
Disclosure and Financial Performance: A Cross-sectional Study of Microfinance Institutions of India

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Abstract

For a country like India, poverty remains to be one of the biggest policy concerns. Amongst various measures to eradicate it, Microfinance, of late, has provided a ray of hope. The Task Force on Supportive Policy and Regulatory Framework for Microfinance constituted by NABARD defined microfinance as “the provision of thrift, saving, credit, and financial services and products of very small amount to the poor in rural, semi-urban, and urban areas for enabling them to raise their income levels and improve their standard of living”.

In numerous studies done across the world, it is generally believed that various microfinance initiatives have been able to make a difference in the target population's lives. However, increasingly, doubts have been raised over the financial sustainability of microfinance institutions. MFIs need to be economically viable and sustainable in the long run but economic implications of long term sustainability are not being considered.

At least in India, there does not seem to be any working model of analyzing the financial performance and thereby sustainability of microfinance institutions. This problem is compounded by the absence of a dedicated legislation on working and management of microfinance institutions. The lack of a regulatory mechanism for financial disclosures by microfinance institutions also abets the problem.

The present study is an attempt to analyze the financial performance of various microfinance institutions operating in India.

Since currently the level of financial disclosure made by these firms is not guided by any dedicated legislation and therefore is mostly voluntary, the study seeks to study the difference in financial performance between institutions practicing differing levels of disclosure policy.

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Introduction

Of late many governments, businessmen and academicians alike have shown great interest in micro finance for its potential role in poverty alleviation activities. Microfinance Institutions have been expected to reduce poverty, which is considered as the most important development objective (World Bank, 2000). Robinson defines Microfinance as small-scale financial services for both credits and deposits—that are provided to people who farm or fish or herd; operate small or micro enterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and local groups in developing countries, in both rural and urban areas (Robinson, 2001). Subsidized credit has long been believed to be the panacea for the eradication of poverty for decades now. But perhaps the only thing subsidized credit could create was Non Performing Assets (NPAs). The realization that the core issue for the poor was access to credit rather than the cost of credit came very late. Microfinance is often credited with putting an end to the interest rate debate for the poor.

A host of players have entered microfinance space, each having a reason of its own. It is believed that, Microfinance, unlike other developmental efforts, gives quick and tangible results (Srinivasan et al, 2006). Many NGOs that were early entrants gradually metamorphosed into full fledged lenders, developmental professionals left their cushy careers to set up microfinance firms. Even many banks have experimented with working exclusively with self help groups and therefore have 'microfinance branches'.

The players range from not-for profits trying to achieve developmental objective through microfinance. At the other extreme are commercial banks that view microfinance as 'good, sound banking', a good source of deposits, and low-risk mass lending.

In fact the success of self help groups in microfinance led many to use them to achieve many other objectives as well. Many governmental schemes are being routed through microfinance, including a very large project funded by the World Bank and being implemented in a southern state of India. Similarly organizations like

Hindustan Lever has looked at the potential of these groups as a channel for retailing and has launched a program called 'Project Shakti' to tap the smaller villages through the micro-credit. They are also being harnessed as an alternative distribution channel. This amounts almost to free riding since these channels have been developed by the MFIs after a lot of persistent hard work and investment. The companies that initiated this are reputed ones like HLL, EID Parry and Philips etc. (Srinivasan et al, 2006).

The persons engaged in championing Microfinance are gaining prominence and it is said that some of the leaders, including many women, have been playing a more active role in other social spheres, to the extent of contesting elections for the panchayat and so on.

