# MICRO CREDIT TO MICRO FINANCE: OPPORTUNITIES AND CHALLENGES FOR SELF HELP GROUPS

N. Jeyaseelan
Anand Joshi

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*Knowledge is Our Business*

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# CHAPTER 1

# EXPLORING THE FINANCIAL INSTITUTION

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**ABSTRACT:**

There are several definitions that vary depending on the kind of financial services, the level of formality of the financial service provider, and the breadth of access that have been used in the debate on the value and drivers of financial inclusion. Before going through various aspects of financial inclusion, I'll first provide a broad description. Financial inclusion describes the availability to businesses and families of formal financial services that are suitable for their requirements and are competitively priced. Geographic access (i.e., proximity to a financial service provider) and socioeconomic access (i.e., lack of prohibitive fees and paperwork requirements) are two ways that access to financial services may be described. Other crucial factors include proper product design that does not include abusive pricing and meets customer wants while being sustainable for both suppliers and customers. There are many distinct types of formal financial organisations, such as banks, nonbank financial institutions, and microfinance organisations. One can distinguish between a variety of different formal and semi-formal non-bank financial institutions, ranging from credit-only finance and leasing companies over postal savings banks to credit and savings cooperatives, even though there is a significant difference between commercial banks and other financial institutions, which are typically subject to fewer regulatory rules and restrictions

**KEYWORDS:**

Financial, Institution, Microfinance, Organization, Strategy.

## INTRODUCTION

I will go through some of these variations. Microfinance is the practise of attempting to provide monetary services to small businesses and people who are not eligible for standard commercial banking services. These people are often low-income, self-employed or unemployed, without formalised ownership titles on their property, and they have few legal identifying documents. It is crucial to distinguish between the idea of microfinance and the organisations that provide it. These organisations range from cooperative banks to nongovernmental organisations (NGOs) like Grameen Bank to commercial banks that are trying to reach the low-end of the market with specialised programmes and commercial microlenders like the Mexican Compartamos [1], [2].

The concentration on the low-end of the market is what unites these various suppliers, even if they use a variety of different strategies to reach this clientele and supply services to it in a way that is financially viable. Numerous of these organisations operate under the tenet of double or triple bottom lines (profit, social impact, and environmental impact). The term "microfinance" is also often used to describe a notion that includes methods of distribution and goods that are unique from traditional banking and are created using. For instance,

according to CGAP (2011), effective access is "convenient and responsible service delivery, at a cost affordable for the customer and sustainable for the provider," and financial inclusion is "a state in which all working-age adults have access to credit, savings, payments, and insurance from formal service providers. It is necessary to remove the obstacles that keep traditional banks from serving the low-end of the market [3], [4].

The function of government-owned financial institutions is significant in this context. The overall track record of government-owned and -run institutions providing credit is rather poor; they use subsidised interest rates leading to credit rationing and rent seeking, forbearance if not outright debt forgiveness undermining credit culture (and thus unsustainable) and have a reasonable (though not properly tested) track record in providing savings services to segments of the population not reached by private financial institutions. It is crucial to emphasise that the absence of official financial services does not mean that the underprivileged lack access to any financial services. The poor utilise a variety of informal financial services and have access to a variety of informal financial service providers, such as money lenders, deposit collectors, businesses that provide credit, pawnshops, and friends and family, have shown via financial diaries. While there are some significant distinctions between formal and informal finance, I want to emphasize them despite the fact that the underlying transactions and even contractual structures may not differ all that much. This alludes to the client's right to dignity and privacy, both of which are sometimes an issue when it comes to unofficial financing. Additionally, there are no official regulations for these transactions to safeguard both the creditor/provider and the borrower/client. Overall, informal finance is mostly local and does not provide the same advantages of regional and sectoral diversity as formal financing because of this.

Efforts to increase financial inclusion are related to research on financial development and reducing poverty. According to theory, if the poor have greater access to finance, they may invest in human capital and microbusinesses to lift themselves out of poverty, which would lower overall poverty. In general, families are expected to be able to smooth their spending and lessen the effect of income shocks with access to financial services. Better inclusion into contemporary market economies is made possible through access to payment and transaction services. Instead of relying on cash, employing safer, more affordable, and quicker methods of sending payments enables more efficient business transactions across wider geographic distances. It will become evident that various financial services often make it possible to attain the same objective, although to varying degrees of effectiveness [5], [6].

Importantly, Collins stated that credit and savings are often perceived as alternatives for the poor, with the former assuming many individuals have access to credit demonstrate that nations with greater shares of government-owned banks in 1970 have thereafter weaker financial development and economic growth. For aggregate research on the impact of government ownership of banks. Cole (2009a) demonstrates that the 1980 nationalisation of banks in India had no beneficial effects on future development, and Cole (2009b) demonstrates that the government-owned banks' lending and repayment patterns follow the Indian election cycle. For a broad discussion of the function of government in the financial sector, see World Bank (2013). Small payments up front with a high payout at the end, as opposed to later having a large payout at the start and several smaller payments. It is important to note that this theory of change is based on the idea that impacts on the household or firm level are directly related to access to financial services. This contrasts with the

research on finance and poverty, which (Beck, Demirguc-Kunt, and Levine 2007; Gine and Townsend 2004; Beck, Levine, and Levkov 2010) has concentrated on the indirect impacts of financial deepening on poverty reduction. What issues in the developing world prevent families and microbusiness owners from using formal financial services? Designing strategies to help lower these obstacles is made possible by identifying the impediments [7], [8].

## DISCUSSION

It is crucial to make a distinction between supply and demand side factors in this context, i.e., those that prevent financial service providers from reaching out to particular groups of households and businesses and those that prevent them from offering certain products and services to households and businesses. The main causes of the restricted supply of financial services at the low end of the market are high costs and risk. The provision of financial services to low-income segments of the population is more challenging due to the fixed costs associated with doing so (i.e., costs that are independent of the amount of deposit or credit, the number of transactions made by a client, or the number of clients served in a branch or by an institution). These customers typically require smaller and/or fewer transactions. The dispersed population in rural regions also reduces the business viability of providing conventional financial services via brick-and-mortar branches outside of metropolitan centres [9], [10].

Additionally, there may be too many hazards involved in reaching out to the bottom end of the market. In developing nations, a significant portion of families and economic actors work in the informal economy and lack the legal documentation required for financial transactions. The absence of appropriate ID systems in many low-income nations and the stricter know-your-customer requirements that have been implemented globally over the last ten years have made this situation worse. Similar to the previous example, volatility raises costs and risks for financial service providers by impacting both the individual level, which is related to fluctuations in the income streams of many microenterprises and households, and the aggregate level, which is related to the dependence of many low-income economies on commodity exports. On the demand side, a major obstacle has been found as a lack of financial awareness. choices regarding the distribution of credit resources as well as savings choices are influenced by behavioural and intrahousehold limitations. Additionally, certain demographic groups' desire to use formal conventional finance is constrained by religious prohibitions on interest-bearing contracts. I will discuss how microfinance institutions have attempted to overcome the obstacles of cost and risk and provide evidence of their relative effectiveness; I organise this discussion by different financial services: credit, savings, insurance, and payments.5 In a separate section, I will specifically discuss the challenge of financial literacy; the final section is concerned with the sustainability of microfinance institutions. The research evaluating the effects of increasing outreach with these various technologies will be covered in the next section. The order in which donors and researchers have given these various services their attention determines the sequencing of credit, savings, insurance, and payment.

### Microcredit Strategies

As was already mentioned, two significant supply-side restrictions that hinder credit institutions from serving the bottom end of the market are cost and risk. Many particular strategies, such as (i) shared responsibility lending, (ii) dynamic incentives, (iii) high payback

frequency, and (iv) a concentration on women, have been used to explain the effectiveness of microcredit. The cost and risk issues are addressed differently by these several techniques. Information asymmetries that lead to excessive risk are a significant hurdle for lenders when trying to serve low-income portions of the household and firm population operating in the informal economy. There is no accessible collateral in the official banking system to deal with such knowledge asymmetries. Group lending, in which responsibility for loan repayment is divided among a group of borrowers, has therefore been one of the conventional methods of microcredit lending. Joint responsibility may effect repayment incentives by functioning as a screening and monitoring mechanism as well as an insurance function, thereby lowering the lender's risk. Delegating screening and monitoring to groups may help lessen agency issues due to the very large information asymmetries and agency costs between lenders and micro borrowers, but there is also the potential of collaboration on the part of the borrowers to benefit the lender. The concept of social capital is also relevant to joint liability lending, and research shows that group members' social capital affects the likelihood of default.

Karlan (2007) indicates that persons who have better social ties to their fellow group members owing to closeness in terms of geography or culture have higher payback and higher savings rates. Closer ties also make it possible for group members to discriminate between various causes of default and not penalise debtors who are unable to repay due to circumstances beyond their control. In laboratory studies conducted in five developing nations, Cassar and Wydick (2010) discover that social trust and group lending may both have a favourable influence on trust. They critically describe significant variations in the impact of social capital across many nations and cultural contexts. More frequent meetings of the groups, according to Feigenberg, Field, and Pande (2011)'s work with an Indian microfinance institution (MFI) that randomly assigns new customers to joint liability groups, increase risk sharing and lower the likelihood of default.

They perceive their discovery as shared obligation (and the resulting social interactions), adding to the social capital. In conclusion, group lending itself may generate social capital even while social capital enhances group lending's efficacy (with implications for where this lending strategy should be more successful). On the other hand, there are growing scepticisms about whether shared responsibility is always preferable. The trade-off in group lending is theoretically modelled by Besley and Coate (1995). Group financing may, on the one hand, promote risk sharing. On the other hand, if a lot of the group's borrowers fail, it can promote strategic default. This hypothesis is supported by Gine, Krishnaswamy, and Ponce (2011), who investigate whether members of a shared responsibility group are more likely to default as the proportion of defaulters in the group increases. They do this by using repayment data on Muslims and Hindu microcredit consumers in India. The Anjuman Committee of Kolar released a declaration in 2009 prohibiting all Muslims from repaying their MFI loans since interest is against Sharia law.

Hindu borrowers in communities where Muslim borrowers predominate. This amply demonstrates the constraints and drawbacks of cooperative financing. How does shared responsibility stack up against personal loans? In their empirical study, Gine and Karlan (2014) compare the relative efficacy of two lending methods by using the gradual and partial transition of an MFI in the Philippines from group to individual lending. They discover that the default rates for both groups of joint obligation and individual borrowers are the same.

Additionally, the bank in question saw an increase in outreach as more clients requested loans after learning about the individual responsibility option. In a second experiment, the bank expanded arbitrarily into new regions using either of the two lending strategies. The authors discovered that credit officers were less likely to form groups under individual liability, which they theorized might be due to their reluctance to grant credit without guarantors in specific regions.

Whether this is true or not, it implies that loan officers see the two alternative lending approaches as posing varying levels of risk. Similar findings are made by Attanasio in rural Mongolia, where they discover no difference in default rates between groups of individual and joint responsibility borrowers. In this situation, the bank began offering credit services in other communities using one of the two lending strategies. According to research, an Indian MFI converted from individual to shared liability loans. Unfortunately, other contract provisions changed as well, such as the interest rate and the number of installments, making it impossible to clearly attribute the consequences to alternative lending strategies. However, the authors discovered that collective responsibility not only resulted in a greater payback rate but also a selection impact, with more dependable borrowers entering the group. The group lending scheme's borrowers were also less likely to skip required savings contributions at the same time employ lab tests with existing and prospective microcredit customers and discover substantial variations depending on how well group members can watch the behaviour of other group members and whether they make decisions alone or jointly.

Lab experiments enable more exact manipulation of contracts, information, and investment returns as well as a larger evaluation of various contract design aspects than real-world studies. Decisions made in a lab, however, could not transfer into the same behaviour in actual scenarios found that group lending boosted risk-taking in Peru, particularly for borrowers who were risk averse, but that this was mitigated when borrowers created their own groups. Despite these impacts on project selection, dual responsibility raises the loan payback rate by requiring borrowers to purchase insurance for one another. Fischer (2013) discovers two conflicting impacts of joint responsibility in India via lab tests. On the one hand, borrowers choose riskier assets without making up for this increased risk to their group counterparts. The peer-monitoring mechanism, on the other hand, causes significant declines in risk-taking and profitability, with the second impact finally outweighing the first. Loan disbursement and repayments, independent of joint or individual obligation, are often carried out in group meetings, which helps down costs for loan officers and may also give extra payback incentives via social pressure. I am not aware of any studies done on this tool's efficacy.

The restricted enforceability of credit claims due to the lack of collateral and the high relative legal fees to the loan amount is another risk faced by lenders to low-income groups of the population. Dynamic incentives, or the possibility of more and bigger loans, are therefore a second crucial component of microcredit. There is evidence that doing so lowers the likelihood of default in South Africa, Peru, Malawi, and other countries. Thus, the assurance that they would be able to borrow more money in the future acts as a deterrent for borrowers and lowers risks for the lending institution. Behaviour restrictions of borrowers, who are unable to amass funds over longer time periods due to present-biased preferences or pressure from family members, have also been a barrier to lending to low-income portions of the population (Fischer and Ghatak 2010). Small and frequent repayments, sometimes on a

weekly basis, have therefore become a third significant characteristic of microcredit contracts. These repayments may be used as a commitment tool to combat hyperbolic preferences. For instance, Bauer, Chytilova, and Morduch (2012) discover that women in India who struggle with self-control and hyperbolic discounting have a larger desire for microloans because social pressure and regular repayments make them disciplined.

In contrast, these conditions of repayment might make it difficult to employ microcredit loans for long-term investment. According to Field in India and McIntosh (2008) in Uganda, there is some evidence that increased flexibility in repayment conditions lowers stress and enhances the likelihood that a loan would be repaid. Field demonstrates that a two-month grace period reduces stress, and McIntosh demonstrates that biweekly repayment rather than weekly repayment reduces drop-out rates and slightly increases repayment probability.6 However, Field demonstrates in a field experiment in urban India that a two-month grace period has positive effects for business creation but also increases default probability, which may indicate higher risk taking by these borrowers. The targeting of women is a last characteristic of microfinance, which is consistent with the fact that women are less likely to use formal financial services than males (Demirguc-Kunt, Klapper, and Singer 2013; Aterido, Beck, and Iacovone 2013). Additionally, according to development study, women are more conservative and less moveable than males, and they prefer to invest more of their money in the family home or in the upbringing of their children (such as in their health or education).

However, as inferred from a number of research, intrahousehold restrictions could lessen the impact of lending to women. De Mel, McKenzie, and Woodruff (2008) found that only male-owned enterprises in Sri Lanka saw high returns on capital after a grant injection; this gender disparity could not be explained by variations in aptitude, risk tolerance, or entrepreneurial mindset. In a similar vein, Fafchamps demonstrate in a field trial in Ghana that female entrepreneurs with bigger enterprises do not exhibit any positive return on capital after cash handouts, but do so after in-kind grants. For smaller businesses, there is no benefit for either form of grant. The findings for males likewise point to a diminished effect of cash donations, however there are fewer significant disparities between cash and in-kind gifts.

**High Interests Rates Are a Problem**

One crucial topic has been whether the high cost of microcredit lending is justifiable or might have a detrimental impact on demand. De Mel, McKenzie, and Woodruff (2008) and McKenzie and Woodruff (2008) estimate capital returns to investment in microenterprises engaged in light manufacturing and commerce, respectively, in Sri Lanka and Mexico. In these studies, the entrepreneurs received cash or equipment as the result of a lottery, and this exogenous shock was used to calculate the return on credit. The returns found by the authors range from 5 to 7 percent every month in Sri Lanka to 20 percent or more in Mexico! Even while in the instance of Mexico these returns may appear excessively high, they are based on grants rather than loans, are only examined over the short term, and may not be repeatable over the long run. Furthermore, because these estimates do not account for the ex-ante riskiness of these investments, it does not follow that the micro entrepreneurs would have followed the same strategy with loan resources. However, based on these figures, it seems that some microbusiness owners can afford to pay the high interest rates levied by microfinance organisations, at least if the loan funds are invested.

Several research have investigated the relationship between demand and interest rates. Dehejia, Montgomery, and Morduch (2012) see a significant short-term decline in loan demand (approximately a unitary elasticity) after an increase in interest rates from 2 to 3 percent per month using data from a Bangladeshi MFI. In contrast, Karlan and Zinman (2008) discover a significantly lower impact in a South African experimental environment. More than 50,000 credit offers with randomly chosen interest rates were sent to consumers in order to gauge their sensitivity to interest rate changes. Because they had fewer outside choices, borrowers turned out to be less sensitive to price fluctuations than anticipated. A greater maturity (and hence lower payback amounts) attracted more demand from borrowers, who were, nevertheless, more sensitive to maturity. In contrast, Karlan and Zinman (2013) discover compelling evidence supporting the existence of a long-term price elasticity of loan demand. They collaborate with Compartamos Bank in Mexico to randomly determine the district-level interest rate, which permanently reduces it by 20 or 10 percentage points. They discover that over a 2.5-year time frame, the reduced interest rate draws in new borrowers and has extremely elastic demand in relation to the amount borrowed, with elasticities below -1. In formal finance, at least, there is no indication of crowding out, and they also discover little opposition from rivals. Overall, there was no discernible impact from this interest rate drop on the bank's earnings since they also do not identify any changes in default rates, even though expenses increased. Since this research pertain to various organisations, environments, and interest rate ranges, it is challenging to reconcile their conclusions. There is undoubtedly more to learn about this topic.

The Sharia's ban on interest rates has been a significant barrier to the growth of microfinance in Islamic nations. In contrast to the Rotating Savings and Credit Association (ROSCA) model, which does not need interest rate payments, El Gamal suggest a microcredit model with payments made by individual borrower’s bank-guaranteed for a price. They discover that this approach has a greater take-up rate than the conventional Grameen-style group lending model in a laboratory trial in rural Egypt. Thus, there seem to be potential avenues for the growth of microfinance in Islamic nations. While receiving funding, Islamic microfinance is still an issue that needs further investigation.

**Savings Items**

As mentioned in the survey by Karlan, Ratan, and Zinman (2013), low-income families and people encounter a variety of challenges when trying to access formal savings; some of these challenges are comparable to those faced when attempting to access other financial services, while others are unique to saves. We can differentiate between obstacles brought on by (i) location, (ii) transaction costs, (iii) paperwork needs, (iv) behavioural limitations, and (v) a lack of financial knowledge. Interventions to encourage low-income segments of the population to formally save have included a variety of different approaches and techniques from the beginning, unlike microcredit, where an initially "standard" microcredit product (group lending, small and frequent repayment amounts, and dynamic lending) was later developed into an array of differentiated products.

The examination of a fictitious natural experiment conducted in Mexico highlights the significance of regional obstacles to formal banking outlets. Aportela (1999) focuses on the outcomes of the early 1990s growth of a government-owned Mexican savings institution. Only a few states experienced this growth, and it doesn't seem that state attributes significantly correlate with the order of the expansion. Aportela demonstrates that the

expansion increased the savings rate of low-income households the ones who were initially targeted by the expansion while having no impact on high-income households by computing savings rates of low-income households from survey responses before and after the expansion started [11], [12].

## CONCLUSION

There was a positive net impact on the total savings of the average family, and this increased financial saving did not seem to have displaced alternative informal methods of saving. Although they are only able to measure this effect on an aggregate level, Burgess and Pande (2005) find that a regulatory requirement in India that was in place between 1977 and 1990 for banks to open four branches in previously unbanked areas before opening a new branch in a previously banked area, led to higher deposit mobilisation. Flory (2011) examines the impact of a bank-on-wheels programme in Malawi, where mobile vans decreased the distance between potential customers and banks, and finds a very modest effect on the uptake of bank accounts. However, he finds that experimentally increasing use of formal savings in rural areas sharply increases interhousehold transfers during peak periods of hunger, thus documenting significant spillover effects to household's ineligible for opening an account. The impact of a biweekly deposit collection service with a low cost is evaluated by Ashraf. in Ashraf. 28 percent of individuals who received the service established an account, and 50 percent regularly utilised it. They also had higher savings rates and lower bank borrowing rates. The take-up rose as one moved more away from the next bank branch, highlighting the detrimental impact of geographic boundaries.

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# CHAPTER 2

# AN OVERVIEW ON MICRO-INSURANCE PRODUCTS

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**ABSTRACT:**

The uptake of these insurance policies has, however, often been disappointingly modest when they are provided, for instance, discover no discernible difference between a regular credit product and a credit cum crop price insurance product in terms of take-up. In particular, maize and eggplant farmers in rural Ghana are equally likely to accept either a conventional loan or a credit with an indemnification provision in case of very low prices. In a research conducted in India, Gine, Townsend, and Vickery (2008) demonstrate that insurance take-up reduces with family credit limitations while increasing with the riskiness of the crops and income. However, in contrast to what a fundamental neoclassical paradigm would imply, families who are risk adverse are less likely to purchase insurance. With the aid of a field experiment in Ethiopia, McIntosh, Sarris, and Papadopoulos (2013) demonstrate that the actual take-up of an insurance product is not significantly correlated with survey-based willingness to pay, with the correlation being strongest among farmers with low marginal productivity and those who were (randomly) assigned vouchers.

**KEYWORDS:**

Digital, Industrialized, Micro-insurance, Payments, Products.

## INTRODUCTION

According to Townsend (1995), many families and businesses in developing nations experience much greater risks and volatility than their counterparts in more industrialised nations. Therefore, it is crucial to have insurance products that can reduce the effect of income or spending shocks on consumption. In addition to informal insurance providers like burial insurance, there are other informal insurance agreements within extended families and within communities. On the other hand, the provision of formal insurance products is constrained by high expenses and risks because of expensive ex ante screening and verification expenses in the case of an insurance occurrence. Because of the variability in rainfall, farmers are particularly vulnerable. Rainfall insurance may lower agency disputes and costs for insurance firms by relying on objective rainfall data collected from a gauge that is physically near to the policy holders. In Gujarat, India, half of the sample in the target region participated in a marketing trial where financial literacy training was offered, according to data from Gaurav, Cole, and Tobacman. Both the training and the money-back guarantee in the event of a loss considerably boosted take-up. Technical explanations about rainfall or soil quality, for example, had little effect on take-up [1], [2].

Farmers' expectations that they won't be required to repay if they are unable to do so may be one of the factors contributing to the low insurance take-up. In a randomised control study with Malawian farmers of maize and groundnuts, Gine and Yang (2009) discover that take-up

is greater among farmers who are merely provided credit than among farmers who are supplied a credit product with an insurance component. Cole (2013) conclude that lack of confidence and liquidity restrictions are important nonprice frictions that limit demand using data from a field experiment in India. In a seven-year analysis of take-up rates in India, Cole, Stein, and Tobacman (2014) find that take-up rates are highly responsive to rewards in a household's village, indicating significant peer effects conduct a systematic assessment of 13 studies evaluating smallholder micro-insurance products, 11 of which concentrate on take-up. However, a few of the research used fictitious rather than real insurance product offerings. Then they say that take-up is positively correlated with greater liquidity, higher income, higher income specialisation, more financial knowledge, and higher agent trust. Additionally, they draw attention to the unexpected finding that greater risk aversion is linked to decreased take-up. Thus, non-price considerations are crucial for uptake, and it may be beneficial to roll out insurance products with literacy or extension initiatives. This study has various implications for how insurance product design should be done. First, in order to gain the confidence of the user base, goods must be made to pay out often. Additionally, it has been shown that a recommendation from a reputable organisation fosters customer confidence. Second, quick payments are crucial because liquidity restrictions matter. Due to these limitations, it could be advantageous to combine insurance and loans to pay premiums [3], [4].

**Services for digital payments**

Even families without formal access to credit or savings services engage in financial activities, with bill payments and receiving domestic or foreign remittances from family members taking the lead. These payments are often conducted in cash, which comes with significant expenses (such the time it takes to go to an office to send, receive, or pay money) and high dangers (like theft). There have been important advancements in payment services, most notably the use of mobile devices for digital payments. Digital payments are more private, less risky, and cost-effective for both the payer and the payee. Just as an illustration, data from the random substitution of manual transfer payout with mobile payout following a devastating drought in Niger demonstrates that the variable cost of social transfer payment payout is 20% lower if done by mobile payment than by manual cash-out, and it reduced costs to recipients by 25%.

Since it makes money flows more transparent, it also benefits governments. For instance, Muralidharan (2014) discover that switching Andhra Pradesh's social security pension from manual cash-out to digital payments through smart cards considerably lowers the prevalence of leakage between government payments and beneficiary receipts. By taking advantage of the random distribution of the programme among sub districts, the authors are able to prove the causal effect of the programme. Benefits from less leakage and time savings for beneficiaries outweigh programme costs by a large margin. As seen by M-Pesa in Kenya, the effect of such new providers on payment habits may be rather severe. A bus or matatu driver, a post office, or friends and family were utilised by half of those polled in the FinAccess study in 2006 to send remittances. In comparison, only 24.7 percent of people in 2009 sent personal (business) remittances via friends and relatives, 2.6 percent (59.9 percent) through a bus or matatu driver, and 2.2% of 3.1 percent is the post office. According to a poll of users, 51.1 percent use M-Pesa for business-related remittances and 65.6 percent use it for personal

remittances. In See Better than Cash Alliance for a detailed review of current digital payment studies [5], [6].

Bill & Melinda Gates Foundation and the World Bank, 2014. According to a broader analysis by Mbiti and Weil (2011), using M-Pesa is favourably correlated with the frequency of sending transfers, negatively correlated with using ROSCAS, and positively correlated with the likelihood of being banked. They also discover that M-Pesa's rivals, including Western Union, are under pressure from the market to lower their pricing. With the implementation of several models, mobile phone banking is now a reality in many nations. The most obvious contrast is between a model led by mobile network providers (like M-Pesa in Kenya) and a model led by banks. Given the lower variable costs, employing mobile phones as an extra delivery channel for financial service supply has proven appealing given the greater mobile phone penetration than bank account penetration in many developing nations. Even while using a mobile phone to pay for insurance or loan installments has been done in a few cases, expanding the use of mobile phones for financial services beyond payment services has been a significant problem [7], [8].

**Financial Education**

In addition to financial literacy initiatives aimed at encouraging people to use savings services and micro insurance, there is a fast-growing body of research examining the impact of business training. Many of the crucial questions required to justify large-scale policy interventions in this area still remain unanswered, as emphasized by McKenzie and Woodruff (2012) in their summary. It appears that the effectiveness of these interventions is very context specific, with many evaluations finding little effect or positive effects only along one dimension. Using 188 papers and a meta-analysis of a portion of them, Miller (2014) conduct a larger evaluation of the literature. They discover that financial education "can consistently improve outcomes such as savings and record keeping, but does less well in preventing outcomes such as loan default," and that "an omitted variable problem" is one significant obstacle that could account for the relatively low success of financial literacy interventions.

If the psychological characteristics that influence both financial behaviour and financial literacy cannot be measured, this may explain why certain programmes are more effective than others. This is a point made by Fernandes, Lynch, and Netemeyer (2014), who demonstrate that studies focusing on measured financial literacy have a much stronger relationship with financial behaviour than studies focusing on financial literacy interventions, particularly in low-income settings. Interventions in financial literacy similarly exhibit a significant degree of depreciation, with no effect remaining after 20 months. This can need stressing the value of more universal educational requirements, such arithmetic proficiency, or the need to teach more general abilities. Tellez-Merchan and Zetterli (2014) consider the usage of mobile microinsurance, for instance. In the framework of a literature review on small and medium-sized firms for IEG, Beck (2013) talks about several of these initiatives. In section 4.1, I discuss how some of these treatments were paired with credit.

