COMPARISON OF PERFORMANCE OF MICROFINANCE INSTITUTIONS WITH COMMERCIAL BANKS IN INDIA

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ABSTRACT

Microfinance in India has been viewed as a development tool which would alleviate poverty and enhance growth of the country through financial inclusion. Out of 6 lakh villages in India, only approximately 50000 have access to finance. India is a country which has the highest number of households which are excluded from banking. With the Andhra crisis of microfinance institutions and issues that microfinance institutions have a mission drift, the aim of the paper is to study the performance and efficiency of microfinance. A sample of microfinance institutions in India have been selected based on their ratings given by microfinance information exchange (MIX) for the study. The performance of these sample MFIs as well as their performance with respect to commercial banks in India have been studied using statistically tools. A microfinance institution is measured for financial sustainability based on its good financial accounts and the recognized accounting practices they follow according to Meyer (2002). Data for the microfinance institutions have been collected from Microfinance information exchange (MIX) where few of the MFIs have started reported their financial data. The MIX has classified the MFIs based on various parameters such as level of disclosure, financial parameters etc and rated them accordingly. Out of the 88 MFIs in India reported on MIX, 24 MFIs are taken as samples, these samples taken were five star rated by MIX. The financial parameters of these MFIs are studied and compared with the financial parameters of commercial banks and their financial performance can be analyzed. The various parameters taken for analyzing the financial performance of MFIs and banks include: Financial structure, Profitability and Efficiency.
Keywords: *Microfinance, financial inclusion, MFIs, MIX, Financial structure, Profitability, Efficiency*

INTRODUCTION

Microfinance has been a development and economic tool which has helped in bringing about financial inclusion in India[1]. It has been viewed as an important tool of women empowerment and to alleviate poverty. It has served to provide financial services and credit to the unprivileged and unbanked sector in India thereby bringing about financial inclusion. The loans provided by microfinance institutions serve the low-income population in various ways as follows:

- They provide working capital loans for business purposes.
- They provide loans for accessing necessities such as food, clothes, shelter and education.
- They serve as alternatives to the loans provided by money lenders.

In addition to various micro finance institutions, various other players contributing to provision of microcredit include banks, insurance companies, agricultural and dairy co-operatives, etc.
The main components of microfinance are as follows:

- ✓ Deposits
- ✓ Loans
- ✓ Payment services
- ✓ Money transfers
- ✓ Insurance to the poor

Majority of the population in India belong to the unbanked sector. Though India has a dense and a robust formal financial system, it has failed to reach the deprived segment of the population. Next to China, India has the highest size of unbanked population in the world. Thus, microfinance sector aims to improve the living of the poor income households thereby providing banking services to the deprived low income population. There are

[1] **State of Microfinance in India ,** Prepared for **Institute of Microfinance (InM)** As part of the project on State of Microfinance in SAARC Countries By Frances Sinha **2009**

various forms of microfinance institutions in India with various service models and they provide products suitable to appropriate target segment which has proved successful of improving the client's economic status.
The various factors which affect the reach of formal financial services to a large segment of the Indian population are as follows:

- ✓ The high fixed and variable costs incurred by banks in servicing low income households. The microfinance institutions incur high transaction costs which are unavoidable for them because of the small size of individual low. The SHG federations and co-operatives which are forms of institutions set up by communities the transaction costs are lower. The microfinance institutions can incorporate economies of scale to reduce transaction costs but it is difficult to achieve because of absence of recovery of costs and profit incentive.
- ✓ Less branches in remote locations due to financial unfeasibility due to low volume and high cost of operation failing to meet the requirements of rural population.
- ✓ Lack of financial knowledge by low income population. Therefore they find it difficult to contemplate existing financial products and services provided by microfinance institutions.
- ✓ Need for collateral for availing credit which the low income household find it difficult to provide for.

