision of microfinance services. It does not include a banking company, co-operative societies engaged primarily in agricultural operations or industrial activities or any individual who carries on the activity of money-lending and is registered as a moneylender under the provision of any State law.

An MFI in India acquires permission to lend through registration (Table 1.1 provides details of the registration requirements). MFIs are registered as one of the following five types of entities (Table 1.1):

Table 1.1: MFIs by type of registration

Category	Type of MFI	Registration
Not for profit	NGO-MFIs: Societies and trusts	Registered under Societies Registration Act, 1860 and/or Indian Trust Act 1882
	Section 25 Companies	Section 25 of Companies Act
Mutual Benefit	Cooperatives	Registered under State Cooperative Benefit Societies Act or Mutually Aided Cooperative Societies Act (MACS) or Multi-State Cooperative Societies Act, 2002

For profit	NBFC	Companies Act, 1956 & registered with RBI
	NBFC-MFI	RBI Circular, May 2011

Source: M-CRIL Microfinance Review 2010.

After the microfinance crisis in Andhra Pradesh, India, RBI created a separate category NBFC-MFI, with the aim to provide recognition to microfinance as a legitimate and important part of financial system. The NBFC-MFIs are required to follow the NBFC-MFI Directions 2011 laid down by RBI. These recommendations assist to check the unethical practices adopted by the MFIs to increase their portfolio size and expand client base. Under the present regulation, an existing MFI have minimum net owned fund of Rs 50 million (5 crore) to qualify as an NBFC-MFI. However, a NBFC-MFI located in North East Region has to maintain a minimum net owned fund of Rs 20 million (2 crore), which is much lower in comparison to the requirement for rest of India. This would encourage new NBFCs to work in un-served and under-served states[4]. The RBI (in 2011) has declared that MFIs cannot charge an interest rate of more than 26 percent for microloans (NBFC Directions, 2011), which was later in February 2014 has removed.

1.2.3 Conceptualizing sustainability

Navajas et al. referred to sustainability as permanence (335). In the context of microfinance, sustainability refers to the long term continuation of the activities by the institution and also the ability to repeat performance through time (Dutta and Das 728). It refers to the ability of the institution to cover their operating cost from the operating revenue generated from their core activities (Marakkath 31). UNESCAP (5-6) reported that a sustainable microfinance institution is able to meet the needs of their clients by offering prolonged services. Pischke (231) referred to sustainability as “independence from subsidy”.

The above definitions suggest that sustainable MFIs are those which can carry out their activities without the need of donations and subsidies. Sustainability of MFIs is

[4] Microfinance industry welcomes RBI NBFC-MFI norms as a positive step, Microfinance Focus, December 5, 2011, accessed on 8th December 2011

also measured on the basis of its contribution to social welfare of the poor (Ganka 30). An important question that arises in the context of sustainability is that whether an MFI should focus on outreaching the poor *(welfarists approach*) or aim to maximize profitability (*institutionists approach*) to remain sustainable. Brau and Woller (1-26) discussed on school of thoughts on sustainability of an MFI. *Welfarists* are focused on the immediate well being of the participants, even at the expense of donations and subsidies. However, Brau and Woller (4) suggested that receiving subsidies depreciate the efficiency of the MFIs. *Institutionists* believe that an MFI must generate profit in order to reach its goal. According to them massive outreach requires substantial financial resources. Hence, institutionists do not consider the goal of outreach and sustainability as mutually exclusive (Woller and Schreiner 3; Cull et al. 7). The MFIs in Assam, India, follow a mixed model in the sense that none of them can be classified as purely *institutionalist or welfarist.*

Sustainability can also be viewed from other perspectives as well. For instance, in microfinance sustainability can be considered at several levels of operations such as institutional, group, individual and can relate to organizational, managerial, and financial aspects also (Kimando, Kihoro and Njogu 22). It has several dimensions depending on user requirement.

The dimensions are as follows (Mahajan and Nagasri 1)–

I. Institutional sustainability,
   - Mission sustainability,
   - Program sustainability,
   - Human resource sustainability,
   - Financial sustainability,

II. Market sustainability,

III. Impact sustainability,

IV. Legal policy environment sustainability.

Pischke (231) presented four concepts that measure the degree of sustainability of the institutions which are as follows, (i) the value of project cash flows to the institution providing services; (ii) accounting profits or loss, (iii) independence from subsidy, and (iv) sources of funding. This indicates that MFIs must maintain good financial accounts and follow recognized accounting practices that provide full transparency for income, expenses, loan recovery, and potential losses (Meyer 4).

