

# Sustainability of Indian Microfinance Institutions

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Nadiya Marakkath

# Sustainability of Indian Microfinance Institutions

A Mixed Methods Approach

 Springer

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ISBN 978-81-322-1628-5      ISBN 978-81-322-1629-2 (eBook)  
DOI 10.1007/978-81-322-1629-2  
Springer New Delhi Heidelberg New York Dordrecht London

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# Foreword

As the world poured aid money into a bucket of Danaides to quench the thirst of the poor, it searched for solutions which could help the poor raise themselves up without dependency. One insight came from entrepreneurial solutions, but the poor missed at least one vital lubricant for successful microenterprise: credit. Early experiments with microcredit, in Brazil, Bangladesh and Bolivia, led to a glimmer of hope. These microcredit experiments were repeated and the hope turned into belief. They were successfully scaled and replicated in other parts of the world, and the belief turned into confidence and expectation that they would work each time, every time, at least most of the times: the poor pay back.

The world was not perfect, and the small loan size led to high transaction cost. These high transaction costs were used to explain the relatively high interest rates and the lack of profits. The search for efficiency in reducing operational costs started.

Donor money poured in to help scale up further. As some of the microfinance institutions went beyond their break-even point, they realized that donor funding could now be replaced with commercial financing. Commercial financing renewed the interest in the search for operational efficiency.

This expectation of profit led to investment, and the industry scaled up fast, very fast, and it became profitable, very profitable. Irrational exuberance set in and was communicated to donors, investors and the development community and the investment turned into a fantasy that credit alone could solve poverty. From this fantasy, mainstream lenders wondered that if microentrepreneurs could repay entrepreneurial microcredit, then surely microconsumers could repay consumer microcredit. The gold rush of microcredit was on and the stampede could only end badly. The fantasy led to a fall.

This fall came, ironically, not because the microfinance institutions became unprofitable, but because they became too profitable. This high profitability fuelled their fantastic growth by raising their sustainable growth rate. The high profitability was initially driven by high interest rates, but clearly as competition came in, the most efficient could grow faster and the reduction of operational costs became important in a world where the fittest survived. The high profitability made people

wonder who was gaining from microfinance: the poor or the creditors? The disillusion led to regulators stepping in to control the microcredit sector from exploiting the poor. Today, questions are being raised on the ethics of microfinance as to product, price, delivery and even its brand image.

The ethical debate will last a bit and certainly new deontological practices will be established, some by the industry and some by regulation. But once the debate has died down, we will come back to the main question: How can we reduce transaction costs and increase efficiency so that the surplus of the microentrepreneurs and of the industry can both be increased? It is to these questions that the remarkable work of Nadiya Marakkath is addressed.

Dijon, France  
1 May 2013

Arvind Ashta

# Preface

As a child, I was taught to believe that we are all inherently good and it is our innate nature ‘to do good’. As I grew up, my interactions with the external world largely conformed to this childhood belief. I found that each one of us had a genuine desire ‘to do good for all’ and have at some point of time in our lives mentally devised plans to create an inclusive world. But for the vast majority of us, the conversion of these dreams into reality was mostly thwarted by thoughts that wrestle around ‘sustainability’. Ultimately, it boils down to the double bottom-line dilemma: Can I do good and simultaneously earn a surplus out of it, so as to ensure perpetuity of goodness? Thus, to my observation (right from childhood till date) sustainability has been a pertinent issue that plays a decisive role in determining the translation of good thoughts into good actions.

As I grew up with this realization, I developed an active research interest in decoding the mystery behind the sustainability of social enterprises. In this book, I document my understanding, gained mostly during my doctoral days, about the sustainability of one of the most celebrated forms of social enterprise that we have in our times—the microfinance institutions. Microfinance institutions, popularly termed as MFIs, work towards creating a financially inclusive world, by providing financial intermediation services to the poor and hitherto excluded masses. The major challenge before these institutions is to attain operational self-sustainability (OSS), by earning enough self-generated revenue to cover its high intermediation costs. Therefore, in this book, using a mixed-methods approach, I investigate the sustainability issues of Indian MFIs. What are the determinant and discriminant factors for the sustainability of Indian MFIs? How are these factors being managed by operationally efficient MFIs in India, which remained sustainable at reasonable interest rates before the onset of the crisis and interest rate ceilings in the Indian microfinance markets? What does the Indian microfinance crisis teach us about sustainability management and mismanagement? It is to these questions that I attempt to find answers in this book. Overall, the results of this mixed-methods investigation are expected to enable Indian MFIs to march towards the attainment of efficiency and sustainability in their operations, without losing their focus on

client welfare. Since the investigation uses a mixed-methods approach, it has the synergistic value of both quantitative and qualitative analysis, making the results cut across disciplines, ensuring methodological replication of this investigation feasible for any social venture facing sustainability challenges.