Due to unavailable and improper reach of formal financial services, the rural low income population resort to money lenders for immediate availability of credit as money lenders have been viewed as a tool which provides immediate credit for essential needs. As money lenders give credit immediately, they charge exorbitant prices. This in turn could lead to a debt trap.

The various players[2] in the microfinance sector can be classified as follows:

- ✓ SHG-Bank linkage Model: This model contributes about 58% of the outstanding loan portfolio.
- ✓ Non-banking finance companies: This accounts for about 34% of the outstanding loan portfolio.
- ✓ Others: Includes trusts, societies etc. This accounts for the remaining 8% of the outstanding loan portfolio.

OBJECTIVES OF THE STUDY:

- To study and compare the financial performance of Indian microfinance institutions and commercial banks in India.
- To analyse financial structure of MFIs in India.
- To analyse Profitability and Efficiency of MFIs in India.

LITERATURE REVIEW:

There are plethora of literature on performance of micro finance institution across the globe, though only few studies have been carried out on the topic related with performance of Indian MFIs, one such study done by Alain de Crombrugghe, Michael Tenikue and Julie Sureda (2007)[3], has studied three important aspects of sustainability such as repayment of loans, financial self sustainability or operational self sustainability and cost-control or efficient use of resources. **Rajarshi Ghosh (2005)[4]** in his research paper **Microfinance in India: A critique**, the evolution of microfinance in empowerment of women and poverty alleviation is studied. Microfinance is viewed as an important tool for providing self employment for the low income rural population. This paper studies the various delivery models of microfinance institutions which contribute to women empowerment in India. **Pankaj K Agarwal and S.K.Sinha (2010)[5] found in their study that t**he sustainability of microfinance institutions is important in order to pursue their objectives through good financial performance. This paper studies the various players in the microfinance sector which range from not-for-profit organizations which work towards a developmental objective to commercial banks which view microfinance as a good source of deposits with sound banking and as a measure to reach their priority lending targets. **Jayasheela, Dinesha.P.T and V.Basil Hans (2008)[6]** studied the role of microfinance in the empowerment of people and provision of a sustainable credit availability to the rural low income population. The research studies the

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[2] Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector Jan 2011

[3] Alain de Crombrugghe, Michael Tenikue and Julie Sureda (2007) Performance Analysis for a Sample of Microfinance Institutions in India" Annals of Public and Cooperative Economics 79:2 2008 pp. 269–299

4 Rajarshi Ghosh (2005) Microfinance in India: A critique, www.aptsource.in/admin/resources/1273818337_UNPAN024232.pdf

[5] **Pankaj K Agarwal and S.K.Sinha (2010) The financial performance of microfinance institutions in India** *Delhi Business Review* X *Vol. 11, No. 2 (July - December 2010)*

[6] **Jayasheela, Dinesha.P.T and V.Basil Hans (2008), "Financial inclusion and microfinance in India: An overview"** http://india.microsave.org/node/1270

opportunities available for the microfinance institutions with an increasing demand for credit in the rural areas due to inadequate formal sources of credit. **"The Microfinance promise in Financial Inclusion: Evidence from India"** by **Naveen K.Shetty and Dr.Veerashekharappa (2009)** studies the importance of microfinance in bringing about financial inclusion. The paper studies impact of the increasing gap in demand and supply of financial services in India which has led to the increasing population of the country to be excluded from the formal financial credit system.