Among the different forms of sustainability, the concept of financial sustainability is widely accepted by the practitioners and researchers (Marakkath 22). The microfinance institutions need financial resources to fulfill their requirements. For instance the institutions need well designed products to satisfy the needs of the customers. This requires qualified staff to design and deliver their products. All these services require financial resources. Clearly, the sustainability of an MFI depends on financial sustainability, where the institution covers operating costs with operating revenue and unsubsidized capital base (Ayayi and Sene 2010). In this thesis the focus is on financial sustainability of the MFIs in Assam.

1.3 Evolution of microfinance

Prior to the emergence of formal financial institutions, moneylenders or informal institutions were providing financial services, at a very high cost, to poor households who had no access to mainstream finance. Many informal credit groups such as *susu*[iii] *collectors* in Nigeria and Ghana, chit funds and Rotating Savings and Credit Associations (ROSCAs[iv]) in India, T*ontines*[v] in West Africa, *Pasanaku*[vi] in Bolivia, *Arisan* [vii] in Indonesia, *Paluwagan* [viii] in Philippines etc were actively involved in financial services. In addition to informal credit, microcredit was provided by small banks such as Raiffeisen in Germany. Several credit-cooperatives were created in Germany, India, Indonesia which provided credit to million of poor people (Lavoori and Paramanik 2). During 1950s and 1960s the emphasis of various programs was on economic growth. However, in 1970s the focus shifted from economic growth to the provision of health, nutrition and education. High cost of transaction led to the failure of subsidized government funded programs or donor driven institutions. In the mean time, several forms of institutions such as the ACCIÓN International in Latin America (in 1973), Self-Employed Women’s Association of India (SEWA) (in 1974), Grameen Bank in Bangladesh (in 1976) emerged in different parts of the world to provide financial support to poor (Lavoori and Paramanik 2). Furthermore, many international NGOs, such as Foundation for International Community Assistance (FINCA), Americans for Community Cooperation in Other Nations (ACCION), Freedom from Hunger, Opportunity International, Co-operative for Assistance and Relief Everywhere (CARE), Consultative Group to Assist the Poor (CGAP), etc. were promoting microfinance programme for creating new business opportunities and combating poverty in a sustainable way.

1980s was a turning point in the history of microfinance. MFIs changed the traditional notion of banks, that the poor, especially the women, are not bankable. The microfinance community started identifying itself as a distinct development field. The institutions such as Grameen and Bank of Rakyat, Indonesia (BRI) were running profitably by providing small loans and saving services. The poor were willing to avail loan and pay the interest rate charged by the MFIs. The nature of microcredit was different from that of subsidized government loans. The loans were targeted for those who were depending on informal sources and emphasis was given on repayment. It was also observed that by late 1980s, NGOs, funding agencies and the other stakeholders started paying attention on the limitations of NGO modality (Fernando 1). The term microcredit became popular among practitioner and academicians.

Uptil 1990s the NGOs providing microfinance service suffered from lack of funding, lack of ownership, governance and their outreach were under scrutiny. This resulted in transformation of NGOs into regulated financial institutions, with an aim to improve accountability, governance, outreach, and financial sustainability (Fernando 3). Hence, the period of 1990s brought a new wave of change in the microfinance sector, with accelerated growth and transformation of NGOs into Regulated Financial Institutions (RFI). In 1992, PRODEM of Bolivia initiated the process by transforming an NGO into a shareholder-owned BancoSol and one year later CorpoSol of Cambodia transformed to FinanceSol (in 1993).

From 1992 to 2003, as many as 39 MFIs in 15 countries were transformed into regulated entities. Fernando (1-2) found that this transformation occurred more in Latin America and than in Africa, Asia, the Pacific and East Europe. Some observers consider the process of transformation as a natural progression (White and Campion 23). Others are concerned that transformation of MFIs leads to mission drift. However, Fernando (1-42) observed positive outcome of the transformation. MFIs have found new shareholders, increased their equity capital and improved governance, institutional sustainability, outreach to the poor and are offering diverse products and services. The process of transformation of the microfinance providers attracted huge flow of capital from private investors and rich individuals (Bateman and Chang 3). Increasing competition and fast development of the sector inspired many MFIs to hire new skills, technologies, and innovation.

