Commercialization of Microfinance Institutions in India: A Debate between Financial Sustainability and Poverty Outreach

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ABSTRACT

Microfinance has been an important tool for poverty alleviation in India, a country which contributes to one-third of the world poverty. Provision of an inclusive financial system offering various services such as loans, insurance facilities has helped poor to even out their consumption patterns, deal with risks and eventually contribute to the economy through various micro enterprises.

With the commercialization or scaling-up of the microfinance institutions (MFIs) there has been a debate on the issue of mission drift i.e. from being institutions for poverty alleviation to being profit oriented. Researchers say MFIs have compromised outreach for the profits. This thesis would like to disagree with the view as a more commercialized MFI in our opinion would serve the needs of the poor better in a sustainable fashion.

We have empirically tested for this in the Indian context and have come with the conclusion that though a large number of challenges are still faced by the industry but no compromise has been observed on the part of commercialized MFIs.
ACKNOWLEDGEMENTS

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CHAPTER ONE
INTRODUCTION

1.1 Background
According to a study by The World Bank, The State of the Poor: Where are the Poor and Where are the Poorest,\(^1\) India contributes to one–third of the world poverty. Despite being one of the fastest growing economies the share of the poor people have grown in the past 30 years (Figure 1). An integral part in the endeavors to promote inclusive economic growth of a country is to provide easy, safe and affordable financial resources to the disadvantaged and vulnerable groups who are otherwise excluded from it. In other words, an inclusive financial system is required for economic empowerment, reducing income disparities and accelerated growth of a country (Helms, 2006 and Thingalaya et al., 2010). The mission of microfinance institutions is the expansion of its services to provide adequate solution to the problem of exclusion. Microfinance refers to a comprehensive range of products (insurance, savings, loans, money transfer services and remittances) which are provided by Microfinance institutions, commercial banks, non-governmental organizations (NGO’s) and cooperatives (CGAP, 2012). The founder of this concept was the Nobel Prize winner Mr. Yunus Khan, who founded the Grameen Bank in the year 1983. Microfinance bypasses the problem of informational asymmetry and lack of collateral which typically prevents the poor to borrow from formal credit institutions. This lack of access can create persistent poverty traps and imbalance in incomes. (World Bank, 2008). Initially, the aims of microfinance institutions (NGO-MFIs) was to reduce poverty by providing uncollateralized loans but they are lately facing stiff competition with the entry of commercial financial institutions, which seek to maximize profits and firm value. Also, NGO-MFIs operate on non-profit basis, their main source income is the donations and subsidies provided by the government or other big institutions, these

\(^{1}\) http://www.worldbank.org/content/dam/Worldbank/document/State_of_the_poor_paper_April17
donations and subsidies provided to the institutions are unreliable and tend to fluctuate.

**Figure 1: Regional Share of World’s Extreme poor population**

![Chart showing regional share of world's extreme poor population](image)

Commercialization is the new buzz word associated with microfinance. In the pursuit to increase its outreach (horizontally and vertically) and sustainability, NGO-MFIs have turned themselves into self-regulated and profit generating bodies. These MFIs seek finance from outside sources such as commercial banks and capital markets by floating its shares. In this dissertation I would like to refer to two definitions given by Christen (2001) and Woller (2002). Christen (2001) defines *commercialization to have three essential elements: profitability, competition and regulation*. While Woller (2002) considers this definition as narrow and defines commercialization as the “*adoption by MFIs of ‘commercial’ approaches to microfinance (e.g., introduction of cost-saving technologies; gathering, disseminating and using market intelligence; the introduction and market testing of new products and services), typically – but not necessarily – in response to market forces*”. Thus, these two definitions combined captures the need for microfinance institutions to be self-sufficient, regulated and sustainable and amalgamate fully with the existing financial industry.
2. **Statement of the Problem**

In 1990s a debate spurred up questioning the abilities of MFIs to reduce household poverty on a large scale with a heavy dependence on donations and subsidies. Commercialization of microfinance or a turn from ‘micro-credit’ to ‘microfinance’ was not just a transformation of services but also an ideological change. Initially, it were the socially minded institutions who worked towards poverty alleviation through provision of small scale productive loans, ‘microfinance’ was in turn seen as a more general movement catering to “better off” poor and in the process establishing commercial and regulated MFIs (Armendáriz de Aghion and Morduch, 2005 and Robinson, 2001)

The proponents of the commercialization ideology promises mobilization of savings, greater access to the markets, provision of loans with higher interest rates and other financial services which would increase profitability of these institutions and make them less dependent on donors. It is also said that this transformation would lead to a wider outreach, greater impact by reaching economies of scale. (Schreiner, 2002 and Christen, 2001) While opponents of this ideology believe that this shift would lead to serving the wealthier clients (poor) through increased average loan size in response to competition faced by the MFIs (Brett, 2006 and Woller, 2002). In this case, the poorest section of poverty pyramid would be left out in the urge to increase profitability. This has often been labeled as Mission Drift. Scaling-up microfinance sector, in order to meet the unmet demand has raised the questions in the minds of the consumers. The thesis here therefore tends to explore whether the scaling up of microfinance has actually increased financial sustainability of MFIs and led to a wider poverty outreach in context of India. The hypothesis of our thesis questions ‘Has scaling up of microfinance in search of profitability and self –reliance in India caused mission drift?’ In other words, we will research if there exists a trade-off between profitability and poverty outreach of the microfinance institutions.
3. **Objectives**

The research is significant as many studies have expressed concern regarding the drift in the objective of the MFIs from social to financial, but only a few have empirically addressed this issue particularly in the Indian context. It is important to dwell more into this area as the Indian MFI market is potentially promising, serving one of the largest population of poor in the world and this where the originality of this thesis lies. There are four main objectives that we aim to fulfill:

1. To study the current trend in commercialization and the different approaches to it.
2. To understand the growth of the microfinance industry in India.
3. To study the profitability patterns of the major MFIs in India.
4. To understand the benefits and challenges faced by the Indian MFIs.