"Microfinance: A new Mantra for rural development" by **Reeta Rautela, Gaurav Pant, Dr.Swati Anand** and **Deepika Sharma** studies the evolution of microfinance institutions in India. Microfinance is viewed as a development tool both in the local and he global environment. With approximately 70% of population in India living in rural areas and with about 26% of population living below the poverty line, microfinance in India is considered to be an important tool for poverty alleviation and rural development. **"Financial performance of Microfinance Institutions: A comparison to performance of Regional Commercial banks by geographic regions"** by **Michael Tucker** and **Gerald Miles** studies the performance of MFIs which are self-sufficient and comparing those with the regional commercial banks based on selected financial ratios. Microfinance institutions provide small loans to the rural low income population. However with growth of the microfinance institutions and with increasing competition, the MFIs have very limited access to funds. The study reveals that the self-sufficient microfinance institutions are strong performers of ROA and ROE **"Performance and Sustainability of Self-Help Groups in India: A Gender Perspective"** by **Purna Chandra Parida and Anushree Sinha (2010)** studies performance and sustainability of Self-help group in India. It is been reported that the self-help group (SHG) programmes is an effective tool which has been used in various countries in order to address a range of socio-economic issues. The performance and sustainability of self-help groups vary based on income generating activities, gender composition of members in the group etc. "**Performance and Transparency: A survey of Microfinance in South Asia"** by **Blaine Stephens and Hind Tazi (2006)** highlights the performance of the microfinance sector in the South Asian region as well as globally. The study has highlighted South Asia for the study due to the region's impressive outreach with microfinance giants in South Asia such as Grameen Bank, ASA and BRAC. The microfinance sector has evolved by providing micro-loans as well as the self-help group programs in order to reach to a vast majority of the poor population. **"Microfinance in India: Discussion"** by **R.Srinivasan and M.S.Sriram** shows the various views of people from various microfinance institutions. Microfinance has been viewed as an effective tool in bringing about financial inclusion and as a measure to alleviate poverty. This discussion also is a study on the various models of microfinance prevailing in India and aims to discuss if these models contribute to the growth and sustainability. It also aims to discuss about the various government policies and regulatory framework prevailing in microfinance sector.

SCOPE OF STUDY

The scope of the research is limited to the microfinance institutions in India. Also, microfinance institutions have been taken as a sample from the Microfinance Information Exchange (MIX). The five star rated microfinance institutions were alone selected. This rating has been given by MIX to the microfinance institutions based on the level of disclosure, quality of disclosure, financial parameters etc. Based on this sample of MFIs taken, the performance of the MFIs in India is analyzed. The study does not take into account the smaller MFIs in India and the MFIs in various other geographical regions in the world.

RESEARCH METHODOLOGY

Data sources:

The data collected for the study includes secondary data. The various sources used to collect secondary data include research papers, journals, articles, annual reports of the company and data from the Microfinance information exchange (MIX) and various other websites.

Methods:

The methodology of study includes collection of secondary data from various research articles and journals. The secondary data collected is further analyzed using statistical tools to draw conclusions based on the results obtained.

Techniques of data collection and analysis:

The secondary data collected is analyzed using various statistical tools and techniques such as one way ANOVA. The technique is used to identify if there exist a significant difference in the performance of MFIs and Commercial banks which includes both the private sector and the public sector banks.

EXPECTED OUTCOMES

- ✓ The various parameters are calculated over the years which help us analyze the growth of microfinance institutions in India and its contribution to financial inclusion.
- ✓ The performance of MFIs in India and commercial banks are analyzed based on certain parameters to check if there exists a significant difference between them. The results obtained would help us identify if there exists a significant difference between MFIs and commercial banks based on those parameters.

RESULTS:

Hypothesis:

$H_{0:}$ There is no significant difference between the means of MFIs and commercial banks.

$H_{1:}$ There is significant difference between the means of MFIs and commercial banks.

LIMITATIONS OF THE STUDY:

- ➢ The data has been collected only for 24 MFIs based on the rating given by MIX and the analysis cannot be generalized for a vast number of MFI institutions in India.
- ➢ Most of the MFIs in India do not report data to MIX due to the accounting practices followed by them.