Commercialization of the MFIs allowed them to grow faster, reach many more clients and to achieve operational self-sufficiency. However, critics argued that commercialization drove interest rates up, increased competition among the MFIs and the MFIs drifted from their original goal of providing loans to financially challenged borrowers. The MFIs were interested in booking higher profit (Lützenkirchen and Weistroffer 5). Commercial viability and profitability led the MFIs to move away from their original social motive. Hence, the issue of mission drift attracted a number of researchers'. Though some of the empirical studies found no evidence of mission drift, when measured by depth, quality, financial position and scope of outreach to poor clients and supported the position that a more profit-oriented microfinance industry is able to serve the poorest more effectively (Fernando 1-42; Cull, Demirguc-Kunt, and Morduch 167-192; Mershland and Strom 28-36). In contrary, Campion and White (1-31), and Rhyne (6-8) reported that formalized MFIs have already started avoiding risky innovations and less attractive markets in favor of immediate profitability and a safer portfolio. The perception has arisen that the industry has given more priority to commercial objectives such as profit and volume instead of its original social motive (Woller 1).

During 2000s there were changes in policies, operating formats, regulation and stakeholder orientations. Expanding commercialization and excessive profit–orientation created major problems in microfinance in this decade. During this period, the cost of offering loans to the clients and operating cost of MFIs attracted attention of many scholars (Sa-Dhan 1-52, and Rosenberg 1-4). Excessive profit-orientation was driving interest rates up, transferring wealth from the poor to MFI managers and investors. This process also increased the share of over-indebted borrowers among

MFI clients. MFIs defended these charges on the plea that the operating cost and other relative costs were very high in the microfinance sector in comparison to traditional formal financial institutions. The MFIs incurred high cost in obtaining the fund and making it available to the borrowers. Hence, many MFIs adopted the practice of offering loans at interest rates which were sufficient to cover their full costs including that of capital, administration, loan losses with a margin for adequate return (Rosenberg et al. 1). However, this practice raised queries related to operational cost and revenue generated by the institution among the stakeholders of microfinance. During this period many researchers studied the cost components of the MFIs (Ranade et al. 1-16; Shankar 1331-1342; Rosenberg et al. 1-4). The issue of commercialization and high interest rates charged by the MFIs was refueled by the unpleasant events reported from various countries such as Pakistan, Bangladesh, India, etc (Das and Dutta 5-24).

1.4 Microfinance in India

After independence of India, institutional credit was adopted as a strategy for rural development and poverty alleviation (Seibel 7). The period between 1960s to 1990s, referred to as "social banking" phase, where Government of India took a series of measures such as nationalization of private commercial banks, expansion of rural branch networks, mandatory system for priority sector lending, extension of subsidized credit, establishment of Regional Rural Banks (RRBs) and the Integrated Rural Development Program (IRDP) in order to alleviate poverty. These initiatives to some extent increased rural outreach and credit volume. But soon it was realized that the operational costs were very high and the institutional structure was neither suitable nor profitable for both the lender and borrowers. Despite these shortcomings, the banking sector reported huge branch outreach; there was establishment of apex institutions such as National Bank for Agricultural and Rural Development (NABARD) and the Small Scale Industries Development Board of India (SIDBI) (Intellcap 12) and many civil society initiatives such as Self Employed Women Association (SEWA) Bank, MYRADA, Annapurna Mahila Mandal and Working Women Forum.

In the next section the progress of Indian microfinance sector was divided into three phases v*iz.* Phase I 1990s: Emergence of microfinance, Phase II: Turmoil in the microfinance industry-the Andhra Pradesh case and the third phase Consolidation phase: Microfinance with new Regulatory Regime (Table 1.2).

1.4.1 Phase I 1990s: Emergence of microfinance

In India, microfinance was initiated in response to fill the vacuum [ix] left by the widespread banking infrastructure (Karmakar 69). The period 1990s was a turning point in the history of financial services for the poor. The microfinance movement gained momentum in 1992, when NABARD along with MYRADA started with the self-help group bank linkage programme (SBLP) (Lavoori and Paramanik 3). It is worth mentioning here that SHGs were initially formed by Self Employed Women Association (SEWA) Bank. The SBLP has uplifted the income and savings of the poor, especially of women (Dutta 42). The period from 1990 to 2000, witnessed the emergence of MFIs, largely of non-profit origin to serve the poor. The MFIs often started as non-profit entities aided by international donor and soft loans from apex institutions such as SIDBI, Rashtriya Mahila Kosh (RMK) and Friends of Women's World Banking (FWWB) (Intellcap 12).