4. **Methodology**

The research would be based on the secondary data and the relevant literature present. The quantitative data is sourced from The Microfinance Information Exchange (MIX) Market and other analytical studies present on the web.

5. **Recent Literature: Financial Sustainability v/s Poverty Outreach**

Aghion and Murdoch (2005) and Goldberg (2005) covers recent literature on microfinance and its outreach but studies on financial sustainability and poverty outreach or to be precise, a trade-off between them are surprisingly few in number (Quayes, 2012 and Hartarska & Nadolnyak, 2007). Many of these studies have gone on to have conflicting and mixed results. (Aghion and Murdoch, 2005)

The given literature explains that the balancing act for the MFIs is complex. The two objectives of the MFIs, financial sustainability and the poverty alleviation are difficult to achieve together. When MFIs target the poorest it becomes even more difficult to achieve their economic objective even if they target
high density regions or the regions where the cash flows are higher which does increases the chances of repayment (SBP, 2002). On the other hand, proponents argue that scaling up of an MFI will eventually lead to the fulfilling of their social objective at the same time as their economic objective (SBP, 2002).

According to SBP (2002) highly motivated NGO-MFIs have faced negative consequences in their urge to become sustainable. There has been a greater focus on covering the cost by speedy repayment of loans. More so, these institutions have focused more on high density areas and focusing less on rural areas. This in turn has led to a high turnover rate, low morale of the employees and dissatisfaction on the part of the clients. The focus has now shifted from long-term loans to short term loans, this has led to continuous elimination of the seasonal sectors such as agriculture. Services of the MFIs are now offered to the retail and service sectors which offer assurance of repayment and away from manufacturing.

Despite these negatives, MFI have benefits to offer to the institutions as well as its clients who are users of its services. In the same vein, it has perils associated to it, the most significant being the issue of Mission Drift.

6. **Research Organization**

The research is organized into 4 chapters. After covering the topic introduction in the first chapter, the second chapter will cover the current trend, theories, dangers and benefits associated to microfinance. The third chapter would briefly talk about the Indian microfinance industry and analytical part of our thesis. We will take different measures to determine if Indian MFIs have experienced a trade-off between the two objectives or have balanced between both. The fourth chapter gives a brief description on how commercialization came about in India, case studies and the conclusion of this thesis.
CHAPTER TWO

COMMERCIALIZATION AND MICROFINANCE

2.1 Financial sustainability and Microfinance

Specific to the field of microfinance, Pischke (1996) refers to a definition from Otero and Rhyne (1994) sustainability can be described as a “lender’s capacity to operate for a considerable period of time, measured in decades, independent of subsidy or altruistic support”. Microfinance and sustainability together spark of the debate on commercialization. The argument in question is if mainstream capital is attracted to the microfinance sector then these investments can finance the costs faced by the institutions without any need of grants. These costs include the cost of operations, maintaining good quality staff and standardized credit portfolios. The proponents argue that the high interest-rates charged on the productive loans provided to poor will have the capacity to bear the profits as well as the high returns. While the opponents say that this will lead significant compromise in terms of the outreach, as the focus of these institutions will shift towards richer clients. Both these views are discussed below.

1970s and 1980s were the two decades when the microfinance initiatives were greatly encouraged. Donor resources came to be directed towards the microfinance industry (Christen, 1997). It was end of the 1980s and beginning of the 1990s that there was a shift in policy and practice. Policymakers demanded profitability and sustainability. Failed subsidized credit programs led to the thought of establishing self-sufficient MFIs. This idea was supported by a number of big international organizations (Armendáriz de Aghion and Morduch, 2005). Banco Sol, a Bolivian NGO, was the first to see the transformation. It now operates as a licensed microfinance bank (Chen, 1997).

The change in the line of thought was also observed as focus shifted from being typically welfarist programs in the 1970s, which worked on subsidies to being more focused towards financial services in the 1980s (Ledgerwood, 2001). Also, some feared that the donor subsidies might not last forever, as
donors would change their donor priorities periodically. Thus to avoid the risk of ‘donor fatigue’, MFIs started to increase their dependence on mobilized local savings and commercial banks. This led to the ‘Financial systems’ approach where high interest rates paid by the poor covered costs incurred by the MFIs (Ledgerwood, 2001 and Christen, 1997). These modified institutions take advantage of the shareholder and investor savings to be financially viable themselves and offer additional products and services to its clients.

2.2 Microfinance Schism

Microfinance Schism refers to debate on the various approaches of finance and services to the poor. There are two schools of thought. Firstly, the Institutional school of thought and secondly, Welfarist school of thought (Murdoch, 2000). The end goal of both schools of thought is to alleviate poverty but the question remain which approach does it in a sustainable way i.e. the means not the ends of the two schools of thoughts are fundamentally different.

2.2.1 The Institutionalist School of Thought

This school of thought suggests that MFIs should be self-sufficient and profit making institutions i.e. they should be able to cover their costs from the revenue generated through lending to the poor. They argue that a financially viable institution is the best to serve the poor. For them, if any inclusive financial service has to be provided at a cheaper cost to a large number of poor people then it has to be sustainable. This view has also been called as the Financial Systems Approach or the Financial Sustainability Approach. This view is based on the Win-Win proposition or the Double Bottom Line Principle. According to the proposition, if MFIs follow good banking practices they will have a double advantage. Firstly, they would be able to earn profits, fulfilling their economic objective. Secondly, in this process they would also be able to contribute to their social objective i.e. poverty alleviation (Brau and Woller, 2004).