Conforming to the mixed-methods style of investigation, the book is structured as follows: To begin with, this book presents a general introduction to microfinance (Chap. 1), specific literature review on MFI's sustainability (Chap. 2) and an overview of the mixed-methods research design used for investigating the sustainability issues (Chap. 3). The mixed-methods investigation pursued is then discussed as four specific objectives, each dealt with in separate chapters of the book. Chapter 4 deals with the quantitative phase of the investigation, which aims to identify the factors determining and discriminating the OSS of Indian MFIs. Chapter 5 deals with the intermediate participant selection phase of the investigation, which aims to identify efficient and sustainable Indian MFIs that can be benchmarked as reference groups for other MFIs in the industry. Chapter 6 deals with the qualitative phase of the investigation, which aims to document how efficient and sustainable MFIs are managing the factors determining and discriminating their OSS status. Chapter 7 then goes to discuss about the dangers involved in the mismanagement of these factors by reflecting on the crisis that hit the Indian microfinance industry. Finally, the book concludes with Chap. 8 which presents a summary of the findings drawn from each of the three analytical phases pursued in this book. The implications of these findings are discussed as the key contributions made by this book.

**Acknowledgements** As mentioned at the onset, this book draws inspiration from the innate goodness that I have seen latent in every human being that I have interacted with. Therefore, I consider each of them my partner in bringing out this book. They are simply too numerous to mention individually, but I owe a deep and genuine sense of gratitude to each of them. In particular, however, I would like to thank my family (each and every one of them, to whom I owe everything in life, that I proudly call today as 'mine'), my alma mater (all those academic institutions which I was affiliated to—from KG to Ph.D.—and all those teachers out there from whom I picked up what I consider 'my way of life'), my mentors (but for whose timely intervention in my academic life I would consider myself 'totally lost'), my research supervisors (all three of them, without whom I would never call myself a 'researcher'), my research collaborators (the very many with whom I learnt the most intellectually stimulating process called 'reflexivity'), my reviewers (without whose sharp observations I wouldn't have appreciated the joy inherent in the process called 'refinement'), my colleagues (all of them who 'reinforced' my belief: 'Work is the most meaningful expression of life!'), my students, potential social entrepreneurs (the co-learners, with whom I love to grow every day, without ever getting older) and my friends (who seemingly appear scattered across the globe but are safely residing in my heart) for kindling and nurturing in me the childlike curiosity critical for any researcher for her investigation.

This research investigation wouldn't have attained full fruition had it not been published and disseminated as a book. I thank the entire team at Springer and SPi Technologies for making this happen. Lastly, I thank in advance every prospective reader of this book, whom I see as an embodiment of goodness. I earnestly wish this book could be of help to you in manifesting your innate goodness, with the requisite focus and flow on its sustainability.

Mumbai, India

Nadiya Marakkath



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# Abbreviations

|        |   |
|--------|---|
| BCC    | Banker, Charnes and Cooper                              |
| CCR    | Charnes, Cooper and Rhodes                              |
| CEO    | Chief Executive Officer                                 |
| CGAP   | Consultative Group to Assist the Poor                   |
| CRISIL | Credit Rating and Information Services of India Limited |
| CRS    | Constant Returns to Scale                               |
| DEA    | Data Envelopment Analysis                               |
| DEAP   | Data Envelopment Analysis Program                       |
| DRS    | Decreasing Returns to Scale                             |
| GNI    | Gross National Income                                   |
| IPO    | Initial Public Offering                                 |
| IRS    | Increasing Returns to Scale                             |
| INR    | Indian Rupee  |
| IT     | Information Technology                                  |
| MFI    | Microfinance Institution                                |
| MIS    | Management Information System                           |
| MIX    | Microfinance Information Exchange                       |
| M-CRIL | Microfinance Credit Rating Information Limited          |
| MPSS   | Most Productive Scale Size                              |
| NABARD | National Bank for Agriculture and Rural Development     |
| NBFC   | Non-Banking Finance Company                             |
| NCAER  | National Council for Applied Economic Research          |
| NGO    | Non-Governmental Organization                           |
| NIRS   | Non-Increasing Returns to Scale                         |
| NPAs   | Non-Performing Assets                                   |
| OSS    | Operational Self-Sustainability                         |
| PDA    | Personal Digital Assistant                              |
| POS    | Point of Sale   |
| PTE    | Pure Technical Efficiency                               |
| RBI    | Reserve Bank of India                                   |
| RFAS   | Rural Finance Access Survey                             |

|       |  |
|-------|--|
| RRB   | Regional Rural Banks                       |
| SBI   | State Bank of India                        |
| SE    | Scale Efficiency                           |
| SEWA  | Self-Employed Women's Association          |
| SHG   | Self-Help Group                            |
| SIDBI | Small Industries Development Bank of India |
| SKS   | Swayam Krishi Sangam                       |
| SPSS  | Statistical Package for Social Science     |
| TE    | Technical Efficiency                       |
| USD   | United States Dollars                      |
| VRS   | Variable Returns to Scale                  |