Uptil late 1990s, the NGOs providing microfinance service suffered from lack of funding, lack of ownership, governance and their outreach were under scrutiny. This resulted in transformation of NGOs into regulated financial institutions, with an aim to improve accountability, governance, outreach, and financial sustainability (Hishigsuren 6-7). Hence, the period from 1990s-2000s, brought a new wave of change in the microfinance sector, with accelerated growth and transformation of NGOs into Regulated Financial Institutions. Many NGO-MFIs moved towards commercial banks for loans and achieved excessive client outreach.

At this point of time, the microfinance community started identifying itself as a distinct development field. The microfinance sector grew rapidly in India during the period of 2004-2009, with an average increase in number of clients' year-on-year being more than ninety percent and the size of portfolio outstanding grew by almost

100 percent year-on-year basis (Venkatesan andd Sukumar 1). However, the growth was concentrated mainly in the Southern part of the India. Sriram (116) reported that the growth of Indian microfinance was impressive but the growth was mainly observed in Andhra Pradesh (AP), adding nearly 1.3 million customers. Given the large demand for credit in AP, five of Indian's largest MFIs viz. SKS, BASIX, Spandana, Share and Asmitha were having headquarters in AP and operational with large number of branches.

The social and economic benefits of the microfinance sector also attracted new investors and encouraged substantial commercial involvement in the industry. With financial support from equity investors, eighteen new NBFCs were established during 2007- 2009. The average debt to equity ratio of All Indian MFIsdeclined from 11.05 percent in 2005 to 2.14 percent in 2012 (Mader 50). Further, there were changes in policies, operating formats, regulation and stakeholder orientations of the microfinance industry. The period further marked increasing competition and fast development of the sector, which inspired many MFIs to hire new skills, technologies [x], and innovation. Innovative funding options such as issue of Non Convertible debentures, securitization, etc were available for the All Indian MFIs. In 2009, SKS, one of the leading MFI in India, successfully mobilized equity capital through IPO (Initial Public Offering) mode, which was 13.7 times oversubscribed (Becker 731).

Table 1.2: Phases of Microfinance in India

Phases	Year	Features
1	2	3
First phase: Emergence of microfinance	Pre take off phase 1990-2000	• Started with wide spread network of commercial banks. Expansion of the network of rural banking. RRBs, NABARD and SIDBI were established. Co-operative banking was structured and developed. • Extensive disbursement of subsidized credits through Government sponsored program such as SGSY • Along with MYRADA NABARD started with SHG-Bank linkage programme was which replicated rapidly. • NGO-based MFIs were developed to provide microfinance products and services on not-for-profit basis. Innovative credit lending mechanisms based on "peer pressure" and "moral collateral" were developed.
	Take off phase 2001-2010	• The microfinance sector grew rapidly in the period 2004-2009, with an average increase in number of clients year-on-year being 91 percent, while size of portfolio outstanding grew by almost 100 percent year on year basis (Venkatesan 1). • Microfinance is seen as a business proposition and commercialized. • Development of for-profit MFIs like Non-banking Financial Companies (NBFCs). 18 new NBFCs were established with a balance sheet size greater than INR 100 crores during 2007-09. • NGO-MFIs are being legitimized. • Customer centric microfinance services and products are given importance. • Policy regulations are increased. • Period ended with Andhra Pradesh crisis.

Continued..

Phases	Year	Features
Third Phase: Consolidation and revival phase: Microfinance with new Regulatory Regime	2011 -2014	• RBI came out with NBFC-MFI Directions 2011, in order to stabilize the microfinance sector. • A separate category, NBFCs-MFIs was created, the margin cap was fixed at 12 percent and the capital adequacy ratio for new NBFC-MFIs was 15 percent. • The performance indicators return on assets and equity are improving. • The new RBI guidelines have increased the confidence of the investors and bankers on the MFIs. • The issue of client protection and transparency in the process has been the top priority for the regulatory bodies
	2015 onwards	• Renewed growth in loan outstanding and client outreach • Attracting banks and private equity investors • RBI declared bank license to some MFIs

1.4.2 Phase II: Turmoil in the microfinance industry-the Andhra Pradesh case

Until 2010, Andhra Pradesh (AP) was often referred to as 'Mecca of Microfinance'. The penetration rate of microfinance was higher than any other state and also some of the largest MFIs (BASIX, SKS, SHARE, Spandana, etc) originated and flourished in the state. The state was also benefited from the state government led programs viz. SHG-Bank Linkage programs and Andhra Pradesh District Poverty Initiative Project (also known as Velugu). With the transformation of SKS, SHARE, Spandana to for-profit NBFCs, the microfinance activities in AP increased in a very rapid pace. However, rapid growth was not with out problems.