Institutionalists calls for the adoption and adherence of what is known as the “Best Practices” by the providers of microfinance. This refers to the practices adopted by the providers depending on the nature
of operations, area they operate in and the clientele they cater to. CGAP and other major donors have for example published material on the banking best practices. However the term “Best” has often not been accepted by many and should be replaced by “Sound Practices” as they feel microfinance is still an intensive learning revolution. Institutionalist have focused more on the scale rather than the depth of the outreach (Woller, 2002). Proponents of this approach believe, raising the cost of the services they provide won’t reduce the demand for them. Moreover, these sustainable programs would help to fulfill the social objective of poverty alleviation without relying on donors. Profitability as a pre-requisite will act as a means to sustainability for these institutions. The opponents feel that if the institutions become financially self-sufficient and increase their scale of operation this would be by extending lending programs to the marginally poor or the non-poor category. In this case who were in dire need for credit would be sidetracked and still left “unbankable”.

2.2.2 The Welfarist School of Thought

They believe to fulfill the social objective of poverty alleviation by the use of donor subsidies. For them a shift in focus to become financially sustainable would distract these institutions from their main cause of poverty alleviation. This school of thought has also come to be known as Poverty Lending Approach or the Poverty Reduction Approach. They believe in poverty alleviation and depth (level) of outreach rather than the breadth of it. They do not deny the importance of institutional viability but they focus most on depth of outreach (Brau and Woller, 2004). The most important target group for them is women. The prime focus of the MFI should be economic and social empowerment of women. As empowerment of women will lead to the empowerment of their children and increase in the standards of living. Generation of self-employment for women would lead to a modest control over the share of household income and in turn benefit cross-section of people and pull them out of poverty (Hashemi and Rosenberg, 2006). Thus they say that these institutions can work on subsidies but there should be no compromise made on their social goal of poverty reduction. Here the investment itself has an intrinsic value and the returns on the investment do not come in way of their social programs. The literature tells us that many of the state
subsidized programs have not been able to bypass the problem of non-existent collateral. With increasing default rates, government treasury has been severely affected.

While group lending and incentivized lending has led to major increase in the repayment rates. Institutionalists are still of the view that subsidized credit and inefficiency go hand in hand. An involvement of the government and state donors can never prove to be beneficial for these MFIs. Studies have shown that a middle ground is being looked at between the two paradigms. As researchers feel sustainability and outreach share similar disposition (Morduch, 2005). Thus a balance between the two has come up as the third paradigm.

2.3 **Commercialization: The Process**

Ledgerwood and White (2006) quotes the definition of Christen and Drake (2002), it says

*Commercialization of microfinance generally refers to the application of market-based principles and to the “movement out of the heavily donor-dependent arena subsidized operations into one in which microfinance institutions ‘manage on a business basis’ as part of the regulated financial system”.*

Commercialization and transformation can be used interchangeably but transformation is one of the ways of commercialization. NGO PRODEM has acted as a transformation pioneer. Created as a joint venture between Bolivian business leader and an American NGO (ACCION) it has many branches across Bolivia providing individual and group capital (Ledgerwood and White, 2006).

The three major ways in which transformation takes place are as follows:

A.) **Non-profit entity ➞ Regulated financial institution**

This is the concept that has been on a path of growth since the 1980s. This method of transformation increases outreach through increased variety of product and services, operational efficiency, wide access to commercial sources of capital and greater transparency (Hishigsuren, 2006). This transformation is supervised and licensed by the Central Bank of the country.
B.) To build a commercially viable MFI from the scratch

This method has popularized from Eastern Europe. E.g. German Micro banks created by German firm Internationale Projekt Consult (IPC) GmbH (Ledgerwood and White, 2006). Coming from the Institutionalist school of thought, this process like the previous one requires supervision and licensing from the central authority after fulfilling some basic minimum requirements.

C.) Traditional banks to be involved in Microfinance (Downscaling Approach)

In this approach large banks come to open subsidiaries or divisions dealing in microfinance. These smaller banks form part of their parent banks E.g. Songebank in Haiti has its subsidiary called Songesol. This worked out to be the most cost-effective method. As start-up costs are taken care of by the parent bank and they can easily pave their way into the market due to their established reputation backing them.

Figure 2: Path of commercialization of an MFI

Source: Ledgerwood and White (2006)

The progress towards commercialization involves five steps as seen in the Figure 2. The first step involves acquiring fixed capital such as the office space, office equipment’s, hiring employees and fulfilling minimum capital requirements as stated by the central bank. The second step involves operational self-sufficiency (profits equal to the costs). The third step involves reaching financial self-sufficiency i.e. enough profits are generated to protect the institution from any financial shocks as well as to make further investments. The fourth step is taken when there is
increase in the scale of operation. Organization enters the financial market to use market based funds by floating its shares. The fifth stage is where the institution operates as commercial entity generation profits. This sequence is followed by most of the MFI's when moving towards regulated institutional bodies.

2.4 Benefits and Challenges: Commercialization of Microfinance

Commercial microfinance is a unique blend of benefits and challenges to the poor as well as the MFI's.

