

## Financial Sustainability, Outreach and Impact of Microfinance Institutions - Is There a Trade-Off?

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In the 1960s and 1970s, the state was at the centre of action with support from development banks and agricultural credit projects. However, in the following decade this conventional approach to finance was substituted by a new model. According to Zeller and Meyer (2002: 4), the new approach began to emerge in the second half of the 1980s as a result of the widespread failure of development banks and the encouraging results of some bold microfinance innovations to serve the poor. It is also important that these innovations, and related efforts to build new institutions, were not borne exclusively from market forces, but relied heavily on financial support from the state and donors. Further, the focus was on building sustainable Microfinance Institutions (MFIs) to expand the financial services to groups that are otherwise not served by commercial banks and insurance companies, with the eventual goal of improving the livelihood of the poor and empowering them (Von Pischke, 1991; Mahajan and Ramola, 1996). Thus, MFIs tried to simultaneously achieve the twin goal of improving their financial sustainability and widening their outreach with welfare impact. The paradigm shift showed that the innovations in microfinance had great potential to expand the financial frontier sustainably and bridge the gap between demand and supply for financial services.

According to Zeller and Meyer (2002), the objective of financial policy changed along with the paradigm shift. Initially the focus was on improving the outreach of MFIs to the poor, that is, (depth of outreach) who are outside the frontier of formal financial services. In due course, the sustainability of financial institutions assumed great significance. Following the work of the Ohio State University and other institutions in the 1980s, the view emerged that the building of lasting financial

institutions requires that they become financially sustainable, that is, they cover their costs. Note, thus, the issue of delivering microfinance services to the poor on a sustainable basis has become more crucial recently for at least two reasons. Firstly, many successful MFIs were established originally with significant funding from donor agencies, where there is a strictly limited supply of funds. Donors would like to see the MFIs achieve sustainability within a reasonable period of time. Secondly, research in the field of MFIs also suggests that only sustainable financial services can have greater welfare impact on the poor. Thus, achieving financial sustainability became a significant criterion in judging the success of microfinance programmes.

The new paradigm has brought out some key principles to eliminate dependence and to achieve sustainability of the MFIs. They are (i) the interest rates that are high enough to cover non-subsidised financial costs as well as administrative costs, and maintain the value of equity in real terms; (ii) pay adequate deposit interest rates to ensure that voluntary savings becomes an increasingly significant factor in financing their loans; (iii) lower administrative costs through efficient techniques and procedures in assessing investment plans, screening borrowers, processing loans, collecting repayments and mobilising savings to ensure that lending rates do not become prohibitive; (iv) maintaining transparency of financial statements through external auditing and publishing of audited statements (Yaron, 1992). It is important for regulators, donors, banks and potential investors to be able to carry out their own analysis of financial institutions that are dealing with the poor. To achieve financial sustainability, it is necessary for MFIs to reach significant 'economies of scale' by developing a streamlined and

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cost effective mechanism in operation. It is necessary to go through an expansion phase relatively early in the life of the MFI to achieve the desired scale. This requires considerable resources for capacity building, increasing outreach and institutional development. It is equally important to minimise costs through efficient use of staff and charging an appropriate interest rate on loans. The key to financial sustainability is controlling costs and bad debts, increasing volumes and spreading distribution by offering other financial services such as savings and insurance (Mahajan and Ramola, 1996).

The access to credit from the MFIs is easier compared to the procedures followed by the conventional lending institutions. By using mechanisms such as social networks, social ties and social sanctions, the MFIs can effectively reduce selection, incentive and enforcement problems inherent to credit transactions, unlike formal financial institutions. Following the Hoff and Stiglitz (1990) line of thinking, Hulme and Mosley (1996) provided theoretical explanations, supported by empirical evidence and examined ways and means of overcoming the problems arising from information asymmetries. They identified two methods for overcoming the difficulties arising from information symmetry, namely, direct methods and indirect methods. Direct methods included intensive loan collection and incentives for savings and repayment, for the purpose of reducing rates of default. Peer group lending was considered as an indirect method for achieving the same purpose. These ideas were integrated, to a large extent, in the post 1980s in many microcredit programmes worldwide. The common belief is that further institutional innovation and microfinance expansion will rely on public intervention and financial support from the government or donor agencies. When scarce government or donor funds are used for microfinance, a social cost is involved in supporting such financial institutions. This consideration raises the third objective of finance, i.e, improving the welfare impact. This objective introduces the highly contentious and complicated issue of measuring the

impact of financial services (Zeller and Meyer, 2002).