Conceptual Framework

As microfinance firms are viewed predominantly as instruments of social change. Their performance has been often measured by non-financial parameters. The concept of social performance has seemed to overshadow the state of financial health of these enterprises. However, the accepted criteria in a number of studies to study the performance of any MFI have been the twain of Financial Performance and Outreach (Chaves and Gonzales-Vega 1996, Christen et al 1995, Ledgerwood 1999, Yaron, 1992, Yaron 1994, Yaron et al, 1998, as cited in Arsyad, 2005). However, there exist various social performance assessment tools and institutionalized rating processes but assessment of financial performance has yet to gain ground. Some of the more popular tools include MFC Social Audit, ACCION SOCIAL, USAID SPA Audit, M-CRIL, Micro-finanza Rating, Micro Rate (SPA), CGAP-Grameen-Ford Progress out of Poverty Index (PPI) etc (Sen, 2008). These tools often focus on outreach indicators. Outreach indicators are considered as proxies for impact of MFI on development (Yaron et al 1997)

The financial performance assessment is devoid of such a multitude of options and methodologies despite critical importance of financial sustainability. Though an ambition for sustainable institutions has been often articulated, there was also opinion that most microfinance institutions working in this field have been unsustainable (Copisarow, 2000 as cited in

Dayson et al 2006). Research studies have shown that this is predominantly connected to the perception of micro borrowers' risk and creditworthiness, and the diseconomies of scale in making small loans (Quach, 2005, As cited in Dayson et al 2006). Microfinance has been attractive to lending agencies because of demonstrated sustainability and low cost of operations. In India, the engagement of NABARD and SIDBI shows that they see long term prospect for this sector (Srinivasan et al, 2006).

However, the methodologies to study financial sustainability are fewer. A Review of studies reveal that amongst those available, most of the tools cover social as well as financial performance both. Principal among them are CAMEL model by ACCION, PEARLS model by WOCCU, GIRAFE Rating by PlaNet and MicroRate (CGAP, 2001 as cited in Arsyad, 2005). Amongst these, except the PEARLS methodology by World Council of Credit Unions (WOCCU), all others are hybrid models using qualitative and quantitative data both (Arsyad, 2005). These methodologies are proprietary and not available for use in public domain.

It is noted with surprise that in India, a review of the studies done on microfinance sector has revealed that there is hardly any study focusing on the financial health of MFIs.

Absence of studies on assessing financial performance of MFI firms in India may be partly due to the branding and common perception of MFIs as not for profit organizations. However the long term viability of any business model depends as much on the financial viability as on its ability to deliver its avowed objectives.

Another more important reason may be lack of financial disclosure by these firms rendering a credible study of their financial performance difficult. Though some of the firms have made their books and statements available in public domain; the information is not adequate for any meaningful interpretation.

It can be seen that without sound financial performance the sustainability of these microfinance institutions is not possible. Increasingly questions are being raised over the cost of funds for these enterprises and their ability to earn margins sufficient to cover their operational costs and still leave some

profit (Arsyad, 2005). It has been pointed out repeatedly that MFIs need to be economically viable and sustainable in the long run (Srinivasan et al, 2006). In fact studies have found strong linkage between the financial sustainability of microfinance institutions and achievement of their social objectives. Low income customers are more likely to borrow from institutions they see as financially viable (Zeller et al, 2003).

The extant business model of most of the MFIs involves huge operational costs since a lot of contact is required with the intended beneficiary. Also as far as the cost of funds are concerned, as the scale of operations go up, MFIs need funds beyond the grant/soft loans etc. The commercial funding requires them have risk capital with market interest rates.

In this backdrop the sustainability of MFIs needs to be looked at very carefully even from a social performance standpoint. The results achieved in poverty alleviation by MFIs can not be an event and given the endemic nature of poverty, requires a continuous and long term commitment from these enterprises.

Morduch (1999) as cited by Crabb (2008), describes the need for more empirical work on the sustainability of MFIs. He points out: "Empirical understandings of microfinance will also be aided by studies that quantify the roles of the various mechanisms in driving microfinance performance...."

Since as pointed out earlier there is a marked disparity in firms' disclosure levels, and despite the fact that presently most of the big donors have linked their grants with disclosure levels many of the firms are not resorting to full voluntary disclosure. This study seeks to assess how the financial performance of these firms varies with their levels of disclosure. We expect to find that on most of the parameters the low disclosure firms under-perform the high disclosure firm, which probably explains their (low disclosure one's) reluctance in disclosure.