2.4.1 Benefits

Commercialization of microfinance has led to better quality of products and services, increased outreach and financial sustainability (Woller et al., 1999). Hoque et al. (2011) identifies the three sources of funding that comes with the commercialization of the Microfinance. These include savings (deposits), loans and shareholder capital. Savings is a source of funding common to the developed part of the world. As this makes a cheap source of funding and is insensitive to the market fluctuations. Deposits form a great source of funding which was earlier impossible due the NGO status of these institutions. Guarantees on loans and a regulatory framework from the traditional banks allow MFI to borrow at low interest rates. Greater access to the market and growing knowledge about the MFI as a lucrative business proposition has attracted investors from all parts of the world (E.K., 2011).
‘Scaling up’ has not only increased the outreach but the strength of the MFIs has also gone up. Services such as micro-insurance, remittance and payments can also be availed through these institutions. The performance standards of these institutions have also gone up since they now have to be regulated by the Central Banks. There is greater transparency and accountability (Christen and Drake, 2002). As there is easier access to the financial markets with commercialization there has been an increase in the competition also. As a result of the competition, advancement has been made in terms of technology, resulting in the introduction of demand driven products. Competition also brings about economies of scale reducing costs in the long-term. Christen and Drake (2002) point out that there are a lot of initial costs that this transformed institution needs to incur (fixed and variable) but the benefits outweighs these costs.
2.4.2 Challenges

One of the major challenges that the transformed MFI faces is that of the *Mission Drift*. This has raised concerns whether the social objectives of the MFIs can be reconciled with financial objectives. Claims have been made that in order to remain financially self-sufficient, Commercialized MFIs focus more on the relatively wealthier clients, neglecting the poor clients. The biggest challenge for the MFIs is to stay focused on their social objective without drifting away in search of profitability. Another point of criticism has been the high interest rates charged by these institutions. In their efforts to cover the high transaction costs and to make profits, high interest rates have been charged by the MFIs. These interest rates have been more than those charged by the traditional banks, posing to be the point of exploitation for the poor (Hermes and Lensink, 2007).

Higher authorities have allowed the MFI to jump the caps placed on interest rates charged by the traditional banks to make lending of smaller loans affordable, as the costs of making smaller loans is more due to the loan losses and higher administrative costs associated with these microloans (Bell, 2006). Increased competition can be a source of potential danger as well. The aim of these MFIs to get larger number of clients may lead to the problem of over-indebtedness and lower repayment rates (Mcintosh & Wydick, 2005). Another problem of commercialization is that large amounts of resources are directed towards activities such as training, advertising and increased paper work involved with reporting to the regulatory authorities (Bell, 2006).
2.5 Regulation and Transparency in the Microfinance Industry

Big institutions such as the World Bank and CGAP have long been calling for a regulatory framework given that the developing countries have suffering from inadequate regulation. Most of these institutions propose to establish a set of ‘best practices’ which will support the MFI to achieve the set development goals set by them. This regulatory framework can differ from region to region depending on the structure of the MFI, the diversity of the region and clientele they cater to. It is necessary that this regulatory framework differs from that existing in the traditional banking as MFIs differs from the traditional banks in terms of the products, clients, structure and lending methodology (Jansson, 2001). It is important for the commercialized institutes to self-control themselves. This can be done by proper accounting practices and efficient planning regarding the deployment of fund, in order to enhance impact and overall operations. Also, there is no historical precedent for the implementation of the laws and guidelines to this sector. This has led a variety of practices and styles governing this sector. Lack of transparency is also a cause of concern. In order to draw potential investors towards this industry, it not only quantity of data which of prime importance but also the quality.
CHAPTER THREE
MICROFINANCE IN INDIA

3.1 Microfinance in India-Background

With a national growth rate of estimated at 5.4% for 2014-2015 (Government of India, 2014), poverty is still a major concern for a country like India as growth is driven only in a few sectors which are the service and industry sectors. According to the NSSO tabulated data, the percentage of people below the Poverty Line in 2011-12 has been estimated at 25.7% in rural areas, 13.7% in urban areas and 21.9% for the country as a whole (Planning Commission, 2011). Although the percentage of poor has declined as continuously in the preceding years, poverty remains one of the biggest challenges. National plans of the successive governments after the independence in 1947 emphasized on improving access to finance to alleviate poverty. According to the Table 1 give below, we can see after the nationalization of banks in 1969, there has been as increase in the share of banks contributing to the household debt. Also the share of other formal sources of finance has also gone up. The share of money lender and informal sources of credit has gone down from almost a 70% to a 15.7%.

Table 1: Share of rural household debt by source of credit, All India, 1951-91

<table>
<thead>
<tr>
<th>Year</th>
<th>Banks</th>
<th>Cooperatives</th>
<th>Government</th>
<th>Total Instl.</th>
<th>Relative/Friends</th>
<th>Moneylenders</th>
<th>Others*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951</td>
<td>1.1</td>
<td>4.6</td>
<td>3.1</td>
<td>8.8</td>
<td>14.4</td>
<td>68.6</td>
<td>8.2</td>
</tr>
<tr>
<td>1961</td>
<td>0.3</td>
<td>10.4</td>
<td>6.6</td>
<td>17.3</td>
<td>5.8</td>
<td>60.9</td>
<td>16</td>
</tr>
<tr>
<td>1971</td>
<td>2.4</td>
<td>20.1</td>
<td>6.7</td>
<td>29.2</td>
<td>13.8</td>
<td>36.9</td>
<td>20.1</td>
</tr>
<tr>
<td>1981</td>
<td>28.6</td>
<td>28.6</td>
<td>4</td>
<td>61.2</td>
<td>9</td>
<td>16.9</td>
<td>12.9</td>
</tr>
<tr>
<td>1991</td>
<td>29</td>
<td>18.6</td>
<td>5.7</td>
<td>53.3</td>
<td>6.7</td>
<td>15.7</td>
<td>24.3</td>
</tr>
</tbody>
</table>

*Others* includes non-institutional sources other than friends and relatives and moneylenders, e.g., traders, agriculturist money lender, landlord, etc.

