Risk and Return in Micro Finance Institutions – A selective study of Micro Finance Institutions in Karnataka.

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Abstract:

Suresh D. Tendulkar Committee, appointed by the Government of India, to estimate the Poverty level in India, uses monthly per capita consumption expenditure to define poverty line. Accordingly, if a person living in rural area, spending less than Rs. 816 per month and a person living in Urban area, spending less than Rs. 1000 per month (as per 2011-12 Prices) is considered to be poor. Based on this cut off point, 21.9% of the total population are poor. A recent World Bank report states that India comprises of 135 million households or 72% of the population whose average annual household income of below $1,800. This massive wide spread social evil, poses a greater threat for the growth and development of the country. Poverty alleviation and raising the average standard of living have always been stated as the central aims of economic planning in India.

Though the robust growth was witnessed in Indian Financial System and institutions after the nationalisation of banks, process of 1969 and 1980, even today, the bank density still stands to be one bank office for every 12,000 population on an average (according to 2012). These organised financial institutions have failed to reach the deprived segment and the poor, leaving approximately 135 million households entirely unbanked. Infact, the size of India's unbanked population is one of the highest in the world, second only to China. According to the World Bank report of 2011, there are 450 million unbanked persons in India.

In the absence of formal financial services, the low income segment has traditionally relied on local money lenders, who used to offer instantaneous credit but at 60 to 70% rate of interest and literally pushing them to a debt trap, which has only a one way entry and no exit. That's why there is a famous proverb which states that Indian poor takes birth in debt, lives in debt and also dies in debt. The credit needs of these deprived class will be very small, which most of the organised financial institutions refuse to fulfil, because of high operational cost. Hence, to the rescue of these deprived class, micro finance institutions were initiated, which appears like god gift.

Despite the fact, that these micro finance institutions were started with noval objective and initially, did wonderfully well, in due course of time, these institutions also started developing operational difficulties, due to high loan outstanding. This research aims at highlighting those difficulties and the need for structured study to overcome those difficulties.

Key words: Micro Finance Institutions, Poverty, Outstanding, Financial system.

Introduction:

India has a population of 121 crores (as per 2011 census), out of which 623. 7 million are male population and 586.5 million are female population. Indian population can be divided into four categories based on their household income levels. They are;

(a) **The Rich**: with an average annual income of $20,000 or more, who constitutes only 0.4% of the total population.

(b) **The Middle Class**: with an average annual income between $4,000 to $20,000 comprises 11million households and constitutes only 5.9% of the total population.

(c) **The Aspires**: with an average annual income between $1,800 to $ 4,000 makes up nearly 22% of the households.

(d) **The Deprived Segment**: comprises of 135 million households or 72% of the population has an average annual household income of below $1,800.

This population is currently being served by around 1,11,723 commercial bank branches (as on March 2012), 12,000 co-operative societies, 15,000 Regional Rural Banks and around 1,00,000 Primary Agriculture Societies.

Though the robust growth was witnessed in Indian Financial System and institutions after the nationalisation process of 1969 and 1980, even today, the bank density still stands to be one bank office for every 12,000 population on an average (according to 2012). These organised financial institutions have failed to reach the deprived segment and the poor, leaving approximately 135 million households entirely unbanked. Infact, the size of India's unbanked population is one of the highest in the world, second only to China. According to the World Bank report of 2011, there are 450 million unbanked persons in India.

The main reason for failure of these organised financial sector to reach the large segment of the India's population is:

(1) **High operational cost:** It has to deal with large number of small debts. It is easy to maintain the book of accounts, if Rs.50,000/- is given as an advance or loan to some person, rather than distributing same Rs.50,000/- to 20 persons at an average of Rs.2,500/-. The credit requirement of the poor will be very less.

(2) Much of low income population is **located in rural areas** that are geographically remote and inaccessible.

(3) **Lack of collateral**. Poor don't posses any assets or valuable which could be offered as security against the loan. Organised Financial institutions lends only secured loans.