The MFIs will be reflecting a critical triangle of the three objectives, namely financial sustainability, outreach and impact. All MFIs attempt to contribute to these objectives, but many stress on one particular objective over the other two. Some MFIs may have a higher level of impact with limited outreach or financial sustainability. Others may have smaller impact but are highly sustainable. In this background, some analysts argued (Otero and Rhyne, 1994; Christen et al., 1995) that increasing the depth of outreach and sustainability are compatible objectives and others argued that there appears to be a trade-off between improving outreach and achieving financial sustainability (Hulme and Mosley, 1996; Navajas et al., 2000). The potential trade-offs between outreach and financial sustainability has been well acknowledged in the literature, but there may be a trade-off between impact and financial sustainability (Zeller and Meyer, 2002; Zeller et al., 1997). According to Sharma and Buchenrieder (2002) the impact of microfinance can be enhanced through complementary services - such as business or marketing services or training of borrowers that will raise the profitability of the MFIs or microfinance projects. The complementary services sometimes offered by the MFIs will increase their operating costs; thereby jeopardising financial sustainability, provided borrowers or other agencies do not cover the additional costs.

### **The Trade-off between Financial Sustainability and Impact**

The original approach on which the microcredit movement was built might be called the poverty lending approach. According to this approach, target of microcredit was to lend to the poorest segment of the population. However, in 1990s the approach of the microfinance market in the developing countries shifted to the MFI's financial sustainability. This approach was supported by a number of development practitioners advocating the commercial phase of the microfinance programme worldwide (Mayoux, 2001;

Wooller, et al., 1999; Morduch, 1999; Hulme and Mosley, 1996). Though, the microfinance sector is driven by common concern for the poor, these approaches led to a trade-off between the two. For proponents of financial sustainability, the overall goal of microfinance (or MFIs) is to provide sustainable financial services to people who are outside the frontiers of formal financial services. To poverty lending practitioners, financial sustainability is important, but the prime goal of microfinance is poverty reduction. It is apparent that advocates of institutional sustainability focused heavily on the supply side of finance, whereas, the advocates of poverty lending concentrated on demand side aspects of financial development.

As majority of institutions providing microfinance services in developing countries are not-for profit entities they depend on grants and subsidised funding from donors and public funding from national/state government. However, there is no guarantee in getting sufficient funds in the long-run from either the government or donor agencies. According to Rahman (2004) "Donors are subject to fads; their development agendas and priorities often shift as government change. Therefore, the argument is that MFIs need to attract capital from private/commercial sources.

Access to these capitals requires that MFIs lend to the poor on a profitable, full cost-recovery basis".

There are two different schools of thought in microfinance, i.e. the Minimalist and the Maximalist approach. The former considers credit alone as a vehicle to raise income and reduce poverty. However, the advocates of the 'maximalist approach' criticised the views of 'minimalist approach' of providing 'credit-alone' services; that will have very modest impact on the welfare of the poor and they are in favour of delivering (blending credit with non-financial services) the credit-plus services. Thus, the credit plus approach in development banking has led to the promotion of multi-functional financial institutions which were encouraged to provide credit to get directly or indirectly involved in

providing other services such as collecting deposits (mobilisation of savings) extension, training, accounting, business management, enterprising, marketing, sale of inputs, sale of consumer goods, and even repayment of previous loans obtained from other sources (Versluysen, 1999; Torre and Gianfranco, 2006). Many thinkers believed that providing complementary services will enhance the welfare impact on the poor on the one hand and, on other, it will jeopardise the financial sustainability of the MFI.