The early signs of distress in Andhra Pradesh (Krishna Crisis) started in 2006, which has created a loss of Rs 75 crore for the MFIs operating in the area and their banks. The period 2005-2007 brought private equity, professionalization and commercialization in AP. In order to achieve more clients and higher profits, MFIs indulged in multiple lending, high interest rates (between 24 to 55 percent) and ignorance of customer protection (Ghiyazuddin and Gupta 3-4). Along with commercialization, came stiffer competition between the state and the private players also among the MFIs (Rhyne 7; Lützenkirchen and Weistroffer 5). The Krishna Crisis and Andhra Pradesh Crisis (2010) fueled the issues of higher interest rates, larger loan sizes, coercive recovery practices, and multiple lending. The perception has arisen that the industry has given more priority to commercial objectives such as profit and volume instead of its original social motive (Woller 1; CSFI 6). MFIs indulged in multiple lending, high interest rates (between 24 to 55 percent) and ignored customer protection. Srinivasan (48) reported that in 2010, there were on an average 9.3 microfinance loan accounts for every poor household with Rs. 67,226 average loan outstanding per household. In spite of this, the MFIs competed among themselves and continuously chased the same set of clients. The loan burden became unaffordable for the poor people (Table 1.3).

Table 1.3: Progress trend of the sector in Andhra Pradesh, India

	FY 08-09	FY09-10	FY 10-11	FY 11-12
Average loan per poor household (in INR)	29,088	49,473	67,226	71,721
Number of loan accounts per poor households	5.60	8.20	9.30	10.90

Adopted from: State of the Sector Report 2011

In response to the crisis, the government of Andhra Pradesh introduced the Andhra Pradesh Microfinance Ordinance 2010 on 15th October 2010, with the objective to protect the clients from exploitation. This regulation brought the MFIs to a standstill. It has resulted in drastic decrease in financing to the poor people (Legtum Venture 2-3). The poor clients were redirected towards informal sources and moneylenders for loans (Srinivasan 52). Loan repayment rate had fallen from 99 percent prior to the issuance of the order, to less than 20 percent of the amount due (IFMR 1). Along with the MFIs, the associated banks faced a massive loan loss provision of Rs 75000 millions. In order to make up the loss, the banks moved for debt restructuring and an aid package of rupees 70, 000 millions was offered for some of the large MFIs. Paul (1) reported that 80 small MFIs were closed down and also some put off their expansion plan, reduced manpower and moved out of Andhra Pradesh. The AP crisis led to the migration of MFIs from Andhra Pradesh to other states of the country and abroad also. SKS Microfinance shifted its head office from Hyderabad to Mumbai and Basix expanded to Sub-Saharan Africa and Asia Pacific. The other MFIs like, Spandana, Share and Asmitha too shifted majority of their operations to other states of India (Reddem 1).

The other parameters such as the number of employees and branches continued to shrink after the crisis. A sharp decline in the number of MFI employees was observed in the subsequent three years. SKS Microfinance had a job cut of 15,000 employees- from 25,735 in end of December 2010 to 9,959 in June 2013. Basix slashed its 9,000 employees (Unnikrishnan 1). The crisis affected the MFIs all over the country. In 2011 the all Indian MFIs suffered from high operating expense, high cost per borrower, low profit margin and lack of investor confidence (Phuzhendi 3-7). The commercial funding for the MFIs dried up, and the number of effective client accounts reduced by 35 percent on a year-to-year basis (M-CRIL viii).

Following the AP Ordinance, a series of reforms were introduced by the Reserve Bank of India (RBI). In 2010 RBI formed a committee, viz. the Malegam Committee, to look into the issues related to the sector (RBI 1-48). Based on the recommendations of the committee, RBI issued prudential and non-prudential guidelines for the MFIs in December 2011, which were implemented by the MFIs from April 2011 (RBIa 43). Changes in the regulatory architecture of the microfinance have impacted the sector drastically. However, the impact was more pronounced in the year 2012 in comparison to 2011. The development of the All Indian MFIsunder new regulatory regime is discussed in the next section.