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Financial Structure:

- **Capital adequacy ratio**

  The capital adequacy ratio is a measure of bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures. This ratio is also known as capital to risk weighted assets ratio. The capital adequacy ratio is calculated as follows:

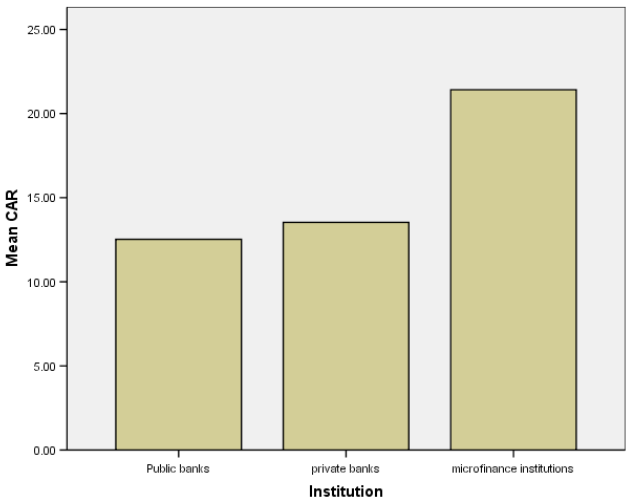
$$CAR = \frac{\text{Tier One Capital} + \text{Tier Two Capital}}{\text{Risk Weighted Assets}}$$

ANOVA

CAR

	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	1063.602	2	531.801	6.478	.003
Within Groups	4843.373	59	82.091		
Total	5906.975	61			

ANOVA output of CAR



Comparison of CAR for banks vs. microfinance institutions

There is a significant difference in the means of the capital adequacy ratio at 5% level of significance. Therefore, alternate hypothesis is accepted. The banks in India are required to maintain a capital adequacy ratio (CAR) of 9% and 12% in case of NBFCs which has been raised to 15% for NBFCs as of March 2011. It has been reported that nearly 45% of the MFIs have CAR in excess of 20% and 25% of MFIs have CAR above 15% and a CAR of 15% is required to be maintained by the microfinance institutions. A higher CAR is essential for the microfinance institutions because a thin layer of capital would not allow for loss absorption in case of default.

- **Debt equity ratio**

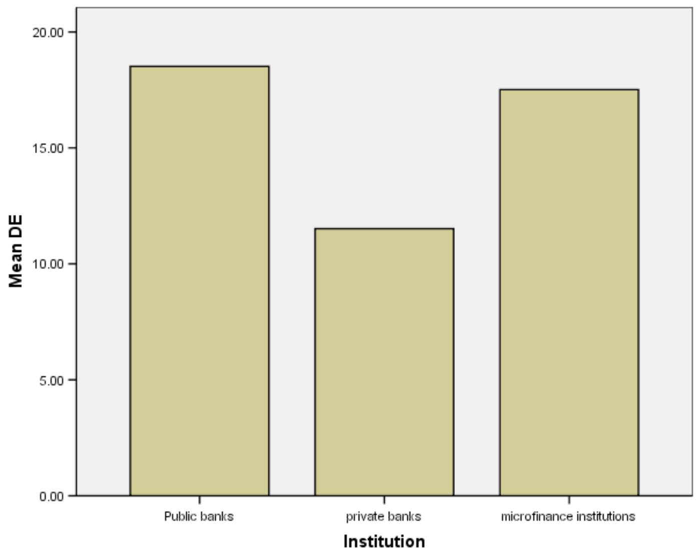
The debt equity ratio is a measure of the company's financial leverage. The ratio is calculated by dividing the company's long term debt by the shareholder's equity. Higher the debt equity ratio implies a risky investment because higher the debt higher the interest has to be paid by the company.

ANOVA
DE

	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	509.128	2	254.564	.652	.524
Within Groups	23019.519	59	390.161		
Total	23528.647	61			

T

ANOVA output of debt equity ratio



Comparison of debt equity ratio for banks vs. MFIs

The output shows that there is no significant difference between the means at 5% level of significance. Thus there is no significant difference in the debt equity ratios of public and private sector banks and microfinance institutions, thereby accepting null hypothesis. From the graph it can be seen that the microfinance institutions have higher debt equity ratios because many of them are growth oriented. Socially oriented microfinance institutions depend on grants and donations and do not have much access to capital. Hence, with most of the microfinance institutions been growth oriented, tap the capital markets for raising adequate capital and have liberal access to commercial debt funds. Hence this leads to a higher debt equity ratio for the MFIs. The public banks also have a higher debt equity ratio because being government banks they have easy availability to credit from the Central bank as well as they get fund from the capital markets whereas the private sector banks are required to be well rated in order to gain access to funds from the capital markets. Hence, they have a lower debt to equity ratio when compared to public sector banks and the microfinance institutions.