There is more evidence, nevertheless, that "just-in-time" interventions related to certain crucial financial choices might be beneficial. One such instance is the evaluation of an antipredator pilot programme in Chicago in 2006 by Agarwal (2014). Under this programme, review sessions with housing counsellors were prompted by hazardous borrowers and/or dangerous mortgage arrangements. The pilot reduced market activity in half, mostly by

driving away lenders who only made riskier loans and by reducing the proportion of borrowers who were subprime [9], [10].

**Low-End Financial Institutions' Sustainability**

As was said, due to high costs and dangers, conventional financial service providers, such as commercial banks, avoid serving the low end of the market. The first wave of microfinance organisations with a double (profit and social effect) or triple (plus environmental impact) bottom line has resulted from this. The NGO model predominated this first wave, which was often supported by donations. The first commercial MFI to go public was Mexican Compartamos, which was criticised by Mohammad Yunus for charging excessive interest rates of almost 100% annually. The entry of more commercially oriented institutions has sparked a fierce debate between microfinance advocates who focus more on the social and outreach side and microfinance advocates who focus more on the profitability side.

The creation of the Microfinance Information Exchange (MIX) and other comparable data gathering initiatives has made it feasible to investigate the trade-off between profitability and outreach. The disclaimer that these databases depend on self-reporting microfinance organisations is crucial for the interpretation of any research based on these data, nevertheless. Many organisations (particularly smaller ones) without reliable data won't report since the MIX relies on both outreach and financial statistics. Using MIX data, Cull, Demirguc-Kunt, and Morduch (2009) demonstrate that microfinance banks have more assets and a bigger clientele than NGOs, but their average loans are greater, suggesting that they may be targeting richer customers. Microfinance banks concentrate less on female borrowers than NGOs and government-run MFIs, but they also depend less on subsidies. Hermes, Lensink, and Meesters (2011) demonstrate a comparable trade-off between the effectiveness and outreach efforts of MFIs using stochastic frontier analysis. Gonzalez and Rosenberg (2006) and Cull both find that the customer bases of more lucrative MFIs are bigger. MFIs that prioritise individual lending over group lending are more likely to be successful. Gonzalez (2007) demonstrates that scale economies are difficult to achieve beyond 2,000 clients, which may help to explain why many banks seek scale economies by making bigger loans to current clients, where there are already obvious scale savings.

There is some evidence of mission drift found by Cull, Demirguc-Kunt, and Morduch (2007), which may be caused by the trade-off between profitability and outreach. Individual-focused lenders outperform group-based lenders in terms of outreach (measured by average loan size and proportion of female clients) but are more expensive. Additionally, the authors discover that higher interest rates are associated with greater loan amounts for the group of individual lenders. The programme was ultimately abandoned as a result of pressure from lenders, highlighting the significance of political economics in promoting financial inclusion. When interest rates above a certain level of 60% annually, default risk and profitability are reduced. The fact that these conclusions depend on cross-sectional research rather than information gathered over time inside institutions is a significant limitation. Another crucial qualification is that, even in the case of successful institutions, profitability is judged in accounting terms rather than economic ones (i.e., accounting for alternative uses with comparable risk profiles).

Despite having historically held dominant positions in their individual marketplaces, rivalry among MFIs has grown to be a problem. The availability of several uncollateralized lenders

may result in increased default rates and customer over indebtedness, similar to how competition in banking can. In a theoretical model, McIntosh and Wydick (2005) demonstrate how increased lender competition might result in the exclusion of poorer borrowers and the tendency of impatient borrowers to double-dip, or take out loans from several institutions, with a greater default rate. The dynamic incentives of recurring loans mentioned above might also be undermined by competition amongst microlenders. According to McIntosh, de Janvry, and Sadoulet (2005), repayment rates and savings rates fell in Ugandan regions where new entrants fought with established, powerful MFIs between 1998 and 2002. Systems of credit information sharing, a subject I will return to later in section 6, may help partially mitigate these adverse consequences of competition in markets with large information asymmetries.

Cull, Demirguc-Kunt, and Morduch (2014) demonstrate that there is a significant interaction impact between banks and MFIs. Using data from throughout the globe, they show that MFIs that are commercially sponsored and that concentrate on individual loans rather than group loans tend to target female borrowers more aggressively and go downmarket. The research on assessing the effects of increasing access to formal financial services among the poor has been quickly developing over the last 10 or so years. Numerous of these evaluations have been conducted as randomised control trials (RCTs), which enable accurate counterfactual building. These evaluations often include banks, consumer lenders, or (more frequently) microfinance organisations; section 8 discusses methodological problems. The parts that follow will also make reference to non-RCT studies using effective identifying methods.

Although early research mostly focused on credit, more recent research has extended to include the effects of increasing access to payment, microinsurance, and savings services. Theoretically, as was covered in section 2, various financial services will have distinct effects. Theoretically, many outcome factors have also been mentioned, such as social outcomes like spending on health care or education, economic outcomes like consumption and income, and female empowerment like spending on family or female items. Credit Access 4.3Over the last 15 years, there have been conflicting findings in the literature on the relationship between loan availability and family welfare or business development and profit. The overall perception is often in the beholder's eye, therefore much of it may be summed up as either a glass half full or a glass half empty. Another conclusion would be that results at the person or household level are often statistically and economically more important than outcomes at the microenterprise level.

One of the first studies of Grameen Bank and two other MFIs in Bangladesh by Pitt and Khandker (1998) revealed a tiny but substantial and favourable impact of the usage of credit on family spending, household assets, labour supply, and the chance that children attend school. Khandker's (2005) panel study reveals much more significant economic benefits and supports many of the results. However, a later examination by Morduch (1998) using other estimating methods casts doubt on the results of Pitt and Khandker. There are serious questions about Pitt and Khandker's identification strategy and, more specifically, the appropriate application of the restriction that loans can only be given to farmers with landholdings of less than half an acre, even though Pitt (1999) responds to these criticisms, with subsequent responses by Roodman and Morduch (2009). Similar to how they do with the panel study of Khandker (2005), Roodman and Morduch (2009) cast doubt on the results since they depend on shoddy tools and absurdly high coefficient values.12 This discussion

highlights the flaws in studies when the researcher has no control over the identifying approach.

Coleman (1999) assesses the impact of an MFI branch expansion in northern Thailand and makes use of the fact that six towns had been chosen as potential candidates for village banks and that a list of self-selected borrowers was available for the village banks that would soon be formed. Coleman finds no discernible effect of loans on physical assets, savings, production sales, productive costs, labour, spending for health care or education, when compared to real borrowers of existing banks in other communities. Cotler and Woodruff (2008) compare small-scale retailers receiving loans from a Mexican microfinance lender with retailers who have been chosen to receive such loans in the future in a study that uses a phased introduction of a new lending programme. They discover that the micro lending programme has a positive and significant impact on sales and profits only for the smallest retailers, but a negative impact on the sales and profits of larger retailers. The economic impact is unexpectedly substantial but consistent with earlier research (de Mel, McKenzie, and Woodruff 2008, in Sri Lanka) examining the effects of grants for micro entrepreneurs. To determine the impact of credit on child labour, Wydick (1999) conducted a study of Guatemalan micro entrepreneurs with varying amounts of credit and access to microfinance. He finds that, generally speaking, having access to credit lowers the probability that kids would skip school, albeit this is not true for businesses like retail trade or those whose families wish to pass down specialised skill sets where there is a very high danger of staff theft. It is crucial to emphasise that this research does not include an external control group and exclusively works with borrowers.

A more encouraging finding from Karlan and Zinman (2010) is that increasing consumer credit in South Africa aided recipients in increasing their income, consumption, and ability to hold down employment. Their research, in contrast to prior studies, used a consumer credit institution rather than an MFI. Identification is done by randomly selecting treatment and control groups from a sample of candidates with credit scores slightly below the cutoff. However, a comparable initiative in the Philippines (Karlan and Zinman, 2011) that boosted individual microloans to micro entrepreneurs had no significant impact on the borrowers' businesses but did raise their social status and access to informal financing. More particular, the profitability of microenterprises improved when companies downsized after borrowing money, sometimes by laying off workers. One argument is that easier credit availability lessens the need for favor-trading within social or familial networks. There is some evidence that education spending has increased. Most of these consequences only affect male borrowers; they do not apply to female borrowers. Therefore, it seems that some business financing is being used for home expenses.

In an RCT conducted in Bosnia, Augsburg (2015) discovered that microcredit promotes self-employment while decreasing wage work and boosting profits, which is more in line with the original goal of microcredit, which was to promote entrepreneurship. Using district-level data on two microcredit expansions in Ethiopia, Tarozzi, Desai, and Johnson (2015) indicate an increase in total borrowing but conflicting evidence about changes in economic outcome factors. They see an increase in student attendance, but they also acknowledge that the two institutions in issue undermined their randomization technique by beginning their activities in the control regions and leaving the treatment areas.

Researchers have also looked at how loans granted with joint or individual responsibility have distinct effects. Attanasio specifically discuss the results of an RCT conducted in rural Mongolia that contrasts the outcomes for borrowers participating in group lending programmes versus those participating in individual lending programmes. They find that the group lending programme greatly improves the chance of owning a business and raises business earnings, but they find no discernible impact on borrowers of individual loans. For borrowers under the group loan system, there is also a sizable beneficial impact on food consumption, but there is no benefit for borrowers under the individual lending plan. The enhanced mutual project screening and monitoring between borrower groups with shared responsibility seems to be one factor contributing to this large differential impact between the two lending approaches.

However, according to a different research, it may be advantageous to abandon the somewhat strict microcredit lending model where weekly repayments begin immediately after disbursement. According, borrowers who are offered a two-month grace period before making their first loan repayment diversify their inventory and are more likely to purchase durable assets, which leads to better earnings three years later. Additionally, the combination of credit and extension services has been examined in a number of studies. In a randomised study carried out in urban Ghana by Karlan, Knight, and Udry (2014), tiny and micro-tailoring businesses were given cash grants, consultancy services, or both. Both treatments failed, which eventually resulted in fewer earnings and business owners returning to their old operating methods. Over the course of one to two years, Karlan and Valdivia (2010) deliver 30- to 60-minute entrepreneurship training sessions during their regular weekly or monthly banking meetings with an MFI in Peru as part of an RCT. The evidence of changes in company income, profitability, or employment, however, is scant to nonexistent. On the plus side, the MFI's customer retention rates have grown and business understanding has improved. De Mel, McKenzie, and Woodruff (2014) find that business training combined with grant funding for the business can increase profitability for existing entrepreneurs in the short term but not the medium term (that is, more than eight months), whereas new entrepreneurs benefit from the training in a more long-lasting way. Business training has diverse consequences, according to Gine and Mansuri [11], [12].

## CONCLUSION

These results imply that longer-term investment strategies are encouraged by loan terms that are more flexible. Recent research has attempted to quantify the impacts of randomised credit distribution at the neighborhood or village level as opposed to the person level since this allows for the inclusion of community-wide effects beyond the immediate consequences on borrowers. After two to three years, Angelucci, Karlan, and Zinman discover very small benefits on socioeconomic outcome factors using a randomised programme placement by Mexican microlender Compartamos. Although they discover beneficial benefits of loan availability on the expansion of microenterprises, there is no discernible impact on their earnings or the entrance or departure of entrepreneurs. Similar to this, household labour supply and income show no statistically significant impacts, although female intrahousehold decision-making authority seems to have somewhat increased. The average impacts' economic impact is not particularly large, and there doesn't seem to be any significant effect heterogeneity. The authors combine the low take-up differential between treatment and control areas (loans were offered in both areas, but marketing was only done in the treatment

areas), heterogeneous treatment effects, and high variance and measurement error in outcomes to explain why there were no conclusive results

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# CHAPTER 3

# DETAILED ANALYSIS ON THE ACCESS TO SAVINGS

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**ABSTRACT:**

The commitment savings account enables families to avoid having to share money with social networks, which makes the impact of the two savings products different. According to Ashraf, Karlan, and Ying (2010), the Philippines had a change in durable goods consumption with the introduction of a commitment savings product. In her experimental research of Nepal, Prina (2013) discovers that having access to savings accounts may aid families in better resource management, prioritizing categories of spending like schooling and food consumption, and feeling more in control of their financial condition. However, she did not discover any impact on wealth. However, Karlan and Linden (2014) highlight the trade-off that savers must make when using commitment savings accounts: overcoming irrational preferences versus losing flexibility. In their context, a soft commitment savings account has a stronger impact on savings and educational spending than a hard commitment savings account. Various systematic reviews have been conducted on micro-savings research.

**KEYWORDS:**

Credit, Financial savings, Institution, Savings, Services.

## INTRODUCTION

A lot of the research cited that examine the effects of customised goods and delivery channels on saving behaviour also examine the influence of these innovations on socioeconomic outcome factors. In order to evaluate the effects on micro entrepreneurs and demonstrate increased investment among female, but not male, entrepreneurs who get subsidised access to savings accounts, Dupas and Robinson (2013a) investigate the extension of savings accounts in rural Kenya. The efficacy of various commitment tools, such as lockboxes with and without keys, individual health savings accounts, and joint health pots of pre-existing ROSCAs are also contrasted by Dupas and Robinson (2013b). Clients who used the lockbox with a key raised their expenditure on preventative healthcare, whereas those who used the lockbox without a key did not. Similar to how using the health pot increased expenditure on preventative care, using individual health savings accounts improved people's ability to pay for unanticipated emergency medical bills. In a similar vein, Brune show that utilising a commitment savings product boosts investment and crop yield by 21%, with a rise in consumption of 11%, compared to ordinary savings products, which have no such benefit [1], [2].

An evaluation of 12 studies conducted in low- and middle-income countries is conducted by include four studies on Sub-Saharan Africa and report mixed results, ranging from no effects on income, mixed effects on education, and positive effects on health. They conclude that "innovative design of new savings products that increase the supply of savings and increase demand for savings by helping people address behavioural challenges were found to increase

income at least in the short run... and can increase income by allowing households to accumulate assets." Overall, considering the dangers associated with microcredit, their conclusion is more favourable about the effect of micro savings. Similar to this, Stewart find mixed effects of micro savings interventions on income and economic possibilities in their larger assessment of microfinance treatments. In conclusion, these studies support the idea that having access to formal savings can improve the protection of household assets from other members, particularly if the alternative is saving within the home rather than using other informal means of saving outside the home (Beck, Pumak, and Uras 2014). the effect studies on microcredit as opposed to the studies Comparing the literature on the effects of microcredit and access to savings products, the latter is often more favourable. They also highlight the necessity for extremely particular goods and methods to get over the limitations faced by low-income families and microbusiness owners [3], [4].

**Micro-insurance Services are Available**

As was said, asymmetric knowledge and agency issues in agricultural insurance may be resolved with the use of microinsurance products like rainfall insurance. Does the adoption of these insurance products alter farmers' investing habits? Only a few studies have looked at this so far. Cole, Gine, and Vickery (2013) discover conflicting effects from the implementation of weather insurance in India, as farmers switch to riskier but more lucrative crops that are more dependent on rain. But farmers that have insurance don't use more inputs. By randomly assigning farmers to receive cash grants, grants of chances to purchase rainfall insurance, or grants of both, Karlan undertake a number of experiments in northern Ghana to determine the relative significance of credit and risk limitations. They discover that there is not only a significant demand for rainfall insurance, but that insurance take-up has a greater impact on agricultural investment than cash awards do. This suggests that risk cost restrictions are more restrictive in this situation than resource and liquidity ones. Karlan find minor behavioural changes between farmers who take up a regular credit product and those who take up a credit with a price crop insurance component in the instance of crop price insurance in rural Ghana. According to Janzen and Carter (2013), an index-based drought insurance policy has good impacts in rural Kenya. They used randomly assigned discount coupons as their identification method. They specifically demonstrate that families with insurance are on average 25% less likely to anticipate cutting down on food after receiving a payment and 36% less likely to anticipate drawing down assets. Overall, the data points to the potential for microinsurance to help farmers and business owners, however the low uptake of such services may restrict their potential benefits [5], [6].

**Digital payment services are available**

As was already said, the inclusion of more low-income people and microbusiness owners into the larger market economy may have a significant influence on outcome factors. According to Aker, randomly switching to mobile grant distribution in Niger causes consumption patterns to alter in favour of a more varied diet, presumably as a result of changes in intrahousehold decision making brought on by mobile grant delivery. Jack and Suri (2014) analyse the effect of decreasing transaction costs after the introduction of M-Pesa on risk sharing using panel data for 2008 and 2010 in Kenya. They show that M-Pesa users are more willing to absorb negative income shocks, particularly among lower-income families. The routes that this the research by Gine and Yang was the only one listed in the systematic review that looked at the effects of actual insurance take-up [7], [8].

In the event of negative income shocks, there both seems to be a bigger volume and a wider range of remittance senders. Using mobile phone transfers over a four-year period in Rwanda, Blumenstock, Eagle, and Fafchamps (2013) demonstrate how these transfers are utilised to aid those afflicted by natural calamities like an earthquake close to Lake Kivu. The mobile phone-based transfers are conducted across greater geographic distances than other types of proven risk sharing, and they are more likely to be sent between persons with a long history of reciprocal trading. These preliminary findings are generally quite encouraging. They demonstrate how using more efficient payment methods may enhance interpersonal interactions and risk sharing across time and location in addition to lowering costs and increasing access to national and international payment systems. As this is a relatively new product, research on the effects of extending digital payment systems is still in its early stages. Several research assessments are now being conducted, and results should be available soon. Analysing whether availability to digital payment services influences people's propensity to engage in the formal economy and influences the investment and profitability of microenterprises is a crucial component.

## DISCUSSION

The issue of how to effectively control institutions that cater to the low end of the market emerges when they increase their volume and reach. Analysts have long recognised the critical difference between institutions that need "only" conduct regulation because they do not on-lend their deposits or use nondeposit resources for lending and institutions that need prudential regulation because they use deposit funding to lend to borrowers. Regulation emphasises consumer protection and is more focused on issues between consumers and the institutions. In practise, there are more options for regulating low-end financial institutions, including (i) registering with a government agency, (ii) publishing routine reports on operations and financial transactions, (iii) being subject to non-prudential conduct regulation and supervision, and (iv) being subject to prudential regulation.15 Even in cases where low-end financial institutions are subject to prudential regulation, there is frequently a special regulatory framework in place [9], [10].

Avoiding regulatory arbitrage, or financial institutions adopting a less stringent regulatory environment if they can, with possible fragility implications, is a crucial task to take into account. In this context, it is crucial to combine a functional approach to regulation—that is, regulating according to the services offered by an institution rather than according to its name—with a risk-based approach, where institutions whose potential failure poses a greater fragility risk for the economy and society are subject to stricter regulation and supervision.

Who should oversee low-end institutions is a similar issue. The only respectable, capable, and politically impartial organisation in many low- and even middle-income countries is the central bank, which makes it the obvious choice to act as the regulator and supervisor of MFIs. It may be difficult to incorporate a new strategy and skill set into a central bank or bank supervisory culture in order to regulate and oversee these entities. Creating a specialised division inside the central bank or bank regulatory body might be a compromise. Supervisory capability is often a significant restriction in either situation. The sheer number of institutions to oversee is another difficulty. Delegated supervision has been proposed in situations when this number is quite big, such as for cooperatives or credit unions where an apex institution is present. Another example is MFIs, which require some of their borrowers to save money for them. According to CGAP (2011), they are essentially exempt from prudential regulation.

World Bank and IMF (2005) have a more thorough discussion carries out institution-by-institution supervision and, in turn, is governed and overseen by the bank or MFI supervisory authority.

The regulatory system does, however, also imply expenses associated with compliance for the regulated businesses, which were pegged by Christen, Lyman, and Rosenberg (2003) at 5% of total assets in the first year and 1% in subsequent years. Some potential effects of these compliance costs on MFI outreach are documented by Cull, Demirguc-Kunt, and Morduch (2011). They demonstrate using cross-sectional data that institutions subject to on-site oversight and ongoing reporting requirements are just as profitable as other MFIs, but at the price of a smaller outreach, as shown by the average loan amount and the proportion of female borrowers. It is important to note that the authors acknowledge that causal inference for this link cannot be made given the nature of the data.

Cull relate the worldwide index on (i) the institutional framework supporting microfinance across 47 countries and (ii) the regulatory framework and practises for MFIs to various outreach and financial performance parameters of MFIs in these nations. Higher outreach of MFIs is positively correlated with the supporting institutional framework, which includes accounting transparency, pricing transparency, client protection, credit information sharing, and the ability to use agents, whereas the strength of the regulatory framework is correlated with financial performance and the proportion of female borrowers at the MFI level. The results are solely cross-sectional, as the authors point out, and although they are resistant to the use of instrumental factors, it is difficult to draw any conclusions about causal correlations. Future research that utilises panel work and takes use of modifications in national legislative and institutional frameworks may be able to solve this problem.

Consumer protection has become more crucial in the context of behaviour regulation. Given the low level of financial knowledge of its clientele, organisations serving the bottom end of the market seem to place a premium on consumer protection. With the potential for over indebtedness, this protection is crucial for all services, but it is particularly crucial for credit. Effective consumer protection in financial services focuses on four key areas: (i) disclosure of interest rates and fees that is clear, simple, easy to understand, and comparable; (ii) prohibitions of business practises that are unfair, abusive, or deceptive; (iii) recourse mechanisms that are effective and simple to use; and (iv) financial education that equips consumers with the knowledge, skills, and understanding they need to make informed financial decisions. To achieve these various goals, many consumer protection tools are available. One of the most fundamental and critical instruments is the necessity for disclosure. One minimal criterion would be to provide clients a clear breakdown of the monthly expenses of borrowing, including interest, principle, and fee payments, for the duration of the whole loan period. An improvement above the minimal consumer disclosure requirements (which bank regulators or the industry's self-regulatory body may implement on a

See, for instance, Beck and the references therein for the following government regulations that forbid financial institutions from selling particular products to anyone other than sophisticated clients (like corporate clients or high-net-worth individuals) and that require financial institutions to conduct affordability checks before extending credit. However, there is a trade-off between excessive regulation that restricts the financial system's ability to provide access and consumer protection. The expenses of financial services, including usury

interest rates, are subject to a final set of regulations that establishes specific minimum or maximum. Although there may be a case to be made to reduce abusive levels of interest and avoid over indebtedness, often such caps are set at an unrealistically low level. Such interest rate ceilings (in the case of credit) or floors (in the case of savings products) can, however, easily turn into a restrictive tool that reduces access to services by riskier customers and customers who need smaller transactions and who are thus costlier for financial institutions. The possibility that lenders may attempt to avoid such limitations by levying fees and decreasing transparency is a significant worry in this scenario.

As was previously said, competition among microlenders may have detrimental effects on repayment incentives, particularly when there isn't credit information sharing among lenders. The advantages of credit information sharing across banks have been extensively theorized and experimentally examined, and the creation of public credit registries and/or private credit bureaus has been a staple of financial sector reform agendas. The majority of countries do not allow MFIs to participate in bank credit registries, in part due to cost concerns on both sides: processing numerous microloans is very expensive, and the cost of inquiries on credit application is too high for MFIs relative to the loan size. This is despite the fact that one of the "best practise" elements is that such information-sharing systems be open to as many institutions as possible. Stand-alone credit registries for microfinance have been built in several nations. This may help with some of the cost problems, but it also strengthens the financial system's segmentation and lessens the possibility that MFI clients would leverage the goodwill they have accrued to gain entry to the banking system.

A few research has examined the effects of sharing credit information in microfinance. According to research by Luoto, McIntosh, and Wydick (2007), one significant MFI in Guatemala saw a 2 to 3 percentage point decrease in missed payments and delinquency after the implementation of a credit registry for MFIs. De Janvry, McIntosh, and Sadoulet (2010) utilise the joint responsibility groups of borrowers who had staggered education following the implementation of the credit registry to assess the various behavioural consequences of sharing credit information. Since group composition remains stable in the short term, the first impact on payback of the revelation of the presence of the credit bureau decreased delinquency by 18 percent as a consequence of enhanced repayment incentives. As assessed across numerous loan cycles where groups might vary their membership, subsequent changes in group composition and the impact of those changes on repayment, i.e. the replacement of high-risk with low-risk group members, are weaker but still evident.

As more nations adopt regulatory frameworks that concentrate on the low end of the market, we may anticipate an increase in data gathering in this sector and problems with Maimbo and Henriquez Gallegos (2014) have recently discussed this topic competition, the framework for regulation and supervision, even deposit insurance, will all become greater significance. Due to network externalities in payment services, which require large investments but can only succeed if accepted by users on both sides of transactions, there can be fierce competition to dominate a market (and thus recover the fixed investment), though there may be less competition once a dominant player emerges. As a result, competition will focus more on innovative and disruptive technologies than on current markets and goods. Making decisions on how much new companies should be allowed to enter the market (for instance, mobile network operators (MNO) providing payment services) and how much regulation should be placed on them would be crucial for the regulator. It is unclear whether a bank-led model,

which prevails in most countries and requires a bank account, is preferable to an MNO-led model, as is the case in Kenya, where the client holds the account with the MNO and interacts only with the MNO and its agents, or whether the best model depends more on the particulars of the country. However, as noted by Bourreau and Verdier (2010), there are more than two forms of cooperation between MNOs and banks, each of which may have very different interests in terms of generating revenue and incurring costs. In some cases, these varied interests are complementary, while in others they are at odds. A crucial decision is whether to mandate network interoperability via legislation or let the market "work it out."

The standard recommendation is a risk-based approach, with accounts and transactions below a threshold size being excluded from the more stringent banking documentation requirements related to Anti-Money Laundering and Countering Financing of Terrorism rules. Another crucial question for regulators is the ID requirements to be imposed on such transaction accounts and payments. For further information, see Bourreau and Verdier (2010). With a paper anticipated in the second half of 2015, a working group supported by the Bill and Melinda Gates Foundation and led by Liliana Rojas Suarez (Centre for Global Development) and Stijn Claessens (IMF) is now creating a policy framework on how to govern digital payments.

**Women's Dimension**

The gender perspective is crucial in the discussion of financial inclusion, as it is throughout the paper, both in terms of access to financial services for both men and women and in terms of female empowerment as a significant outcome variable. Some of the pertinent cross-cutting topics are outlined in this section. To start, women are often less likely than men to have access to official financial services. At the same time, women make up a significant portion of the self-employed in emerging nations, need financial support. Demirguc-Kunt, Klapper, and Singer (2013) find a sizable gender discrepancy in account holdings, however there is a lot of regional variance. For various Sub-Saharan African nations, Aterido, Beck, and Iacovone (2013) demonstrate that this unconditional gender disparity becomes small once additional factors are taken into consideration. This result is true for both individual account holding and entrepreneurial access to credit. In the case of businesses, they provide an explanation for this result based on a selection bias and for people who exhibit gender differences in other factors associated to the usage of financial services, such as household and job status, income, and education.