1.4.3 Phase III: Consolidation and revival phase: Microfinance with new Regulatory Regime

After the microfinance crisis in AP, the RBI came out with NBFC-MFI Directions 2011, in order to stabilize the microfinance sector. A separate category, NBFCs-MFIs was created, the margin cap was fixed at 12 percent and the capital adequacy ratio of new NBFC-MFIs was 15 percent. The RBI (in 2011) has also declared that MFIs cannot charge an interest rate of more than 26 percent for microloans (NBFC Directions 1-12). However, in February 2014 RBI removed the 26 percent interest rate cap on loans given by the MFIs and linked the interest rate with some other important criteria[xi].

Since 2012, with regulatory intervention, the sector has regained its growth and potential to serve the poor (Microfinance Barometer 2013). CARE (1) termed this period as consolidation phase for the MFIs, where RBI recognized the role of MFI's in financial inclusion and set certain prudential criteria for operations (RBI 1-12).

Table 1.4: Performance indicator of All Indian MFIsfrom FY 2009-10 to FY 2014-15

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Loan outstanding (in Rs millions)	183,430	215,560	209,130	223,000	240,360	326,060
Number of active clients (in millions)	27	32	27	27.5	26	32
Portfolio at Risk (median) (%)	0.51	1.09	1.31	0.56	0.54	0.31
Write-Off (median) (%)	0.0	0.04	0.08	0.10	0.13	0.04
Return on Assets (median) (%)	1.56	1.41	0.85	1.18	1.16	2.22
Return on Equity (median) (%)	9.90	7.45	4.71	4.46	4.69	11.61
Profit margin (median) (%)	9.31	8.80	7.13	7.92	7.81	12.74
Yield on gross portfolio (nominal) (median) (%)	23.92	26.63	24.02	22.47	22.72	22.94

Source: Microfinance Information exchange 2014, http://www.mixmarket.org/

From Table 1.4 it is observed that intervention of the regulatory authorities and Government of India seems to have been gradually improving the overall situation of the microfinance industry (Nair and Tanka 6). The performance indicators namely return on assets and equity are improving (Table 1.4). The new RBI guidelines have increased the confidence of the investors and bankers on the MFIs. The funding environment has improved with 65 percent increase in debt finance in the financial year 2013 from the previous year (CARE 3). Resumed funding in the form of equity and debt helped the MFIs to stream line their operations. In the financial year 2014-15, the All Indian MFIsreported 61 percent increase in loan portfolio and 29 percent increase in borrowers, from that of the previous year (MFIN 5). Bandhan Financial Services transformed itself into a full fledged bank and RBI announced Banking licenses for more than eight microfinance companies, which includes RGVN (NE) MFL from Assam.

In the financial year 2015, Sa-dhan, an association of microfinance institutions (MFIs), received the status of a self-regulatory organization (SRO). The issue of client protection and transparency in the process has been the top priority for the regulatory bodies. SIDBI along with Sa-Dhan and MFIN has put in place unified Code of Conduct (CoC) for MFIs. Sixteen assessments have been undertaken by independent agencies such as Prime M2i Consulting Limited, Micro Credit Ratings International Limited, ICRA Management Consulting Services Limited, Access ASSIST, etc. To improve transparency and to check the creditability of the MFI clients, MFIs are updating their client information to the credit information companies or credit bureaus. High Mark Credit information Services is the India's first credit bureau launched in 2011. Till 2012, 119 MFIs are registered with it and out of which 74 MFI are actively updating the database (Phuzhendi 8).

1.5 Microfinance in North East Region of India

The North East Region (NER) of India comprises of eight states. The region is made up of diverse ethnic groups, cultures and languages. As per Microfinance Vision 2015, North East Region is the most financially excluded region of India and offers opportunity for microfinance service providers. The Microfinance Vision 2015 report on NER of India states that the growth of the microfinance sector in India has been much skewed with large parts of the NER remaining highly underserved. Microfinance Vision 2015 report states that

"....The banking and finance infrastructure in the region is very weak, with North East lagging in almost all critical banking outreach indicators. In June 2009, average population per commercial bank branch for northeast was as high as 21,000, 40% higher than the national average of 15,000. Manipur in particular had an average population of 33,000 per commercial bank branch which was highest for any state in the country.

The region offers low investment opportunity which is reflected by low credit-deposit ratio. ....In terms of deposit accounts, again North East has the lowest ratio among all the regions in the country......"