Profitability:

- **Return on assets**

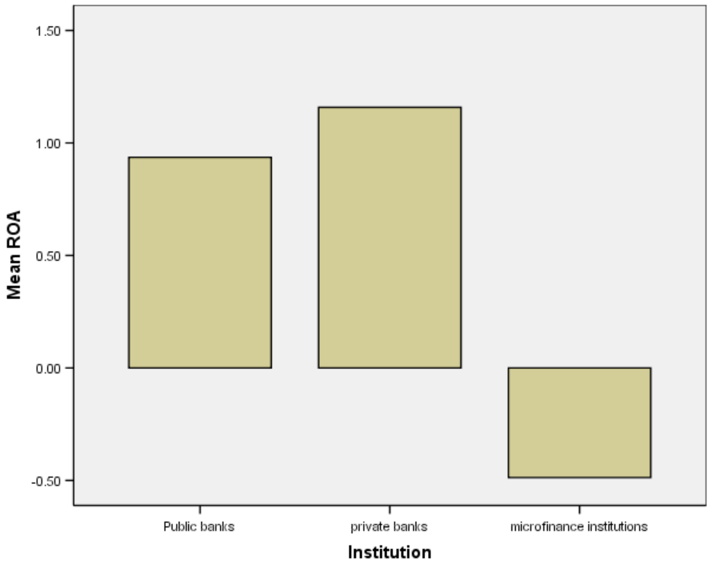
  The return on assets indicates how effectively a management generates earnings from its investments. It indicates how profitable a company is relative to its total assets. It is expressed as a percentage. It is also known as 'return on investments'.

ANOVA

ROA

	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	32.403	2	16.201	.192	.826
Within Groups	4642.656	55	84.412		
Total	4675.059	57			

ANOVA output of return on asset ratio



Comparison of return on asset ratio for banks vs. MFIs

There is no significant difference in the means of ROA for commercial banks and the microfinance institutions at 5% level of significance. Thus, null hypothesis is accepted. It has been reported by Sa-Dhan that the median of ROA and ROE of all MFIs in their sample of 264 MFIs were about 1.6% and 11.5% respectively. The median ROA and ROE of the 10 largest microfinance institutions are about 4.3% and 29.5% respectively. The smallest microfinance institutions have negative median of ROA and ROE which indicates that they are not sufficient and are at present loss making. High ROA and ROE is required to attract private capital to achieve its mission of poverty alleviation. Microfinance institutions have a small asset base than the commercial banks which impacts their profitability. The return on assets for commercial banks is higher than MFIs as they are allowed to accept deposits and hence contribute to more income for them. The optimum range of ROA as per ACCION audit is greater than 3% (> 3%). This implies that the Indian microfinance institutions are still lagging behind on the profitability front.

- **Return on equity**

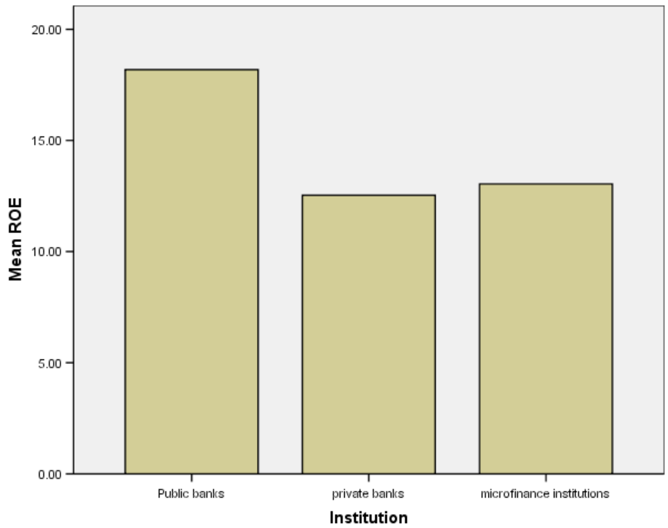
  The return on equity gives the measure of profitability of a company. It indicates the profit generated by the company from the money invested by its shareholders. Return on equity is expressed as a percentage. ROE is also known as 'Return on net worth'.