For Latin America, Bruhn (2009)'s results on availability to entrepreneurial finance are comparable. However, gender gaps in important determinants of access to formal financial services, such as employment and income status, legal limitations (such as those on asset ownership and holding in some countries), and education, provide an important justification for concentrating financial inclusion efforts on female individuals and entrepreneurs and looking beyond conventional banking techniques targeted at salaried, formally employed, and educated people. For instance, Beck, Behr, and Güttler (2013) provide data from two MFIs that lend to both men and women in Bolivia and Albania. As mentioned in section 4, there is some evidence that gender differences in the impact of microfinance treatments may be found. On the one hand, women frequently have more success with initiatives to enhance savings than men do. However, given the limitations placed on women by intra-household issues and other factors, certain treatments are less effective for women than for males. This suggests that in order for such treatments to be effective, they must take into consideration

the unique limitations that women encounter. Finally, financial inclusion may contribute to the empowerment of women. The data is contradictory so far, which may be related to the fact that certain goods and services are inappropriate for handling disputes inside households. As was previously said, draw the conclusion that there is insufficient proof of a beneficial effect of microcredit on female empowerment [11], [12].

## CONCLUSION

The microfinance movement has concentrated on women for a number of reasons other than the fact that women lack access to traditional financial services. It has often been stated that loans to female borrowers have a more direct influence on the welfare of the household than loans to male borrowers since women are more concerned with their families and children. Kevane and Wydick (2011) found that there is a trade-off: younger women have more time limitations due to family responsibilities and are less likely to grow their microenterprise's employment with loans than male micro entrepreneurs or older women. Another factor is that intrahousehold limitations sometimes prevent women from using formal financial services; nevertheless, this might also mean customised solutions that shield women from having to share credit or allow funds to flow freely inside the household. Because they are less mobile than males and often make more cautious investment choices, female borrowers are seen as less of a credit risk, according to a supplier-focused argument.20 Repayment rates are usually higher for women than for men.

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# CHAPTER 4

# DETAILED ANALYSIS ON THE MICROFINANCE IN INDIA

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**ABSTRACT:**

The importance of credit increased as a result of the need to increase agricultural output and encourage landless people to engage in self-employment. In 1969, banks were becoming national, and they served as development tools throughout the 1970s and 1980s. But once again it became evident that banks performed much less than was required despite the need to lend to priority sectors and the mandatory credit for programmes supporting the poor's self-employment, such the IRDP. Then, in the 1990s, as a result of economic changes that repositioned the banks' goals in support of sustainability, they abandoned the underprivileged. The development of innovative methods for giving the underprivileged access to credit was left to NGOs6. This is what caused the two main microfinance models to evolve during the last twenty years. In both, banks act as lenders, but either a "self-help group" (SHG) or a microfinance institution (MFI) handle the front end.

**KEYWORDS:**

Banks, Microfinance, Poverty, Programs, Self-employment.

## INTRODUCTION

Following the economic changes that were implemented in the 1990s, the Indian economy was able to see rapid development. Between 2004 and 2011, the GDP increased by 8.45% annually1. India still has a high level of poverty and poor levels of human development. While expansion helped decrease poverty and hunger and generate prosperous areas, a significant portion of the population remained impoverished, with 37.2% of Indians still living in poverty2 and 77% remaining susceptible to economic shocks3. For socially disadvantaged groups like Scheduled Castes, Scheduled Tribes, and Minorities, this percentage was significantly higher. India maintained its low position. The introduction of high yielding wheat and rice cultivars, known as the "Green Revolution" of the late 1960s, led to a tremendous increase in agricultural productivity and the area under irrigation. But this just made disparities between big and small farmers, wealthy and poor, and places with irrigation and those with rainwater worse. So, in the middle of the 1970s, the then-prime minister, Indira Gandhi, began a "di-rect attack on poverty" with massively supported initiatives for wage employment in public works and self-employment via the purchase of credit-based assets. With names shifting from NREP to Food for Work to JRY to NREGA for wage-employment programmes and from SFDA to IRDP to SGSY to NRLM for self-employment programmes, these two techniques have maintained the major pillars of poverty eradication [1], [2].

For the impoverished in India, access to finance has always been a big barrier. The traditional sources of credit for the poor were big farmers, merchants, intermediaries, pawn brokers, and

moneylenders. Poor people who were unable to pay excessive interest rates sometimes lost their land and finally turned into slave workers for money lenders. Since the British colonial era, there have been several initiatives to reduce reliance on payday lenders by offering institutional credit. The newly independent India placed a high premium on the need to produce enough food to feed the expanding population. In the first two decades, 1947–1967, cooperatives played a decreasingly significant role in the provision of finance for agriculture. The top 10 banks were nationalised in 1969 by the prime minister at the time, Indira Gandhi, who also ordered them to establish several rural branches. The government then established a network of Regional Rural Banks in 1975, after the abolition of money lending during the Emergency, in order to assist the rural poor, particularly small and marginal farmers, rural craftsmen, and agricultural workers. The number of branches expanded quickly between 1969 and 1990 with an emphasis on the physical growth of banking services.

The other projects included creating a large extension network and promoting modern agricultural practises, building large infrastructure projects for irrigation and power, working on community development projects, integrated development projects, area level development projects based on particular geographies, etc. The so-called priority sector comprises several non-poor sectors, including major farmers, commercial agriculture, small-scale industries, self-employed professionals, and exports, even if the final column in the chart above seems impressive. Only approximately 5% of bank credit flowed to small borrowers in 2004, demonstrating the banking system's inadequate capacity to serve these borrowers [3], [4].

**Self-Help Group - Bank Linkage Model - Successes and Gaps**

Since the middle of the 1980s, NGOs have been experimenting with credit groups in an effort to improve the poor's access to credit. Self Help Groups (SHGs) were first established by MYRADA, an NGO in Karnataka, and PRADAN, an NGO in Rajasthan, in order to promote credit and savings and to provide training on self-help principles7. Many Indian officials from the Government of India (GoI), the Reserve Bank of India (RBI), and the National Bank for Agriculture and Rural Development (NABARD) were sent to Indonesia by the German technical agency, then known as GTZ, to demonstrate the potential for financing to the underprivileged via NGOs. A pilot initiative to connect SHGs with banks was authorised by the RBI in 1992, and as a result, the SHG-Bank linkage programme (SBLP) was created in 1996. The Andhra Pradesh government in particular, as well as many other state governments, provided the SBLP with significant policy and promotional backing. With the aid of funding from the World Bank and NABARD, it was scaled up nationally. 7.46 million SHGs existed as of March 2011 [5], [6].

Global Implications of the Crisis in Indian Microfinance, 2010, Andhra Pradesh Consultative Group to Assist the Poor (CGAP), 2010. Johnson, David. Furthermore, Meka, S., Access to Finance in Andhra Pradesh, Institute for Financial Management and Research—Centre for Microfinance, 2010. The biggest microfinance programme in the world has connections to banks all around India. There are over 4.78 million SHGs with outstanding debts totaling INR 312 billion9 (about 4 billion euros). The next year, 2011–12, saw banks disburse INR 165 billion in all of India, including AP, and INR 84 billion in AP. The SBLP has had significant direct effects on improving the incomes of low-income families and indirect effects on empowering women. Although a huge step forward in terms of improving the poor's access to

credit, the SHG model has a significant flaw: it is subsidy driven, with at least three different sorts of subsidies.

The first is the price of setting up the SHGs. NGOs handled this in the beginning, but as the size increased, government organisations gradually took over this function. However, both demanded subsidies. In AP, the money was primarily provided by World Bank loans totaling USD 600 million to the Society for the Elimination of Rural Poverty (SERP), which is operated by the AP government. The second subsidy consists of lending money with reduced interest rates. While successive state governments attempted to subsidise the rate at which SHGs received funding, banks initially loaned to SHGs at a rate of 12% per year. In AP, it decreased gradually from 12% in 1996 to 9% before to the state elections in 1999, and then to 3% after the elections in 2004, during which the SHGs were guaranteed "paavla vaddi" (3% pa, or quarter percent per month interest).

## DISCUSSION

The cost of funding for SHGs has been decreased to 0% when the subsidy was enhanced in 2011 to cover the whole interest. The third kind of support comes from the bad loans that banks must write down. The early SHG recovery rates were 95% or more, but when the poor saw the programme was becoming a vehicle for political favour, they gradually decreased. Following the AP MFI Ordinance, which caused a wave of MFI loan defaults, SHG loan repayments originally surged but have now dropped to 60–70%. The rising subsidy has also contributed to rising credit monopolization by the wealthier members, corruption, and a decline in repayment rates due to loan forgiveness expectations [7], [8].

### The Development of MFIs Following the Launch of Banking Sector Reforms

Small loans are now distributed via MFIs or SHGs rather than by banks directly. The proportion of institutional credit to overall credit fell between 1991 and 2001 after growing for three decades starting in 1951. For rural regions, it dropped from 64% to 57%. When it came to satisfying their loan demands, more than 70% of the poorest families (those with less than 60,000 rupees in assets) relied on non-institutional sources. Banks were repelled from lending to tiny borrowers by the need for tangible security, significant transaction costs associated with processing small sums, and worries about loan recovery. To suit their demands, a different system was required. Since 1976, the Grameen Bank of Bangladesh (GBB) has consistently proved a viable microcredit concept. The GBB concept, which was initially supported by donations, eventually reached a point where it could sustainably assist in addressing the financial requirements of the underprivileged. By the middle of the 1990s, several nations had a keen interest in the GGB model. In 1995, Dr. Manmohan Singh, India's then-finance minister, said that his country should develop a bank for the underprivileged similar to the GBB. However, Indian financial institutions, under the leadership of NABARD, chose the locally developed SHG model over the GBB model. However, many Indian NGOs that tried with both methods discovered that they could sustain themselves under the GBB approach. The majority of Indian MFIs embraced the GBB model when SIDBI and then private sector banks like the ICICI Bank began heavily supporting NGOs for microcredit, with a few outliers like BASIX [9], [10].

**Sustainability as a Focus of International Development Policy**

Due to the success of the Grameen Bank in Bangladesh, there was a worldwide demand for its replication, which was first systematically carried out at the Microcredit Summit in Washington, DC, in February 1997. The movement attracted thousands of groups from developing nations, all of which tried to broaden their influence. Additionally, funders like the USAID, DfID of the UK, CIDA of Canada, the German, the Dutch, and Scandinavian donors, as well as European donors, started to support microfinance in developing nations with large amounts of money. Large-scale loans were given to MFIs in India through apex lenders like the Rashtriya Mahila Kosh (RMK) and the Small Industries Development Bank of India (SIDBI), both of which started out as development NGOs but rapidly embraced the sustainability ethos. The International Finance Corporation (IFC), the World Bank's private sector arm, and other development banks like the German KfW, the Dutch FMO, and the British CDC all started to take an interest in microfinance and started investing in MFIs that were more focused on business, like banks and non-bank finance.

National Sample Survey Organisation, All India Debt and Investment Survey, 59th Round, December 2005.companies. They also made investments in a variety of new funds, many of which focused on lending to and purchasing shares in microfinance organisations. These organisations were known as "microfinance investment vehicles" (MIVs), the first of which were established in 2000. In 2012, there were as many as 150 MIVs listed on the Mix Market data repository. Many of them collected money from socially conscious investors who were prepared to accept a lesser return if they felt their investments were benefiting the underprivileged. By 2005, the goals of microfinance investors ranged from those wanting no profits to those seeking huge returns. The United Nations designated 2005 as the "International Year of Microcredit," and Prof. Mohammed Yunus and the Grameen Bank of Bangladesh received the Nobel Peace Prize in 2006. Compartamos, a Mexican MFI that started out as an NGO before evolving into a non-bank lending organisation and finally becoming a microfinance bank, issued an initial public offer. The IPO was 13 times oversubscribed and was regarded by all financial market standards as a major success. As a result, investment in MFIs increased, and new groups of investors—those prepared to take on structured loan commitments and private equity investors—entered the market. They brought a lot of knowledge, money, and expectations for big returns with them. They also gave rise to the aspirations of some MFI promoters who discovered they might earn a sizable sum of money by providing rapid development and strong profitability in their MFIs.

**MFIs' Successes and Weaknesses in India**

The state-owned Small Industries Development Bank of India (SIDBI) and loans from commercial banks under priority lending quotas since 2000 have both contributed to the expansion of MFIs. They started off lending to NGO-MFIs, but after a while, as the quantities owed grew, they demanded some ownership as a risk buffer. Around this time, the bigger NGO-MFIs started to become for-profit NBFCs. By 2006, these NBFCs had advanced to the stage where they were able to begin luring equity investments from specialised microfinance investment vehicles and private equity funds13. For instance, within a few years after being NGOs, SHARE received equity from Legatum, Spandana from JM Financial, and SKS from Sequoia by 2007. By 2010, India's MFI growth had peaked, expanding at an average rate of 80% annually, and its out-reach had grown to almost 27 million people.

**Successes of MFIs**

MFIs were able to do what the banking industry throughout the years was unable to. In only 15 years, the number of MFI borrowers went increased from just Working Group on Inclusive Finance in China, April 2011, Pete Sparreboom, "Indian Microfinance Crisis," 2010. 31.7 million in 2010 compared to 3,000 in 1995. With its extensive infrastructure, the banking industry only showed a reduction in lending to small borrowers throughout the same period14. MFIs reduced reliance on payday lenders. MFIs provide a range of loans for housing requirements, animal husbandry, non-farm enterprises, and agriculture. Microinsurance was introduced by MFIs for borrowers' life and health insurance, and some cutting-edge ones also incorporated weather insurance for crops and animal insurance.

A few MFIs engaged in an impulsive rush to develop their portfolio in the months leading up to the SKS IPO in August 2010, and the multiple and higher ticket lending that resulted led to over-indebtedness in a tiny percentage of the borrowers. The repayment demands overwhelmed a lot of low-income families. MFI employees, used to over 100% of installments being paid on time, put pressure on recoveries when clients started skipping payments. The media started to report on forceful recoveries and, in some instances, borrower suicides. After a political reaction, the state of Andhra Pradesh passed a legislation in October 2010 to restrict MFIs.

**Problems with MFIs**

From 2006 forward, Indian MFIs, notably the four in AP — SKS, Spandana, SHARE, and Asmitha saw rapid expansion but struggled to control it. The great majority were using the Grameen Bank, Bangladesh model, delivering a single product—a year-long loan repayable in 50 equal weekly instalments—with SEWA and BASIX being the exceptions. They hired a lot of individuals, but they did not properly supervise or train them. The expansion and health of the loan portfolio as well as a decrease in operating expenses appeared to be the primary metrics that the MFI managements and Boards were concerned about. The field staff quickly discovered that it was best to focus on what was being observed and rewarded while ignoring everything else, such as visiting remote villages to look for clients who were truly in need, supporting and training client groups before granting them the authority to approve one another's loans, ensuring client education, or even providing adequate disclosure about interest rates and other terms.

**The Political Roots of Andhra Pradesh's Microfinance Crisis**

The simultaneous growth of the MFI model by private actors and the SHG Bank Linkage Model pushed by the State is what led to the microfinance crisis in AP. According to estimates, there were around 6.25 million MFI borrow- and 19.11 million SHG Bank Linkage members in Andhra Pradesh. Clearly, bank loans to MFIs have been expanding more quickly than bank loans to SHGs in terms of percentage growth. Apparently, N. Srinivasan, in absolute terms, the rise in MFI loan outstanding in 2010 likewise surpassed the growth in SHG loan outstanding16. MFI's rapid growth allowed it to overtake SHG as the most widely used microfinance model.

The political establishment did not accept this since it would mean losing control of a significant voter base. The political leaders and government workers were in agreed that if MFIs occupied the dominating area, they would lose control of a significant programme and

the funding associated with it. This fear is a major factor in the personnel of the government-sponsored Andhra Pradesh Society for Elimination of Rural Poverty's (SERP) animosity against MFIs.

Although the SHG movement in Andhra Pradesh began as a grass-roots movement, political parties wanted to co-opt it. Since 1999, when the Telugu Desam Party's (TDP) then-chief minister Chandrababu Naidu utilised women's SHGs as his vote bank and won re-election, microfinance has grown in significance to Andhra Pradesh's political politics. Women's SHGs were seen as a political constituency and potential vote bank beginning with the TDP17. Before the 1999 elections, Mr. Naidu convinced banks to reduce the interest rates on loans to women's SHGs from 12% to 9%. Under the direction of the late YS Rajashekhar Reddy (YSR), the Congress attempted to win the game of electoral politics before the 2004 elections by promising to provide women loans at 3% pa interest18. He honoured this promise after becoming office with the Pavala Vaddi programme. Interest rates once again figured prominently in populist politics during the 2009 elections. TDP agreed to grant interest-free loans up to a maximum of 25,000 rupees and 3% loans for loans over 25,000 rupees in an effort to win back the support of women voters. However, Naidu struggled to have much of an influence given the YSR's prominence. During that time, the bank loan recovery rates to SHGs decreased.

While recovery was above 95% in 2007–2008, it has significantly decreased by 2010–2011 to a reported 60–70%. Sadly, YSR passed away in a helicopter accident six months after winning re-election in 2009. The Congress High Command chose to install longtime ally Rosaiah as Chief Minister, despite the fact that his son Jagan Mohan Reddy was widely anticipated to take the position. As a result, Jagan rebelled. He continued searching for concerns to bring up, and he was interested in the one about microloan borrowers who felt so hounded that some committed suicide. He discovered the ideal story to humiliate Rosaiah and the Delhi High Command: a 2006 media report showing Rahul Gandhi and Vikram Akula seated at an SKS women borrowers' club meeting. A picture of Smt. Sonia Gandhi, the leader of the Congress party, presenting Akula with the Social Entrepreneur of the Year award at the India Economic Summit was also included.22 Why would Rosaiah's government move against MFIs when the Gandhis are their friends? was a question pounded home by Jagan's publication Sakshi and his TV station of the same name. The story was covered by different media. The Congress was severely embarrassed as a result, and they even published a denial, yet the accusation persisted.

The remarks made by political party leaders in October 2010 when media criticism of MFIs was at its height had an impact, forcing the Congress government in A.P. to pass a strict rule restricting MFIs. The Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 201024, which was subsequently enacted as the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Bill 2011, was introduced by the Andhra Pradesh government. Multiple provisions of this statute essentially prevented MFIs from operating in the state. For instance, MFI workers had to wait in a busy public area for borrowers to arrive and pay rather than going to the borrower's home or place of employment for recoveries. Without the government's previous consent, no new loans were allowed.

Although the law's stated purpose was to shield MFI borrowers from pressure and excessive debt, it essentially made it impossible for MFIs to operate in AP. Two key clauses required MFI employees to wait at a "central place" and wait for borrowers to arrive there since

visiting borrowers at their homes or places of employment might be seen as coercive behaviour. Second, after the first loan, no more loans were permitted without government approval. This alone significantly reduced recovery times. However, opposition politicians, particularly former Chief Minister Chandrababu Naidu, took advantage of this to criticise the government. Based on NABARD Reports 2008, 2009, 2010, and 2011 and the Status of Microfinance Survey. India's microfinance crisis: The Rahul Gandhi Factor, Panchayat Raj & Rural Development (RD-1) G.O.M.S. 356 was issued on October 19, 201 gain popularity by claiming that MFI loans should not be repaid and advising customers not to do so25. Similarly, Narayana of the Communist Party of India26 issued a remark. Mass default ensued as a result. 90% of the late loans—over 9.2 million totaling Rs 72000 million (approximately USD 1.5 billion at the time)—remain unpaid as of April 2012. Banks nationwide in India panicked and ceased financing to MFIs, which caused the MFIs' outstandings to drop by half.

People ceased making MFI loan repayments after adopting the comfortable interpretation. The loan flow from banks to SHGs in AP also decreased as a result of the AP MFI Act, 2011, which was passed in 2011. The AP government created a unique institution as a result. This apex cooperative credit organisation, known as Sthree Nidhi27, was established to provide interest-free loans to women28. It distributed Rs 660 crore in loans to women's SHG members using a high-tech platform. But while bank credit grew scarcer and money lenders remained to be the major source of financing at interest rates of 5–10% per month (60–120% annually), this rarely had any impact on the general availability of credit. Thus, the AP Government declared "vaddi leni runam" or an interest-free loan as a last act of political desperation to portray itself as the protector of the poor.

**Responsible finance is a fourth emerging scenario.**

A number of regulatory changes and operational enhancements were brought forth by the AP crisis. The Microfinance Institutions Network (MFIN), a self-regulatory organisation founded by the major MFOIs, which are NBFCs, joined the RBI-approved credit bureaus, submitting over 70 million loan records, and adhering to a code of conduct that forbade excessive and repeated lending. In order to prevent problems before they occurred, MFIN also systematically began working with political and administrative authorities. India, certain State Governments, large NBFCs that operate as MFIs, industry associations of MFIs operating in the nation, other smaller MFIs, and major banks, among others, recommended (i) defining microfinance loans as up to Rs 50,000 per household, of which no more than 25% could be for consumption purposes and placing an in-come limit of the clients (Rs. 50,000 pa); (ii) imposing a margin cap and an interest rate cap on individual loans; ( The Committee also provided a number of suggestions with reference to corporate governance, MFI monitoring, etc.30 The wide regulatory framework was approved by the RBI. Loans to MFIs would continue to be considered priority sector lending as long as they meet the Malegaon requirements. In addition, there are restrictions on the customers' maximum incomes (Rs. 60,000 for rural clients and Rs. 1,20,000 for urban clients), the amount of debt they may have (Rs. 50,000 or less), the percentage of their loans that can be utilised for consumption (maximum 25%), etc. The RBI also set a limit on interest rates (up to a maximum of 26%) and net interest margins (to a maximum of 12%). The RBI's adoption of the Malegam Committee's framework gave the industry the much-needed orderliness.

**Development and Regulation of Microfinance Institutions Bill 2012**

To further bolster the regulatory environment in the microfinance business, the GoI presented the Microfinance Institutions (Development and Regulation) Bill 2012 in the Parliament. The Bill's features include (i) defining microfinance broadly to include savings, insurance, money transfers, etc.; (ii) including NBFC MFIs in its purview in addition to NGO-MFIs; (iii) recognising the RBI as the sole regulatory body for NBFC MFIs and excluding MFIs from the scope of the Money Lender Act; and (iv) strengthening client protection standards by creating advisory councils. increased need for fee and price transparency

One may see the present stage of the microfinance industry as the start of a time of qualitative revolution. The current phase (2011-onwards) could be seen as a period of qualitative consolidation of the microfinance industry with the strengthening and increased clarity on regulatory framework and consumer protection norms - in other words, the phase of "responsible finance" - whereas the first phase (1996-2010) could be characterised as a period of rapid expansion of the MFI sector with a quantum jump in micro-lending to small borrowers.

The second phase will broaden the scope of financial services provided by MFIs to also cover savings, insurance, pension services, and money transfer, while the previous phase concentrated more on micro-credit. Consumer protection standards are more stringent in the second phase. Multiple lending and over-indebtedness cases will drastically decrease now that Credit Information Bureaus have access to nearly 70 million MFI loans. The incidences of improper customer conduct and abusive collection tactics are sure to decrease with the establishment of Ombudsmen. The RBI reducing interest margins on the one hand, and the banks restricting the amount of credit they provide to MFIs on the other, have both helped to slow the high growth, high profit environment that existed from 2006 to 2010. After the price of SKS shares fell from a high of INR 1400 to a low of Rs 60, even the investor craze has long ago subsided. But more cautious investors are returning and making investments in MFIs that are operated more capably [11], [12].

## CONCLUSION

The AP problem was not brought on by overzealous authorities trying to save SHG women from pressure or by the careless behavior of a few MFI promoters. The whole eco-system had failed, from the wealthy European investors to the low-income borrowers in AP communities. Each person had a role to play in how this tragedy developed. The investors anticipated huge returns even if they were unrealistically high and viewed microfinance as a chance to do good while earning well. In order to meet these demands, the MFI promoters, CEOs, and managements bent over backwards. Banks used a significant amount of leveraged loan funds to drive this expansion since they saw it as a simple and profitable method to fulfil their commitment to lend to priority sectors. MFI field workers had incentives to tighten their recoveries and lend more. But all of these stakeholders still have a lot to learn. MFIs need to understand that they can't only deal with the poor on their terms since they are the politicians' main source of support. Banks must realise that they will never be as effective at reaching the poor as devoted MFIs, thus they must support this route rather than creating their own imitation channels. Multilaterals like the World Bank must realise that they cannot aid the underprivileged by giving money that is then utilised by politicians to prop up interest rates to unaffordable levels. Other investors, including its investment arm, the IFC, must learn to

lower their expectations of returns or go elsewhere for them. Politicians must understand the fundamental truth that they cannot lower a commodity's price (interest rate) while expecting its supply to increase.

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# CHAPTER 5

# CORE VALUES OF MICROFINANCE UNDER SCRUTINY

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**ABSTRACT:**

The foundation of economics, business, and finance in general is Value-1. It is generally accepted that all economic activity is motivated by the desire to produce benefits for those who engage in or initiate it. Competitive markets and the freedom to enter a contract serve to transform individual agents' pursuit of their own advantage into benefits for all parties involved. The extent to which this transformation is successful depends on a number of conditions that are outlined in any economics textbook. The function of finance is essentially neutral under the radical interpretation of traditional neoclassical economics. Value creation is solely dependent on the availability of the factors of production, the technology used by businesses, and the expertise required to convert inputs into outputs, and subsequently into economic advantages

**KEYWORDS:**

Commercial, Institution, Microfinance, Scrutiny, Value.

## INTRODUCTION

What has traditionally been referred to as microfinance (henceforth referred to as MF) has undergone significant transformation during the previous ten years. The reality of MF has evolved, as have the nomenclature, the conversation surrounding MF, the public's perception of MF, and last but not least, the ethical underpinnings of MF have also started to shift. What previously began as a simply moral development assistance activity has evolved into a new sector of the economy where commercial considerations appear to be far more important than conventional moral and developmental goals. The many facets of transformation are intricately intertwined, and this interaction needs careful thought. The goal of this study is to serve as a conceptual framework and a jumping off point for the topic of how to evaluate these developments and if such an evaluation justifies reevaluating the ethical underpinnings of MF [1], [2].

Many people who are involved in the "microfinance community" and even more observers who are looking in from the outside appear to believe that "the dark side of microfinance" has recently come to light, that the conventional model of microfinance has been proven to be ineffective and "needs to be replaced by a new one," that "heroes have turned into villains," and even that the "entire concept of microfinance" is flawed. The main factor contributing to their change of Recent events imply that this foundation may not be as solid as it once was. Starting with rural finance in the 1970s and 1980s, microcredit in the 1980s, Micro-finance in the 1990s and into the new century, access to finance starting in the middle of the 2010s, and inclusive finance most recently. Despite these terminological advancements, I still refer to the entire subject as microfinance. The cited sources are Business Week (2006), FAZ (2011),

Sinclair/Stanford (2012), and Bateman (2010), in that order. Compared to discussions of the past decades, advances in the reality of microfinance and the discussion around it during the past five years have more profound roots. There were spirited discussions about MF even before Muhammad Yunus and his Grameen Bank were given the Noble Peace Prize in 2006. However, they focused more on the issue of whether the commercial approach to MF, as opposed to the approach to microfinance exemplified by Yunus and his bank, is more suited to achieve certain social and developmental goals. In contrast, the principles and aims themselves are up for discussion today [3], [4].

Section 2 of the essay begins with a discussion of two various concepts of value that are relevant to microfinance. Then, in part 3, it discusses the objectives of microfinance from many points of view, engaging in a dispute between the strategy that Yunus and the Grameen Bank appeared to represent and the supposedly commercial strategy. The possibility that MF's ethical orientation has vanished is addressed in Section 4 along with possible reasons for it. In section 5, I'll reiterate why I believe that, despite the advancements brought about by the commercial approach, MF still needs a strong ethical or value foundation and how a microfinance institution (henceforth MFI) can work to ensure that it does not lose its value base even though it may seek access to the capital market. Whether all of this implies going "back to basics" is the question posed in the subtitle, and my response is given in the concluding section 6, which follows.