In this context, it is important to understand the trade-off between financial sustainability of the MFI and reaching the poor in order to pursue development in their wellbeing. It is well documented that in the developing countries large number of not-for profit entities is playing a vital role in financial intermediation. These institutions are trying to achieve greater levels of self-sufficiency through full-cost pricing on their credit services on the one hand and trying to improve the welfare of the poor, on the other hand, through various credit-plus. Therefore, it is indispensable to identify whether or not there is any trade-off between the objectives of the MFI on financial sustainability and impact on the poor.

### The Empirical Review

Lack of access to credit is generally seen as one of the main reasons why many people in developing economies remain poor. Since the late 1970s, however, the poor in developing countries have increasingly acquired access to small loans through the group-lending microfinance programme. The 'discovery' of group lending opened up the promise of microfinance (Armendariz and Morduch, 2005). In particular, during the past ten years, the programme has been introduced in many developing economies. Between 1997 and 2005 the number of MFIs increased from 618 to 3,133 and the number of people who received credit rose from 13.5 million to 113.3 million, with 84 per cent of them being women (Daley-Harris, 2006). Policy makers apart, the academic world has also shown increased

<sup>1</sup>The Grameen Bank in Bangladesh and other donor-supported group lending projects in various parts of world follow this approach.

<sup>2</sup>This approach to microfinance is associated with the Bank Rakyat Indonesia and Bancosol in Bolivia are pioneers of this approach in the world.

<sup>3</sup>Credit-plus' is a (maximalist approach) clump of credit, savings, insurance, training, marketing, education and skill and technology acquisition.

interest in microfinance, and several questions have been addressed in the ensuing literature. One major strand of this literature focuses on expanding sustainability, outreach and impact of microfinance from an empirical perspective.

### **The Empirical Review: Financial Sustainability, Outreach and Impact of MFIs: The trade-off?**

The role of MFIs in the financial sector in several developing economies is escalating rapidly. Various studies in different countries on the performance of the MFIs confirm this (Adongo and Stork, 2005; Zeller and Meyer, 2002; Meyer, 2002, Cull, et al., 2006). For example, in Bangladesh the MFI Grameen Bank reported 2.4 million members at the end of 2000, with 95 per cent of them being women, and \$225 million outstanding loan. In general, numbers of MFIs have registered impressive outreach in several developing economies including India, Cambodia, and others (Meyer, 2002).

Various studies have been conducted to answer the questions of financial sustainability, outreach and impact on the poor and the trade-offs in pursuing the goals simultaneously. Many MFIs have the dual objective to provide financial as well as social/economic services, like, health care, educational, and micro-enterprise development for the underprivileged. In this sense, MFIs are not always perceived as profit maximising financial institutions. At the same time, the remarkable accomplishment of microfinance lies in the fact that some of the successful MFIs report high rates of repayment, sometimes above 95 per cent. This rate demonstrates that lending to underprivileged borrowers without credit histories or the assets to post collateral can be financially sustainable ventures (Sengupta and Aubuchon, 2008). The sustainable microfinance industry continues to grow with a wider client base and is often viewed as crucial for its access to mainstream sources of finance. However, the heterogeneous nature and spread of MFIs in the world lead to difficulties in the estimation of financial sustainability, outreach, and

impact. According to the Microfinance Information Exchange (2007), anywhere from 1000 to 2500 MFIs serve some 67.6 million clients in more than 105 countries. Of these 67.6 million, more than half live below the poverty line. That is, some 41.6 million of the poorest people in the world have been reached by MFIs. Nevertheless, some MFIs (SKS, SHARE in India) have also begun to seek public and international financing, to further increase their working capital and expand the scope of their operations.

The promise of microfinance is that it can deliver critical benefits to underserved borrowers only when the programmes have achieved sustainability. And if that objective cannot be met, the challenge is then to develop a framework for thinking about microfinance as a social tool that may need to rely, to some degree and in some places, on continuing subsidies (Armendariz and Morduch, 2005). However, the reality is that much of the microfinance movement continues to take advantage of subsidies in one way or the other.