(4) The **cost of operating** a branch in a remote location is financially not feasible.

(5) Low income households are not interested in the same products that are usually needed and used by middle and rich class because of their **different immediate needs**, regular flow of income.

(6) The Poor segment is often **illiterate and lacks financial knowledge**, making it nearly impossible for it to even contemplate availing existing financial service.

In the absence of access to formal financial services, the low income segment has traditionally relied on local money lenders, who used to offer instantaneous credit but at 60 to 70% rate of interest and literally pushing to a debt trap, which has only a one way entry and no exit. Hence they are called as "***Loan Sharks***", as it is really difficult to escape from the clutches of shark.

The Micro finance sector targets the Deprived and the Aspires segment, who are almost excluded from the traditional and organised financial system and helps the deprived people to move up the income ladder.

Meaning of Micro Finance:

Micro Finance is a financial service of small quantity provided by financial institutions to the poor. It means provision of thrift, credit and other financial services and products with an aim of raising income levels and thereby raising their standard of living.

Micro Finance Loans serves the low income population in multiple ways. They are:

- It provides working capital to build business and that too collateral free loans.
- Achieves women empowerment, because these loans are dispersed through SHG's
- Protects them from getting into debt traps and Loan Sharks.
- Micro Finance model takes the advantage of existing community support system and networks to encourage financial co-operation and discipline.

As of March 2009, the Micro Finance Institutions in India has reported a client base of 22.6 million with an outstanding portfolio of $ 2 billion. From March 2008 to March 2009, with a span of 12 months Micro Finance Industry has experienced a 59% growth in its client base from 14.2 million to 22.6 million and 52% growth in its portfolio outstanding, which increased from $ 1.5 billion to $2.3 billion. This reflects 14% increase in the absolute growth in portfolio outstanding and 33% increase in the absolute growth in the number of borrowers from 2008 to 2009.

Micro Finance Institutions have shifted their focus from agricultural lending towards non-farm lending. Non farm lending is less risky because handicrafts producers and small store owners receive a fairly steady stream of income. In addition Micro Finance Institutions develops a new lending practice called as 'Group Lending' or 'Joint Liability Lending'.

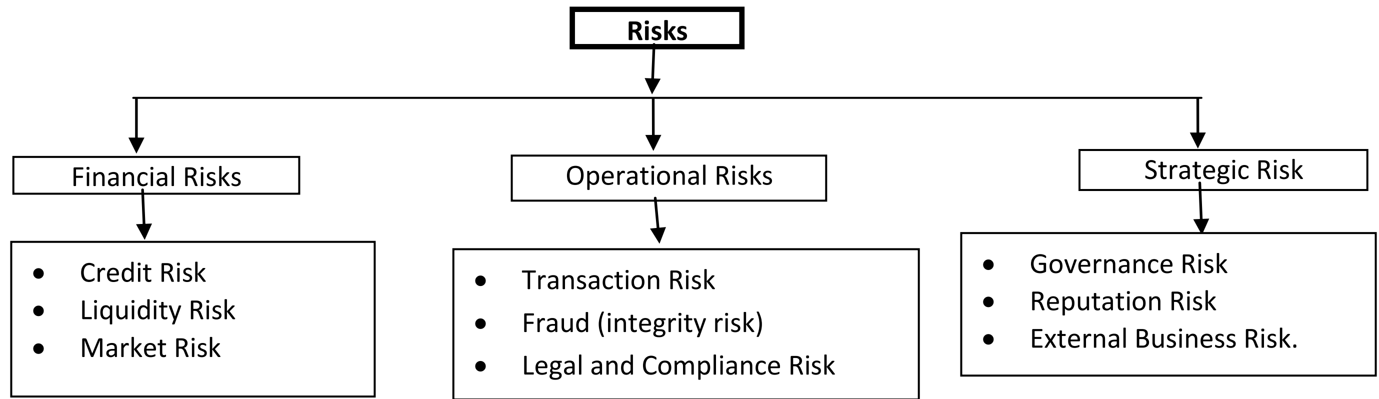
In this borrowers organise themselves into a group of five or ten and present themselves to the Micro Finance Institution. After agreeing to the rules, the first two members of the group receive a loan. If the first two borrowers successfully repay their loan then about four to six weeks later, the next two are offered loan, after another four to six weeks later, the last person is offered a loan. As long as all the members in the group repay their loans the promise of future credit is extended.