These facts show the extent of financial exclusion in the NER of India. The CRISIL INCLUSIX financial inclusion index[xii] (2014) also suggests that North Eastern states lag behind than other states in India. CRISIL 2014 report states that the NER scores 30.9 in INCLUSIX 2012 as against 28.5 in 2011 and 26.5 in 2010. Though the position of NER seems to be gradually improving, still the situation is not very impressive. The Microfinance Institutions Network Report (MFIN) 2014 shows that among all states of the NER, microfinance is limited to Assam, and some parts of Manipur and Tripura.

MFIs in the NER are facing severe constraints due to number of factors, including limited funding, lack of experience, high operational costs and moderate human resource quality (AMFI-WB 1). Several NGO-MFIs are facing huge constraints due to their low capacity, non standardized processes, weak controls and lack of funds. These NGO-MFIs have small portfolios, are not able to mobilize funds and therefore have become stagnated. Due to lack of infrastructure and communication problem, banks are not able to spread to each and every part of the state, resulting in the growth of informal agencies. The informal agencies are playing dominant role in western parts of Assam (Das 22). These informal societies/trusts are run by local youths, who pool their own money to provide loan to people. The local people trust informal money lenders, as the owner/s belong to the same locality/area. In these areas, the MFIs are not able to gain faith and confidence of local people till now. This reflects inadequate outreach of MFIs and high demand of credit from local people in certain parts of Assam. The credit absorption capacity of local people is very high as majority of them belong to business community. Credit from informal money lenders is easily available. Few MFIs of the state have shifted from financial activities to social activities, due to capital constrain and legal problems.

With the efforts of NABARD, SIDBI and RGVN the Microfinance was initiated in some parts of Assam in early 90s (Das and Dutta 111-112). These organizations extended financial support to NGOs and helped them in forming SHGs. The progress under SHGs-Bank linkage was not uniform across all parts of Assam. As per the Status of Microfinance report 2014-15, in North East Region Assam, Meghalaya and Tripura reported higher number of credit and savings linked SHGs in comparison to other states. In Assam the number of savings linked SHGs is highest among the states in NER. Similarly the bank loan disbursed by the banks for microfinance in Assam, is 92 percent of the total amount disbursed in north eastern states (Status of Microfinance 46).

1.5.1 Microfinance in Assam

In Assam the presence of MFIs and microfinance activities is more visible in comparison to other states of the NER. Sa-dhan, recently prepared a directory of 268 MFIs operating in India. Among these MFIs, only 26 MFIs report from NER. Among these 26 MFIs, 18 MFIs are from Assam. The gross loan portfolio of MFIs in Assam is Rs 2467.5 millions, with client outreach of 3.691 million in the financial year 2014. These facts seem to suggest that as far as the microfinance in north eastern region is concerned, Assam is the dominant state in terms of microfinance activity. In Assam microfinance is extended through two models- group model and individual model**.** In Individual lending model, loan is extended to an individual based on his/her own personal credit worthiness. The group lending model is further categorized into Self-help group model, grameen model and joint liability group model.

Among the North East states, Assam is also the largest of the states in terms of population. Seventy percent of the North East populations are in Assam (as per 2011 census). It is the second largest state in terms of area in the North East Region of India. Assam covers a geographical area of 78,438 sq. km which accounts for about 2.4 percent of total geographical area of the country. Assam is divided into 27 districts (during the period of study), including five distinct regions, and are divided into upper and lower administrative divisions, viz. lower and upper Assam. Total population of Assam was 31.2 million as per the census 2011.

Assam is actively participating in SHG bank linkage programme. The western part of Assam is supported by both formal and informal financial practices. Central Assam consists of the districts of Nagaon, Darrang and Morigaon where all major MFIs are operating. In the southern part of Assam only a few NGOs are providing microfinance. From the studies of Nair (2010-11) and SIDBI, (2011) it appears that the operational cost of the MFIs is higher in North Eastern states as compared to other parts of the country. As mentioned above, the North East Microfinance Vision 2015 has identified some constraints for microfinance operations in Assam. The Andhra Pradesh crisis has also affected the funding scenario of MFIs in Assam. MFIs have curtailed their branch expansion plans and stopped forming new lending groups. For instance, UFSPL closed their Barpeta branch and AFPL closed down their branches in many districts of Assam. According to the Annual Report of RGVN (NE) MFL 2012-13, the declaration of RBI guideline resulted in decline of equity investments and debt funding. In addition to this the political unrests, communal riots in many parts of the state and the news of fraudulent chit fund companies, increased the operational cost for the MFIs operating in Assam (Annual Report of RGVN (NE) MFL, 2012-13).