Source: All India Rural Credit Survey and All India Debt and Investment Surveys (AIDIS)

Source: Basu and Srivastava, 2005
3.1.1 History and Growth

Indian microfinance has grown rapidly with a focus towards its main objective of financial inclusion (Ghate, 2007 and Thingalaya et al., 2010). Financial inclusion not only leads to social and economic empowerment but also gives a formal identity as well as a pass to participate in activities which could improve their livelihood. Microfinance was introduced in India for the section of the population comprised of laborers, farmers, informal and unorganized sector, minority groups, women and senior citizens (Kumar, 2012).

Until the 1990’s the state sponsored programmes supplying credit to the poor were inefficient. Their aim was to provide credit subsidies to the poor to make them self-sufficient by establishing micro-enterprises. Mahanta et al. (2010) explains “The programs suffered from critical investments, lack of bank credit, over-crowding in certain projects and lack of market linkages. The programs were basically subsidy driven and ignored the process of social intermediation necessary for success of self-employment programme”.

In the private sector, microfinance service started with the establishment of Self Employed Women’s Association (SEWA) in 1974. It was an organization which brought working women together to set up a bank of their own, providing loans and other kinds of support services. It was more of a movement to empower women and improve their position both socially and financially. Mysore Rehabilitation and Development Agency (MYRADA) was another organization which helped fresh credit management groups (CMGs) or Self Help Groups (SHGs) in Karnataka, Andhra Pradesh and Tamil Nadu. It issued them credit from the funds received in the form of grants from National Bank for Agriculture and Rural Development (NABARD) (31.3%) and other sources (40.9%). A part of the seed money came from MYRADA itself (27.8%) (Shetty, 2012). It also helped them establish connections with different NGOs which could help them raise loans for productive as well as consumption purpose (marriage, clothing and religious functions).
A boost to the micro-credit industry was seen in real terms with the establishment of the NABARD bank in July, 1982. It started its pilot project in 1992 which allowed SHGs to obtain credit from the commercial banks without having any collateral. With the growing demand for credit as seen by the SHG-BL, there also came up alternative institutions as intermediaries for loan disbursement to the rural poor (Varma, 2009). In Table 2 (Deutche Bank Research, 2007), we see that two of the Indian MFIs for having the highest borrowers (Spandana and SHARE).

As of today microfinance industry has apex institutions such as and Rashtriya Mahila Kosh (RMK), NABARD and Small Industries Development Bank of India (SIDBI) (Mahanta et al., 2010). At the lower level there are cooperatives and regional rural banks. There are private company MFIs (registered under Section 25, Indian Companies Act), cooperative MFIs, NGO-MFI which support SHGs and CMGs such as ADITHI in Patna, ASA in Trichy, SEWA, MYRADA etc. Increasing number of commercial banks are also now involved with the microfinance industry.

3.2 The delivery methods of the MFIs in India

There are two methods of delivery of microfinance for microfinance in India.

- SHG-Bank Linkage model
- MFI model

While the SHG-Bank Linkage (SHGBL) has a good outreach, MFI model is gaining momentum. The SHGBL model has NABARD as its apex institution, MFI model has microfinance institutions registered under the Reserve Bank of India. The SHGBL model has been promoted by MARYADA (Karnataka) and PRADAN (Tamil Nadu and Bihar) initially with the launch of the pilot project of NABARD (Sinha,
2009). This programme provides credit to the SHGs without collateral via the NGOs from the commercial banks. The MFI model follows mixed strategy approach and customize their services depending upon their area of operation and the clients they target. In addition MFI approaches, management and services dependent on the type of MFI (non-profit MFI, societies and trusts, Company MFI (profitable)).

3.3 The factors differentiating MFIs in India (CRISIL, O. 2009)

- Lending model
- Loan repayment
- Mode of interest rate
- Product offerings
- Legal structure

**Figure 4: Lending Model of MFIs in India**

The Lending model given above explains how the lending system of a microfinance institutions work.

These institutions can be lenders to a group or to an individual. Group lending works for SHGs and Joint Liability Groups (JLG). While for individual lending, MFI follow the retail financing model. Borrow
who have completed stipulated successful cycles of repayment as a part of the group would be given individual loans. Dairy cooperations also give loans to the famers. MFI in this way improve their procurement and distribution chain (CRICIL, 2009). Lending to SHG follow a monthly repayment structure. As for the JLG the repayment structure is fortnightly or weekly. While MFI lending to the trades have daily repayment, those lending to the farmers have a cash-flow based repayment structure depending on the crop pattern (CRISIL, 2009). MFIs following a JLG charge a flat interest rate of 12%-14% on loans. While those following a SHG charge an interest rate anywhere between 18%-25% p.a. on reducing balance basis. MFI apart from offering credit also offer other services such as micro-insurance, remittances and savings/thrift. On legal basis MFIs are classified in as follows: (CRISIL, 2009)

- Non-profit MFIs (Societies, Public trusts non-profit companies e.g. Pradhan, Rashtriya Seva Samiti)
- Mutual benefit MFIs (cooperatives registered under the government e.g. Pustikar Laghu Vyaparik Pratisthan Bachat and Sakh Sahkari Samiti Limited.
- For Profit MFIs (Non-banking financial companies, local banks and producer companies e.g. SKS Microfinance ltd., SHARE Microfinance ltd.)
3.4 Geographical Outreach of MFIs in India

**Figure 5: MFI client outreach (customers in millions)**

Microfinance institutions are gaining momentum slowly and steadily as we can see from the Figure 4 here. The total client outreach of MFIs was recorded at 26.6 million with a gross loan portfolio of Rs.209.13 billion (State of Sector Report). A marginal decline was observed in 2012 but this was because of the liquidity crisis faced in 2010-11. Both SHGs and MFIs have seen growth as far as the client outreach is concerned. A growth rate of 19.1% was observed in 2010-11 by the MFI in terms of customer outreach.