If any member of the group defaults a loan, then all members are denied access to future credit. Further, eight to ten such groups are organised into centres and repayment is collected during public meetings. While this ensures transparency any defaulter will be visible to entire village and it is a matter of shame as they are denied to the access of future credit.

Hence Micro Finance Institutions report high repayment. Generally more than 95%. This rate demonstrates that lending to the underprivileged or poor borrowers without collateral is financially

sustainable too. These high repayment rates indicates that Micro financing institutions are profitable or as it is phrased 'MFIs could be financially sustainable.'

But one shouldn't mistake that Micro Finance Institutions are risk free. Infact, Micro Finance Institutions also faces risks, more or less like organised financial institutions, but which are of different nature. Those risks encountered by Micro Finance Institutions are classified as follows.



A brief description of these risks are as follows:

Credit Risk	(a) Difficulty in obtaining funds (b) Competition with Commercial Bank (c) Eroding Lending Standards (d) Over indebtness
Liquidity Risk	(a) Borrowers late or non repayment. (b) Absence of Collateral (c) Difficulty in meeting the current cash obligation
Market Risk	(a) Interest Risk (b) Foreign currency Risk (Sudden appreciation of dollar)
Transaction Risk	(a) Handing a large number of very small loans (b) Cross Verification is extremely difficult due to large number.
Fraud Risks	(a) Direct theft of funds by loan officers (b) Verification of account balances.
Governance Risks	(a) Inadequate body to make effective decisions (b) Sometimes negative publicity (c) Absence of standard governance mechanism (d) Non assurance of future funding by Micro Financing Investors. (e) Lack of debt enforcement institutions.

Hence risks faced by Micro Financing Institutions endanger their long term sustainability.

Need for the Study:

Most research has focused on how microfinance helps to get poor people out of poverty? Or how does it contributes for the economic and social welfare and development of the beneficiary? But there is lack of studies on microfinance from an ***investor perspective***.

Since Micro Finance deals with collateral free loans, there is high risk of lending. Which are the motivating factors of MFI's, that induces them to invest in microfinance? Is there any comprehensive and systematic approach to identify, anticipate, respond and to minimise the major risks that threaten their existence. Could there be a cost-effective policy and procedure to mitigate those risks. Can there be a mechanism to identify the potential risk and to avoid unexpected losses.

Hence a detailed research on the above mentioned topic would be opt to understand MFI's capacity to deal with risk factors involved in lending collateral free loans and ROA (Return on Assets).

Review of Literature

1. **Ebenezer Bennet (2012)** states the importance of microfinance institutions and different types of risks that they face in Ghana. Microfinance organizations in third world countries are new off-springs from the banking industries whose contributions cannot be over emphasized. This stems from the fact that they have helped in alleviating the poverty menace in third world countries such as Ghana. Most microfinance organizations in spite of their contribution towards helping prospective Ghanaian investors in establishing their own businesses are saddled with a number of challenges, chiefly among them include: how to manage risk in their respective operations; how to identify risk areas vulnerable to their operations; and pragmatic ways of mitigating risk management in microfinance institutions. A number of microfinance in Ghana has been operating outside the confinements of the laws regulating financial institutions. The researcher aimed at collecting data, both primary and secondary using research techniques and methods. It was recommended that the research findings would be used to identify risk areas in microfinance institutions as well as collaterals should worth in value more than the facilities provided by obligors; the findings of the research shown that dependency on single revenue have effect on microfinance institutions and multiple borrowing have effect on the profit of microfinance institutions. It is concluded that Ghanaians have benefited from the activities of microfinance institutions. (Ebenezer Bennet, All Nations University College; Bharathidasan University, August 25, 2012)
2. **Prof. Geetha Nagarajan**, analyses the impact of external factors on the returns. Micro Finance Institutions faces many risks, that threaten their financial viability and long-term sustainability. Some of the most serious risks come from the external environment in which the Micro finance Institutions operate, including the risk of natural disaster, economic crisis or war. While Micro Finance Institutions cannot control these risks directly, there are many ways in which the Micro Finance Institutions can prepare itself and minimize their potential for negative impact. ("Microfinance in the Wake of Natural Disasters" by Geetha Nagarajan, MBP Publications, 2011)
3. **Prof. Rajshekar** from ISEC states that - many NGO's (Non-Governmental Organisations) have made attempts to alleviate poverty and empower the poor through Micro Finance, in socially and Economically backward region. Some of these NGO's had promoted credit unions, which, however, had problems of free riding due to their large size. (Prof. Rajshekar, 2000, Micro finance