Hence, it is observed that, the microfinance in Assam, is still at an early stage of development, facing severe constraints, including limited funding, lack of experience, and high operational costs. In this context, it is important to investigate the cost borne by the lender in credit disbursement and by the borrowers in procurement of credit. The benefits of cost reduction could be transferred to the borrowers by reducing the interest rate on loan products.

Notes:

[i] Northeast India is the eastern-most region of India. It is connected to East India via a narrow corridor squeezed between independent nations of Bhutan and Bangladesh. It comprises the contiguous Seven Sister States (Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland, and Tripura), and the Himalayan state of Sikkim. The region is culturally rich and is inhabited by diverse ethnic groups. Microfinance is limited to the state of Assam and some parts of Manipur and Tripura.

[ii] For details of Business correspondent model see "Financial Inclusion by Extension of Banking Services - Use of Business Facilitators and Correspondents", (2006), https://www.rbi.org.in/Scripts/BS_CircularIndexDisplay.aspx?Id=2718.

[iii] Susu collection is one of Ghana's most ancient traditional banking systems. In the Akan language, the term 'Susu' means "small small" as to indicate the saving contribution paid on a daily basis by those economically active poor that decide to join the scheme. In particular, Susu collection is a system in which a person (e.g. a trader, an artisan, etc) decides to make a daily contribution to another person, the Susu collector, for an agreed period, usually a month (31 days). For the deposit collection service, the Susu collector is remunerated with a fee. Hence, the Susu Collection system provides a way for saving up i.e. saving small amounts of money over a period of time to build a lump sum that may be used when needs arise in the future (http://www.aaeafrica.org/start/the-susu-collection-system-in-ghana-and-experiences-in-linking-formal-and-informal-financial-intermediaries/).

[iv] ROSCAs is a means to save and borrow simultaneously. These are user owned and organized informally. (Roa 289, Chapter 20 in a book edited by R. Nandagopal, V. Srividya- Emerging Financial Markets, Excel Publications, 2007).

[v] In Tontines individuals with a common social link gather together and pay an amount of money either in tontines (collecting money for one member) or in savings in order to help each other. They can also put goods or services (soap, oil, dishes, food, and labor force) in tontines. The basic element of this practice is trust built through familiarity. Members of Tontines collect money or goods that are loaned in rotation. – (for detail see http://www.fairobserver.com/region/africa/tontines-informal-financial-sector-and-sustainable-development-cameroon/#sthash.8WMyfREL.dpuf).

[vi] The word *Pasanaku* means 'passes between us', Pasanaku devises a game out of saving money. A group of players is formed, made up of family, friends or colleagues. Each member of the group puts in an agreed amount of money each time the group meets and after every Pasanaku one member of the group wins all the money donated. Eventually everyone wins back the total amount of money they put in; there's no risk and no losers (http://www.bolivianexpress.org/blog/posts/pasanaku-saving-with-the-heart)

[vii] Arisan, or social gathering, is a popular activity among Indonesian women. In general, the gatherings involve informal credit and saving schemes in a form of lots, besides social interaction among group members. The activity used to be held (a few still are) at the houses of group members – (See more at: http://www.thejakartapost.com/news/2013/05/05/inside-world-arisan.html#sthash.PAKUKDOI.dpuf)

[viii] Paluwagan is a form of rotating savings and credit association made up of Filipinos members, who contribute the same amount of money to a common fund on an a specific date. The frequency of contributions depends on the agreement of the members. It can be daily, weekly or monthly.

[ix] Vacuum in terms of providing financial services and the mismatch between the products and product delivery mechanism which banks were providing.

[x] The new technologies such as Management Information Systems (MIS), Point of Sale technologies (POS), Automatic Teller Machines (ATMs), Interactive Voice Response (IVR) systems and smart cards were adopted by the MFIs over the years. Equitas uses an SMS-based collection tracking software, which helps the field-level functionaries to keep track of the daily centre meetings (Nair and Tankha 86).

[xii] The CRISIL (2014) report provides the extent of financial inclusion across 638 Indian districts. CRISIL INCLUSIX is a relative index on a scale of 0-100, and combines three critical parameters of basic banking industry, viz. branch penetration, deposit penetration and credit penetration.

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