Conning (1999) uses the data published by the Microbanking Bulletin (1998) on comparative statistics of 72 MFIs from across the globe. The list includes large Asian MFIs such as Indonesia's BRI and BKD, Thailand's BAAC co-operatives; the much celebrated BancoSol and other Bolivian MFIs, as well as many FINCA village banks. His study focuses on the contract design problem faced by MFIs that want to maximise the impact and outreach of their lending activities to a target population of poor borrowers while remaining financially sustainable. According to Conning (1999), "Tradeoffs between outreach, sustainability and financial leverage are shaped by the endogenous monitoring and delegation costs arise within a chain of agency relationships subject to moral hazard between borrowers, loan staff, MFI equity-owners, and outside investors. All else equal, sustainable MFIs that target poorer borrowers must charge higher interest rates, have higher staff costs per dollar loaned and are less leverage." In his analysis Conning argues that reaching the poorest of the poor is more costly than reaching

other segments of the market even when there are no fixed lending costs, and that leverage may be much harder to achieve for MFIs that target the "low-end" of the market. However, he rightly says that attaining sustainability today will mean more leverage, outreach and impact tomorrow.

Morduch (1999) used the same data of the Microbanking Bulletin (1998) for the analysis of profitability and sustainability of MFIs. According to him hundreds of microfinance programmes across the world continue to rely on the donors for operational capital. The study revealed that most of the MFIs have crossed the operational sustainability hurdle. However, the promise of microfinance to reach households that are destitute, marginalised and live below the poverty line remains un-fulfilled. In 2003, the Microbanking Bulletin conducted a survey of 124 MFIs with a commitment to becoming financially sustainable. This survey found that 66 MFIs surveyed were financially sustainable, just slightly above 50 per cent. For micro-lenders focusing on the "low-end," just 18 of 49 were financially sustainable as of the July 2003 accounting - just 37 per cent. On the other hand, the data on MFIs shows that programmes reaching poorer clients can also accomplish operational sustainability while covering the full costs of transactions. But, on the other hand, the norm continues to be subsidisation.

It is very difficult to derive any meaningful inference from the survey conducted by the Microbanking Bulletin on MFIs. In this context, Armendariz and Morduch observed that, "In terms of financial management, the programmes are thus skimmed from the cream of the global crop. We lack comparable data on the 2,572 MFIs counted by the Microcredit Summit at the end of 2002, but the bulk presumably show weaker financial performances than 124 in the Microbanking Bulletin" (Armendariz and Morduch, 2005: 232).

Paxton and Cuevas (2002) studied MFI influence on financial sustainability and depth of outreach with regard to the rural population, women, and the poor and

illiterate clients in Latin America. They found that village banks tend to have greater depth of outreach, whereas credit unions have higher levels of financial sustainability. They argue that this does not necessarily reflect a trade-off between objectives, outreach and sustainability of the institutions. While, their study revealed that achieving financial sustainability and reaching a larger section of the poor is determined by the persistent access to external financial support. The study conducted by Navajas et al., (2000) in rural and urban Bolivia, in evaluating the poverty level of clients and financial self-sufficiency of the five MFIs elucidated that there was absolute trade-off between financial sustainability and reaching the poorest of the poor. Further, the study observed that while all five MFIs moved toward financial sustainability, none of them reach the poorest of the poor. The study carried out by Zeller et al., (2002) measured the poverty level of MFIs' clients in relation to the general population in the intervention area of the MFI in four case study countries in Central America, Eastern and Southern Africa, and South Asia. Their study results revealed that the group lending MFIs in South Asia were successful in reaching the poor people with financial sustainability. However, the MFIs in other countries were less sustainable and had a tendency to serve the better-off people in their operational area.

Hulme and Mosley (1996) presented a much more comprehensive analysis of 13 different MFIs across seven countries with different structures and all having the objective of poverty reduction. They found that the institutions having with a tendency for financial sustainability had lower arrears rates and subsidy dependent indices than those that were less financially sustainable. The study summed up that the average income impact of borrower households above or on the poverty line is higher than those below poverty line, as compared to income changes encountered by a control group. Thus, the impact of microfinance increases, at a decreasing rate, with client income. However, in the study is a little ambiguous on the

relationship between poverty reduction and financial sustainability. The study brings out the interesting implication that poverty impact and financial sustainability both can be enhanced if adequate institutional reforms are introduced, like cost recovery interest rates, saving and insurance facilities, intensive collection of loan installments and incentives to repay.