programmes and women empowerment: A study of two NGO's from Kerala; Journal of social & economic development, 3 (1), 76-94)

4. According to **Hoff, Karla and Joseph E. Stiglitz (1990)**, lenders are entrusted to examine imperfect information problems of three kinds in the rural credit markets. They are problems of screening, incentive and enforcement. The first one relates to the problem of ensuring the likelihood of default of the borrowers and it looks into the willingness of the borrowers to make repayment. The incentive problem relates to the problem of borrowers to take actions, which makes repayment more likely. The third problem relates to the problem of ensuring repayment. The information costs involved for both lenders and borrowers for bringing about the transactions are called transaction costs. As a result, the availability of credit to the rural poor from formal banking institutions has always remained as an outstanding issue. (Introduction: Imperfect Information and Rural Credit Markets-Puzzles and Policy Perspective. The World Bank Economic Review.4 (3): 235-50)

5. **Krauss and Walter (2010)** examine whether microfinance shows low correlation with international and domestic market performance measures. Their dataset contains annual data for the period 1998-2006. In total they consider 325MFIs based in 66 emerging market countries. They use fixed-effects panel regressions to examine the relationship of MFI returns, measured by five key financial variables (return on equity, profit margin, change in total assets, change in gross loan portfolio and loan portfolio at risk), to global market risk—measured by the S&P 500, Morgan Stanley Capital International (MSCI) world, and MSCI Emerging Markets indexes—and domestic market risk, measured by domestic GDP. Krauss and Walter (2010) also perform regressions for a sample containing MFIs and emerging market institutions (EMIs), and MFIs and emerging market commercial banks (EMCBs). These regressions aim to show whether MFIs show lower or higher correlations with domestic and global market risk than EMIs or EMCBs. Their analysis shows that MFIs are not correlated with global market movements, whereas MFIs are significantly correlated with the domestic macro economy. Relative to EMIs and EMCBs, MFIs seem to be more detached from global capital markets. However, concerning the domestic markets, MFIs and the two benchmarks have comparable correlations. This leads Krauss and Walter (2010) to conclude that "MFIs may have useful diversification value for international portfolio investors away from country risk exposures. For emerging market domestic investors, who may have this ability to a much more limited extent, domestic microfinance investments do not seem to provide significant portfolio diversification advantages" (Krauss, N. and Walter, I. 2009. Can microfinance reduce portfolio volatility? Economic Development and Cultural Change)

6. **Ahlin and Lin (2006)** use a sample of 112 MFIs from 48 countries for the years 1996-2004. By using within and between panel regressions, they examine whether performance of MFIs is affected by the macro economy. They focus on four performance measures: self-sustainability, default rates, costs per borrower, and growth in clientele. Concerning the macroeconomic variables, they use real per capita income growth rates, inflation, labour force participation rates, manufacturing's share in GDP and net foreign direct investment as a fraction of GDP. Their study indicates that the macroeconomic environment is a significant determinant of MFI performance, which questions the relevance of investments in microfinance in order to reduce portfolio risk. However, they also show that MFI success is for a substantial part determined by MFI-specific factors. (Ahlin, C, Lin, J. and Maio. M. 2010. Where does microfinance flourish? Microfinance institution performance in macroeconomic context. Journal of Development Economics)