**Figure 6: MFI Borrowers as a percentage of female population**

Source: Johnson, 2008
Though client outreach in India is increasing slowly but at present outreach in India is at 8% (Biswa and Ram, 2014). Many microfinance programs have come to be directed towards women as repayment rates and saving rates are higher amongst them. Thus they turn out to be more reliable clients then men. However not many women opt for these programs or apply for loans causing the outreach to be reduced (Sarumathi and Mohan, 2011).

Since the illiteracy rates for women in India are high it necessary to educate them about their rights. Empowerment of women by providing them access to safe finance will not only improve their livelihood status but would also be a key to moving microfinance industry to a new level.

Figure 7: State-wise Penetration of Microfinance (Microfinance clients/Rural Population * 100%)

The prevalence of MFI in unevenly spread across India. Not only is the growth rate of MFIs but also the no. of clients which are heterogeneously distributed. Southern states such as Andhra Pradesh, Karnataka, Kerala, Pondicherry and Tamil Nadu have the maximum share of MFIs and its clients. Whereas Northern states such as Delhi, Haryana, Punjab, Jammu and Kashmir, Himachal Pradesh and Rajasthan have zero or nearly zero percent prevalence of MFIs.

Though signs of improvement have been seen in the states of Maharashtra and 13 other states but this growth of new commercial MFIs is fairly consistent. As of now there has been an increase in outreach as far as the MFI are concerned but it has been largely uneven due to the geographical complexities and political involvedness.
3.5 Profitability and Returns of MFIs in India

Figure 8: Return of Assets (ROA) and Return on Equity (ROE) for MFIs (Chakrabarti and Ravi, 2010)

Chakrabarti and Ravi (2010) quoted figures from the State of the sector report for the year 2010 saying that 62 out of the 70 MFIs had positive return on assets. Also, the return was excess of 2% for these MFIs as compared to a typical banking company which had a return of 1.6% to 2%. Returns on Equity for MFIs indicate a healthy return. There are in total seven MFIs reporting a return on equity of more than 50%, with the highest return reported to be 147%. There are a significant number of institutions, however, that have ROE of less than 10% (Chakrabarti and Ravi, 2010).

3.6 Average Loan Size of MFIs in India

Table 3: Comparison of the average loan size

| Source: SHG data from provisional data provided by NABARD and MFI data from Sa-Dhan. The Bharat Micro Finance Quick report 2012 and Mix Market data. |
|---|---|---|---|---|---|---|
| | 2008 | 2009 | 2010 | 2011 | 2012 | Extent of increase in 2012 |
| SHG Member | 3606 | 4129 | 4572 | 4893 | 6420 | 1527 |
| MFI Customer | 4223 | 5192 | 6870 | 6779 | 7803 | 1024 |

Source: Microfinance of India, State of Sector Report 2012-13

The comparison given in Table 3 gives the average loan size for five consecutive years i.e. from 2008 to 2012. The average loan size has increased for the five years.
Hulme (2000) indicated that average loan size can be used as a proxy indicator to measure mission drift as a large average loan size could indicate a shift of focus of the MFI from the poor to the relatively richer clients, as poor clients usually prefer smaller loans. In order to cover the costs faced by the MFIs, they opt for bigger loans which can usually be paid by the relatively richer clients. Though there has also been an increase in the loan size witnessed by the Indian MFIs over the years but increase in average loan size is likely to prove to be beneficial to MFIs in the current context of margin and interest caps that are placed (State of Sector Report, 2012). Many researchers have also criticized average loan size as a proxy measure for poverty and mission drift for various reasons because increase in outreach and entry into new markets may lead to increase in loan size.

3.7 Challenges faced by the MFIs in India

- **Low outreach**
  As discussed earlier the outreach of the MFIs in India is only 8% as compared to 65% for Bangladesh MFIs. It is important to understand here that the commercialization process for MFI is a fairly recent phenomena. They are struggling to meet their costs along with their aim of increasing the outreach. Most of the MFIs have focused on female clients as they are more reliable than men for savings and repayment of loans but to increase outreach MFIs have to focus on men as well. It is also ironical that the poorest of Indian states such as Bihar and Orissa have low prevalence of MFIs. State governments here should provide support and encouragement to them to invest in their states.

- **Quality of services and Products**
  It is important not only to increase outreach but also provide good quality of services and products to its clients. Whether it’s provision of loan or insurance it is necessary that the product is well developed and suits the needs of the clients it is targeted towards. For example, an average loan size of an MFI maybe so small that it cannot be used for productive purpose and may just be suitable for fulfilling their liquidity requirements. Also, provision of
loan may not be enough, the loan officer should also keep a check on how the product provided is being utilized.

- **Lack of attention towards urban poor**

  Most of the attention of MFI is towards rural poor but we do have to realize that with growing urbanization, increasing number of rural people are moving to the urban cities in search of work. Equal attention has to be given to the urban poor. As far as the present statistics are concerned more than 100 million urban poor are there in India (Nasir, 2013).

- **Missing Regulatory Body**

  Section 25 companies and non-bank financial companies are yet to be registered under any kind of regulatory authority. The consequences of this are that MFIs are unable to take any kind of deposits. These savings are not only for the clients but also act as a source of funding for the MFIs itself. This is crucial aspect in today’s time as commercial borrowing is not adequate due the increasing demand by MFIs. Also when there is lack of regulation there is lack of effective management and governance as the MFIs do not feel obligated to follow any code of conduct. This may lead to malpractices and also hamper their path of growth.