**The Two-Faced Concept of "Value" and the Function of Values**

Value can indicate one of at least two things. They should be referred to as Value 1 and Value 2, respectively. Both are pertinent to MF, and I will argue that it is crucial to understand how they are connected as well as how essential and substantial they have been at various stages of MF evolution. Value 1's premise is derived from conventional economic theory. Generally speaking, anything creates value if it results in a flow of net economic advantages to a specific individual or group of people, which might be the result of an action, a choice, a transaction, or a corporation or other similar organization. As a result, asserting that "MF creates value" (Value 1) suggests that MF is, by some measure, economically advantageous to a roughly defined set of individuals. Value (and hence Value 1) is defined in a more technical sense as a stock measure that expresses the current value of a flow of benefits, such as, for instance, the net present value of the cash flows coming from making an investment [5], [6].

This idea dates at least to Irving Fisher's (1904) writings. Value 2 is the idea of a political, social, or ethical evaluation. People's behaviors, actions, and social structures can all be considered for valuation in the sense of having or displaying value. For example, an action might be considered to have Value 2 if it is motivated by kind, possibly altruistic intents or if it can be anticipated to have good effects on individuals other than the one who engages in it. The term Value 2 may also be used to describe specific reasons as well as individuals whose behavior is influenced by these motives. Therefore, the statement that "MF has Value 2" means that microfinance activity is inspired by people or organizations, such as development aid organizations, with the intention of assisting others or creating Value 1 for those other than those who engage in this activity, and/or that it is beneficial for some people that MF activities are initiated and implemented. As a result, Value 2 is predicated on the idea that MF benefits or provides Value 1 for individuals who will use these services. Since it appears that MF's Value 2 orientation, which served as its once-firm ethical underpinnings, has

deteriorated recently, Value 2 is the primary topic of this essay. However, all discussions regarding the moral appeal and ethical foundations of MF, or its Value 2, have always been intertwined with discussions about the advantages that it actually confers on individuals and nations, or its Value.

## DISCUSSION

Financial institutions and money allow for exchanges that improve wellbeing between different. A careful reader of a previous draught of this work advised replacing "Value 1" with "Ecological Value" and "Value 2" with "Ethical Value." I have chosen not to follow his advice because I believe Value 2 to be an equally economically significant idea that is connected to Value 1. In some circumstances, voluntary trades even help the entire economy. The concept dates back at least to Adam Smith, as is widely known. Any consideration of justice, equality, cultural progress, etc. is left to governments in the ideal neoclassical model society, potentially with assistance from private philanthropy or charity. While Value 2 issues are crucial to them as a method of expressing individual or group preferences, Value 2 is essentially unimportant in the corporate sector. There is also no place for Value 2 since markets are presumed to be faultless and straying from unfettered profit maximisation would be sanctioned by economic annihilation in the form of corporate insolvency. According to Friedman, businesses have an ethical obligation to maximise their profits [7], [8].

However, the actual world differs from the neoclassical economics model world. Markets are not flawless, and agents may not be entirely rational. The unequal or asymmetrical distribution of information among the parties who could engage into a contract is one of the reasons markets are unreliable. The second reason is because real-world contracts are virtually never comprehensive. This is because one party to a possible contract may have greater knowledge than the other, and the less informed person may be aware of his or her informational disadvantage and choose not to participate into that contract. A broad definition of institutions is "sets of rules that shape agents' decisions by imposing restrictions on the actions that people can take and by providing sanctions and rewards." To some extent, institutions work to mitigate the negative consequences that may result from the asymmetrical distribution of information and the incompleteness of contracts. Governments, courts, businesses, laws, and many more types of institutions exist. But not just markets are flawed. Additionally, governments, legal systems, and other formal institutions cannot construct a "ideal" society, such as the one that is claimed to exist in the model world of fundamental economics textbooks, because they do not operate properly.

Value 2 is used in this situation. Considerations related to value 2 that serve a dual purpose include a desire to alleviate the pain of others and support them in realising their full potential as human beings. One is comparable to that of charitable giving and philanthropy in traditional neoclassical economics: it is an expression of the ideas that some individuals wish to see carried out in this society. Contrary to the neoclassical paradigm, the imperfection of markets may allow for the implementation of these interests in real life. Value has always been of the utmost importance to MF and its variants11. However, over time, both the particular substance that Values 1 and 2 take on as well as their relative importance have altered. As a result, defining their position necessitates first taking a quick look at the development of microfinance. In the history of microfinance, there are two distinct eras. I refer to them as MF 1.0 and MF 2.0 in keeping with the theme of this conference, which is

titled "Towards Microfinance 3.0". You might also refer to them as conventional and modern microfinance, respectively [9], [10].

The introduction of the notion of commercialization, which took place towards the end of the 1990s, is what distinguishes MF 1.0 from MF 2.0. At first, commercialization was simply understood to mean that an MFI should aim to pay all of its expenses, be financially self-sufficient, and not depend on donor funding. Cost coverage and financial self-sustainability were not concerns in MF 1.0, but they are now a major focus in MF 2.0. It should be noted that almost all MFIs in the early years of MF 2.0 were NGOs, and their capital was primarily provided by foreign donor institutions, whereas in the later years, registered and regulated banks with corporate legal structures became more significant, and funding came from private investors to a greater extent.

Value 1 was almost solely interpreted in MF 1.0 as advantages for MFI clients. It was anticipated that by making modest loans at advantageous conditions available to their clients, donors and local MFIs intended to create Value 1 for those clients. The fact that the term "beneficiaries" was commonly employed at the time to refer to customers or borrowers shows unequivocally that the major goal of relevant assistance do- nots was to benefit others. The assumption that MF was primarily driven by the desire to assist was made even at the level of local MFIs and maybe even of the international consultants who were engaged in many cases. This was a blatant example of Value 2.

One critical assumption was frequently made during the MF 1.0 phase: MF creates Value 1. Those who were lucky enough to acquire these loans saw a benefit in receiving modest loans from an MFI at advantageous conditions. While reaching and benefiting the target group members played a crucial role, little thought was given to what the entire project meant for the local institutions that were utilized as a test group.12 Whether it actually improves their lives was barely ever asked. See note 1 above for examples of small company or enterprise financing as well as inclusive financing. A second underlying premise of this strategy was that the donor institutions would be successful if they could demonstrate that the monies designated for development aid had actually reached the so-called target populations. A way of producing Value 1 for them was doing what they were meant to finish. This assumption was less worrying, though, given the substantial funding provided by foreign donor organizations route for both the employees of these institutions and the foreign funds. It was presumed, more or less implicitly, that they were driven by Value-2 factors in addition to having good intentions.

The particular forms and contents of Values 1 and 2 as well as their respective weights began to alter with the introduction of the commercial approach in the middle of the 1990s. Two things, though, remained unchanged. It was still believed that MF would primarily aim to provide Value 1 for clients and that this outcome would really occur. Therefore, the Value-2 consideration of international funders, consultants, and local MFI employees continued to guide MF. The new component was related to the regional MFIs that acted as intermediaries between international lenders and donors and the underprivileged local borrowers. Assuring that fulfilling this function would support the local MFIs as institutions—or, to put it another way, that it would provide Value-1 for the local MFIs as businesses—was now seen as crucial in addition to being lawful.

The majority of MFIs in the early years of modern microfinance were NGOs with the legal status of foundations or associations. However, it quickly became clear that having an NGO's legal structure and absence of an actual owner was more of a burden than a benefit because it was no longer thought to be in line with the main goal of helping certain target groups. In order to establish the legal foundation for an MFI that would be a more professional organisation, several local NGOs were transformed into corporations between 1995 and 2005, and MFIs were transformed into licenced and registered target group-oriented specialised microfinance banks.13 Only a short time later, donors and consultants began to establish microfinance banks "from scratch" or, as it is also known, as "greenfield investments."

What were formerly distribution conduits for foreign cash became actual financial intermediaries since the newly formed firms had owners who had invested capital. Many of them began to take deposits. All of this increased the number of stakeholders who might make a claim to getting Value 1 in exchange for their efforts. Value 2 by itself was no longer thought to be sufficient to motivate MFI action. As envisioned by proponents of MF 2.0 and the commercial approach, Value 1 self-interest concerns increasingly affected the agendas and operations of many MFIs. This was, on the whole, a beneficial development because the new MFIs of the MF 2.0 period would not have been able to expand and offer services at a much bigger scale and at considerably lower prices than those of the MF 1.0 era had there not been a greater orientation to Value 1 for all parties. One shouldn't ignore Value 2's ongoing contribution, either. The MF of today views transactions as voluntary agreements that must provide Value-1 for all parties involved. Positive Value 1 for all parties, however, is only a prerequisite for the emergence of MF. It does not meet the requirements. Value 2 was also necessary for MF to maintain its ethical reputation.

Useful and gaining both the public support that underpins significant donor financing for MF as well as the donor backing that was still required to launch commercially focused MFIs. The individuals participating in MF in their separate positions must take into account similar factors. Many of them have other choices that pay higher, including traditional banks. So it stands to reason that Value 2 must have still been important to them. The fundamental tenet of the commercial approach is not that client concerns should be given less weight, but rather that because commercial microfinance follows a different business model, it may benefit clients more. The concern for Value-1 for customers and the concern for the interests of MFIs as institutions complement one another over a longer period of time. Although it seems like "perfect harmony," this is regrettably not the complete picture.

Private money has increasingly been a crucial component of MF in the latter stages of the MF 2.0 period, which has occasionally had extremely detrimental effects. The initial public offerings of the Indian MFI SKS in 2010 and the Mexican MFI Compartamos in 2006 are two such situations that stand out. I will go into more depth about these scenarios below. In both situations, private institutional investors purchased a sizable portion of the issued shares.

These two instances show how the entry of private investors—who may be considered to have no other goals than their personal financial gain—into the MF sector alters both the relative weights of Values 1 and 2 as well as the content of Value 1. The interests of private investors, or the development of Value 1 for them, appear to have totally supplanted the earlier interest in the creation of Value 1 for clients or target groups, while Value-2 has been completely ignored, at least in these circumstances. The ethical attraction of microfinance is

challenged by this significant shift in the value orientation of MF. It appears that the two examples will no longer be the exception. According to an article published on October 5, 2012 by the Indian Financial Economic Times, "Private Equity Firms Woo Indian Microfinance Institutions" to an astonishing amount. As a summary of this section: In MF 1.0 (or classic MF), efforts by international donors and the local MFIs who were their partners to provide Value-1 for the target populations were motivated by Value 2 considerations.

The Value 1 interests of the MFIs that play a crucial role in developing and disseminating MF services for specific target groups, as well as the people and institutions supporting these new-type MFIs, are added to the Value 2 considerations and the Value 1 aspirations of clients in MF 2.0 (or early modern microfinance). Atleast in some instances, the tendency towards increased commercialization in recent years has altered the core of MF's value orientation. Clients' Value 1 no longer seems to be as important. Investors' Value 1 has taken its position as the main concern, and one can be concerned that all traces of Value-2 are likely to vanish from a number of MFIs.

**Two Opposing Methods of Small Business Finance and Microfinance**

The phrase "objectives" refers to what a social activity, like MF, is intended to accomplish in light of a consensus among experts, the general public, or knowledgeable decision-makers. It is nearly hard to clearly differentiate aims from underlying values, at least when it comes to ultimate or highest ranked objectives. aims may be thought of as a mechanism to communicate various opinions about how the overarching aims might be achieved at a lower level of abstraction. The phrase "traditional values" refers to beliefs and principles that were prevalent up until 2006, the year Yunus and his bank received the Noble Peace Prize, the first MFI IPO, and the start of what I refer to as excessive commercialization.

There was broad consensus that MF was created to benefit customers at the highest level. On practically every point of what this meant in practise, experts differed, even at the next level of generality. More specifically, there was dis- agreement about • the definition of the target groups that MF was meant to directly benefit: really poor people vs. micro and small enterprises and their owners and their employees; • the definition of the overall objective: poverty alleviation vs. improving the economic environment in which poor people live and in which small and very small firms operate; • the kinds and the scope of services MFIs should provide to the target population: all those services that poor people need vs. merely financial services; the importance attached to the requirement that MFIs cover their full costs and become financially self-sustaining after a brief initial period vs. the dis- regard for such considerations; the directness of efforts to ultimately benefit the target population: reaching poor people and providing immediate benefits for them vs. strengthening the institutions that would provide financial services to those who formerly lacked access to financial services, or even to strengthening the financial system of certain countries

One may get at the major "battle line" of the 1990s and the first years of the new century by combining these aspects. On the one hand, there is the viewpoint of those who choose to provide rapid and comprehensive assistance to disadvantaged target populations in order to reduce poverty. "The poverty alleviation camp" is what it is known as. Up until 2002, the Grameen Bank was the top institution. MFI was one example in this movement, and Yunus was its most well-known supporter. On the opposing side, we have some who favour a more targeted "finance only" strategy and indirect assistance for the target population. This

"commercial camp" emphasizes financial sector development, institution construction, and MFIs' commercial orientation. The leading models for this camp of MFIs were the local bank units of Bank Rakyat Indonesia (BRI) and the MFIs funded by ACCION and IPC.As previously stated, the disagreement between these two parties throughout the 1990s was not over the main goal of MF but rather differing perspectives on how to achieve it. The nebulous but logical and extremely believable idea of "outreach" was one way to frame this debate [11], [12].

## CONCLUSION

There are two aspects to outreach. A MFI with "deeper outreach" will reach and service poorer customers, and one with "wider outreach" will reach more relatively poor clients. Early on in this discussion, it was widely accepted that there would be a trade-off between the depth and breadth of outreach, and the two sides had different ideas about which aspect of outreach was more crucial. While those living in the commercial camp were more focused on a broad outreach, those in the poverty alleviation camp gave depth precedence. The relative preference for depth and breadth touches on a number of topics. A straightforward disagreement in value judgments is one component. The goal of reducing poverty is prioritized by those who support it over building strong financial institutions and the financial sector. For many of them, it is even unethical to require low-income borrowers to pay in full for the financial services that are made available to them. The proponents of the commercial method contend that MFIs that prioritize eradicating poverty and use a soft approach would find it difficult to recoup their costs and establish themselves as stable financial institutions and will consequently be unable to offer loans and other financial services to their clients on an ongoing basis. They believe that the capacity to offer services permanently is of the utmost significance for their consumers, even if doing so necessitates the MFIs charging somewhat higher interest rates.

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# CHAPTER 6

# THE ECONOMIC RATIONALE OF THE INSTITUTION BUILDING APPROACH TO MICROFINANCE

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**ABSTRACT:**

The commercial approach to MF, also known as the institution building strategy or the financial sector approach, is supported by more evidence than only the claim that it has a greater impact than the approach to alleviating poverty. It can also be backed up by a compelling economic case that Ingo Tschach produced in his dissertation on "the theory of development finance." He makes a point that I believe is significant enough to briefly discuss here. Unlike the textbook concept of a commodities market, where supply and demand curves cross and jointly set the price at which the market clears, financial markets do not operate in this way. Information and incentive issues have a significant impact on financial markets, and this is especially true for markets for loans to very tiny and small enterprises in developing nations. Information asymmetry causes moral hazard and adverse selection, which in turn cause credit rationing, as Stieglitz and Weiss demonstrated in a seminal article. Potential borrowers may have economically worthwhile projects for which they ask for external financing, but credit rationing prevents them from receiving the loans they need. Evidently, credit limitation is a common occurrence in marketplaces where MFIs operate. A generalization of the Stiglitz and Weiss argument offers an economic justification for microfinance in the vein

**KEYWORDS:**

Businesses, Financial, Loans, Microfinance, Significant.

## INTRODUCTION

Any emerging nation will have businesses of varying sizes. Small businesses typically have limited capital, both in absolute terms and in relation to the amount of labour they employ. Smaller businesses require less funding. They frequently possess, therefore their marginal return on capital is larger. This has been repeatedly observed to be an empirical reality. One might assume, for the sake of simplification, that businesses demand loans whose size is in line with their own. The smallest businesses would provide the most alluring loanable capital applications if markets were ideal. This is not the case in reality, though, for two reasons. Giving tiny and very small loans to businesses with equally small sizes has substantial transaction costs, which are presumable to increase with both the amount of the loans and the businesses requesting the loans. The second reason is that it might be challenging for lenders to accurately determine how creditworthy very tiny and small businesses who are looking for loans are. These straightforward factors make it possible to derive a demand curve between interest rates and loan/firm size [1], [2].

If one examines the loan market's supply side in a typical developing nation, one may identify two sectors or two components of the entire supply. One area is the supply of informal and semi-formal loans, which is mostly supplied by money lenders. It is reasonable to suppose that lenders of capital can evaluate the creditworthiness of micro and small businesses. Their capital is constrained, though, and their transaction costs are quite expensive. As a result, they are only able to provide very tiny loans at extremely high interest rates to very small enterprises. The other area is the traditional banks' credit supply. These banks provide loans to big companies that aren't too hard to assess, as when they have audited balance sheets and collateral, and they seek moderate interest rates that would be enough to pay their costs, including transaction fees. Contrary to money lenders, conventional banks lack the expertise needed to assess very tiny and small businesses and their initiatives. They do not offer loans to them for this reason, even though the interest rates on those loans would be greater [3], [4].

A segmented market is created by combining the loan demand curve with the two loan supply segments. Three categories make up this market. The first section is where money lenders give very expensive, very little loans to very small businesses that can afford to take out these expensive loans due to their extremely high marginal returns on capital. The third sector involves big businesses obtaining sizable loans from traditional banks at reasonable interest rates. The second category is the medium one and is made up of small businesses that want to receive small loans but not very tiny ones and have strong returns on capital but not very high returns. However, the interest rates on loans from money lenders are too expensive for them, and banks do not lend to them because they lack the tools to evaluate their credit worthiness. The two categories of suppliers that have been thought of thus far do not satisfy the lending need of these companies. Since they have more capital available for lending than traditional money lenders and some relevant expertise to assess small firms, which banks typically lack, the middle segment of small firms is their natural domain. This is where MFIs can find an appropriate and also financially attractive market niche. They should be able to satisfy the needs of businesses that fall in the centre of the company and loan size spectrum [5], [6].

The relevance of this function of MFIs in financing small businesses goes well beyond just supporting a class of tiny, but not very small organisations that normally do not qualify for loans from banks and money lenders obtain the loans they require. If the gap was not closed, it would pose a serious barrier to growth, preventing all individuals who would work in small businesses from expanding their workforce and earning more money. Consider the scenario when the gap is not filled to see why this is the case. The owners of extremely tiny businesses in this situation would be aware of the gap and would expect that if their companies developed, they would fall into the trap of having a business that was both too big for loans from money lenders and too small for loans from traditional banks. They wouldn't even attempt to expand their businesses as a result, which would prevent them from generating cash and jobs.

This is, in my opinion, the strongest justification for why MFIs should adopt a commercial mindset, strive to become financially stable institutions, and focus on funding small businesses rather than the economic activities of the extremely poor. By accomplishing this with success, they eliminate a significant barrier to economic growth and development and have a significant influence on the development of the economy as a whole. Even though only indirectly, this would also result in a significant improvement in the circumstances of

those who are really poor since they would be able to obtain employment and earn money by taking on newly generated occupations [7], [8].

**The Discussion of Meta-Ethics**

It is insufficient to claim that those who live in the commercial camp and those who live in the camp dedicated to eradicating poverty have different views on what is more important for the welfare of the poor—building financial institutions or developing the financial sector. The two approaches are different in another dimension, and this dimension specifically makes reference to ethical ideals. There are two distinctly different perspectives in the overall philosophical discussion of what determines the ethical or moral worth of human activity. One of them is a viewpoint that dates back to the teachings of the renowned 18th-century philosopher Immanuel Kant and was widely held among German and European philosophers and their adherents in the general public in the 19th and early 20th centuries. This view, which was later known as "ethics of conviction" (in German: Gesinnungsethik) by Max Weber, holds that conduct is regarded as ethically good if it is founded on morally admirable intentions and principles that are suitable to serve as general rules of conduct and as the foundation of the legal system in an ideal state. According to this view, MF can be regarded as ethically good if it is based on the following principles: I just briefly touch on this topic here because Schmidt (2010) has addressed it.

## DISCUSSION

Max Weber discusses this viewpoint and coined the word "Gesinnungsethik" of his very important book "Politik als Beruf" (politics as a vocation) from 1919. He is alluding to Kant (1788) in this sentence. Later writers, including Kohl (1990), raise the question of whether this is an accurate picture of Kant's undoubtedly more complicated viewpoint, but they ultimately agree with Weber. It is morally beneficial if and only if it is founded on ethically significant ideals, such as the desire to assist people in need. It is obvious that MF with a focus on eradicating poverty has this attractive trait and may be seen as an embodiment of the Kantian ethics of conviction.

The opposing viewpoint is that which Max Weber, a similarly respected sociologist and economist, established and popularised around a century ago in an explicit challenge to the dominant theory of Kant and his adherents. He referred to his method of applying practical ethics as verantwor-tungsethik (German: ethics of responsibility). He contends that morally righteous intentions and underlying guiding principles are less significant than ethically valuable conduct that is based on careful planning and the expectation of achieving effects that can themselves be deemed morally righteous by some appropriate standard. For as long as these principles are regarded as ethically sound, Weber criticised the ethics of conviction for ignoring the question of what the actual effects of adhering to valuable principles are.22 From a Weberian perspective, MF appears to be ethically good - or have Value 2 - if it can, upon careful analysis, be expected to create net benefits - or Value 1 - for its clients or their countries.

When it comes to the discussion around MF23, it can be said that the approach to eradicating poverty mostly complies with Kant's ethics of conviction. What makes MF such a morally alluring idea is precisely that it is grounded on ethically good ideals and intents, as Yunus has stated in countless talks. Facts and numbers are significantly less important to him than values and objectives. The most crucial questions that he consistently avoids in his

speeches—and frequently even dismisses as largely irrelevant—are what the true impact of the type of MF is that he supports, how this impact can be reliably measured, and what his concept implies for the function and operating methods of MFIs [9], [10]. Most professionals in the commercial camp, who are mostly economists or social scientists, want to adhere to Weber's ethics of responsibility. The fact that consequences matter more than principles is obvious to the majority of them. If the stronger influence of commercial MFIs can be presumed to exist24 and if the commercial orientation does not compromise ethical values, the meta-ethical controversy would support their stance. Predictable effects are a necessary precondition. The foundation of Weber's argument is the notion that it is possible to foresee the effects of the action under consideration. If not, his meta-ethical argument is substantially weaker, and the Kantian position is thus stronger in terms of relative strength. In a previous work, I outlined one defence for doubting the predictability of the effects of commercial MF. This argument is based on the fact that it is impossible to foresee how innovations will affect us. Schmidt (2010) is cited. Another point that goes in the same direction is that, contrary to what was previously believed, it is far less obvious that MF assists impoverished households directly, as stated by Roodman (2011) and others.

**Significant Shifts in Microfinance Reality**

Microfinance appears to have hit a low point in reputation over the last six years before rising to a high one. Relevant developments that contributed to this decline happened simultaneously on two different levels: in reality and in the discourse around MF. The IPOs of two significant and well-known MFIs are the most prominent incidents that have seriously harmed the reputation of microfinance. It might be sufficient to simply recap the key elements of both instances and the controversies surrounding them. The Mexican MFI Compartamos company went public in 2006. The Compartamos shares were listed on the Mexican stock exchange, and 30% of the outstanding shares were distributed to American and Mexican investors. No additional shares were issued during the IPO, and Compartamos received no new funding. The managers of the MFI and two important development-oriented organisations, IFC, the private sector arm of the World Bank, and ACCION, the largest and most reputable microfinance support organisation in the world, had retained the majority of the shares that were sold.

Financially, the Mexican MFI's IPO was a huge success. The shares had a relatively high issue price. When the shares were valued at their issue price, Compar- tamos had a market value of almost USD 1.5 billion. The IPO was lauded by some observers, particularly the original owners of Compartamos, as a significant milestone demonstrating that microfinance had finally entered the "real financial market" and passed its test there. Others had a different perspective and defended their critical viewpoint by pointing out that Compartamos' enormous profitability as an enterprise over the past six years since the time when the former NGO was transformed into a corporation, and the expectation that it would maintain its profitability in the near future by adhering to its policy of charging exorbitant interest rates, could only be reflected in the high issue price. This IPO, according to Yunus and others, showed the moral decline of some MF players. The fact that many of the shares were sold to American hedge funds, including IFC and ACCION in a prominent position, raised concerns since it allowed the sellers to make financial gains never before seen in the MF. The biggest and fastest-growing Indian MFI, SKS, also launched an IPO in 2010, and it was equally financially successful. In this instance, investors appear to have paid a very premium price for

the shares due to extraordinarily strong growth rates rather than extravagant interest rates. The issue price was really so high that it could only be explained by investors' expectations that SKS's incredible growth would last for a considerable amount of time.

This MFI was financed by investors who had just financial gain in mind, and senior executives took advantage of the situation to reap enormous gains for themselves. SKS and a few other sizable Indian MFIs appear to have adopted loan-granting and client-repayment procedures that have little in common with prudent micro lending, which is a very troubling feature of this IPO. It's common knowledge that many debtors who were unable to pay back the enormous debts they had taken out from SKS and its competitors committed themselves. This resulted in a widespread microfinance problem in Andhra Pradesh, which is also well recognized.

Unfortunately, there were more incidents that contributed to MF's diminished reputation on a global basis. A few strictly commercial banks entered what they called the microfinance business after 2005, which is another issue. But instead of encouraging plain consumer lending, they advocated loans that were somehow connected to their clients' income-generating activities, which led to major issues for their consumers. Additionally, the availability of extremely modest loans to impoverished customers increased quickly in a number of countries, which resulted in client over-indebtedness and growing MFI default rates.

Last but not least, there was a dispute over the actions of Noble Laureate Mohammad Yunus, a guy who had best exemplified the past good side of MF. The role of his bank and other businesses in the Grameen Group of Enterprises came under intense media scrutiny, with reports and comments questioning the group's ever-expanding range of business activities and its astonishingly close collaboration with large multinational corporations in terms of ethics and development. Yunus was compelled to resign from his role as CEO of Grameen Bank in 2011, in part due to these claims, and the Bangladeshi government asserted its right to choose the bank's next CEO. Even if many of the allegations proved to be unfounded, the reputation of MF as a whole was harmed by throwing a cloud on its most admired figure.

It should be noted that another component of microfinance altered negatively as well, if only as a footnote. It is about how appealing MF is to regular investors. The profitability of MFIs and MF investment vehicles was seen to be particularly favourable to them up until the middle of the previous decade since it was essentially unrelated to broader economic and stock market trends. As a result, it was decided that MF investments were useful tools for portfolio diversification (see Krauss/Walter 2009). The overall financial system has been significantly more integrated with MF during the past few years. As a result, the financial returns of MF investments began to be strongly associated with overall market trends, which significantly reduced their investor attraction. Observational data are available in Wagner (2012).

**Significant Shifts in the Microfinance Conversation**

While the Compartamos IPO and its problematic aspects received little attention from the media as a whole, the SKS IPO's events, the ensuing Indian microfinance crisis, and the entry of purely commercial lenders who promoted consumer lending under the false name of MF received considerable media attention. The highly regarded German Newspaper Frankfurter Allgemeine bluntly declared that the model of microfinance had failed, and others declared

that microfinance would be almost dead, at least as far as its ethical appeal is concerned. One very well-known American business magazine published several articles about the "dark side of micro lending." The shift in perspective in the more specialised literature on microfinance is much more significant. I'll keep this short and merely make a few brief observations about three recently published books on MF that have received a lot of attention.