7. **Gonzalez (2007)** analyzes whether changes in domestic GNI per capita significantly affect MFI portfolio risk, measured by four indicators: Portfolio at Risk over 30 days, Portfolio at Risk over 90 days, Loan loss Rate, and Write-off Ratio. His sample contains 639 MFIs in 88 countries for the period 1999-2006. By using fixed and random effects panel regressions, in which he controls for several variables that may affect portfolio risk, the study shows that only with respect to Portfolio at Risk over 30 days there exists a statistically significant relationship between changes in GNI per capita and portfolio risk of MFIs. Regarding the other three indicators for portfolio risk, he finds no evidence for a relationship between MFI asset quality and changes in GNI per capita, suggesting that microfinance portfolios have high resilience to macroeconomic shocks. His study, therefore, provides some evidence that microfinance may provide attractive opportunities for portfolio diversification. (Gonzalez, A., 2007. Resilience of Microfinance Institutions to National Macroeconomic Events: An Econometric Analysis of MFI Asset Quality. MIX Discussion)

Research Gap:

- Ebenezer Bennet report analyses the importance of microfinance institutions and different types of risks that they face in Ghana and pragmatic ways of mitigating risk management in microfinance institutions. Similar Research with respect to Indian Context is needed.
- Similarly Prof. Geetha Nagarajan, analyses the impact of external factors on the returns. Micro Finance Institutions faces many risks, that threaten their financial viability and long-term sustainability. Some of the most serious risks come from the external environment in which the Micro finance Institutions operate, including the risk of natural disaster, economic crisis or war. A detailed study on different factors that affects financial viability and Long-run sustainability of MFI is needed.
- Prof. Rajshekar from ISEC states that - many NGO's have made attempts to alleviate poverty and empower the poor through Micro Finance, in socially and economically backward region. Some of these NGO's had promoted credit unions, which, however, had problems of free riding due to their large size. Managing books of accounts and cross checking is major problem. Most of MFI are financed by banks or most of the time they rely on government funding or assistance. After 'Krishna Crisis' in Andhra Pradesh, Banks also hesitate to lend to MFI's.
- Hoff, Karla and Joseph E. Stiglitz (1990), states that Micro Finance lenders are entrusted to examine imperfect information problems in the rural credit markets. They are problems of screening, incentive and enforcement. A credit market transaction is said to be complete, only when the loan borrowed is repaid on time in normal course. Hence identifying the credit worthiness of the borrowers, ensuring that borrowed money is utilised for funding productive activities and making timely repayment is necessary.

So Micro Finance institutions need to deal with these risks effectively.

- The core of risk management is making educated decisions about how much risk to tolerate? How to mitigate those that cann't be tolerated.
- There is a need to develop and design a comprehensive & systematic approach to identify, anticipate and to respond to those major risks.

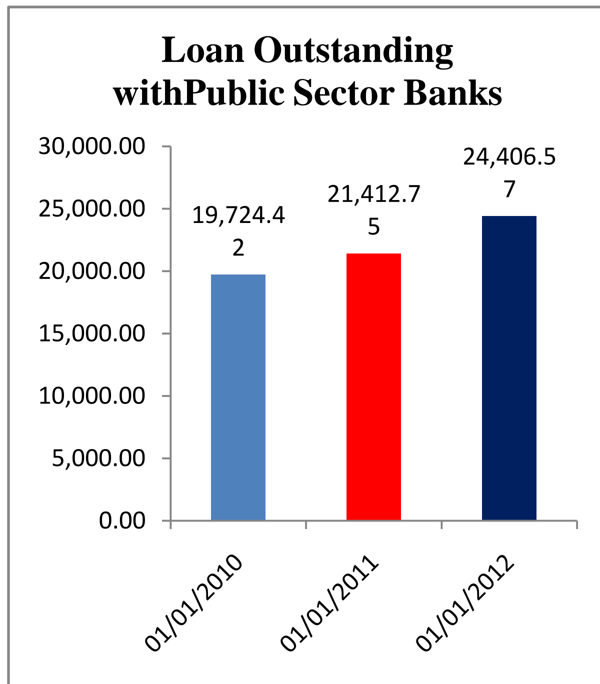
(Value in Crore Rs.)