Patten et al., (2001) provided a more recent historical example of the resilience of MFIs and their clientele. They compared the performance of the Indonesian MFI, Bank Rakyat Indonesia (BRI), to formal Indonesian banks during the East Asian financial crisis. They found that the BRI's performance was superior to that of the formal banking sector in terms of loan repayment and savings rates. It is believed that "large scale sustainable microfinance can be achieved only with the financial system approach" (Robinson, 2001). To be able to reach large numbers of clients, the MFIs need to achieve self-sufficiency, but this should not be attained at the expense of the benefits to these clients in terms of poverty reduction. The study by Gibbons and Meehan (2000) in the Microcredit Summit Campaign 2000 is founded on the belief that it is possible for MFIs to serve very poor clients and achieve financial sustainability. The paper presents evidence from the academic literature and detailed case studies of three MFIs that have achieved this objective. The paper concludes that there is no inevitable trade-off between poverty impact and the rapid growth of MFIs to serve large numbers of clients. Further, according to Gibbons and Meehan (2000), "thus it is not the clientele served that determines MFIs potential for financial self-sufficiency, but the degree to which its financial services program is well-designed and managed."

The study by Churchill (2000) supports this conclusion through the empirical analysis of 114 MFIs (Microbanking Bulletin, 2000) across the globe. The study reveals that there is no evidence that sustainable MFIs cannot work with very poor clients. The data suggests that it is possible to provide very small loans and be financially self-sufficient. These, institutions can

also target women more effectively than sustainable programmes that provide larger loans (Churchill, 2000). Therefore, financial sustainability can be attainable by delivering small loans for women borrowers who are marginalised by the financial sector. And, thus, the objective of microfinance can be reached without any trade-offs between financial sustainability and reaching the poor.

Simanowitz and Walter (2002) studied two MFIs - CRECER (Credito con Education Rural), Bolivia and SHARE Microfin Limited, India - which demonstrated that MFIs could achieve excellent performance with the combined objectives of poverty impact and self-sufficiency. The case study institutions have achieved 100 per cent financial self-sufficiency, outreach to the poorest people in their countries, and significant positive impact on the lives of their clients. Thus, the study concludes that poverty-focused MFIs can clearly achieve excellent financial sustainability. However, the study points out the need for research in finding the trade-off between financial and non-financial (social) impacts and sustainability of microfinance institutions.

The study by Qayyum and Ahmad (2007) used the Non-parametric Data Envelopment Analysis to examine the efficiency and sustainability of MFIs in South Asia. The study has estimated the efficiency and sustainability of MFIs working Bangladesh, Pakistan and India. The study found that eight MFIs from Pakistan, six from Bangladesh and five from India were at the efficient frontier. However, the MFIs that attained financial sustainability had 10,000 active. Thus, reaching the poor by the MFIs is negligible. It is apparent from this study that sustainable MFIs are not reaching large numbers of poor people. Hence, the study found a trade-off between reaching large numbers of poor for wider welfare impact and financial sustainability of MFIs.

Adongo and Stork (2005), applied the Ordinary Least Squares for the Analysis of Covariance model consisting of cross-sectional data that captured various features

of selected MFIs in Namibia to identify the factors that influence financial sustainability. The study found that 143 sample MFIs in Namibia were not financially sustainable. The degree of financial un-sustainability was lowest for term micro-lenders and was highest for multi-purpose co-operatives involved in the provision of microfinance. Therefore, the study reveals that MFIs providing multi-services (credit-plus services) are less sustainable than others. Nevertheless, the study does not find any empirical evidence to suggest that low PCI households hinder the financial sustainability of the MFIs. Thus, trade-offs exist when MFIs offer various services to their clients and not when achieving financial sustainability by serving a large number of poor households.