Hugh Sinclair's 2012 book "Confessions of a Microfinance Heretic" is the first one. As the title implies, both the tone and the content of this book are very controversial. The author describes his unpleasant interactions with many MFIs and MF support groups that he had previously worked for. He illustrates how reckless, power- and profit-driven, and least of all lacking in social and developmental responsibility, these organisations and the top individuals behind them are. Of course, there are MF institutions and individuals that merit criticism in the same manner as Sinclair does in his book and associated writings as well as in public appearances. Furthermore, it is legitimate to note that the previous MF hoopla may have encouraged the entrance of sketchy personalities into MF. Sinclair does not, however, explicitly generalise the information he captures for specific circumstances. Therefore, it may be said that he was unlucky to see black sheep more than once throughout his time working as an MF consultant. Aside from his warning about making overly general assertions, his book gives the impression that what he writes is a general characteristic of today's MF and that there are several bad apples. In this regard, he significantly adds to the ongoing criticism of MF.

The second book is more significant and substantively dense. Why Microfinance Doesn't Work? Milford Bateman (2010) takes aim at what he sees as the fundamental flaw in the relatively recent generation of MFIs. His response to the topic posed in the subtitle—"The Destructive Rise of Local Neoliberalism"—is obvious. Bateman criticises aid-supported MFIs and donor support for these "new style MFIs" as cementing underdevelopment and property instead of fostering development and making a contribution to the alleviation of poverty, as have been repeatedly claimed by thousands of MF enthusiasts, in equally strong words as those of Sinclair. He suggests just ending the strategy of advanced nations providing technical and financial support for the MF as a conclusion. In this study, I perceive two key justifications. The first is that modern MF is an example of neoliberal policy, which significantly undervalues the value of government initiatives in fostering economic growth. Modern MF is in fact heavily influenced by anti-government and pro-private sector ideologies thinking. Bateman would have known how problematic the kind of government interventions he so fervently supports if he had been better knowledgeable about the history of development finance and development assistance policies. To put it another way, I tend to agree with his diagnosis on this issue but disagree with his conclusions and suggestions.

His second important point focuses on the type of economic activity that many "new-style MFIs" want to foster with modest loans, in his opinion. He contends that the really poor do not earn enough cash from their economic activities to justify using monies from development aid. If financing was allocated to small and medium-sized businesses with some growth potential rather than informal and other micro-enterprise activity, development would be boosted and therefore the economic status of vast portions of the population would benefit more. With his second point, Bateman is not alone among microfinance experts. In fact, some significant MF players have already modified their strategies in light of the realisation that financing small businesses can have a greater positive impact on development than financing

solely consumers or even micro-scale or informal economic activity. Additionally, a significant portion of MFIs with a commercial origin have not or have only partially embraced the language of Yunus and his supporters towards the reduction of poverty. Therefore, it is challenging to see how Bateman comes to the broad conclusion that "microfinance does not work".

David Roodman's "Due Diligence" from 2011 is the third and unquestionably most significant recent book. The title "An Impertinent Inquiry into Microfinance" may give readers the impression that this is yet another book that takes a comprehensive aim at microfinance. Thankfully, this assumption is unfounded. The book provides a very sobering and thoughtful—indeed, "diligent"—account of contemporary MF and a thorough evaluation of its advantages. Claims about what MF could do are regularly made and used as the benchmark for MF evaluation. And by this measure, the intellectual exercise's outcome is pretty underwhelming. One assertion—possibly the one that has garnered the most traction—is that MF is the perfect tool for reducing or perhaps eliminating poverty. Roodman examines the data and recent econometric studies that appear to support the argument that MFIs assist individuals escape poverty and comes to the conclusion that there is no evidence to support this assertion. However, this result has to be viewed with a healthy dose of scepticism. What researchers whose work Roodman and Levitsky (1990) contains many of the contributions. The proceedings of the inaugural World Microfinance Conference, which took place in Washington, D.C., in 1989—during Ronald Reagan's administration—are summarised in this book. As an example, have a look at the collection of papers on the previous directed credit strategy in Adams, which has the enlightening subtitle "Undermining Rural Development with Cheap Credit." The policy that Adams so vehemently criticise in their book, as well as publications by the same group of academics in the early 1980s, is very similar to what Bateman suggests. For instance, take a look at Pro-Credit Holding's (2012) most recent annual report.

Analyses focus on the extremely short-term and immediate consequences. If these impacts cannot be demonstrated, it does not mean that MF does not improve the wellbeing of a significant portion of the population, including the poor and the extremely poor. One can scarcely argue that the impact of German cooperative banks and savings banks, for example, since their establishment in the 19th century have been overwhelmingly favorable. However, it took years for this effect to manifest, and current econometric studies are unable to fully explain the process by which these financial firms allowed previously excluded clientele to obtain financing [11], [12].

## CONCLUSION

The second assertion that Rood-man looked at was that MF fosters empowerment. His analysis is similarly pessimistic in this case. In rigorous econometric analyses, empowerment has no immediate effects that can be observed. The argument is, however, not as strong as it was in the case of property reduction because the relevant research can only record immediate and obvious consequences. Up to this point, one might claim that both the changes in the "reality" of microfinance and the discussions in the public and academic circles about MF are pointing in the same direction: MF cannot and does not fulfil its promises, hence it has significantly lost its attraction. This evaluation would, however, ignore the fact that Rood-man also takes into account a third assertion. It is the assertion of those who support the growth of financial institutions and the financial industry in the direction of more

inclusive finance. On this point, his evaluation is unquestionably favorable. Unfortunately, he skips over the issue of whether the beneficial developments in what he refers to as "microfinance as industry building" have a favorable long-term effect on significant portions of the economically active people in emerging and transitional nations. There are several reasons to think considerably more favorably about MF, including its welfare implications for the general population, according to the broader literature on the connection between finance and growth.

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# CHAPTER 7

# THE RENEWED DEBATE ABOUT OBJECTIVES AND VALUES OF MICROFINANCE

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**ABSTRACT:**

The recent changes and the widespread perception that MF, as it has been practised up to this point, has lost some of its ethical appeal necessitates a reexamination of why values, particularly what I have referred to as Value 2 above, are crucial for finance in general and microfinance in particular. The usual response to this topic is that values and ethics are important because they offer guidance and can influence the behaviour of economic agents in situations when markets and politics fall short of providing clear guidance, produce unfavourable results, or allow opportunity for discretion. Financial markets in the real world do not operate as conventional economics courses predict. They encourage prejudice and exclusion as well as exploitation and other immoral behaviour. This "market-centered policy failure" results in a hole that needs to be, and can be, filled by "Values 2" in the shape of personal integrity, professional ethics, etc. Policy interventions (regulation, state banks, etc.) cannot compensate for this. The discussion surrounding the role of ethics in general banking and finance following the financial crisis has sufficiently established this point: Profit-making without ethical restraint has caused harm, and even the biggest investment bank in the world, Deutsche Bank, is currently working to revive their corporate culture in a way that emphasises more responsible client service, transparency, and fairness, not least because doing so would be beneficial to the bank itself.

**KEYWORDS:**

Debate, Objectives, Microfinance, Judgment, Behavior.

## INTRODUCTION

This is much truer for small business financing (henceforth SBF) and development financing. The notion that unconstrained markets do not operate as one would want and that, as a result, some intervention is necessary that is itself driven by Value 2 considerations has historically served as the inspiration for efforts in these fields. These considerations are founded on value judgements and beliefs that Chances should be dispersed fairly, People in poverty and those who lack access to financing require assistance; Better financial access promotes democracy and peace in the long run, as well as economic progress and widespread development in most circumstances [1], [2].

The host nation's government does not sufficiently encourage broad-based financing. As I have explained above, strong and stable institutions are necessary for MF and SBF to function effectively. These institutions must adopt a commercial strategy if they want to remain effective for an extended period of time. They cannot thrive, develop, and provide "Value 1" for anybody if they are not lucrative. However, there is a chance that the marketing

strategy can go too far. Profit-maximizing behavior may be implied by the morally righteous and economically sensible goal of generating a profit, or, to put it another way, by covering all costs, including the cost of equity. Although all profit-maximizing financial institutions tend to discriminate, exploit, etc. if they have the potential to do so, as the incidents in Mexico and India plainly indicate, blatant profit maximisation would run against to the reasoning behind why MF and SBF were founded in the first place. Therefore, having a strong foundation in values in the sense of Value 2 is crucial for commercially oriented MFIs and small business banks. Values are a remedy for an overly commercial mindset. Given that values are crucial for solid, commercially focused MF and SBF organisations, one must examine these values and the objectives they serve more closely. The current jectives of MFIs are: Institutional sustainability (or Value 1 for the institutions) and outreach/impact/benefit (or Value 1 for customers) continue to be important goals. However, this has to be improved in terms of functionality for the impending "Microfinance 3.0" period. There are three different categories of goals and values [3], [4].

Be fair and open with customers and other partners; be responsible when lending; be open with money lenders, regulators, and contributors. Since this dedication to responsible lending has been blatantly disregarded lately, MFIs specifically need to be held accountable for ensuring that their clients never borrow more money—from one MFI or from many MFIs—than they would ever be able to return. A firm belief in the importance of responsible lending implies that MFIs should refrain from engaging in consumer lending that has no positive effects on the environment and exercise extreme caution in every transaction to ensure that their clients can handle the debt loads they incur when they take out loans [5], [6].

Traditional goals of MF include helping customers by giving them more alternatives, rather than claiming to directly reduce or even eradicate poverty (because this is not possible), bolstering the relevant financial system, and preventing financial exclusion; and enhancing the availability of financing for very tiny, small, and even mid-sized firms that can generate revenue and jobs but have not yet been able to do so with credit at reasonable rates in order to promote economic growth. Value concerns, such as striking a healthy balance between Value 1 for customers and other stakeholders and Value 2, are crucial for all parties involved in running and managing MFIs. They are also standards that financiers and donors ought to follow when determining how to provide loans, equity, and technical help to MFIs. They should also be heavily involved in the recruitment, development, and assessment of MFI employees.

**Assuring MFIs That Want to Access the Capital Market Are Value-Oriented**

Millions of individuals who are already engaged in the workforce, as well as very tiny and small firms, nevertheless lack access to the financial services that would improve both their own circumstances and the growth of their nations. Because of this, the organisations that offer these services have a moral duty to grow the scope of their business. This goes along with the need for MFIs to expand in order to become more desirable as business organisations to both employees and their own creditors and investors. Growth creation is important for financial institutions that are regulated and controlled like banks.

According to their loan portfolios and the amount of deposits they would desire to mobilise, they may need to enhance their equity. However, even for established financial institutions, obtaining equity is challenging. Retained profits or self-financing are two sources of equity.

Retained profits are typically insufficient, especially if the institutions feel it is important from an ethical and developmental standpoint to make less profit than they would need if they had to rely solely on internal financing to meet their expanding equity needs. However, given the pace at which most MFIs have grown recently33 and at which they will hopefully continue to grow, retained profits are frequently insufficient. National and international development financing institutions are another source of equity. Additionally, their resources are insufficient to support the expanding MFI sector's equality requirements. As a result, raising stock from private sources is inevitable.

Here, we first encounter the kind of private "social investor" who seeks both a financial and a "social" return and who could be willing to accept a less financial payout provided they can be sure that they are supporting a worthwhile endeavour from an ethical standpoint. However, this form of equity is also constrained, particularly given how challenging it is to coordinate the outside funding from several "social investors." In the end, there isn't much that can be done to prevent resorting to institutional and private investors whose financial interests trump their social or political ones. The option of addressing the general market for equity capital by issuing shares in the form of an initial public offering (IPO) and then having their shares listed and traded on an organised stock market is one that is worth thinking about, at least for big and expanding MFIs. It is crucial that the shares be issued to the public (as opposed to a private placement) since this increases investor liquidity and increases the appeal of MFI shares as an investment.

## DISCUSSION

But it's not as simple as it would seem. This is not really the case because an IPO is usually a challenging process, especially for businesses with unconventional business models and those who operate in industries that the capital market is unfamiliar with. A more significant factor is that ownership in a publicly traded company entails specific rights for the new shareholders and the legal responsibility for the issuing firm to safeguard those shareholders' interests and, at least in part, pursue a course of action consistent with those interests. Any institution's nature is fundamentally altered by an IPO. It may suggest that a facility's social and developmental mission has been abandoned in the event of such a facility [7], [8].

Making sure the social and developmental focus endures, which has traditionally been a motivating cause behind the founding of an MFI or a similar organisation. Ignoring recent instances of unnatural and excessive development, which have been observed in a lot of nations and places, most notably in the Indian state of Andhra Pradesh. Furthermore, development organisations like the IFC, who have frequently acted as early investors in MFIs with a commercial focus and which are compelled by their internal regulations to exit their participation after a specific time period, may find it beneficial to have shares listed on an organised market is difficult. After an IPO, there is a sizable chance—or rather, a substantial danger—that a sizable portion of the equity will be owned by the general public or even by institutional investors with just financial interests- that the authority gained through owning shares will be utilised to change the MFI's structure so that it more closely resembles the financial interests of outside shareholders. In the Compartamos case, for example, or by expanding operations more quickly than would be consistent with the rules of responsible lending, as in the SKS case, strong outside shareholders could exert pressure to the effect that an MFI becomes more profit oriented than it had been previously. Or, as is recently occurred

in a number of countries, outside investors may convert a micro and small business-oriented MFI into a consumer lending organisation.

If an MFI with a social and developmental orientation is poised to grow to the point that it requires equity funding from outside private investors36 in order to expand, those who previously founded it and who may still be in charge of it are in a difficult situation. They risk their MFI's commitment to ethics if they resort to the capital market and, eventually, investors they can't choose. They restrict the good effect they would otherwise have on their potential clientele if they avoid obtaining outside equity and miss the chance to expand operations. But going public, seeking outside equity financing, and giving decision rights to investors who might not share your developmental orientation are not all-or-nothing choices. There are various strategies for reducing the potential drawbacks of going public.

The first thing that comes to mind is to restrict the percentage of shares that are sold to outside in- vestors. Making ensuring that the shares owned by individuals other than the anonymous outside investors are, to use financial jargon, "in stable hand" of investors who can be relied upon to adhere to the original social and developmental objective, is another alternative. Placement of big blocks of shares with dependable "anchor investors" would be a component of this strategy. The third choice is to come up with a legal structure for the issued shares that gives outside shareholders less ownership power than regular shares. If the underlying legal framework permits it, one alternative that can be selected is non-voting preferred shares.

Naturally, it must be expected that anyone who would purchase freshly issued shares would be aware of the ramifications of any attempt by the MFI's current owners or management to limit their ability to influence the institution's orientation and strategy. In this case, they would A "similar organisation" might be one that does not itself constitute an MFI but owns or manages local MFIs. Since there are currently a number of significant networks of MFIs with central institutions that might become public, the case of "similar organisations" is significant from a practical standpoint in the current situation. This is especially true if an MFI tries to meet its equity needs by soliciting outside investors like hedge funds or private equity companies. Their capacity to re-orient a company in which they invest is key to their business strategy.

Understand that it would be impossible to obtain a large enough majority to take control of the entire company and integrate it into an existing large commercial banking group, or that an outright conversion of a small business-oriented bank with limited profitability into a more profitable firm focused on consumer lending would be very difficult, if not impossible. Potential outside investors may choose not to purchase shares in light of these limits, or they may provide less money than they would if they had the choice to convert the MFI into a more lucrative but unethically or developmental- ly less valuable financial institution. This is a cost that the current owners must bear, and de facto so must its future consumers as well because it prevents the MFI from potentially expanding its business. However, given the unfavourable effects that the de facto takeover by exclusively profit-oriented investors and the ensuing strategic reorientation seem to have had in the two cases mentioned above, where hedge funds and private equity firms, respectively, have become the dominant shareholders, it may be worth paying this price. It's likely that the price may be so high that an IPO won't even be viable. However, some pertinent recent experience indicates that this may not be the

case and that there would be sufficient investors who would be prepared to acquire equity holdings with restricted rights and possibilities to restructure a development-oriented MFI.

Is it suggested that we return to "Basics" in light of recent events? is the query posed in the paper's subtitle. This, in my opinion, indicates a potential return to prior values and their function in MF, SBF, and related disciplines within the larger framework of development finance. Due to space limitations, I am unable to go into great detail into the more general questions of whether and how much a "back to basics" would be necessary. However, even if this is primarily intended to highlight a distinction, a few lines on this may still be relevant. Going "back to these basics" would be exceedingly undesirable in terms of the majority of elements of MF in the early 1990s style.

Even though the small business banks of today almost look like any other bank, compared to the MFIs of the early 1990s, they may have seemed more exotic and romantic to journalists, politicians, and other outside observers, but a return to these "basics" would come at the expense of the millions of clients who would be unable to access financial services if the MF industry were to once again become the amateurish cottage industry of 20 years ago. The enormous number of consumers served by the majority of MFIs now have considerably easier access to financing because to advancements in MF. Nowadays, a lot of MFIs act as "universal banks" by providing a wide range of lending products, savings accounts, money transfers, and other services. Individual lending has largely taken the role of group financing. A number of MFIs have undergone corporate restructuring, becoming regulated and monitored financial intermediaries. The majority of MFIs have significantly increased the scope of their activities, which has caused the cost of intermediation to fall below 20%, a figure that seemed unattainable just 20 years ago. Finally, a lot of MFIs have either completely stopped depending on donor funding or at the very least significantly cut back on it.

Is "Back to Basics" advisable in terms of the significance of values, particularly Value 2? My response in this case is clearly yes. There are undoubtedly a lot more MFIs than those Hugh Sinclair mentions in his book where Value 2-orientation is entirely absent. A number of MFIs may be inclined to depend less on a commitment to moral ideals than they did 20 years ago, even in the absence of such severe examples. The overall financial crisis and the microfinance crises in India and a few other countries, according to optimists, have likely sparked a revival of value orientation. A growing number of MFIs and networks of MFIs, such as the ProCredit Banks, are making an effort to increase staff members' understanding of the social, developmental, and ultimately very political role that development finance aimed at the poor and small businesses plays. Their employee training programmes now include more pertinent components.

Although some observers have voiced concerns about MFIs from the commercial side, it is important to remember that thousands of MFI managers and tens of thousands of employees have always had a strong ethical focus. But there are also significant distinctions between the current scenario and that which existed 20 years ago. Value 2 now plays a more significant role than it did in the past due to the requirement to adopt a clear commercial orientation and the tighter ties that have formed between MFIs and the "normal" financial system. It is necessary to take steps to ensure that the Value 2-direction does not become lost since these relatively recent MF features pose a danger to the value orientation of MF. The corporate culture, organisational structure, governance, and ownership structures of complex MFIs and

MFI networks must now include Value 2 in a significant way. Ways must be discovered and matched rules must be put in place to prevent MFIs, their managers, and employees from being tempted to ignore or even forget their ethical commitment in the face of escalating daily demands. It is not enough to provide adequate freedom for behaviour that is guided by values; stronger commitments must also be made to the continued importance of values. The issues I raised above about the difficulties of MFIs going public are only one illustration of this sort of commitment.

So, structurally speaking, we are unable to return to the fundamentals and the previous function of values. Good intentions, the appropriate attitude, and charisma no longer cut it in today's world. MFIs' governance and ownership systems must include institutional components that guarantee a significant role for ethics and Value 2. Even while this could make it more challenging to access the capital markets, a reputable MFI must always be selective about whom they sell their shares to. There are methods to accomplish this in virtually all legal systems, such as by incorporating pertinent language in the agreements they reach with the investment banks taking part in the IPO process.

The interest rates imposed by microlenders, also known as microfinance institutions (MFIs), have been the most contentious aspect of contemporary microcredit since its inception1.2 These rates are higher than typical bank rates—often considerably higher—in part because it always costs more to lend and collect a given amount via thousands of small loans than it does through a few large ones. greater interest rates must be used to offset greater administrative costs. How much higher though? Given that poor borrowers have little bargaining power and that a growing portion of microcredit is moving into for-profit organisations where higher interest rates could, according to the story, mean higher returns for the shareholders, many people are concerned that poor borrowers are being exploited by excessive interest rates.

The Microfinance Information Exchange (MIX) gathered financial data from hundreds of MFIs between 2003 and 2006, which CGAP evaluated some years ago. Microfinance Information Exchange (MIX), KfW, and Consultative Group to Assist the Poor (CGAP) collaborated on the study for this publication. The word "microcredit" used in this study refers to relatively tiny, briefer-term, mostly uncollateralized loans given to low-income micro entrepreneurs and their households utilising unconventional methods including collective responsibility, frequent payback intervals, rising loan amounts, forced savings plans, etc. Financial service providers known as MFIs concentrate, often solely, on providing financial services to low-income clients whose main sources of income are generally informal rather than pay from legally recognised employers.

Microcredit dominates these financial services in the majority of MFIs today, but savings, insurance, payments, and other types of money transfers are now being included, along with increasingly diverse and adaptable credit products. MFIs come in a variety of shapes and sizes, including unofficial village banks, nonprofit lending organisations, savings and loan cooperatives, for-profit finance companies, licensed specialised banks, specialised divisions of universal commercial banks, and government programmes and institutions. The fundamental goal of that research (Rosenberg, Gonzalez, and Narain 2009) was to compile empirical evidence to assist frame the debate over whether microcredit interest rates were appropriate, allowing for a conversation that was more fact-based and less ideological.

In this work, we examine a richer and more comprehensive set of MIX data, which spans the years 2004 to 2011. Although we save the most of our discussion of technique for the Annex, we should make one distinction right away. The preceding CGAP article included data from a reliable panel, which meant that trend analysis was based on data from 175 successful microlenders who had submitted their reports annually from 2003 through 2006. This method painted a picture of what transpired over time to a typical group of microlenders.

Contrarily, the majority of the data in this study comes from MFIs that reported at any point between 2004 and 2011.3 As a result, data for years when they produced reports might include, for instance, a microlender that entered the market in 2005 or one that shut down in 2009. This method, in our opinion, better approximates the position of a typical group of clients through time and provides a clearer picture of the evolution of the entire market. The disadvantage is that because the sample of MFIs was chosen using a different methodology than the prior article, trend lines in this paper cannot be mapped against trend lines in that paper. (We did compute panel data for a consistent collection of 456 MFIs that reported from 2007 through 2011; we utilised this data primarily to verify patterns that we describe from the whole 2004–2011 data set.)

In the paper's Annexe, the data collection and the methods that produced our results are further addressed. The "appropriateness" of interest rates, expenses, or profits will not be heavily discussed in this article as our major goal is to evaluate market developments during the time. This paper's online database, which is discussed later in the text, which readers may use to delve further into the underlying MIX data and, in particular, to examine the dynamics of specific nation markets, is a significant innovation. We may summaries the distribution of the more than 6000 yearly observations from 2004 through 2011 for readers who are curious in the make-up of this group. Notably, this is the distribution of MFIs rather than the number of clients served [9], [10].

Five more years of data show some significant changes in the sector, which is not surprising. For instance, through 2007, interest rates significantly decreased globally before levelling out. Operating (staff and administrative) expenses, whose long-term fall was halted between 2008 and 2011, are partially to blame for this. As micro-lenders expanded beyond subsidized resources and increasingly relied on commercial borrowings, their cost of capital increased as well. Average returns on equity have been declining, and the proportion of borrowers' loan payments that go to profits has drastically decreased. This is encouraging for those who are worried about the exploitation of low-income borrowers, but it may be less clear for those who are worried about the industry's financial performance. Interest rates have increased along with operational costs and the cost of funding for the subgroup of lenders that cater to low-end (i.e., poorer) clients. Contrarily, low-end lenders are significantly more lucrative than other lenders on average (with the exception of 2011, when the group's profitability was hampered by a repayment issue in the Indian state of Andhra Pradesh). But for many readers, the peer grouping that matters the most will be made up of the micro-lenders that are active in a certain nation. We fervently advise these readers to personalize an examination of what has been happening in each particular country using the online pivot tables [11], [12].

## CONCLUSION

The primary determinants of how high interest rates will be, or their components, will be examined, as in the 2009 report, along with interest rates themselves. The difference between

revenue and expenditures incurred by lenders from their interest income is known as profit (or loss). Here is a condensed version of the crucial formula. Behind this study is a thicket of data. We have restricted ourselves to the tops of some of the more significant trees in order to avoid making excessive demands on the reader's patience. Users of the pivot tables may choose from 14 financial indicators and see data for the years 2004 through 2001 that have been adjusted or uncorrected, as well as weighted averages and quartiles, broken down into any of nine distinct peer groups, including specific nations. We had to choose from more than 800 alternative data cuts available to choose which groups of this data to include in the report. The majority of the data on this page is given as worldwide cuts, frequently divided into peer categories such area, for-profit status, lending process, etc.

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# CHAPTER 8

# THE ESTIMATION OF THE COSTS OF FUNDS

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**ABSTRACT:**

Micro-lenders fund their loans using a combination of debt (money borrowed from depositors or other lenders) and equity (their own money). The equity is essentially free, at least for a non-profit lender without shareholder owners who receive dividends. However, using borrowed money comes with a price in the shape of interest charges. Costs of funding have been increasing. The nominal prices at which micro-lenders might borrow money to fund their loan portfolios as rising gradually and steadily. When we consider the real (i.e., net of inflation) cost of capital, this increase is both less significant and more jerky. The most likely reason for the increase in borrowing costs is that as micro-lenders grow, they are able to fund a smaller portion of their portfolios with the limited heavily subsidized liabilities from development agencies, forcing them to rely more and more on more expensive commercial and quasi-commercial debt from local and global markets

**KEYWORDS:**

Average, Costs, Loan, Micro-lenders, Profit.

## INTRODUCTION

Some individuals anticipate a significant reduction in funding costs as more microlenders mobilise voluntary deposits, although this outcome is far from certain. Average funding costs actually appear to be somewhat higher for lenders who significantly depend on voluntary savings than for lenders that accept no such saves across the time period of our analysis.17 Also keep in mind that any reduction in financing costs brought about by mobilising savings may be countered by increases in the expenses associated with managing savings, particularly for small liquid deposits targeted at the micro clientele.

### Loan Loss Cost

The majority of microloans are not backed by any collateral or are secured by collateral that, when collection costs are taken into account, is unlikely to satisfy a defaulted loan amount. Because they may swiftly spiral out of control, outbreaks of late payment or default are particularly risky for a microlender. Sound accounting practise dictates that when a borrower is several payments behind on a loan or something else occurs that lowers the likelihood of full collection, a "loan loss provision expense" that reflects the loan's loss in value should be recorded. Instead of waiting for the whole loan term to end and collection efforts to fail before registering the loss, this practise recognises potential loan losses right away. The provision expenditure is simply reversed if the lender records a provision expense for a loan but the loan is later fully repaid. In this section, we examine microloan portfolio quality (i.e., collectability) via the prism of net loan loss provision expenditure. It is important to note that

this statistic represents real loan losses over time, not merely levels of delinquency (late payments) [1], [2].

In recent months, loan losses have been rapidly increasing in India and Mexico, but the global average has remained mostly steady. The recent collapse of microcredit repayment in Andhra Pradesh is mostly to blame for the rise in India.20 The seeming major issue in Mexico has been developing for a longer period of time. However, average loan loss in the rest of the globe has decreased from a concerning level of over 4% in 2009 back towards a safer level just around 2% in 2011.