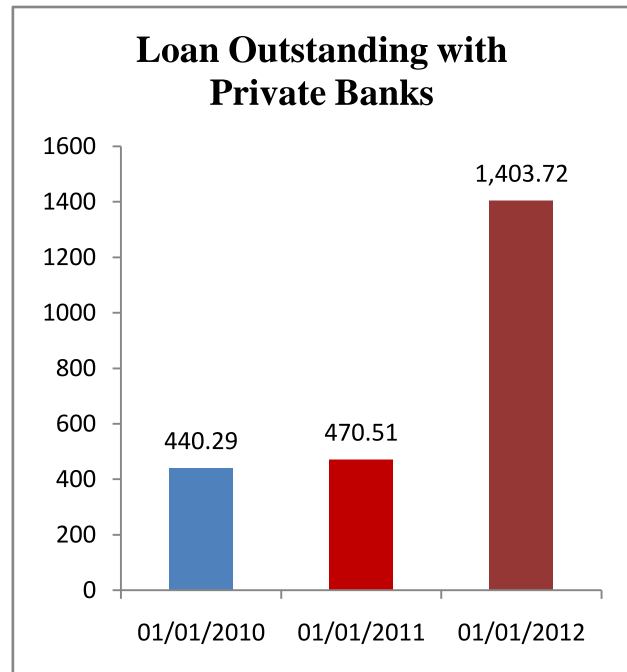
- ❖ Micro Finance institutions will be giving collateral free loans. The objective may be social motivation. But there is a need to maintain balance between the risk, return and helping out the poor.
- ❖ Any default in recovery or repayment of loan would adversely affect the other beneficiary. Hence a structured study in this direction is needed.

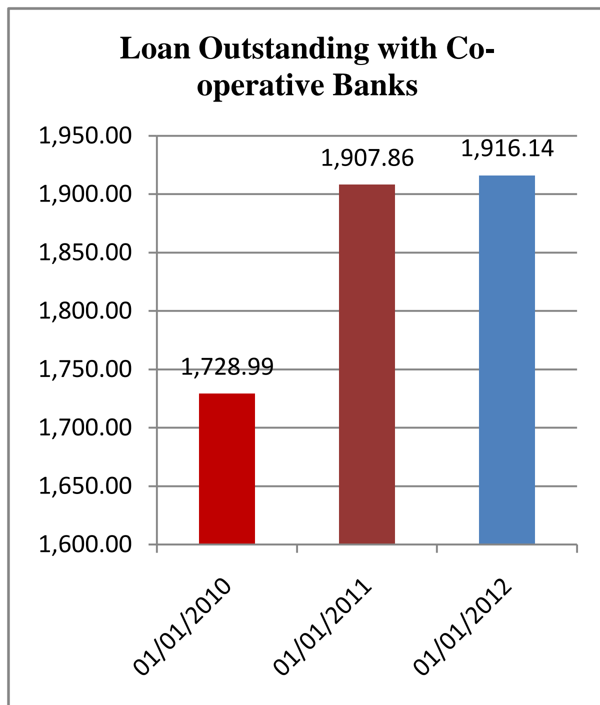
The next table depicts the increasing incidence of Non-performing assets of Micro Finance Institutions from last three financial years. By the end of 31st March 2012, Micro financing institutions had a total loan outstanding of Rs. 36,340.00, out of which total NPA was 2,212.73crore rupees, which is very huge. Hence it gives us a scope to study the reasons for mounting Non-performing Assets, as these institutions play an important role in the upliftment of the poor.