Thus we can say there are still a few gaps, these have be filled by the MFIs with the support of the government and external agencies. The state has to ensure that it gives them the proper regulatory environment so that proper growth can be ensured of these MFI not only in the rural but also the urban areas.
CHAPTER 4
CASE STUDIES

For profit MFIs have always been accused ripping off poor by charging high interest rates and using tough rules for repayment but there is a need to understand that MFIs face a lot of pressure from all sides. They face political interference as high interest rates gives the politicians enough to backlash against them. They also face huge pressures from its shareholders to keep their social and economic indicators positive and give timely dividends for investments to come in. While non-profit MFIs do not face such pressure as there financial needs are met by the grants and loans from banks at subsidized rate of interests

In this chapter we will look at two MFIs. One would be a For Profit MFI: SKS Microfinance Limited. The second we will consider would be Not for Profit MFI: Cashpor Microcredit. They would be compared on the basis of a number of indicators (financial and outreach indicator) to asses trade-off between outreach and sustainability.

4.1 The Commercialization of the Indian Microfinance Institutions

Both MFIs and SHGs come under the apex bank of India: RBI. Under the RBI, lending requires the commercial banks to allocate their loan portfolio to the undeserved sector as a compulsion. This acts as a source of funding for the profit and non-profit MFIs. A little over a decade ago there existed only NGO-MFIs which worked on the Grameen model of group lending. With the growth observed in the finance industry few of these NGO-MFI started to transform themselves into Non-Bank Financial Cos. (NBFCs) to take advantage of the equity. With this came up the profit model for MFIs. The NBFC-MFIs now account more than four-fifths of all MFI loans (Chen, 2010). The source of funding for these MFIs come from commercial sources. With growing competition amongst the MFIs gives the client more choices but this may also lead to the problem of repayment for the clients and over indebtedness. Commercial MFIs are different from commercial banking as the former operates on the double line principle of fulfilling the financial aswell as social objectives.
4.2 The Case Studies

4.2.1. SKS Microfinance Ltd. (For Profit Microfinance Institution)

<table>
<thead>
<tr>
<th>Total No. of Branches</th>
<th>1261 (as of 2012)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets (USD)</td>
<td>414,2 million (as of 2012)</td>
</tr>
<tr>
<td>Sources of Funding</td>
<td>Grants, Loans and Shareholder Capital</td>
</tr>
<tr>
<td>Number of Depositor</td>
<td>--</td>
</tr>
<tr>
<td>Mission</td>
<td>It is to provide financial services to low-income households</td>
</tr>
<tr>
<td>Current Legal Profile</td>
<td>NBFI</td>
</tr>
<tr>
<td>Regulatory Status</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: (MIX Market, 2012 and Annual Report 2012-13 SKS)

Started on January 1, 1997 SKS Microfinance was an NGO. Back then it was funded by individual donors with focus on clients from Andhra Pradesh, its home state. By April 2005 it transformed itself into a commercial MFI with its operations expanded beyond Andhra Pradesh, it came to be known as SKS. SKS microfinance apart from the regular group lending also lends to individual clients who have fulfilled certain requirements. SKS only caters to women borrowers. Apart from this SKS is also into micro-insurance. SKS is also closely associated with its NGO called SKS society. This NGO provides non-financial services to the poorest to make them capable clients of the microfinance institutions. SKS runs its own schools and it has also recently collaborated with an initiative ‘Deworm the World’ which distributes deworming tablets to rural children.

By March 2006, SKS was ready raise funds by offering shares of the company to individual investors. It raised an equity of US 1.6 million (Chen, 2010). In 2010, SKS debuted on the Bombay Stock exchange by making an Initial Public Offer. The offer was oversubscribed with large number of foreign investors subscribing to it such as JPMorgan, BNP Paribas etc. SKS is now India’s biggest MFI in terms of scale of operation and outreach.
With the IPO coming about, the Andhra Pradesh government started scrutinizing the operations of SKS to see whether the money was actually going towards increasing outreach. They compelled SKS to scale back its operations which lead to mass defaults. Repayment rates fell from a 99% to a mere 5% in the year 2012 (Garud, 2013). The borrowers were badly affected by this which also led to farmer suicides in Andhra Pradesh. Negative profits were recorded at 297.1 crores for FY 2012-13.

**4.2.2 Cashpor Microcredit (Non-profit Microfinance Institution)**

<table>
<thead>
<tr>
<th>Total No. of branches</th>
<th>341 (as of 2013)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets (in USD)</td>
<td>90.3 (as of 2012)</td>
</tr>
<tr>
<td>Source of Funding</td>
<td>Loans and Grants</td>
</tr>
<tr>
<td>Number of Depositors</td>
<td>--</td>
</tr>
<tr>
<td>Mission</td>
<td>All BPL women in the BIMARU states having access to microcredit services, and many of them utilizing these services to lift themselves and their families out of poverty</td>
</tr>
<tr>
<td>Current Legal Profile</td>
<td>NGO</td>
</tr>
<tr>
<td>Regulatory Status</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: (MIX Market, 2012 and Annual Report 2012-13, Cashpor Microcredit)

Cashpor Microcredit (CMC) was a subsidiary of Cashpor Financial and Technical Services (CFTS), as of 2002. Since CFTS did not get a clearance to offer financial services it transferred its operations to CMC in the year 1997. Now CMC operates as the not for profit MFI in parts of eastern Uttar Pradesh and western Bihar. They work for women below the poverty line. CMC has also developed a housing index to identify homes to whom it could lend. It works as a Joint Liability group and has adopted practices followed by the Grameen model and the ASA model of Bangladesh (CRISIL, 2009). The company also offers scholarships to women in health education, financial literacy, and community health facilitator.
training programs; and insurance products (Business week, 2014). They have also recently collaborated with Healing Fields Foundation (HFF) in order to develop Community Health Leaders in U.P. This program is expected to provide intermediary health services.