ANOVA

ROE

	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	407.733	2	203.866	.022	.979
Within Groups	553309.178	59	9378.122		
Total	553716.911	61			

ANOVA output of return on equity ratio



Comparison of return on equity ratio for banks vs. MFIs

There is no significant difference in means for Return on equity for the commercial banks and the microfinance institutions at 5% level of significance. Thus null hypothesis is accepted. However the equity structure for the MFIs and commercial banks are different. The equity for microfinance institutions is smaller whereas the commercial banks have a higher equity structure. The equity for a majority of MFIs is mostly in the form of donations whereas for commercial banks the equity is invested or they represent retained earnings. The small equity bases for the MFIs report a higher ROE ratio for them. The commercial banks have a higher ROE due to their other sources of income as well as income from their deposits whereas MFIs are not allowed to accept deposits. The optimum range for ROE as per ACCION audit is greater than 15% (> 15%) indicating that the Indian microfinance institutions have yet to have achieved those standards.

- **Net profit margin**

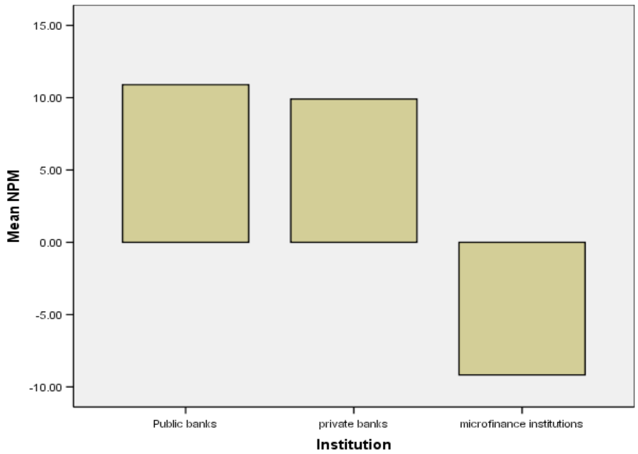
  The net profit margin is an indication of how effective is a company at its cost control. Higher net profit margin indicates that the company is more effective in converting its revenue into actual profits. The net profit margin is calculated by dividing the net income by revenue or by dividing the net profits by sales. It is expressed as a percentage.

ANOVA

NPM

	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	5639.629	2	2819.814	.852	.432
Within Groups	192066.472	58	3311.491		
Total	197706.101	60			

ANOVA output of net profit margin ratio



Comparison of net profit margin ratio for banks vs. MFIs

There is no significant difference between the means of commercial banks and microfinance institutions. Thus, null hypothesis is accepted. The net profit margin of microfinance institutions have reported to be higher because of the higher interest rates charged by them. However these wide higher margins have been reported by the large ten microfinance institutions and the NBFC legal forms of MFIs. The graph above shows that the net profit margin for the MFIs are lower and this indicates that there are a large number of MFIs which are not sustainable and requires subsidies and grants in order to carry on their operations. Moreover, the Operating expense ratio and the yield are related to the loan size and this loan size is higher for banks and smaller in case of MFIs. Most of the MFIs incur high costs of servicing the poor rural population due to smaller loan sizes which in turn reduces the financial profit margins.