The microlenders' reports to MIX were used to establish the loan amounts in Figure 9, which are often but not always based on externally verified financial accounts. However, a variety of accounting policies are used by microlenders, particularly the unregulated ones, to identify and disclose problem loans. Like other lenders, microlenders frequently underestimate their credit risk. The majority of external auditors are extraordinarily tolerant when it comes to allowing overly pessimistic approaches to loan loss accounting, and their errors are rarely on the high side. In order to apply a unified accounting policy to the reporting of those losses, MIX performs an analytical adjustment to reported loan losses.21 The MIX loan loss adjustment may not adequately reflect the risk of each institution's portfolio because the goal of this adjustment is uniformity, not fine-tuning to the specific conditions of a given lender. However, there is little question that the MIX modifications produce a picture that is more accurate than the numbers provided by the institutions' financial statements when looking at large groupings of microlenders [3], [4].

The Mexican loan loss accounting may be quite near to being realistic, as illustrated in Table 1 where MIX's modification has a minor impact on Mexican loan loss rates. However, the adjustment almost triples India's average loan loss for 2011, increasing it from 9.7% self-reported to approximately 29% adjusted. The authors have not gone back to analyse each of the Indian microlenders' individual financial statements in MIX, but it seems likely that there may be a sizable backlog of unreported loan losses that will continue to drag down total Indian profitability in the coming years [5], [6].

**Analysis of peer groups**

In the peer group breakouts for this indicator, the only distinct pattern we've seen is that for-profit microlenders have, on average, had higher loan losses than non-profits do (Figure 10). This would seem to be a first-impressions indication of a tendency towards riskier lending and collection practises among for-profit MFIs on average. Except for the for-profit rise in 2011, which was mostly brought on by the loan losses of Indian for-profits, the gap appears to be closing.

**Operating Costs (and Loan Amount)**

The costs associated with carrying out the loan activities, such as employee salary, supplies, travel, depreciation of fixed assets, etc., are referred to as operating expenditures. Operating costs make up the bulk of the income from most micro-lenders' loan portfolios, hence this factor is the biggest influence on the interest rate that borrowers ultimately pay.

Operating expenditure reductions (i.e., efficiency gains) have stalled recently. The idea that interest rates would decline is a big part of the hope for reduced rates. Micro-lenders become increasingly adept at making loans as they gain experience. According to conventional

economic theory, when businesses (or the industry as a whole in a specific market) gain more expertise, one may often anticipate cost improvements in emerging sectors. However, the most important efficiency lessons are eventually learnt, and the learning curve flattens out; at this point, efficiency increases slowly, if at all, in the absence of technical advances.23 There is optimism that, in addition to the learning curve, the push of competition will compel lenders to come up with more effective delivery methods.

## DISCUSSION

However, the declining trend was halted in 2008 and then again in 2011. Are operational expenses for microcredits approaching the bottom of their learning curve? Or are these hiccups only transient and more efficiency is still to come? At this moment, no conclusions can be drawn—certainly not based on global average behaviour. Efficiency trends vary significantly by area. Operating efficiency has somewhat increased since 2006 in very young markets like Africa and the EAP, but it has remained stable or even grown in all other areas. Operating expenditure as a proportion of the average outstanding GLP has been the metric we have used to gauge administrative effectiveness up to this point. You might think of this ratio as the operational cost per outstanding dollar. It is useful for a variety of things, although comparing the "efficiency" of various microlenders may be tricky. Using a comparison between lenders servicing various target audiences and a comparison between licenced and unregulated lenders, we will elaborate on this crucial and sometimes ignored fact [7], [8]

This type of "efficiency" is frequently equated with good management. However, this can be substantially false, especially when contrasting various microlender types. Even with the finest management, managers at low-end microlenders and unregulated microlenders lend and collect significantly smaller loans, which often cost more to administer than large loans do when assessed per dollar loaned. However, employing this latter strategy makes the premium lender appear worse. Are their managers really any less effective? No, it does tend to cost more to make a single large loan than a single small loan. For example, the larger loan may need further investigation or a more experienced loan officer. The key fact is that operational costs per loan rise along with loan amount, but not at a pace that is proportionate. This leaves us with the same conclusion as at the start of the paper: it is often more expensive to lend and collect a given amount of money through several small loans than through a few large ones [9], [10].

Let's get back to comparing the effectiveness of licensed and unregulated microlenders. The cost-per-dollar metric we employed in Table 2 gave the impression that the efficiency of the unregulated lenders was lower and was really declining. However, if efficiency is used as a gauge of management effectiveness, the comparison is unfair given that unregulated loan amounts are already on average about half as large as regulated loan levels and are continuing to shrink.27 Cost per loan is used in Figure 16 because it is a more accurate indicator of how efficiently things have changed through time. The likelihood that cost control in unregulated microlenders is truly improving is suggested by this presentation.

Returning to the target market peer groups we can see that low-end lenders no longer appear to be particularly inefficient from the perspective of cost per loan, and their average cost levels have remained fairly consistent in comparison to per capita income. In contrast, high-end lenders have been more efficient since 2005 (although part of this is likely due to their decreasing average loan amounts). This explanation of efficiency measures may have been

too complicated for some readers. Instead, we provide a straightforward takeaway message as an apology.

**Mission Drift and Mobilization of Savings**

One prevalent worry is that these commercialized microlenders may progressively abandon their focus on serving low-income borrowers in favour of larger (and ostensibly more profitable) loans as more and more of the microcredit portfolio transfers into regulated banks and other for-profit organisations. The MIX data makes it difficult to uncover evidence to support this issue, though. As we shall see in the next section when we consider lenders' profits, the presumption that larger loans will often be more profitable doesn't seem to be accurate to begin with. In reality, since 2004 (Figure 18), the average loan size in for-profit, regulated MFIs has been progressively declining.29,30 Despite this, mission drift worries may not necessarily be unjustified. If commercialization is causing mission drift, it does not appear that this mission drift is manifesting itself in a broad move to bigger loans.

Smaller (and presumably poorer) borrowers typically have less access to deposit services from their microlenders, which is not unexpected. Figure 19 demonstrates that compared to institutions that offer little or no voluntary savings, banks that offer considerable voluntary savings services have loan amounts that are significantly greater. Additionally, the magnitude of the loans is increasing in the former while decreasing in the latter.

**Benefits**

The difference between revenue and expenses is the term for profit. Net profit is frequently expressed as a proportion of assets used or as a percentage of equity investment in financial institutions.

**Profits in Context**

Prior to examining the quantity and trajectory of MFI earnings, we must first define how profits will affect borrowers. Because microcredit earnings are so debatable, it might be simple to overestimate their impact on the interest rates that borrowers must pay. Figure 20 illustrates how much microcredit interest rates would decrease in the unlikely scenario where all lenders decided to forego any return on their owners' investments. Even without profits, rates would still be quite high, thus their influence is not negligible. Naturally, these figures are average; there are numerous micro-lenders whose earnings account for a higher proportion of the interest they charge. Notably, profit's influence on interest rates is waning. Profit as a proportion of interest income decreased gradually from over 20% in 2004 to around 10% in 2011.

**Micro-lender Profit Level and Trend**

The industry has a wide range of profit levels. About a quarter of microlenders had yearly returns on shareholder investment in 2011 that were more than 20%. Profits of more than 40% were made by about 5% of the total. Only seven of the 44 MFIs with returns on equity above 40% in 2011 were big lenders with more than 100,000 clients out of a sample of 879 MFIs. On the other hand, many microlenders experienced financial losses, particularly in Africa and South Asia (where certain lenders operating in Andhra Pradesh had a very terrible year). Profits are the most contentious of the numerous interest rate factors. Some believe a microlender has no right to say it is working towards a "social" mission if it is making a

profit—even a very little profit—from the services it provides to underprivileged customers. Others contend that more competition will eventually drive down prices and spur innovation and rapid service development. We won't try to quantify a "reasonable" profit level for microcredit because it is very difficult to do so from empirical data.32 We are only able to compare the average profitability of commercial banks and microlenders.

**Peer group analysis:**

Unsurprisingly, for-profit microlenders generate stronger returns on equity than non-profit MFIs, with the exception of 2010–2011, when the group's performance was negatively impacted by Indian for-profits. More unexpectedly (at least to some), low-end lenders have often been far more lucrative than broad-market or high-end lenders, with the exception of 2011, when low-end lenders in India suffered the brunt of the financial crisis.

**Rates of Interest**

The nominal interest yield of MFIs decreased from 2004 to 2007 but did not fall from 2007 to 2011. In 2011, it averaged approximately 27%. Interest rates for microlenders who cater to low-end borrowers have been rising. Banks and other regulated microlenders' rates have decreased, but NGOs and other unregulated microlenders' rates have increased.

**Price of Funds**

As microlenders finance a larger portion of their portfolio with commercial borrowing, funding costs have increased significantly. Microlenders servicing low-end clients have seen the largest increases in funding costs. At least so far, voluntary savings mobilisation has not resulted in a reduction in funding expenses. Loan Losses Despite recent substantial increases in bad loans in two important countries, Mexico and India, global average loan losses have remained mostly stable. According to MIX's analytical loan loss adjustments, several Indian microlenders' 2011 financial statements may have significantly underestimated their likely loan losses, resulting in an overhang that might continue to hurt their profitability in coming years.

**Operational Costs**

The biggest factor affecting interest rate levels is operating expense. Though trends vary by location, the drop in the average operating expenditure (i.e., increase in efficiency) has slowed recently. In Africa and EAP, the cost per dollar outstanding has decreased significantly since 2006, whereas it has stagnated or increased in the other areas. The operational cost plateau that has occurred over the previous several years might signal the bottoming out of the learning curve effect, or it could be the beginning of additional drops. The most common metric for measuring operational performance is cost per dollar outstanding, however doing so when comparing different micro-lenders' abilities to control expenses can be quite deceptive. Not surprisingly, low-end micro-borrowers have much less access to savings services than high-end micro-borrowers. Average loan size trends do not support a hypothesis of mission drift in commercialized micro-lenders. Over the period, average loan sizes dropped much more among for-profit micro-lenders and regulated micro-lenders than among nonprofit and unregulated micro-lenders.

**Profits**

From around one-fifth in 2004 to less than one-tenth in 2011, the portion of borrowers' interest payments that went to micro-lender profits fell. Although micro-lenders often provide lower returns on shareholders' investments than commercial banks do, their average returns on assets are somewhat better than those of commercial banks. Over the course of the time, micro-lender returns on shareholders' equity decreased significantly; a large portion, but not all, of this decline is attributable to the grave recent issues in the Indian state of Andhra Pradesh. With the exception of 2011, when the Andhra Pradesh crisis negatively impacted low-end micro-lender profitability, low-end markets were much more lucrative than others over the time.

We implement standardized procedures for loan loss provisioning and write-offs, and that's our last step. The way that MFIs account for late payments on loans varies greatly. The day a payment is missed, some lenders consider the full loan sum to be past due. Others wait until a loan's entire term has passed before deeming it late. While some MFIs never write off poor loans, carrying on a defaulted loan that they have little hope of ever collecting, others do so within a year of the first delinquency [11], [12].

## CONCLUSION

Any loan with a payment that is more than 90 days late is categorized as "at risk." For loans that are 90 to 180 days past due, we provide 50% of the outstanding total, and for debts that are 180 days past due or more, we offer 100%. Delinquent loans may be renegotiated (refinanced or rescheduled) by some institutions we provision all renegotiated amounts at 50% since the risk of default on these loans is higher. As soon as we have enough information, we make adjustments to ensure that every debt is entirely written off within a year of being late. (Note: These provisioning and write-off policies are solely used for benchmarking. We do not advocate that all MFIs implement the same set of rules.) These adjustments are, for the most part, an approximate estimation of risk. They merely serve to level the playing field for benchmarking and cross-institutional comparison at the barest minimum. Despite this, the majority of participating MFIs have strong loan portfolios, thus loan loss provision costs does not significantly affect their overall cost structure. We would simply exclude a program from the peer group if we believed it did not accurately reflect the general degree of delinquency of the population.

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# CHAPTER 9

# FINANCIAL SERVICES THAT CLIENTS NEED: THE BUSINESS MODEL RECONCILING OUTREACH WITH SUSTAINABILITY

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**ABSTRACT:**

Microfinance has improved the lives of disadvantaged families throughout the world by supporting their ability to generate money, regulating their spending, and providing assistance. Helping them achieve crucial family objectives like education, housing, and retirement income security. In a number of nations, the development of microfinance has contributed to financial deepening and overall economic progress. This has been amply demonstrated in Bolivia, where private microcredit now accounts for 13% of all private bank credit in the economy and private microcredit is now worth 11% of GNP. The truth has always been that offering formal financial services to low-income households is a challenging business, notwithstanding claims made in early development finance literature that the lack of credit was caused by hesitant bankers and morally bankrupt, stupid impoverished consumers. Due to their lack of experience in this area, banks are unable to envision how these services may be offered successfully. When poor families consider the financial services now available, they cannot understand how they are appropriate for their particular situation. This confirms the view held by traditional retail banking that the poor are not a lucrative business segment since they do not save and pose significant credit risks

**KEYWORDS:**

Families, Financial, Microcredit, Services, Significant

## INTRODUCTION

In addition to potentially enhancing the lives of low-income families and the wider populace, formal financial services can also advance economic development. A country's ability to finance its economy is correlated with its rate of economic expansion overall. Countries with more private lending to private businesses and active stock markets experience faster economic expansion than those with less developed banking systems. Additionally, well-functioning financial systems reduce the financial barriers that impede the growth of industries and productive sectors. Lendol Calder makes a strong case that the growth of the consumer finance sector in the 20th century influenced the behaviour of the middle class in North America. Entering into credit agreements typically requires the borrower to give up some of their current consumption to repay installment credit, become more selective about the consumables they buy, and work longer hours to obtain their material goals. Consumer credit has grown to be a significant driver of economic growth, and governments go to great lengths to keep the cost of credit low for consumers and home buyers during economic downturns [1], [2].

The benefit of a financial service for the poor will always be much larger than transaction costs. The maths makes sense. The costs are proportionately higher for smaller transactions,

whether it costs a bank a dollar to have a customer withdraw cash from a teller window, 35 cents to have that same customer use an ATM, or ultimately 15 cents to use a mobile money network.7 Up until now, the poor have resided further away from the national financial system's hubs than their middle class neighbours. Agent banking will surely bring connection points much closer to the poor, but it will also bring many more points closer to the burgeoning salaried middle class, who is supposed to be their main benefactor. The poor will probably always pay more to access any system and conduct transactions, especially in relation to the volume of their movement. They will still have to pay the fees these connection points will demand to handle cash or spend more time to go to the connecting point. We have a long way to go before the economy is totally digitalized and those expenses become meaningless.

Any provider of formal financial services faces an additional barrier because of how risky the lives of the impoverished are. They have a very limited planning horizon because to their very erratic revenue and the potential for significant, abrupt changes in their overall financial status. The loss of a job, a health emergency, or some other catastrophic occurrence causes a sizeable percentage of the poor to fall below the poverty line in any given year, despite the fact that a great number of the poor manage to escape poverty. While having access to formal basic financial services can aid households in it is more difficult for the financial institution to build and offer products that improve the bottom line as a result of this unpredictability [3], [4].

On the credit side, income fluctuation makes it harder for lenders to do their jobs. The lender has a tough time determining a potential client's creditworthiness due to the asymmetry of information on family income and cash flows and the degree to which he or she fulfils his or her financial commitments. Additionally, once a credit connection has been created, the variance in income and cash flows during the term of the contract may occasionally make repayment seem in jeopardy. On the savings side, the erratic nature of income and cash flows can make it challenging to build up sizable account balances. Given the inability to make direct electronic wage transfers, for example, it is difficult to deposit money into the account on a regular basis. It can also be challenging to maintain balances in the face of unforeseen household expenses. On the insurance front, poor families would seem to be excellent candidates for micro-insurance due to their increased risk exposure, but they are typically hesitant to pay for the intangible 'benefit' of a payout in the unknown future for an uncertain (but relatively likely) occurrence. Numerous low-income households have yet to benefit directly from microinsurance in any significant way [5], [6].

These fundamental difficulties posed by the nature of the poor and their transactions must also be seen in the light of the wider array of other opportunities in retail banking for those who support a financial inclusion agenda. Consumer finance, auto and housing finance, bill payments, and currency operations can all generate more profits faster without undergoing the significant institutional change required to successfully serve the poor, especially in areas where there is a sizable emerging middle (salaried) class. Unless the services are an expansion of those currently offered to paid workers in the same locations, there may be a significant opportunity cost to entering the low-income sectors. This appears to be especially true for middle- and lower-income nations where a sizable fraction of the population works as a paid wage worker. The current methods of micro lending need the employment of a relatively large number of specialized loan officers, who may soon make up a significant

fraction of the overall workforce in a retail bank. Senior management are hesitant to enter this labor-intensive line of products due to the influence of banking labour unions in many locations. The pay for bank employees is likewise decent. When integrating less well-paid micro lending loan officers into the bank, there is sometimes a difficulty with internal equity. The incorporation of the microcredit model into commercial financial institutions is further complicated by the fact that microcredit loan officers frequently get remuneration that is far higher in variable incentive-based pay than bank officers.

## DISCUSSION

Microfinance institutions have easier access to financing when financial markets improve, particularly if local capital markets expand. Often, it appears that they can get money more quickly and readily from domestic and global financial markets than if they tried to pounce on local savings. The deposit mobilising branch or agent network requires a significant initial outlay for infrastructure. Results of microinsurance have been uneven. Credit-life insurance is widely accepted and has been offered in conjunction with microcredit agreements; many MFIs see it as a significant source of income. However, clients have not embraced the concept of insurance all that much. Perhaps not enough customers have benefited from having an insurance policy, and as a result they do not see this financial service as having any tangible value, especially if they are required to pay monthly payments. Perhaps the present line of items is really a continuation of those that were created for prior, quite distinct market sectors and does not actually address significant client demands. We still have a long way to go before the poor consider micro-insurance products to be a typical part of their portfolio, according on early experience with the products [7], [8].

The fundamental loan types and distribution strategies for microcredit were established by 1985. All of these very tiny organizations—individual loans, solidarity group lending, and village banking—were being replicated all across the world. Village savings and loan organisations were afterwards created separately in Asia and then Africa. All four strategies target pretty clearly defined client categories and have highly standardised operating mechanisms. The poorest customers are often the focus of organisations that employ "village banking" or "savings and loans groups," whereas the less impoverished are the focus of organisations that utilise "individual loans." Since the late 1980s, organisations that have focussed on the original three lending techniques have focused on strengthening organisations that have the best chance of expanding to encompass hundreds of thousands or perhaps millions of microcredit consumers. After twenty years of strong development, a number of concerns have been voiced regarding the ability of microcredit to help the poor escape poverty (something many members of the general public believed it could achieve). Additionally, a string of occurrences, including initial public offerings (IPOs), aggressive behaviour, and even predatory practises, have exposed the purely economic basis of particular organisations. We are currently observing a desire to refocus on clients as a result of this.

For many people, this entails bringing up topics related to the high calibre of the provided financial services. They are questioning if the loans are beneficial for the borrowers, whether they are being issued ethically, and whether the interest rates, solidarity techniques, and collection tactics adhere to the ideals of "responsible finance." The problems are NOT Despite the fact that consumer finance is the topic of this chapter, the author sees these conversations as crucial in a rapidly evolving field and as a particularly effective way for

organisations supported by the development community to set themselves apart from consumer finance in general.

This article contends that it is now necessary to refocus our efforts on offering a wider range of formal financial services that are more user-friendly, secure, and inexpensive for low-income consumers. Can we address the fundamental problems with helping the poor that have persisted throughout time and are only partially resolved? Can we develop new delivery methods, goods, and company structures that result in significant improvements in the availability of formal financial alternatives to informal finance? Exist any customer segments that we have the ability to reach but do not? Are there family lifecycle events for which we might develop products to prevent families from falling into poverty? Anyone who thinks that the growth of national banking systems depends in large part on financial inclusion should be concerned about the answers to these concerns. The search for innovation that will be necessary to reach the hundreds of millions of unbanked in lower-income nations will be driven by these questions.

**Market Segments**

Microcredit, and even other non-credit financial services, do not adequately serve a sizable proportion of households that survive on less than a $1 per day (per capita). According to a market study of formal financial services conducted by Oliver Wyman for the Bill and Melinda Gates Foundation in 2008 and 2009, the vast majority of these poor people worked primarily in agriculture, casual (day) labour, domestic work, and small- and microbusiness labour. Even though some people are undoubtedly included in solidarity groups in many countries, most micro-credit programmes do not specifically target these groups. Microcredit remains biassed towards informal sector workers who engage in 'urban-based' independent economic activities (even if these take place in small towns in rural areas), and NOT towards the needs of farmers, low-level salaried workers, and casual labourers for education, health, shelter, and consumption.

**Too Poor for Credit**

In many nations, conventional microfinance ignores the needs of even more impoverished employees in the informal sector. It may be more beneficial to use a strategy like BRAC's "ultra-poor" graduation programme, which combines in-kind income support with a savings product that, over time, builds the capacity to repay tiny loans through newly developed income-generating activities, because the incomes earned by the bottom quintile of the income distribution are too variable to support credit relationships. In order to help the poorest households, several middle-income nations have implemented conditional cash transfer programmes in recent years about the best way to transfer these cash flows into bank accounts. This links these families to the country's financial system and to networks for transactions, enabling them to take use of various governmental and financial services. These initiatives may have a more immediate impact on reducing poverty than microfinance, particularly for households without microenterprises [9], [10].

**Regional Inequalities**

Some regions, such as Latin America and South Asia, have successfully penetrated a sizable portion of the conventional "targeted" clientele. Although there are exceptions in certain nations where microfinance has a long and strong heritage, such as Morocco, Bosnia,

Uganda, Ghana, and Indonesia, other regions have lagged. Sub-Saharan Africa has not had the same 'take-off' of microfinance as either of the pioneering areas. While microcredit has mostly been an urban and periurban phenomenon in Latin America, programmes throughout South Asia have had a "rural" bias, focusing their loans on small towns and villages.

**Classes of Clients**

Despite this, there are still sizable, largely underserved communities in even the nations with the highest market penetration. The goal of the numerous solidarity group programmes offered by Grameen, BRAC, ASA, Proshika, and others, for instance, was never to create the Bangladeshi version of the Latin American microenterprise (a small-scale furniture maker). The very impoverished female residents in rural parts of Latin America are also comparatively less extensively served, with significant outliers like the Mexican clients of Compartamos and the Bolivian clients of Crecer and Promujer.

**SMEs**

There has recently been a lot of worry about a financing deficit for small businesses, which play a significant role in creating jobs and advancing the global economy. According to a recent estimate by the IFC, roughly half of SMEs lack the loans or overdraft lines of credit they require for business purposes.12 They listed the obstacles to SME financing as a higher degree of default risk brought on by information asymmetry, a lack of credit bureaus, poor loan origination capability (analytical techniques), weak legal frameworks for enforcing loan contracts, a lack of policy support, high transaction costs, among other factors. When compared to medium-sized enterprises, these obstacles are significantly more important for small businesses. Small enterprises are typically controlled by families, and they continue to combine personal and corporate money. They are less formal, notably in terms of how thoroughly financial transactions are recorded in books and financial accounts, which serve as the foundation for bank credit. They are less integrated and more vulnerable to business risk involving the primary owners and operators. The Global Partnership for Financial Inclusion (GPFI) of the G20 is where the IFC is now working to coordinate the activities of development finance institutions in this area. The IFC has identified over 150 models for lending to SMEs.

**Small Farmers**

In the Oliver Wyman research of under-served clientele living on less than $2 per day, 600 million farmers made up the single-largest category. Increased access to financial services and well-designed products may have a significant impact on the growth of impoverished nations overall as well as on disadvantaged rural families. For instance, a 1% rise in GDP related to agriculture would raise spending by the lowest 30% of the population by almost 2.5 times more than growth in any other sector. From a gender perspective, research indicates that if women in developing countries had equal access to productive agricultural resources as men, farm yields would rise by an estimated 20–30%, increasing national agricultural output by 2.5–4.0%. However, estimates suggest that growth in agriculture is approximately 3.2 times more effective at reducing poverty for people living on less than USD 1 per day than non-agricultural growth.

**Casual Labourers and Low-Wage Salaried Workers**

Day labourers and low-wage employees made up the second-largest segment of the Oliver Wyman study's underserved clientele, not microenterprises. In these two groups, there are almost as many people who make less than $2 per day as there are small farmers. Additionally, they are not the target of the majority of microlending initiatives since their revenue is either highly erratic or comes from pay. The majority of these workers are day labourers on farms or construction sites, domestics working in houses, or employees of micro and small companies. They do not have access to official financial services other than remittances. Their inconsistent incomes—whether it be because it fluctuates from day to day or season to season (for casual labourers) or because of job insecurity (for employees)—are the main obstacle to their access.

**Life-Cycle Events**

Although some client segments are currently underserved by a comprehensive array of formal financial services, even those who do have some access typically only have access to one, extremely restrictive, and highly standardised product that primarily serves as an additional source of general finance for the household. Organisations focused on achieving volume as rapidly as feasible in order to develop sustainable, scalable financial institutions to serve the underprivileged. In terms of products, this meant a one-size-fits-all strategy. However, in order to achieve our various family goals, every one of us—the poor included—needs different financial goods and services at various times in our lives.

Young couples require funding to consummate their union, establish their home or company, and cover the expenditures of having their first child. Later, they will need to put money aside for their children's education, marriage, and provision for their own ageing bodies, for a day when they won't be as active. They frequently have to rely on money from their children, rent from homes they own, government assistance, and their personal savings as they near the end of their life. Funeral costs may be expensive when a person passes away. Low-income households have a range of unique financial demands, many of which may not be adequately met by the microfinance products now available since they were created to fund working capital for commercial and productive operations. The cash flows connected with certain of the longer-term activities managed by impoverished households may not be well suited to either loan or savings products, despite the fact that both are effective for general short-term needs. They also aren't adaptable enough to accommodate the specific cash flows linked to household financial objectives. Because their re-payment dates don't coincide with household financial flows, borrowers frequently find themselves having to borrow money from other sources to repay microcredit.

**Investments in Productive Assets:**

Families frequently need to acquire expensive items like freezers, over-lock machines, and water buffaloes, whose repayment schedules would benefit from being stretched out over much longer periods of time than is typical with microcredit. Although they do so gradually, these assets do help the family's income. Servicing this loan would exhaust the whole household's repayment capability when MFIs want payback in 4-6 months, as is frequently the case, eliminating any additional funding for requirements like schooling, working capital, or emergency expenses.

**Emergencies and/or Catastrophic Events:**

Sudden emergencies happen in every family. Someone falls sick, loses their job, or passes away in their family. A family's finances may also be strained by a variety of minor, less significant occurrences that call for quick care. With a few exceptions, the majority of MFIs do not make cash instantly accessible upon request to cater to such crises, despite the fact that many "savings and loans" organisations and village banks do offer an emergency loan provision. Few MFIs accept deposits, which might be useful in an emergency and be far less expensive for the consumer than borrowing. And occasionally, terrible weather, civil unrest, or other disasters affect families, wiping off all of their assets. Currently, "credit-life," which covers the outstanding loan debt and, in many circumstances, enough to pay for part of the borrower's burial, is the primary micro-insurance that is readily offered. Index-based insurance that would safeguard assets in the event of a weather-related loss has not yet established a solid track record, in part because weather stations and their historical data are in poor shape [11], [12].

