

## **Microfinance, client-centricity and financial performance: evidence from India**

### **Authors:**

**Richard Fairchild, Ian Crawford, Philip Brown: School of Management, University of Bath, UK.**

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### **Abstract:**

The original mission of micro-finance institutions (MFIs) was to provide “micro” loans to low income individuals who were excluded from access to formal finance, in order to empower those individuals, and to help them start their own businesses, and work their way out of poverty. Recent years has seen rapid growth in MFIs, with transformation from non-profit organisations into regulated, sustainable microfinance NBFCs and banks. Key questions that we consider in this paper are: a) how well do present-day MFIs perform in reaching impoverished individuals (that is, ‘being true’ to their original mission), b) how do sustainable MFIs balance the potentially competing demands of social and financial performance? In order to analyse these issues, we particularly focus on MFIs in India.

We consider the relationship between commercial MFIs’ social and financial objectives, employing both a game-theoretic and empirical approach. Particularly, we consider whether MFIs can be both “customer-centric” and financially-orientated at the same time. This is of particular interest in the climate of the current financial crisis, together with the ‘meltdown’ of the microfinance sector in India. During the crisis, it is even more important to understand the economic and behavioural factors affecting the relationship between the MFIs and the impoverished micro-borrowers.

In our theoretical model, we consider how MFIs can enhance the financial performance of the ventures that they lend to by improving client-centricity. In our empirical study, we focus on Indian MFIs, analysing both primary (interviews and questionnaires) and secondary data (financial data from the MIX database, press reports). From our triangulated analysis, we develop a Thematic Scoring Model (TSM) that enables us to rank the MFIs across financial and social dimensions. Overall, we demonstrate that a) the MFIs in our sample can be differentiated based on client- and product-centricity as well as financial performance, b) client-centricity, product appropriateness and scale are important factors c) that the best-performing MFIs balance these objectives, and particularly the twin goals of financial performance and client centricity. An important message for MFIs is that client centricity is of particular importance during the financial crisis, as the impoverished micro-segment population is particularly vulnerable to volatility in income and the impact of external events. Furthermore, we demonstrate that the MFI industry is an evolving one, with client-centricity becoming increasingly important, particularly in the face of growing competition in the sector.

## **1. Executive Summary**

The original mission of microfinance was to provide “micro” loans, business training and other financial services to those excluded from formal financial services, and to provide low income individuals with the financial tools they needed to start their own businesses and work their way up the economic ladder. Recent years has seen rapid growth in micro finance institutions (MFIs), and the transformation from non-profit organizations into regulated, sustainable microfinance NBFCs and banks, fuelled by access to wholesale debt and new sources of equity. Whilst this growth has been a natural outgrowth of the mission of microfinance the question is whether the underlying MFI business models have evolved. In

particular, a key question is whether or not rapid growth has been facilitated by product centric business models with limited recognition of the diversity of client needs.

The viability of the microfinance model was demonstrated by Muhammad Yunus with the development of the Grameen I model. According to Rutherford (2000), “Grameen Bank began as a project to deliver credit to poor rural Bangladeshis in 1976.” However, Yunus recognised that Grameen I was flawed in its approach. Particularly, it was inflexible, and insensitive to customer needs. Therefore, in 2002, Yunus introduced the Grameen II model, which is much more focussed on the needs of the customers.

In recent years, MFIs have been commercialised, and have experienced significant growth. Some observers argue that, as a result, MFIs have experienced ‘mission-drift’, becoming more focused on financial goals, at the expense of social objectives.

In this paper, we consider whether MFIs can simultaneously satisfy the twin objectives of strengthening the financial ‘bottom-line’ while still focussing on the client, and providing economic empowerment. We address this in the following ways. First, we consider the existing literature from scholars, practitioners, and industry experts that considers this issue. We then place the issue in the context of Indian microfinance. We identify that client-centricity is an important factor to be considered, alongside financial goals.

Next, we develop a theoretical principal-agent model that considers the economic and behavioural issues involved when an MFI makes a loan to a micro-entrepreneur. After receiving the finance, the entrepreneur invests in a project, and then exerts effort in creating value. Since the entrepreneur has to share the income with the lender, his effort incentives are weakened (moral hazard). The MFI has the option to invest in client-centricity (creating the behavioural factor of empathy), and/or engaging in costly monitoring/interference (which sours the relationship, creates anxiety for the entrepreneur and weakens effort). We consider the conditions under which the MFI should invest in client-centricity/empathy, and demonstrate that client-centricity may be good for performance.

Our theoretical analysis of the importance of social as well as financial goals paves the way for our practical real-world analysis. Our approach to tackling this study is multifaceted, combining secondary data analysis with primary research, comprising both questionnaires

and interviews. We draw on several quantitative and qualitative sources for our empirical analysis. Our analysis centres around a case study of 18 Indian microfinance institutions. At a qualitative level, we conduct questionnaires and interviews, and we consider press releases. At a quantitative level, we analyse financial data from the MIX. The combination of these data allowed us to rank the MFIs in our case study according to a number of parameters laid forth in our research methodology.

The increasing trend towards commercialised microfinance, especially in India frames this analysis. The emphasis therefore placed on client-centricity throughout this study is particularly topical. We examine the relationship between client-centricity and financial performance and the extent to which they are co-dependents forms the basis for many of our conclusions.

To properly assess the MFIs within our study we devised a Conceptual Model of Client-Centricity to frame our thinking, and awarded scores to each MFI across a range of indicators using a Thematic Scoring Model. MFI's are ranked according to scores awarded by the Thematic Scoring Model, in light of how well each balances the themes making up the Conceptual Model of Client-Centricity.

Our findings indicate a general correlation between client-centricity and financial performance, and whilst causal links are difficult to infer given the parameters of our study, the relationship apparent at the conclusion of our analysis is noteworthy. Our work is particularly important in emphasising the importance for MFIs to understand, in an increasingly competitive and evolving climate, the economic and behavioural factors affecting the performance of their micro-loans, and to address client-centricity in the current financial crisis, as their impoverished borrowers are particularly vulnerable to external events.