The study of financial self-sufficiency of seven MFIs in Bangladesh by Hossain, et al., (2000), argues that there were substantive reforms in the microfinance sector in Bangladesh. It strived towards a more fully developed financial intermediation system for the poor. Further the study found that the 'credit-plus services' or 'maximalist approach' was very costly and reduced the financial sustainability of the MFIs. Hence, most NGO-MFIs will have to segregate their credit programmes from social development programmes. However, the study failed to provide the proper link between the effect of credit-plus services and the sustainability of the MFIs. The study used data from 1993 to 1995 for the analysis. However, the sector has changed vastly since the last decade. In this context, the study is not conclusive to derive any meaningful implications on the influence of credit-plus services on the financial sustainability of the MFIs.

A survey by Cull, et al., (2006), on the performance of leading MFIs in 49 countries presented interesting results. It was found that over half of surveyed MFIs were profitable after making adjustments in subsidies. It also found no evidence of trade-off between being profitable and reaching poor households. The study on the performance and sustainability of two MFIs in the Philippines (Chua, 1998) illustrated that donor support

played a crucial role in contributing to the MFIs impact, outreach, and movement towards sustainability. Further, the study argued that on attaining financial sustainability there was a need for appropriate pricing, and for maintaining a good portfolio. However, both the institutions in this study were fairly responsive in meeting the credit needs and improving the standard of living of their clients.

The history of microfinance in India, as elsewhere, has been an attempt to move from highly subsidised financial services with low access for target clients to a sustainable financial service with high access for target clients. However, the destination has not always been reached by all MFIs in India. The top 10 MFIs in India by March 2006 reached more than 2 million poor customers and were able to grow without any subsidy (Mahajan, 2008). The study by Sinha, et al., (2000), shows that most of the microfinance programmes in India have not reached a significant number of the poor, nor have they achieved financial viability and sustainability. The study also found that the MFI that follow the 'minimalist' approach are more cost-effective than those that use the 'maximalist' approach. Thus, the 'minimalist' MFIs working with SHGs that manage their own funds have been more successful in keeping their operating costs low and in approaching financial self-sufficiency. The study adopted only 'cost indicators' for the analysis of financial sustainability and completely ignored the significance and consequence of the outreach and impact of credit-plus services. Further, the study used 1995 data for the analysis. However, the microfinance sector has changed widely in the last decade with dynamic institutions, delivery models, products and services, and clients.

### Conclusion

One of the important issues raised in the studies on microfinance in recent years is the sustainability of the microfinance programme. It is well accepted that providing microfinance services is costly business due

to its high transaction and information costs. Even till date, a large number of MFIs still rely on donor subsidies (external support) and are not financially sustainable. In the 1990s, the importance of financial sustainability and poverty reduction gave rise to an important debate between the 'financial systems' and the 'poverty lending approach'. The 'financial systems approach', on the one hand, emphasises the importance of financial sustainable MFIs and on the other hand, the 'poverty lending approach' concentrates on using credit to help in overcoming poverty, principally with cheap or subsidised interest rates. However, both the approaches have the ultimate goal of serving the (financially) excluded poor households in a more sustainable manner. The means by which these goals should be reached differ fundamentally.

Further, the question arises whether un-sustainable financial institutions can serve large numbers of poor with greater welfare impact. On the other hand, if the MFI emphasises on achieving the financial sustainability, then is it possible to serve the poor with a low-priced financial services. Thus, the debate between the two schools has not been concluded yet. However, the recent developments in microfinance industry seem to favour the financial system approach. The major argument to support this view is that large-scale outreach to the poor on a long-term basis cannot be guaranteed if MFIs are incapable of standing on their own feet. Thus, the paper brings various issues related to the existence of the trade-offs between financial sustainability and reaching the poor for larger welfare impact of the MFI. Most importantly, if the focus of the MFI is to offer 'credit-plus services', but the costs are high, it jeopardises financial sustainability. Thus, study assumes that there may be a strong trade-off between financial sustainability of MFIs and the impact of microfinance services.

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#### Compendium of Papers presented in an National Conference held at JKSHIM