## CONCLUSION

The majority of low-income households must gradually assemble building supplies to expand or renovate their dwellings. The optimal time for families to start saving is when they "have a little extra" they can put aside. Building supplies can be bought with cash to create a less liquid asset that retains value. These resources are vulnerable to theft, loss, and deterioration owing to weather conditions, which raises the price of creating wealth. Education, weddings, and other large expenses: Every family has specific times when major expenses entirely outweigh monthly budgets, necessitating the need for additional funding. Savings for yearly holidays or festivals, coming-of-age celebrations, funerals, medical expenses, scheduled surgeries, transportation, or weddings are classic examples. The timing of these significant purchases typically does not match the highly structured microfinance programme that may be offered in the community. When most of these objectives might be achieved with programmed commitment savings accounts at a far lower cost to the poor, if they were accessible, the majority of microfinance still takes the form of loans. Numerous client groups and significant life cycle events that affect families contribute to the potential need for well-designed and executed financial services, which is now unmet. A strategy to refocus on customers should be developed around a range of secure, inexpensive, and simple-to-use solutions that cover a substantially wider range of objectives, cash flows, and behavioral concerns.

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# CHAPTER 10

# CLIENT CENTERED INNOVATIONS THAT BUILD ON CORE PRODUCTS

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**ABSTRACT:**

Instead speaking in generalities about creating goods and services that are more suited to clients' financial situations, we should strive to understand how they can differ from what is now offered. What's so remarkable about refocusing on customers when it's obvious that the poor utilize existing goods for a wide range of objectives and circumstances. The section that follows describes a number of ground-breaking goods or services that, according to our definition of microfinance in this chapter, reflect microfinance Version 3.0. They incorporate particular elements that shape the connection around behavioural traits that aid in the attainment of family goals and that take into consideration family income flows while drawing on the lessons we have learnt about what works for the impoverished. These goods weren't picked because they were enormously popular; rather, they were chosen for their capacity to serve as examples. If these particular innovations are helpful and durable, only time will tell. Together, they offer insight into the characteristics of more client-focused future developments.

**KEYWORDS:**

Banking, Customers, Financial, Money, Services.

## INTRODUCTION

One particularly significant application of micro-credit concepts to a new target population that requires goods that react to a quite different cash flow is agricultural microfinance. Traditional Latin American micro-lenders have modified their methods to provide loans that directly support agricultural producing operations. Loan officers with agronomic training have been engaged by Agro-Amigo, PRODEM, Caja Los Andes, and PROCREDIT El Salvador to provide loans to farmers with terms and conditions that are tailored to the crop cycle. For instance, loans may have balloon payments due during harvest and disbursements that are spaced out to account for crucial points in the investment cycle, such as planting and soil preparation [1], [2].

A number of urban MFIs have lent to particular subgroups of micro-entrepreneurs using a value chain strategy. The "Patrimonio Hoy initiative" by CEMEX in Mexico stands out as one of the most intriguing examples of a client-driven approach to product design. Cement and other building materials are sold by the Mexican business CEMEX in metropolitan areas. The team of Patrimonio Hoy spent several months with slum inhabitants to learn their lifestyles, their construction habits, and their contacts with the distributor of building supplies, as Prahalad explains in his book, The Fortune at the Bottom of the Pyramid. As a consequence, they created a financing model based on solidarity groups that allowed

customers to save money for construction supplies before eventually borrowing a bit to finish their tiny projects. Local employees ran the savings and credit clubs, and the approach included local wholesalers in a way that boosted their sales [3], [4].

**Deposit Mobilization**

This is perhaps the most promising area for future design and delivery innovation. It would appear that there would be plenty of room to develop products around particular family objectives, such as covering yearly school costs or planting expenses, and around particular financial flows, such as harvest payments or the daily income from a microenterprise. A field trial with the Opportunity International Bank of Malawi examined the viability of this strategy. Smallholder cash crop farmers were given the choice in this (randomised control trial) exercise between a regular savings account and a commitment savings account, where they voluntarily "froze" their accounts until a certain date just before planting season so the money would be available for farm inputs. The relatively few farmers that adhered to the pledge produced a rise in agricultural input consumption (9.8%), as well as an increase in acreage under cultivation household spending in the months right after harvest (17.4%), agricultural output in the next harvest (22%), and puts (26%). When farmers faced demands from their social networks, they could "credibly claim" that their money were restricted thanks to commitment accounts [5], [6].

**Micro-insurance**

When compared to microcredit and deposit mobilisation, microinsurance is still in its infancy. Simply put, we don't know which things, except credit-life, benefit the poor the most. In reality, the MFIs that provide credit life generally get a decent deal. Making ensuring that microinsurance provides the poor with excellent value is the main difficulty. The Micro Fund for Women in Jordan's "Carer" insurance product is one illustration of an innovative approach to insurance. The organisation first concentrated on creating a conventional health insurance product that would guarantee its customers could receive the healthcare they need by collecting a premium that would then cover costs at the doctor's office or the hospital. They arrived to the conclusion that the ladies had access to health services but were putting them off because of the additional expenses associated with hospitalisation after researching their customers' demands as they connected to health occurrences. As a result, they created the Care-giver policy, which pays a daily rate for each night spent in the hospital as well as hospitalisation expenses, missed wages from time spent hospitalised, transport expenses, and other expenses related to missing work while ill. Customers liked the solution because it filled in the gaps in the expenditures related to a health incident. Even after paying out 300 claims over a clientele of 13,500 women after a year, the product claimed to have achieved complete sustainability. Additionally, women are receiving care more often than in the past [7], [8].

However, understanding customers involves more than just identifying a new market niche to exploit. The Micro Insurance Learning and Knowledge Project (MILK) of the Micro Insurance Centre is drilling much deeper than any other effort in an effort to examine individual insurance products from the perspective of the business case for the insurer and to determine whether these products represent good value for customers. To determine if their investment in premiums is a wise one, the subsequent "Doing the Math" activities compare premium payouts to the alternative methods that low-income households would typically pay

for the cost of risks covered by the insurance. Even though they are not RCTs or impact studies, they do represent an important step in how we should be interacting with customers when designing micro-financial products in the future!

## DISCUSSION

The reform of the national payments system, as seen from the standpoint of potential customers, may be the most significant advancement in the financial services sector in many years. We still need to see, but the potential. Yang, Burne, Gine Goldberg, and "Commitments to Save: A field experiment in Rural Malawi", May 2011. It may be possible to reduce transaction costs to previously unheard-of low levels, opening the door for the inclusion of exponentially more people with lower incomes. These transactional systems are increasingly facilitating conditional cash transfers, other government payments, tax payments, and the transfer of money (remittances) between private individuals. Initially, these systems were developed on retail networks to clear banking halls of bill payments. These two latter tasks have the potential to involve hundreds of millions of impoverished people who make less than $2 a day and could serve as a key component of any national financial inclusion strategy [9], [10].

### Payments Systems

Several nations have made investments in the growth of their national payments systems during the past ten years. In order to provide access to the financial system in communities and villages without bank branches, certain nations have taken steps to develop transactional platforms that link non-banking (retail) infrastructure with it. The benefits of using these "agent" banking systems to send government-conditional cash transfers, wage and other payments, and even private remittances, are being recognised by national governments. when a result, governments incur less expenses when making these payments and have more control over how money flows when it leaves the informal sector and enters the financial system.

Brazilian agent banking is the best in the world. The four major banks that control the majority of the agents quickly covered practically all 5,564 municipalities in the nation after their formation in the late 1990s. Currently, they handle tiny transactions worth well over a billion dollars annually through their 150,000 or more agents. According to CGAP, bill payments make up about 90% of transactions in urban regions, while deposits, withdrawals, loan repayments, and other activities made up 60% of transactions in rural areas. Due to the current fee structure, profits are higher in rural regions even if there are fewer and smaller transactions per day. Because to agent banking, there has been a significant 500% growth in consumer lending. 'Simpli- fied' saving accounts were established in at least 12 million instances.

The troubles the Brazilian agent-banking system has encountered are undoubtedly a sign of what most other more recent systems will experience in the years to come. Agents worry about a lack of protection; 41% have reported being robbed, with an average loss of $8,100; they are liable for the first $540 of that loss. Nearly 30% of employers say their own employees have embezzled money. And 16% have had customers commit fraud, primarily using fake currency. The majority of agents visit the bank twice daily to clear their accounts and spend a significant amount of time managing cash. In many places, poor connection cuts profit margins from 10% ($124) per month to 2.6% ($27) per month. Since most agents do

not actually know how much money they are generating from fees, they do not consider it a driver for the model.17 The average agent makes a pitiful profit of $5 per day. Banking agents have noticed a significant increase in their other business as a result of increased foot. In February 2010, CGAP published "Branchless Banking in Brazil: Building Viable Networks." be the main driving force behind their continued participation. Nevertheless, agent banking is essential for boosting financial inclusion in rural regions.

**Mobile Money**

One really intriguing agent-banking variation is mobile money. Through a huge network of agents, most of whom are airtime resellers, mobile money enables consumers to transmit money through their cell phones. These resellers are dispersed throughout the nation, but are particularly prevalent in less affluent areas and rural communities that frequently receive remittances from relatives who work in urban areas. The goal is to significantly reduce transaction costs for fundamental financial services, maybe to less than $0.15. Most airtime resellers and other agents are tiny, regional companies that only pay their staff a small portion of what a bank teller would make.

M-Pesa in Kenya, where 15 million Kenyans have used the system to send money to others since 2007, is the most significant mobile money experience to date. M-Pesa processes more transactions per month than Western Union does worldwide. The mobile money business, which is still expanding, is a substantial source of revenue for its Telcom parent company, Safaricom. Families that use M-Pesa have significantly decreased their transaction costs from $3 per payment to less than 50 cents. A study has shown that clients who use M-Pesa can maintain a better pattern of consumption, and in particular, a better food consumption pattern when facing negative income shocks, such as losing a job, cattle death, crop or business failure, or health shocks. This is because M-Pesa's effectiveness as a money transfer system turbo-charges social networking.

Unquestionably, the growth of this mobile money network is fostering tremendous innovation in the financial and other services provided to the poor that are based on a constant flow of extremely modest transactions. Journalists noted early on that the expansion of banking agents into a few previously untapped regions of Brazil's Amazon River had increased levels of company growth and, as a result, municipal tax collection. Local households were able to get their remittances, salary checks, and other payments locally and spend them as well, rather than needing to travel several hours down-river to transact. Exploration of this influence on neighbourhood economies and, ultimately, national economies is only being started. Four local effects of M-Pesa were found, according to a recent study [11], [12].

**Growth of the local economy**

Essentially, the researchers discovered that M-Pesa facilitated higher money movement, which enhanced local spending. For other people and local business owners, this meant additional sales. The establishment of M-Pesa agents also resulted in new business and job prospects; current store owners may also broaden their offerings by integrating this now-highly sought-after service.

**Security**

The study concluded that M-Pesa helped to money security by enabling users to safely deposit money in their mobile money account, in addition to physical security (i.e. muggers realising that few people carry liquid cash).

**Capital accumulation**

The ability to save money rather than spend it allowed wage workers to safely amass financial resources on their phone without using a bank account or a less secure method, such putting cash under the mattress.

**Business environment**

"M-PESA boosts the flow of cash and lowers the total transaction cost of transferring capital along a network. In Kenya's official financial systems, M-PESA transfers the least amount of money, but its volume and number of transactions are growing, reaching a wider range of Kenyans in terms of income, age, and access depth and breadth (Jack and Suri, 2009). Additionally, a new AfDB brief explains why it believes that M-Pesa may be contributing to Kenyan inflation since the velocity of its transactions is three to four times higher than other components of money. This is likely one of the few negative externalities of M-Pesa.

The question for all agent-banking systems from the client's perspective is whether they can reduce transaction costs to the point where new services can be developed or where classic financial products may gain in appeal. The experiences are still fresh, and the fee arrangements are still in flux. For instance, M-Pesa's current cost structures reward small savers. Only withdrawals from the system are charged; deposits are free. Small savers who consistently deposit money but seldom take it would benefit from this, which is a trend that financial organisations would like to promote. However, M-Pesa brokers are already pushing for fees on all transactions, which may quickly reverse this 'favourable' bias against those who routinely save modest sums of money. It is impossible to predict whether the poor will pay less as a percentage of the overall transaction until charge structures are finalised. It will be intriguing to watch if mobile money can expand faster than it does right now. Banks are now preventing it in a number of nations.

Pushing (non-mobile money based) agent-banking models into less affluent villages and towns in less developed nations will be another difficulty. As of now, medium-income nations with a sizable "bill-paying" middle class and sufficient transaction volume to support the system have seen the fastest growth of agent-banking models. On the strength of remittances and conditional cash transfers, new systems are being floated in the world's poorest nations. It is obvious that these volumes are insufficient to float the more capable "Brazilian" type banking agents. The creation of agent-banking transactional platforms does not, however, ensure the creation of client-centric, higher-value financial products that are more responsive to family objectives, cash flows, and vulnerabilities. A poor individual in a rural should not be deemed to be "included" only because they receive a remittance from a family member in the city or a conditional financial transfer from the government. The most fundamental measure of financial inclusion should be the ability of a person to deposit money into an account for an ad- hoc purpose and ad- hoc period of time. Then, based on the volume of transactions in these accounts, we should ask if they are actually beneficial. Then and only

then will we be able to determine if the proliferation of agent banking is the most important pro-poor disruptive 'technology' in the history of contemporary retail banking.

**The Value of Stable Institutions**

To provide customers with a wider variety of more sophisticated financial services that are secure, inexpensive, and simple to use, strong banks are essential. The requisite financial and human resources can only be invested in next-generation goods by organisations that have attained continuous profitability, a strong equity foundation, safe access to money from financial markets, and wide-ranging outreach. These next-generation financial services must be delivered at very large scales because of their economics scale that can only result from that scale at a very cheap price point. Low-balance savings accounts, a larger selection of micro-insurance, and more individualized credit products will all necessitate much lower transaction costs. New business models that combine microfinance institutions with administrators of national payment systems, providers of insurance and reinsurance, national retail chains, and perhaps even mobile phone carriers will give rise to many of these goods.

Fortunately, the microfinance industry has grown extremely consolidated in most nations, reaching more than 80% of all consumers through the top five MFIs.22 The top 200 MFIs can make the significant expenditures in back-office MIS, branch and agent networks, market research, and more employees since they all have several million or 10 million dollars in equity. They operate on a national scale, provide services to tens of thousands or even millions of customers, and frequently have already formed significant business alliances to open up new options for customers. Despite this, there are still numerous nations in which no MFI has attained the necessary scale to engage in the agreements supporting Version 3.0 business models that will better meet the interests of clients. In order to build the essential supporting infrastructure in such nations, support organizations, microfinance investment vehicles, and donors will still need to offer technical help, access to international financial markets, and support. To successfully promote the partnerships that will form the new business models for complete financial inclusion, governments will need to put in place the proper regulation and supervision schemes, non-bank financial institution frameworks, payments/transactions networks, and coordinate among a variety of agencies.

The establishment of the Global Partnership for Financial Inclusion of the G20 and the Alliance for Financial Inclusion, which brings together the leading financial authorities from approximately 80 countries, are both significant moves in the right direction. Both programmes have contributed to a growing understanding of how crucial it is to include the majority of the people in the official financial system in order to promote economic growth, food security, and the fight against financial crime. Global technical organisations like CGAP, UNCDF, the UN Special Advocate for Financial Inclusion, the IFC, and others who have given their skills have generously supported these organisations.

If it becomes our primary client-facing goal, it may also detract from the larger purpose of comprehensive financial inclusion. Responsible finance doesn't advance the sector or offer a variety of suggestions for how a larger and more varied clientele might be supplied with a wide range of beneficial products. It emphasises "do no harm" far too much and "do good" far too little. Only because we have strong, resilient financial institutions with a double bottom line and a concern for reaching the lower market can we shift our attention back to our clients. To promote the field's expansion, we must be more resolute. A sizable number of

market sectors are underserved, and the necessary institutional structures still need to be established. Building the required infrastructure that can result in the biggest reduction in transaction costs in the last 40 years is more crucial than ever for governments. To guarantee their profitability, businesses may occasionally need to make their infrastructure available, push their transactional volume through payment systems, or work with certain financial institutions to directly provide financial services. Governments must always establish objectives for financial inclusion and implement the necessary financial legislation and oversight.

The chances left to provide clients with greater service have been identified in this study. With the current lineup of microloan products, there are certain clients who work in agriculture, small business, day and occasional labour, fishery, and forestry who are underserved. Men in the lowest economic tiers are generally underrepresented in these services. In several nations and areas of the world, microfinance has only just begun, and the institutional frameworks are still insufficient. With more consideration given to the financial objectives, cash flows, and vulnerabilities of the poor, a wide range of financial requirements might be better met. It is obvious that creating savings accounts that may receive little sums each day and protect them from the everyday demands to spend is the biggest task of all. While we have learned a lot about the poor's financial habits, we still haven't developed any products that will benefit millions of families [13], [14].

## CONCLUSION

The latest initiative to refocus on clients is salutary and pertinent. The group of people who have supported microcredit and, more generally, microfinance has created a sizable number of effective financial institutions that assist the underprivileged. It took more than 20 years to show that microfinance could function as a legitimate component of the financial system that institutions that help the needy could be successful and turn into publicly traded enterprises, and can expand to a size that is significant on a national basis. These are outstanding accomplishments that are uncommon in many other development-related professions. Even yet, the availability of financial services to the poor is characterized by a relatively small selection of loan products, some, but insufficient deposit services, and scant insurance beyond credit-life. There is a lot of excitement about how payments systems may help the poor, but it's not yet apparent if these systems will work in rural communities and low-income neighbourhoods. The next step in a broad plan to offer financial services to the poor is to identify the services that will be most beneficial to them and that we can offer financially. In order to do this, we must have the following in mind. The current discussion on responsible finance is beneficial, though not essential

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# CHAPTER 11

# MICROFINANCE- PERSPECTIVES FOR SUSTAINABLE FINANCIAL SERVICES DELIVERY

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**ABSTRACT:**

Microfinance has developed over the past three decades into a viable and scalable development financing strategy. Microfinance had reached full financial self-sufficiency by the end of the previous decade, which was regarded as a milestone for primarily NGO-type organisations, who were already providing services to millions of consumers at the time. But the actual acceleration was seen in the 1990s and the first 10 years of this century, when commercialization became more and more important. As client outreach and microcredit businesses develop at an unheard-of rate and become fully-fledged, licenced microfinance institutions (MFIs), Latin American organisations like Banco Sol or Mibanco are setting the pace. In the last 10 years, it has been possible to watch the rapid growth of microfinance in Eastern Europe and the former Soviet Union, as well as the formation of emerging MFIs in Sub-Saharan Africa, albeit at a much lesser level. More specifically, the last five years have seen a greater integration of microfinance into the financial markets as well as the emergence of private commercial lenders and professional networks, some of which fall under the institutional wing of microfinance organizations like Pro-Credit Holding.

**KEYWORDS:**

Delivery, Financial, Organization, Services, Sustainable.

## INTRODUCTION

In addition, an increasing number of microfinance investment vehicles and equity capital providers entered the sector. It was made feasible by the entry of risk-averse but socially conscious private investors since some of them were successful structured funds. The good news about irresponsible practises, fierce competition, inadequate control systems, and inappropriate regulatory environments clashed with the bad news about a history of impressive growth in client outreach and a success story of an industry building process based on a social rationale, all of which were fuelled by research findings denying microfinance to have had any real impact on poverty. Microfinance appears to have fallen short of the lofty expectations of many believers who thought it would be a panacea for the way things are done. out of obscurity. Numerous voices who had before lauded microfinance highly now decry it as "yet another" failure of development concepts. As a result, it is now uncertain if microfinance is at a turning point once more [1], [2].

Given the rising risks, concerns about sustainability, and, of course, the nearly 3 billion people who haven't had access to trustworthy and affordable financial services up until now, KfW organised a symposium on the future of microfinance at the end of 2012. This event sought to review the achievements of microfinance, address unethical behaviour and concerns about its potential for effect, and pose the issue of what the "Microfinance 3.0" generation of

the industry would entail. "Microfinance 3.0" should show that balancing financial and social goals is not only feasible but also linked in the sense that achieving financial viability is a need for successfully completing the development mission. However, all objectives must be fairly and responsibly balanced. This essay attempts to address some of the significant issues that will likely require more debate as the microfinance environment continues to change. It draws on some of the talks that took place during the KfW symposium [3], [4].

**A Look at Modern Microfinance**

With a current outstanding aggregate loan portfolio of around 45 to 60 billion USD, 150 million impoverished consumers have been served after nearly four decades of spectacular progress. More than 100 poor nations use microfinance, which has emerged as one of the most efficient and long-lasting development finance strategies. It has enhanced institutional ownership and capacity to bring about changes for the benefit of their customers in addition to reaching out to this outstanding number of clients and their families. There were heated discussions about whether social or financial sustainability should come first fifteen years ago, but as time went on, a number of organisations demonstrated that the two could be balanced. Evidence that financial sustainability is required in order to provide more customers with better products both now and in the near future is one aspect of the success story. This outreach would have been impossible without the commercialization of microfinance. Therefore, there is a definite commitment to expanding microfinance in the future.

Efficiency is increasing, although slowly, which is causing interest rates on microloans to gradually decline. This has also been made possible by the market's expanding but generally healthy competition. Asset quality is still relatively strong, indicating the resilience of the microfinance markets as a whole even during turbulent times. Overall, there was no evidence to support claims of a global microfinance crisis. In addition to the general sound nature of the loan portfolio, there were no indications of a large-scale mission drift, either in terms of customer outreach or "exploitative" interest rates or irresponsible returns. The portion of MFI yields that went to profits has actually dipped a little. The "world" of microfinance has evolved, in certain countries, into an ecosystem that includes, among other things, non-financial service providers including telecommunication platforms [5], [6].

Technological advancements have made it possible to reach out to the rural population, which has thus far lagged behind in terms of access to finance, at lower transaction costs. One of the main problems with new delivery models has been branchless banking, which allows for the removal of temporal and geographic restrictions and helps clients lower transaction costs. Despite being encouraging, these developments nonetheless bring up a number of challenges that require discussion, including sustainable business strategies and legal concerns. On the financial front, we observe a persistent interest on the part of private sector actors in microfinance, an awareness of how MFIs "tick" and what they require. There is reason to think that private financing sources will increase rather than decline. Given the financial requirements, this is both essential and highly desirable. However, a number of obstacles exist, indicating that microfinance still has a long way to go despite having only attained its cruising altitude.

## DISCUSSION

The fundamental principles of microfinance require additional support. The impressive accomplishments of microfinance occur at a time when certain media and academics are making unprecedented claims of failure and lack of influence. A discussion on the fundamental principles of microfinance has been sparked by signs of apparent reputation and repayment crises in a few specific marketplaces in very diverse geographic areas, which culminated in late 2010 events in Andhra Pradesh. Concerns regarding its overall future were also raised by this. The headlines in the press read things like, "The party is over," "Suicide of a great idea," and similar things, and some of the reviewers had a terrific time selling their books.

Although the idea of failure predominated, the issue of too high expectations was less frequently brought up. The age-old debate over whether it is ethical to profit off the savings of the underprivileged is once again coming to the fore. The growth of the (perceived) over-indebtedness risk for customers and suppliers was emphasised in the 2012 Banana Skins study. Restoring confidence and ensuring industry good practise standards are being followed present a challenge. In this situation, open and equitable client treatment are essential, as well as a strong commitment from governmental and commercial microfinance donors. There is no global microfinance crisis, according to all available facts, but the critics are correct to point out some of the terrible practises we have observed; they need to be taken seriously and dealt with forcefully [7], [8].

Smallholder farmers and small companies are only two examples of the many clientele that have yet to be handled. There are still a lot of individuals who require financial services; according to estimates from the CGAP, more than 2.7 billion people who make less than $2 per day do not have access to credit. Additionally, these individuals have modest yet distinct demands to enhance their quality of life. This begs the question of how these demands may be effectively converted into a demand for financial services and how this demand can be properly satisfied by competent financial products. The issue is to offer financial services other than traditional microcredit, such as non-credit financial services. Numerous other credit products, such as loans tailored to the needs of small businesses that have occasionally graduated from the "microenterprise world," have attracted the interest of an increasing number of MFIs, in part because they have the potential to have a significant positive impact on business and development (by creating jobs), but also because they are a response to the overheated "classical" microcredit markets. However, the demand for social and financial security is met by a variety of financial services, such as credit, savings, and insurance. This has to be complemented by good regulation, which has made progress but is still far from being completed (see section 3.5 for additional information).

We must be clear about what microfinance can do, as well as the influence and reach it can have in advancing development and reducing poverty. The claim that microfinance has failed to fulfil the widely held promise to help people escape poverty is related to this. However, there are other examples that demonstrate how using microfinance services has improved the lives of millions of individuals. However, it is appropriate to wonder "how do we know" and "what impact are we talking about". While dispelling the "panacea myth," the difficulty is to get agreement on the best approach to quantify effect and to be explicit about its dimensions. To obtain a fair assessment of the effects of microfinance, "knowing your client" and "poor economics" knowledge are viable avenues. The question should be how, not to what extent

customers have been helped out of poverty. How effectively a business treats its customers and how well underserved customers may benefit from financial services in order to better their life circumstances.

Financial system development is still necessary in order to realize the goal of stable, regional financial systems. It is a stable financial system that not only offers stability but, perhaps more critically in many emerging nations, expands the population's access to money and to better, more varied services. In short, the financial system development argument maintains that it has a development function so that also the population, including impoverished people, can and may benefit from it. This is in contrast to modern conceptions that financial sectors are at best not damaging to people. The foundation of the financial systems development paradigm is the idea that providing people with access to financial services will significantly enhance their quality of life in developing nations (as well as everywhere, of course). Given the enormous potential, there is still much to be done and numerous difficulties to overcome. Given the recent harsh criticism and the success story of microfinance, the sector may indeed be in some ways at a turning point. Bringing microfinance to the next generation, using technology fully and responsibly, outreach, and the sustainability pledge will be crucial to the success of this new phase. This is the goal of "Microfinance 3.0."

**Reputable, ethical, and deposit-taking institutions**

There are many clientele groups, each with its own demands. It takes powerful institutions to service these (better). They should be handled properly since this is a necessary condition for them to function well in terms of outreach and long-term viability. In order to satisfy the need of expanding, increasingly diversified populations, they should be sustainable. Additionally, they ought to be deposit takers since financial intermediation is important for a healthy financial system to assist the poor; deposits help the poor in many ways, such as by providing funds for "predictable" shocks like education, marriage, or old age. Professional institutions require a licence of some type, as well as the necessary equipment, money, strong internal control systems, excellent management, and qualified employees to get this licence. These institutions need a large number of qualified employees, thus training and skilled human resource management are essential given the difficulties that staff recruitment, training, and retention face in many nations. Professional institutions require effective IT and management information (MIS) systems for internal controls. These should be incorporated into the product manuals, notably the credit approval method, and include solid risk management and internal audit [9], [10].

**Effective Corporate Governance**

The success of the development mission ultimately depends on the promotion of ethical behaviour, professional performance, and good corporate governance. Strong boards that provide clear strategic supervision in line with the goal, effective support management that performs its tasks, and constant MFI-first behaviour are essential requirements. Between shareholders, the board, and management, there is a distinct line of responsibility drawn by good corporate governance. In a larger sense, it entails putting in place the proper internal control systems to direct management's efforts towards attaining its objectives in an open, accountable manner.