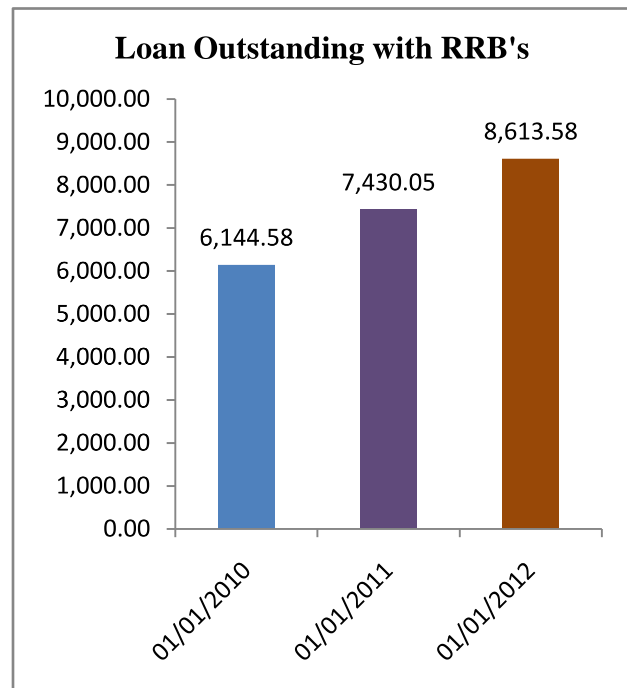
Source: NABARD annual paper 2011-12

Agency	**Loans Outstanding**			**Amount of NPA's**			**% of NPA's to Loan Outstanding**		
	31/3/10	***31/3/11***	***31/3/12***	***31/3/10***	***31/3/11***	***31/3/12***	***31/3/10***	***31/3/11***	***31/3/12***
Public sector banks	19,724.42	21,412.75	24,406.57	513.53	1,019.90	1,581.05	2.60	4.76	6.48
Private Banks	440.29	470.51	1,403.72	23.93	47.09	74.37	5.44	10.10	5.30
RRB's	6,144.58	7,430.05	8,613.58	218.53	272.82	426.34	3.56	3.67	4.95
Co-operatives	1,728.99	1,907.86	1,916.14	67.04	134.30	130.97	3.88	7.04	6.84
Total	28,038.28	31,221.17	36,340.00	823.04	1,474.11	2,212.73	2.94	4.72	6.09


Loan Outstanding withPublic Sector Banks
30,000.00
25,000.00
20,000.00
15,000.00
10,000.00
5,000.00
0.00
19,724.42
21,412.75
24,406.57
01/01/2010
01/01/2011
01/01/2012


Loan Outstanding with Private Banks
1600
1400
1200
1000
800
600
400
200
0
440.29
470.51
1,403.72
01/01/2010
01/01/2011
01/01/2012


Loan Outstanding with Co-operative Banks
1,950.00
1,900.00
1,850.00
1,800.00
1,750.00
1,700.00
1,650.00
1,600.00
1,728.99
1,907.86
1,916.14
01/01/2010
01/01/2011
01/01/2012


Loan Outstanding with RRB's
10,000.00
9,000.00
8,000.00
7,000.00
6,000.00
5,000.00
4,000.00
3,000.00
2,000.00
1,000.00
0.00
6,144.58
7,430.05
8,613.58
01/01/2010
01/01/2011
01/01/2012

As per the NABARD report of 2011-12, the total loan outstanding from Micro finance Institutions to Public Sector Banks, amounts to Rs. 24,406.57 crore as on 1st January 2012. Whereas the loan outstanding from Micro finance institutions to Private sector banks is Rs. 1,403.72 crores for the same period. Such huge outstanding clearly depicts that there are difficulties in loan recoveries, which questions the sincerity and credibility of Micro Finance Institutions. A structured effort is needed in this direction to understand the major difficulties that lending institutions are facing.

