Chapter 21

Innovative Strategies Devised by Indian Microfinance Institutions

Nadiya Marakkath
Tata Institute of Social Sciences, Mumbai

ABSTRACT

This study is a discussion on the Non-Governmental Organization-Microfinance Institution Partnership Model and the Securitization Model used by Indian microfinance institutions to achieve cost efficiency. These two models are effective strategies devised and used by efficient and sustainable Indian MFIs to reduce their operating cost and financing cost. Achieving such cost efficiency is crucial for microfinance institutions to attain operational self-sustainability without levying high interest rates. Using the interview method, the study elicits information on these innovative strategies and recommends them to be worthy of emulation for other microfinance institutions operating in the Indian microfinance industry.

INTRODUCTION

Microfinance refers to the provision of financial services to low-income clients. By providing financial access to the poor clients, microfinance plays a decisive role towards financial inclusion. It economically empowers the poor and integrates them to the mainstreams of the economy. The institutions that provide such financial services to the poor are called Microfinance Institutions (MFIs). These MFIs act in an environment of high information asymmetric credit market risk, where there is a dearth of information about the credit history of the poor clients. These information asymmetric credit market risks are mitigated by the MFIs by using unconventional group lending models that work on joint-liability principle, sans collaterals. Though this unconventional group-lending model has the potential to mitigate risk and facilitate financial intermediation at the bottom of the pyramid, it has one major challenge associated with it high intermediation costs. In

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order to cover this high intermediation costs and attain operationally-self sustainability (OSS), it is imperative that MFIs remain cost efficient.

OSS denotes the ability of MFI to earn revenue to cover its costs and reach the poor now and in future (Schreiner, 1996). More specifically, it is the ability of MFI to generate enough revenue from its operations to cover its financing costs, transaction cost and loan loss provisions. Attaining OSS is imperative for the MFI to perpetually operate in the sector. In order to attain OSS, without resorting to the practice of levying high interest rate from the poor, it is essential that MFIs concentrate on achieving cost efficiency.

Considering the pertinence of achieving cost efficiency, this work aims to understand the innovative strategies used by efficient and sustainable MFIs, to remain cost efficient. This is expected to provide a valuable learning experience for other MFIs which aim to improve its cost efficiency.

LITERATURE REVIEW

Information asymmetric risk arises in credit-lending transactions, as the lender has less information about the creditworthiness of the borrower, than the borrower himself. Such risks are all the more exacerbated in microfinance market as the poor borrowers lack credit history. Information asymmetric credit market risks denotes the ex-ante risk of adverse selection*, interim risk of moral hazard** and the two ex-post risks of costly audits and enforcement*** (Akerlof, 1970; Scholtens & Wensveen, 2003; Stiglitz & Weiss, 1981).

MFIs mitigate these information asymmetric credit market risks—adverse selection, by affecting group formation among the poor borrowers with joint-liability; moral hazard, by inducing group members to influence the way other members select their projects; costly monitoring, by helping the lender avoid external audits and enforcement problems, by encouraging borrowers to repay their loans without the lender having to impose sanctions—by its unconventional group lending models (Ghatak & Guinnane, 1999; Ghatak, 2000).

But the group-lending model used by MFIs to mitigate these risks, results in high operating costs for the MFIs (Thorat, 2006; Savita, 2007). The group lending models entails peculiar costs such as group formation costs, costs of training the borrowers on the procedures, costs of higher degree of supervision and higher frequency of installment payments, all adding to the operating costs of the MFI. Moreover since the average microfinance loan size is small, the transaction cost on a percentage basis for such microfinance loan tends to be higher. Adding to this, the MFIs experience less control over their financing costs, as cost of funds sourced from banks and financial institutions usually comes in fixed ranges of pricing. Thus the high intermediation costs incurred by MFIs are a major challenge at the stake of its sustainability.

In Indian microfinance industry, the average operating costs, ranges from nearly 6 to 18 per cent and the average financing costs, ranges from nearly 10 to 14 per cent of interest rates levied by the MFI (Chakraborty, 2010). The Malegam Committee, a special sub-committee appointed by Reserve Bank of India during the post-microfinance crisis period in India, cited that on an average the interest rate charged by Indian MFIs comes to 28-36 per cent in the year 2009-10. The Malegam Committee Report (2011) also cites few large Indian MFIs to be levying interest rates close to 50.53 per cent. This depicts that on an average the Indian MFIs experienced its operating costs and financing costs to be on the higher end of the average. This makes them charge higher cost-covering interest rates from the poor clientele, so as to remain sustainable. But after undertaking an efficiency and sustainability assessment on a sample of 50 Indian MFIs for the year 2009-10, Nadiya & RadhaRamanan (2011) cite the presence of few efficient MFIs, which operates sustainably by levying a reasonable interest rate of 26 per cent* or lower from the poor. It is of interest to know how these efficient and sustainable MFIs are managing...