Unsurprisingly, there is still considerable work to be done before strong corporate governance is widely implemented. This will also enable good expectation management, such

as the board's expectations for growth and return, which won't push the institution beyond what is responsibly doable. The common denominator of activity across many varied sorts of funders is sound corporate governance practises, which assist to level the playing field for investors in an investor environment that is becoming more diverse. The 2012 Banana Skins Report listed a lack of sound corporate governance as the second biggest threat to the MFI sector. In comparison to the 2011 report, it received a 2-notch improvement.

**Offering a Diverse Range of Financial Services**

"Microfinance 3.0" does not suggest a total overhaul of the industry's business models. Serving current customers with new items like school financing services, for instance, might be a promising change. Although it is true that traditional microcredit shouldn't be the only service provided because there are many financial needs for which it is not the ideal solution, this does not imply that credit products should be completely abandoned or scaled back. The task is instead to develop credit solutions that are specifically aimed towards customer needs.

**Agriculture loans:**

Supporting income generation by providing smallholder households with access to loans is receiving more attention. As a significant portion of the global population without access to finance, this target group is the focus of the new CGAP strategy.

**Small business loans:**

For many MFIs, providing finance to small enterprises makes sense. Although few in number3, some of them are previous microbusiness owners who are now able and ready to accept larger loans. If the MFI rigidly restricted the loan size at the typical microloan average, they would just stop being clients. Why would a respectable MFI want to lose these loyal customers? However, there is also a chance to attract new customers. Since tiny enterprises can employ personnel like unskilled labourers and thereby involve the extremely poor in the economic and financial system, this does not always indicate a mission drift. Additionally, small company loans boost MFI efficiency, which helps to offset the increased transaction costs associated with reaching out to clients in underserved or rural locations. Due to the significance of small enterprises for the local labour market, small company loans can also function as a gearbox to the formal sector.

**Loans for energy efficiency:**

"Green microfinance" has received a lot of attention and has a lot of promise. While this is happening, there are an increasing number of strategies to either directly finance the use of renewable energy through microloans or provide energy efficiency loans for micro and small enterprises, as well as for private households, such as the exchange of windows (many examples in South East Europe) or biogas schemes for private households in Asia4.

**Education loans:**

In developing nations, such as Africa, where even the poorest sections of the population are making significant sacrifices to pay school fees for their children, there is a particularly strong demand for education loans. According to recent estimates from CGAP, between 10 and 20 percent of micro entrepreneurs are eligible for small business loans for future business expansion because of their track record, their personality, and the growth of their enterprise. See the Microfinance (Debt) Fund for Asia (MIFA), a cooperative project by KfW and IFC,

with its biogas "window" (subcomponent). Students are in particular need of financial assistance when the new academic year starts in August or September. For many households, having access to financial services can ease their severe financial limitations and open up the possibility of human growth through professional or higher education. Naturally, suitable savings items are also required. Education loans can also refer to loans given to educational institutions that are already clients of many African MFIs. One of the most cutting-edge areas of financial services is education finance, however the industry is still developing and there aren't many experiences to draw on. However, DFIs or institutional investors should promote this sector vigorously. Savings are undoubtedly the most important non-credit invention. The difficulty is to maintain sufficiently powerful MFIs that are able to mobilise deposits on a wide scale in addition to being licenced to do so. The fact that local savings account for a sizable portion of MFI funding is encouraging, but far too many MFIs remain without a deposit-taking licence. Therefore, it is obvious that the microfinance 3.0 environment will see organisations that solely offer microcredit diminishing or disappearing over time.

It has been a feature of the new development finance paradigm that MFI financing does not necessarily have to be cross-border money but instead should, to a growing amount, originate from local sources, along with the outreach dimension, also known as financial deepening and broadening. Deposits are crucial for the MFI to become more independent from foreign (currency) funding sources, as well as for better serving its clients. The challenge then becomes how the sector can be successful in adding an increasing amount of local funding—most notably, local savings—as well as, perhaps, bond holders and other sources of private capital to the liabilities side of the balance sheets of MFIs. External donors are increasingly considering offering at least a portion of their cross-border money in local currency through programmes like the TCX Fund when this is not currently practicable.

In terms of branchless banking, there is a lot of anticipation that financial services, particularly those related to money transfers offered via mobile phones, would revolutionise consumer outreach, particularly in rural regions. It is true that high processing costs relative to banks are one of the difficulties MFIs face, which results in higher microcredit interest rates than banks would charge. Payment services may be provided considerably more affordably and/or individuals in isolated places might be reached if the cost of this transaction could be significantly reduced. Additionally, there is the possibility of connecting public payments, including social transfers and payments to public employees, through "access to finance channels," which might be useful for integrating sizable portions of the unbanked population. However, mobile phone companies and similar companies are frequently the service providers rather than banking institutions. What part can they play in the development of the financial system, and how should the system change to accommodate them? Again, a level playing field is required, along with sufficient regulation. Innovations in payment services.

Technology-based solutions are useful in many ways than only lowering transaction costs from the standpoint of MFIs. When their potential to lower clients' transaction costs is taken into account—a feature that is sometimes overlooked—they can take on a significant amount of significance. From the standpoint of the customer, transaction costs, for instance, include travelling to a financial institution in the capital of the neighbouring district only to make loan payments or take money from a savings account. For many individuals, this also includes the opportunity expenses of lost income incurred while travelling to the MFI.

Although there has been a lot of interest in microinsurance, the majority of services still refer to life insurance, the majority of which are required when taking out a loan. Only a small portion of these insurance contracts—though it is an increasing portion—are made voluntarily to protect oneself from a sudden loss of the family breadwinner and its financial ramifications. Compulsory life insurance, on the other hand, should be viewed as a component of credit technology and employed by MFIs as a way to lower the credit risk. For the portions of the population at the base of the pyramid, demand is growing in the more challenging insurance sectors, such as livestock insurance, weather insurance, and ultimately health insurance. However, many aspects of impoverished people's lives, such dealing with natural disasters, would call for insurance services rather than other financial ones.

**Treating customers fairly and openly, including in pricing**

Any MFI-client relationship is built on responsible practises, including fair and transparent treatment of parents, avoiding excessive debt, ethical collection methods, and fostering financial awareness. There shouldn't always be a trade-off between responsible service delivery and strong financial success when institutions behave professionally. Responsible behaviour, on the other hand, does not support the institution's long-term growth. Practises like flat interest rate fees and other opaque norms would progressively disappear under "Microfinance 3.0," whereas responsible loan approval policies, supported by effective incentive programmes for MFI personnel, would become the norm. Overall, responsible finance extends beyond microfinance and consumer protection; it is a crucial component in the development of stable financial systems.

**Reliable Financial Systems and Favorable Regulation**

Although the majority of what might go wrong seems to rest inside the institutions themselves, as the 2012 Banana Skins research has shown5, a healthy atmosphere is still crucial for excellent MFI performance. A "marketplace" called "Microfinance 3.0" features efficient. Of the top 12 dangers highlighted, around two-thirds have to do with MFI management and governance, and roughly one-third have to do with fairly external variables like improper regulation and political interference effective credit bureaus and a microfinance regulatory framework that is suited to the requirements of MFIs, i.e. that is supportive of their growth. The desire to improve access to finance for the lower income portions of the population may occasionally conflict with the macroeconomic aim of stable financial sectors, however this conflict appears to be overstated in many nations. On the other hand, some regulators are starting to recognise the dangers of financial exclusion to the health of the financial industry.

Responsible regulation has been among the shortfalls in several markets, as some of the debt patterns have indicated. You may refer to this as the ignored or forgotten part of prudent finance. Although the general regulatory environment appears to be getting better, some incorrect regulatory actions have raised questions. Although it is not certain whether the overheating of the microfinance sector and customer over-indebtedness are necessarily related, at least there is a distinct timeline. Do regulators succumb to the political pressure brought on by these crises and toss away the baby with the bathwater by putting insufficient regulatory limits while having the best of intentions to stop unethical behaviour?

### The Function of Funders

Funders of microfinance must be in addition to, complementary to, and integrative with the rest of the sector. The financial environment is evolving quickly. Initially, do- Neither grants nor loans, development finance institutions (DFIs), which account for 60% of all cross-border financing, have been a major source of funding. Commercial funders can now participate thanks to DFIs. DFIs have established MFI greenfield banks as examples of best practises and as sources of funding that have also assisted in the establishment of 100 to 200 top-performing, fully licenced MFIs that actually handle the majority of customer outreach in developing nations. They demonstrated that microfinance can function successfully even in tough nations by acting in places where private sector operators would not have gone [11], [12].

## CONCLUSION

Minimum capital requirements that are insufficient and even exorbitant. The (re)introduction of interest rate caps that may jeopardise the viability of MFIs. Ineffective debt crisis management and over-indebtedness prevention. Restrictive loans to deposits ratios, which limit lending operations by tying the loan portfolio to the amount of savings raised and may be detrimental to newly established deposit-taking banks if no exceptions are made. These patterns unmistakably demonstrate the necessity for more communication with regulators. Instead hindering the growth of a sector, regulators should work to promote it. The establishment of efficient credit bureaus should take precedence over regulations that support the sector and aim to create a fair playing field. Effective credit businesses include, among other things, the following. All financial institutions are required to provide credit bureau reports. The credit bureau promptly offers regular, dependable, and thorough information. The credit bureau offers both good and negative information (such as the client's successful past).

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# CHAPTER 12

# THE RESOURCE FUNDER'S PERSPECTIVE

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**ABSTRACT:**

The former comprises loans for education, agriculture, and energy efficiency. The latter includes insurance goods, money transactions, and savings. KfW is an organisation that supports responsible finance. This specifically refers to how a financial institution handles its customers, and it should do it in a way that is fair and transparent and incorporates cutting-edge credit technology. It encompasses competent regulation and oversight, as well as "good quality funding" in a broader sense. Instrument diversity: KfW offers a wide range of tools that are tailored to each sector's environment and the financial requirements of its professional partner institutions. KfW primarily offers mezzanine and senior loans, guarantees, and TA grants to its partners. It also has equity participations (funds, holdings), direct participations (MFI networks), and other types of participations.

**KEYWORDS:**

Funder, Microfinance, Perspective, Strategy, Substantial.

## INTRODUCTION

Microfinance has received funding from KfW nearly from the beginning. Together with other DFIs, it is currently one of the most significant funders. KfW has been actively involved in supporting a favourable market environment in addition to funding microfinance, with a portfolio of over 2 billion euros in outstanding obligations. Long before the start of the financial crisis, in 2007, it began advocating ethical microfinance. The goal of KfW is to create a thriving microfinance industry with several fully functional, regulated, deposit-taking MFIs. The goal of KfW is to improve and expand un(der)served populations' access to credit, savings, and other financial services (such as money transfers, payment services, and micro-insurance. KfW has continually made investments in its expanding portfolio of microfinance companies for more than ten years in order to accomplish this aim [1], [2].

### The Microfinance Strategy of KfW

Based on KfW's substantial and long-standing sector expertise, its microfinance approach is composed of six key components:

Professional and responsible partner institutions that operate in a supportive atmosphere are prioritised by KfW, who also places a strong emphasis on institution creation. The successful institutions are most required to effect adjustments for a good market development. Even while an increasing number of institutions have a successful track record, considerable work has to be done to make these even stronger institutions as well as the following layer of highly capable but immature institutions. The network method entails using KfW's extensive expertise in (structured) funds and Microfinance Investment Vehicles (MIVs) to promote best practises through investments in microfinance funds and holdings. Networks frequently use

standardised processes and practises, which increases the effectiveness of institution formation. Working with networks implies promoting regional and international efforts rather than only concentrating on projects in a single nation [3], [4].

Focus on income-generating loans for MSME clients: The main target market has been MSMEs, or micro, small, and medium-sized firms. They provide a considerable contribution to the production of jobs and income in emerging nations, particularly for the low-income segments of the population. These businesses can't take advantage of numerous economic prospects since they don't have access to banking services. KfW would not, however, promote lenders that just serve consumers. "Microfinance plus": Expansion to additional credit products (such as rural finance, "small business loans," energy efficiency, education finance), as well as savings: KfW encourages the development of additional financial services in addition to credit.

**The Microfinance Portfolio of KfW**

The microfinance portfolio made up the largest portion (39%) of the overall financial sector portfolio in 2012, totaling 2.1 billion euros. 62% of this volume was given by KfW funds, 31% by funds from the German federal budget, and 7% by private investors. 2% of the microfinance portfolio was designated for technical assistance from the German budget sources. Five distinct strategies are used by KfW to promote microfinance: greenfielding, upgrading, downscaling, connecting, and structured funding [5], [6].

New (greenfield) MFIs require equity funding as well as capacity development. KfW has assisted in the establishment of a number of MFIs, most of which are affiliated with network holding companies like ProCredit, ACCESS, ADVANS, and Finca Microfinance Holdings. Similar to this, KfW supports unlicensed microfinance institutions and small non-governmental financial organisations as they upgrade to become registered, deposit-taking financial institutions. The Cambodian ACLEDA Bank, a national NGO for the growth and credit of micro and small enterprises, is an amazing example. It was founded in January 1993. Ten years later, ACLEDA Bank quadrupled its capital to 13 million USD and obtained a commercial bank licence. Another ten years have passed, and the issued and paid-up capital now exceeds $100 million USD. In addition, ACLEDA Bank has established its own affiliates in Laos and Myanmar. KfW further encourages downscaling strategies by helping commercial banks provide microfinance products. The Small Industries Development Bank of India (SIDBI), Corporación Financiera de Desarrollo (COFIDE), or Seker Bank in Turkey are long-standing collaborators. Finally, KfW has supported structured financing initiatives that have improved and stabilised the access of successful MFIs to private capital. Some of these are flagship programmes, including the Microfinance Enhancement Facility (MEF) or the European Fund for Southeast Europe (EFSE).

The microfinance industry and its clients were not spared from the effects of the global financial crisis. Credit risks have escalated as the crisis's impacts started to directly impact customers. Many MFIs have demonstrated that they can effectively manage the crisis phase in this setting. There is confidence that the industry will survive the crisis (even) stronger because there is proof that it has proven resilient. On the other hand, a number of nations showed symptoms of "unhealthy" rivalry and over-indebtedness. In light of this, the following inferences may be made from the ongoing discussion.

Building a strong market environment and strengthening MFI are the current challenges. Building institutions is important not only for their financial and social performance but also for making them (more) resilient to the effects of crises and unhealthy competition. For MFIs to continue to attract private capital and ensure that the under(served) population in emerging and transitional countries has sustainable access to credit, crisis resilience will be a key consideration. There cannot be a healthy market development without such powerful institutions. Commercial microfinance and responsible financing don't have to be at odds with one another. True, certain procedures went horribly wrong, and criticism must be taken seriously. Unfair customer treatment, bad incentives, and a lack of monitoring all offer valuable lessons. Additionally, operating a microfinance company requires having a strong sense of value.

## DISCUSSION

Because only these institutions can fulfil the promise of financial inclusion, the demands of clients are paramount, and strong, competently managed institutions continue to be at the centre of society. To promote savings in this situation, more work still has to be done. A solid infrastructure is also important. Although it is not a goal in and of itself, technology may be considered as a crucial component. DFIs should be explicit about their responsibilities, which include establishing standards for good corporate governance, promoting funding arrangements that are appealing to private investors, developing new products, and providing funds for a strong financial infrastructure. Everyone agrees that microfinance has had a significant positive influence on the development of the sector. However, the requirement for better effect measuring methods is highlighted with regard to client wellbeing. As opposed to focusing on individual "success stories," it is important to examine how well an MFI serves its clients. Pushing the financial frontier to underserved markets, populations, and geographies is the ultimate goal. The two underlying premises should be as follows.

To better their living situations, people in emerging nations require and may benefit from financial services. Financial firms can substantiate this argument since financial services actually help individuals. Overall, there is reason to believe that the next generation of microfinance, dubbed "Microfinance 3.0," will promote greater financial inclusion. This generation of microfinance will be driven by strong institutional professionalism, a strong commitment to providing clients with innovative products that are tailored to their needs, a conducive regulatory environment, and a set of values that will ensure that responsible finance practises become more firmly established in the microfinance sector.

The effects of microfinance on developing nations are now the subject of heated debate. Millions of micro, small, and medium-sized business owners who previously had access to financial services have now been financially included thanks to microfinance (Love and Peria, 2012). Only thirty years after the Grameen Bank was established, there are already indications of an excess of microcredit and even borrower over-indebtedness, particularly in developing nations. Microfinance does, however, provide a less controversial contribution to the growth of the economy, the promotion of investment, and the creation of jobs [7], [8].

Many micro, small, and medium-sized firms (MSMEs) have business characteristics that can be accurately reflected by the lending methods used by microfinance institutions (MFIs). Loan amounts are carefully increased for good borrowers to build relationships. Loan products are standardised by providing mostly installment loans (standard loans), with loan

repayment beginning right away after loan disbursement. Loan sizes are adjusted to the borrowers' incomes based on thorough client assessments. The success of microfinance is seen to be largely due to the high payback rates, which are even attributed in part to product standardisation (Armendáriz de Aghion and Morduch, 2000; Jain and Mansuri, 2003). Product standardisation, however, also has a number of disadvantages.

There are fewer prospective projects that can be realised when repayment schedules are incompatible with investment returns. Fast turnovers and consistent cash flows at almost the same level are necessary for a project to be financed with a short-term installment loan. In order to generate returns high enough to cover the loan sum, longer-term initiatives must first mature. Due to inconsistencies in cash flow and repayment responsibilities, advantageous investments may not even be realised. Due to this, the majority of MFI clients are merchants who use their loans to finance working capital, and the proportion of loans for long-term projects is still low (Dalla Pellegrina, 2011).

In addition, even though microfinance has touched a lot of urban entrepreneurs, it still has to fulfil its promise to MSMEs in rural regions, especially to business owners in the agriculture industry. According to Binswanger and Rosenzweig (1986), the majority of agri-cultural production types are characterised by a high degree of seasonality, which causes discrepancies between expenses during planting season and earnings during harvest. Standard loans, which can't take into consideration the seasonal cash-flow patterns of agricultural producers, tend to fall behind particularly here.

The literature therefore specifies the providing of microfinance loans with flexible payback schedules (flex loans). Although flex loans have the potential to expand the reach of MFIs, currently only a small number of MFIs are ready to make repayment schedules more flexible. This article offers a mixed-methods evaluation of product adequacy and the consequences of providing standard and flex loans to agricultural enterprises based on field visits and data from the management information systems of two banks of the Access Holding Microfinance AG in Tanzania and Madagascar. The remainder of this paper is structured as follows: In the second section, we will briefly explore why standard loans are typically used in microfinance and how this impacts the kinds of MSMEs that MFIs support. The analysed MFIs will be briefly given in the third section. We will offer four evaluation questions and the evaluation process based on this backdrop. We will evaluate agricultural loans in both banks using these assessment questions in the fourth section.

**Principles of Micro-lending**

Governments and central banks in many developing nations have begun to improve the regulatory and operating environment in the financial sector, motivated by the negative experiences of the supply-led development finance period in the 1960s and 1970s and the failure of state-owned development banks in the 1980s (Adams and Graham, 1981; Maurer, 2011). These advancements were crucial prerequisites for the successful growth of the commercial microfinance industry, which is driven by numerous initiatives like creating new MFIs and professionalising existing ones in order to better serve MSMEs (Krahnen and Schmidt, 1994; Maurer, 2011). Since informal MSMEs are typically ignored by traditional banks, they have served as MFIs' typical target consumers. Commercial MFIs often utilise income-based individual (liability) lending strategies rather than the traditional, collateral-based lending approach used by normal banks or the shared liability premise of group lending

that is typically applied by non-commercial MFIs. Thus, the family and business income, or total household income, establishes a loan applicant's ability to repay the loan and serves as the MFI's foundation for deciding whether to issue the loan and how much credit would be provided. Since accurate revenue statements and balance sheet information are scarce in the unregulated MSME sector, MFIs themselves conduct thorough evaluations of loan applicants to determine their ability to repay loans1. Individual lending MFIs are now widespread worldwide, mostly in metropolitan areas, thanks to the help of donors, development finance organisations, and commercial banks [9], [10].

The reader is referred to Ar- mendáriz de Aghion and Morduch (2010) and Kong and Turvey (2008) for more information on the fundamentals of microfinance. The supply of standard loans is one of the primary factors contributing to MFIs' success. Individual lending MFIs also frequently utilise standard loans. The repayment schedules of standard loans cannot be synchronised with the borrower's cash-flow circumstances, despite the fact that installments of standard loans are tailored to the borrower's income, including the cash flow of the financed project and other sources of income for the borrower's household (Armendáriz de Aghion and Morduch, 2010). Therefore, conventional loans may be suitable for companies that consistently provide rapid returns, such as tiny merchants (Lantos, 2007). Standard loans, however, seem illogical for longer-term projects with irregular and unpredictable return patterns since such enterprises need time to develop before initial returns are realised. Only if an entrepreneur is able to cover transitory cash flow shortages of the financed project with income from other sources can the project be funded. As a result, when cash flow and repayment responsibilities do not match, lucrative projects cannot be realised at all or may only be realised with increased repayment risks. Therefore, product standardisation may lower default risks for customers with consistent cash flows but restricts MFIs' attention to projects that meet the standards of the product (Weber and Musshoff, 2012). Unsurprisingly, the majority of MFI clients are business owners that have quick turnovers and primarily use their loans to finance working capital. However, the percentage of long-term loans provided by MFIs, particularly loans to business owners who primarily earn seasonal income from the agricultural sector, continues to be low (Dalla Pellegrina, 2011).

According to Binswanger and Rosenzweig (1986), agricultural output is usually characterised by a high degree of seasonality, which frequently causes periodic imbalances between costs during planting and income during harvesting seasons. Because of this, agricultural economics literature frequently stipulates loans with variable loan payback schedules that are in sync with agricultural output cycles (Meyer, 2002; Dalla Pellegrina, 2011). Meyer (2002) makes the case that enterprises in Bangladesh that generate a large amount of money from agriculture would be better off with loan repayment schedules that match anticipated cash flows and defer principle payments until after harvest. Furthermore, according to Dalla Pellegrina (2011), standard loans from MFIs are less appropriate for financing agricultural projects than (flexible) loans from conventional banks and unofficial lenders. Therefore, it is believed that one reason why MFI penetration of agricultural clients is still low is the lack of sufficient loan products for agricultural enterprises (Christen and Pearce, 2005; Llanto, 2007).

The outreach of MFIs to rural regions, where the majority of agricultural output occurs, is hindered by greater operational expenses as compared to metropolitan areas, in addition to inferior loan products. It takes more time and fuel for banks to contact and supervise borrowers due to greater distances and lower population densities. One of the major

operational cost components in microfinance is thought to be the collection expenses (Shankar, 2007). Here, grace periods lengthen the period during which loan balances are due. As a result, the MFI earns larger interest returns, helping to offset higher operational costs.

Even though flexible repayment plans have the potential to expand MFIs' reach into rural regions, the majority of MFIs are still hesitant to do so. They may worry that greater flexibility may result in lower repayment rates. There is, however, no actual data to back up this worry. However, the majority of research examining the impact of flexible repayment plans on loan repayment is based on experiments, which have produced contradictory findings that have not yet been validated in practise. In a field experiment conducted in India, Field and Pande (2008) randomly distributed microfinance loans with either weekly or monthly repayment installments to borrowing groups of an MFI. They discover that varying repayment plans have no appreciable impact on loan delinquencies. Field add on their first studies by examining the impact of a two-month grace period2 on borrowers' loan delinquencies in a subsequent trial with the same MFI. They discover that loans with grace periods have greater loan delinquencies. Nevertheless, although being randomised, the awarding of grace periods was arbitrary and unrelated to the debtors' underlying cash-flow patterns. As a result, they were unable to influence whether the examined borrowers need the grace period to make up for cash-flow caused liquidity gaps. In a related experiment, Czura attempted to build on past research and implicitly addressed possible borrower cash-flow deficiencies by randomly allocating loans to borrowing groups in India. They exclusively concentrated on dairy producers in order to reduce other potential influencers. In their experiment, all borrowers utilised their loans to acquire lactating dairy cows, or animals that were producing milk at the time of purchase but would cease producing it two months later. The borrower will have a cash flow shortage at that time since this occurrence was anticipated to happen after loan delivery. Standard loans, loans with pre-determined grace periods, and loans with variable grace periods—where the borrower was permitted to defer up to two repayment payments at any time three months after loan disbursement3—were all given to the borrowers by Czura. According to their findings, flexible grace period loans did not have greater loan delinquencies than normal loans. God-quin (2004), who examines the loan repayment behaviour of MFI borrowers in Bangladesh, provides more evidence in support of their experimental findings that grace periods do not weaken repayment discipline. She discovers that compared to regular loans, loans with grace periods have much lower loan delinquencies. These results imply that moving from conventional loans to flex loans does not always alter the quality of repayment.

**Organisations**

Access Bank Tanzania (ABT) and AccèsBanque Madagascar (ABM) are the institutions that we looked at for our review. Only ABM now provides and has developed flex loans. ABT is a commercial MFI that places a particular emphasis to MSMEs. The bank is owned by the five founders—the Access Holding Microfinance AG, the Belgian Investment Company for Developing Countries, KfW (the German Development Bank), the International Finance Corporation (IFC), and the African Development Bank—and operates in Tanzania as a full-fledged commercial bank. The bank gradually expanded over its first four years of existence, from 2007 to 2011, and now has eight branch locations in the broader Dar es Salaam region. ABT pays out all loans in Tanzania Shillings (TZS), the local currency, and the bank's policies are specifically tailored to and only permit the disbursement of individual loans. In

the micro sector, the bank only provides regular loans as of 2013 loans to agricultural enterprises are still given according to the conventional lending standards. They thus have set repayment schedules and maturities without grace periods, and are not yet tailored to the cycles of agricultural output. ABM's founding shareholders, Access Holding Microfinance AG, BFV-Société Générale, KfW, IFC, and the Triodos-Doen Fund, run it as a full-fledged commercial MSME bank in Madagascar. ABM has 17 branch offices where its services are available. Unlike ABT, which only has branches in the capital city of Antananarivo, where ABM started its operations after being founded in 2007. Like ABT, ABM too exclusively makes individual loans and only disburses all loans in local money (Madagascar Ariary, MGA). The micro sector now offers six main types of company loans: basic loans, housing loans, emergency loans for unanticipated personal expenses (such as accidents), flex loans, warehouse receipt loans4, and value chain loans in collaboration with an input [11], [12].

## CONCLUSION

The borrower is only required to partially satisfy his repayment obligations (principal and interest) during a grace period. The graced repayment duties are delayed until a later time, often when returns are place. Due to the monthly repayment schedules, delaying two installments is equivalent to giving yourself a two-month grace period. Dairy cows typically rest for two months in between each lactation episode. The cow doesn't produce any milk while it is resting, thus there are no expenses or benefits installments has the ability to improve MFI efficiency because flex loans don't have a greater rate of loan defaults. Therefore, it is not unexpected that the commercial microfinance sector is behind a new initiative to improve access to funding for agricultural MSMEs. The fundamentals of this novel "Agricultural Microfinance Model," which adapts the basic microfinance technique for agricultural MSMEs, were given by Chris- ten and Pearce (2005). In this endeavour, the German Access Holding Microfinance AG was one of the first institutions to launch flex loans for agricultural MSMEs in Africa, particularly in Madagascar.

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