As per the NABARD report of 2011-12, the total loan outstanding from Micro finance Institutions to co-operative banks, amounts to Rs. 1,916.14 crore as on 1st January 2012. Whereas the loan outstanding from Micro finance institutions to Regional Rural Banks is Rs. 8,613.58 crores for the same period. Co-operative societies were established with the objective of mutual help and Regional Rural banks were established for the purpose of catering the financial needs of the villagers. Such huge outstanding, poses

Statement of the Problem:

"Risk and Return in Micro Finance Institutions – A selective study of Micro Finance Institutions in Karnataka".

The research would concentrates on six important variables.

- Analysing the performance of MFI
- Understanding the various motivating factors of Micro Financing Institutions for lending collateral free loans.
- Repayment capacity of the borrowers and the percentage of defaulters.
- Identifying and analysing the impact of risk on the performance.
- Failure of few Micro Finance Institutions in the country. The reasons behind them
- Learning from the experiences of those who failed.

Objectives of the study: (From the investor's perspective)

1. To Review the structure and performance of Micro Finance Institutions
2. To examine the operations of Micro Finance Institution in the study area
3. To identify and analyse the impact of risk on the performance of Micro Finance Institutions.
4. To examine the factors involved in lending and returns of Micro Finance Institutions.
5. To suggest measures for the sustainability of Micro Finance Institutions.

Data Sources:

Primary data:- Sources: (a) Personal Interview Method (b) Method of Questionnaire (c) Personal Observation Method. First Hand Data regarding the total lending, total recovery and Loan outstanding will be collected from Association of Karnataka Micro financing Institutions (AKMI) comprising of 24 Micro Financing Institutions working across Karnataka but head quartered in Bangalore.

Those participating Micro Financing Institutions of AKMI are

GMASS Prawarda	Rores Micro entrepreneur Development Trust	Urs Seva Trust	Samuha Micro Finance
Future Financial Service Ltd.,	SKDRDP	Kaveri Credit India Private Limited	Samasta Micro Finance
Asmitha Micro Finance Limited.	Nava Karnataka Rural Development Society	IDF financial service private limited	BASIX
Agriculture Science foundation	Prakruthi foundation	SKS Micro finance	Chaitanya India Finance Credit Private Limited

Apart from these MFI, other popular MFI's functioning in Karnataka like MYRADA, ANNAPOORNA, UJJIVAN... etc., would also be considered for the required information.

Secondary data will be collected from various sources such as

- Audited reports of the above foresaid MFI.
- Various Journals.
- Yearly Hand Book of NABARD
- Books, Manuals

Research Area: MFI's operating in Karnataka State.

Time Period: Research would carried out on the basis on financial performance of MFI's from 2010 to 2015 (5 years performance).

Research Methodology:

- To accomplish the aforesaid objectives, the trend rates of growth will be calculated.
- Pearson rank correlation will be used to find out the relationship between risk and return.

Hypothesis:

- Micro Finance Institutions follow "Higher the Risk, Higher the return" policy
- Despite various risks encountered by MFI, they are financially sustainable.
- Legislations of the government are in favour of MFI's and promote their growth.
- Financial objective of MFI's supersedes its social objective.

Scope of the study:

Research in the above said direction would be truly beneficial to Micro Finance Institutions as it would help them to identify, anticipate various risks and get prepared to it. Research in the above topic would suggest measures for the long term success of Micro Finance Institutions. If possible research work, also

would like to suggest ***adoptable frequent payment structure*** that eases the process of loan recovery without employing any coercive measures. This mitigates the risk factor to greatest extent.

Conclusion:

Millions of poor people in India are presently denied their right to make their own financing choices and access to financial services. Micro financing institutions would help realising the objective of providing banking and financial services to the poor. Due to the existence of various risks and some of the allegations such as MFI charges usurious interest rates ranging between 25 – 30%, MFI are languishing and many got closed down in the process. Pursuing research in "Risk and Return in Micro Finance Institutions – A selective study of Micro Finance Institutions in Karnataka" would be beneficial in exploring the weakness and providing ample suggestions to deal with these risks and achieving long run sustainability.

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