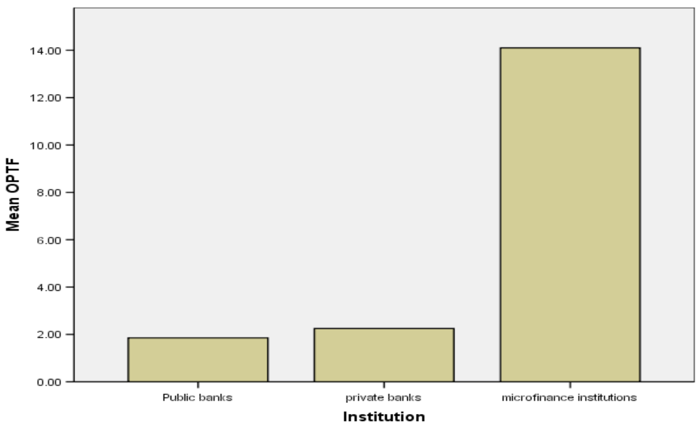
Efficiency:

- **Operating expenses to assets**
  An expense ratio is calculated by dividing the operating expenses by the total assets. It is also known as management expense ratio. The lower the ratio implies that the institution is more profitable and shows its ability to cover the costs effectively.

ANOVA
OPTF

	Sum of Squares	Df	Mean Square	F	Sig.
Between Groups	2059.637	2	1029.819	17.752	.000
Within Groups	3190.596	55	58.011		
Total	5250.233	57			

ANOVA output of operating expense/total asset ratio



Comparison of operating expense/total asset ratio for banks vs. MFIs

There is significant difference in the operating expenses to total assets ratio of commercial banks and MFIs at 5% level of significance, thereby rejecting null hypothesis. The operating expenses to total funds are higher for the microfinance institutions when compared the commercial banks. The reason for this is because the MFIs have incurred training expenses for their staff members, education of borrowers etc. The higher asset base for the commercial banks favourably impacts the ratio for the commercial banks. Also, the delivery model of MFIs at the doorstep of borrowers is a reason for the MFIs to have incurred high operating costs when compared to commercial banks. The commercial banks cover their costs due to their business model and their larger loan sizes which reduces their transaction costs.

RECOMMENDATIONS:

Microfinance institutions have faced a lot of issues about its performance and sustainability. Microfinance institutions have been viewed as an important tool in poverty alleviation and financial inclusion. It is an important sector which would improve the living conditions of the poor and lead to the development of the country. Some of the issues faced by microfinance institutions include high interest rates, multiple lending, coercive methods of recovery, lack of transparency etc.

- The MFIs incur high operating costs because of their business model which is the door step service delivery model. They incur these costs because of training of staff and small loan sizes. These higher operational costs are the major reason for the higher interest rates of the MFIs. These operating costs could be reduced by the use of technology.
- Mobile banking would also provide a valuable tool for reducing costs. Technology is an important tool in building operating system for identification of borrowers and communication of data.
- The UID (Unique Identification Program) project and the use of bio-metrics would serve as a valuable tool for the microfinance sector. This would provide sufficient details about the identity of the borrower.
- A separate agency such as CIBIL could be set up for the microfinance institutions to access the credit worthiness of the borrowers. This would reduce over-borrowing and control delinquency without resorting to coercive methods of recovery.
- The members of the microfinance institution should be a member of only one Joint liability group (JLG) or Self help group (SHG) so as to prevent multiple lending. The information registered in the agency would make a record data such as the loans taken by borrowers, their repayment history, details regarding their livelihood etc.
- The borrowers being low income rural population are often uneducated and it is required for the microfinance institutions to educate the borrowers. Educating the borrowers is important for the microfinance institutions in order to enhance their outreach. Service centres could be set up banks in the rural areas to improve the outreach of microfinance services.
- The microfinance institutions lack transparency. Reserve Bank of India should set up a regulatory authority to monitor the performance of the microfinance institutions. Though the microfinance institutions follow the norms and standards set by the RBI, a separate regulatory authority would more efficiently monitor the performance of the MFIs.
- The microfinance institutions should be mandated to report their financials to this regulatory authority in order to ensure their performance and sustainability. Improved efficiency of MFIs would reduce costs and consequently reduce the interest rates, increased business volume and would thus benefit both the MFIs and the borrowers.
- The microfinance institutions should disclosure the interest rates for various products offered on the websites as well in their offices.
- Most of the micro-loans are given for the start of micro-enterprises and the loan would have to be repaid from the cash flows generated from the business. Hence, sufficient repayment time should be given by the microfinance institutions to the borrowers.
- The microfinance institutions should ensure that the loans are given for useful purposes which would earn a living for the household and not for unnecessary purposes.
- Regular audits such as ACCION audit could be conducted by the regulatory authority to monitor the performance of MFIs. Subsidies could be provided for these audits as most of the MFIs do not undergo this audit as it is expensive.
- The microfinance institutions also face a lack of funds from commercial banks. And most of the microfinance institutions are converting into NBFC MFIs in order to have easy access to funds from banks. This transformation is due to the profit motive of the microfinance institutions. The microfinance institutions should be given the access to raise funds from capital markets providing they are well rating in their performance. With the tremendous growth of MFIs, investments in