4.3 Indicator Analysis (As per table No. 4 in the appendix)

Cashpor Microcredit and SKS microfinance both stated 17 years ago in 1997. While Cashpor is still has an NGO status, SKS is a NBFC. Main source of funding for Cashpor is from various private banks and grants. SKS has access to the market and has raised money from banks and various individual sponsors. More funding for SKS is likely to display better outreach and expansion. The analysis done above is in the years when SKS faced the Andhra Pradesh Crisis. The outreach indicators such as gross loan portfolio, number of active borrowers, the number of branches and assets (Equity) display that SKS has shown larger growth as compared to Cashpor. Average loan size, which is one of the important indicators of mission drift, shows SKS has a smaller average loan size as compared to Cashpor due to the large no. of clients. Though operational self-sufficiency ratio is low for SKS for the FY2012-13, this is due to the Andhra Pradesh Crisis but in the preceding three to four years it had been increasing before experiencing a sudden drop for that year. Since SKS has been on an unprecedented growth before 2012 we see that its staff strength has also been on a rise since the past few years, though it had experienced a drop in 2012. The revenue ratio is also high despite encountering a loss in 2012. Though risk coverage figure are not given for the year 2012 but it had been more than Cashpor for the previous years. Despite the crisis, SKS was able to raise huge amounts of funds in FY2012-13 though this figure is lower as compared to the previous years. Case load per staff member is lower for SKS resulting in better services to its clients. Cost per borrower and the interest rate is higher for SKS is higher displaying that larger financial support is required to run a for profit enterprise.
4.4 Conclusion

Mission drift maybe a concern for a commercial MFI but it is not the only and the most baleful one. Studies have shown that commercialized MFIs have been able to pursue their social and financial goals. It is also necessary to look at institutional factors such as the operational setup, lending methods and environment as they also determine how the MFI reaches its social and financial goals. Thus studies show that more emphasis should be made on reducing the cost per client rather than the issue of mission drift as this may not be necessarily pertinent to all commercialized MFIs.

The dissertation also came to the conclusion that there exists no trade-off between outreach and financial sustainability given the Indian context. In fact regulated and commercial MFIs enjoy greater profits as well as greater number of clients, especially women. The Indian microfinance industry is growing at an unprecedented rate presently but there are a number of challenges that it still faces. Thus there is a need to look back and then analyze the future course of action. MFIs in India have been operating for several years but still there exists a substantial unmet demand. This goal can only be achieved by enhancing their scale of operations through a profit oriented, self-sufficient model. An evidence of this can be seen from the case studies of SKS (For profit MFI) and Cashpor Microcredit (Not for profit MFI) which were compared on financial and outreach indicators. These indicators were also looked at in a general scenario in India.

One of the major challenges for the Indian microfinance industry is to increase its outreach and also to serve different kinds of poor and not only rural women as most of MFIs cater only to them in India. There is a need to increase the presence of MFIs beyond Southern states moving towards the Northern States with a more homogenous distribution. Cooperation amongst various stakeholders for the provision of an inclusive financial system is the need of the hour.
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Table 4: For Profit (SKS Microfinance) V/S Not For Profit (Cashpor) (2012-13 Figures)

<table>
<thead>
<tr>
<th>Comparison Indicators</th>
<th>SKS (For Profit)</th>
<th>Cashpor Microcredit (Not for profit)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Years of Existence</strong></td>
<td>17 years</td>
<td>17 years</td>
</tr>
<tr>
<td><strong>Gross Loan Portfolio (USD)</strong></td>
<td>434.6 million</td>
<td>86.3 million</td>
</tr>
<tr>
<td><strong>Number of active borrowers</strong></td>
<td>4.3 million</td>
<td>548,934</td>
</tr>
<tr>
<td><strong>Average loan balance per borrower (USD)</strong></td>
<td>100.9</td>
<td>157.2</td>
</tr>
<tr>
<td><strong>Assets (USD)</strong></td>
<td>414.2 million</td>
<td>90.3 million</td>
</tr>
<tr>
<td><strong>No. of branches</strong></td>
<td>1261</td>
<td></td>
</tr>
<tr>
<td><strong>Operational Self Sufficiency</strong></td>
<td>53.6%</td>
<td>119.6%</td>
</tr>
<tr>
<td><strong>No. of Depositors</strong></td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Cost per Borrower</strong></td>
<td>13</td>
<td>11</td>
</tr>
<tr>
<td><strong>Loans per staff member</strong></td>
<td>264</td>
<td>351</td>
</tr>
<tr>
<td><strong>No. of Employees</strong></td>
<td>10,809</td>
<td>1,566</td>
</tr>
<tr>
<td><strong>Funds raised</strong></td>
<td>2874.7 (crores)</td>
<td>570 (crores)</td>
</tr>
<tr>
<td><strong>Risk Coverage</strong></td>
<td>--</td>
<td>47%</td>
</tr>
<tr>
<td><strong>Profit margins</strong></td>
<td>13.64%</td>
<td>16.43%</td>
</tr>
<tr>
<td></td>
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<tr>
<td>-------------------------</td>
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</tr>
<tr>
<td><strong>Interest rate</strong></td>
<td>24.55%</td>
<td>21%</td>
</tr>
<tr>
<td><strong>Average outstanding balance</strong></td>
<td>77</td>
<td>161</td>
</tr>
<tr>
<td><strong>Revenue ratio</strong></td>
<td>353 (crores)</td>
<td>70 (crores)</td>
</tr>
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</table>