microfinance sector have gained importance with the emergence of microfinance funds. This would lead the microfinance institutions to be sufficient so as to gain easy access to funds.

- Sufficient microfinance institutions should be allowed to accept deposits from the public. This would improve the profit margins for the microfinance institutions as well as reduce the interest rates.
- In order to be profitable and self sufficient, some of the MFIs make larger, more profitable loans to more viable clients and this hinders the goal of providing credit to the poor. In order to avoid such issues, a separate regulatory authority is required for the MFIs in order to achieve development of the country.

CONCLUSION:

Microfinance has been an important tool in poverty alleviation, empowerment of women and in bringing about financial inclusion. However India has the highest number of households, about 145 million, which are excluded from the banking system. Also, out of the 6 lakh villages in India, only approximately 50000 have access to finance. (as on January 2011). Globally there are about 2.5 billion people which constitute nearly half of the world's adult population do not use formal financial services (data as on January 2011). Out of these 2.5 billion, nearly 2.2 billion of the unbanked population live in Africa, Asia, Latin America and the Middle East. Hence there exists a great opportunity for the microfinance sector to provide credit to the low income population thereby reducing poverty and thus in the development of the country as a whole.

Although the microfinance sector has reported an impressive growth, with the ordinances passed by the government, there is a lack of capital for some of the microfinance institutions in the country. Therefore, continuous efforts are required to diversify the sources of funding available for the microfinance institutions in order to attract foreign investments for well established microfinance institutions in order to serve the rural low income population, increase efficiency of staff members, alleviate poverty and also make them profitable.

The large ten microfinance institutions dominating the sector, the other small microfinance institutions can adopt their business models, policies and practices in order to increase their outreach and to operate on a sustainable basis. The awareness in promoting the microfinance sector and to incorporate financial inclusion, many banks have become committed in providing their service. The government has also taken an increasing interest in promoting the sector.

The NGO-MFIs transforming themselves into NBFC-MFIs are on the increase. There are lot of innovations in the microfinance sector so as to overcome the issues faced by them. The government plays a major role in the development of the microfinance sector. Macroeconomic stability, liberalized interest rates, alternate funding options, mobilization of savings, opportunities for institutionalization are some of the issues which require government attention. The government is required to develop legal and regulatory framework for the microfinance sector in order to promote its growth and in turn achieve the objective of poverty alleviation and thus contributing to the development of the country.

Though the performance of microfinance institutions have improved significantly over the past years, sufficient regulatory and governance would help achieve the goal of poverty alleviation and financial inclusion and this could be achieved with the combined cooperation of banks, government and other players in the country. Thus with development of effective strategies and with the combined effort of all players in the society such as donors, government, banks, corporations, NGOs, etc, the long term goal of the government to achieve financial inclusion and poverty alleviation would be attained.

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