Data & Methodology

Meyer (2002:4) indicated, "Measuring financial sustainability requires that MFIs maintain good financial accounts and follow recognized accounting

practices that provide full transparency for income, expenses, loan recovery, and potential losses." One of the biggest problems in conducting this kind of study with MFIs in India is that for want of mandatory disclosure requirements and lack of dedicated legislation governing MFIs; it is very difficult to get reliable and actionable data on the financials. There is no legal framework forcing the firms in the microfinance space to disclose their financial statements periodically.

However, since there is a huge amount of donor money from mostly western countries available to be tapped by MFI firms in developing countries, the problem of non disclosure assumes a significant dimension. How does a donor decide about the suitability of a MFI firm to receive donations and grants in the absence of data on its financials? To overcome this, the CGAP or the Consultative Group on Assisting the Poor, a global body of dominant donors in MFI space framed its own guidelines and linked the donations with the quality and amount of disclosure made by aid seeking MFIs.

"The donors, who make up the Consultative Group to Assist the Poor (CGAP), have developed disclosure guidelines to specify information that should be included in MFI financial reporting. Donors, other investors, board members and managers of MFIs rely on financial statements when they assess financial sustainability and the loan portfolio. But many financial statements do not include enough information to permit such an assessment. The disclosure guidelines help to address this problem. The guidelines are not accounting standards but augment accounting standards to improve MFI reporting. They are voluntary norms. They require disclosure of some information not normally found in financial statements like grants and donations, in-kind subsidies, portfolio composition and delinquency status. They do not prescribe a choice of accounting basis or method but call for the reporting of the basis or method used. The guidelines come with brief explanations of why the required information is important."

This voluntarily disclosure is facilitated by a web portal called www.mixmarket.org that maintains financial and other reports voluntarily submitted by MFIs that are a candidate for receiving donations from CGAP. On the lines of MIX and rider attached by foreign

donors on the MFIs to seek voluntary disclosure before they can be considered for grants, some of the Indian MFIs have started to report their financials to MIX (www.mixmarket.org). By far mix market is most reliable database currently available on MFIs. Mix market has a system of classifying the reporting firms into star categories. This ranges from one to five stars. This is based on their level of disclosure, vintage, quality of disclosure, financial parameters etc. A five star MFI would mean a firm submitting almost all relevant financial statements with prescribed frequency. A four star or a three star rated firm reflects lower level of disclosure or its poor quality or insufficient frequency.

Out of over a hundred MFIs currently reporting to Mixmarket, we have chosen only five star rated MFIs. They are 24 in number. These firms are high disclosure firms. All the other star category firms (four and below) are low-disclosure firms. This group has total 35 firms.

However the Mix market database shows in case of high-disclosure firms (five stars) the latest financial data is available for year 2008 and in some cases 2009 as well. But in case of low-disclosure firms the data is only erratically available (precisely why they are rated lower). Most of the firm have not been regular in reporting and for a large number of firms the data for 2008 is either not there or is only partial, rendering itself incapable of use in our analysis. However for 2007 the data for low disclosure firms is available for larger number of firms.

To ensure comparability, we have chosen the financial data of 2007 (FY 2006-07).

Thereafter their financial performance has been compared on 22 different ratios. These ratios have been chosen again from the reporting format of Mix Market. The reporting format broadly analyzes the companies on seven parameters of financial performance (see appendix 1 for the definitions of the ratios comprising these parameters):

- | | |
|----|-------------------------------|
| 1. | Financial Structure |
| 2. | Overall Financial Performance |
| 3. | Revenue |
| 4. | Expenses |
| 5. | Efficiency |

- 6. Productivity
- 7. Risk

These parameters are most comprehensive and globally accepted indicators of financial health of a MFI as Mix market uses it across the world for classification. Apart from the above seven parameters we have considered three balance sheet aggregates as well for the purpose of comparison, namely, Gross Loan Portfolio, Total Assets, Savings and Total Equity.

The sample is composed of 24 firms in High Disclosure Group and 35 firms in Low Disclosure group, making the total number of firms analyzed for this study 59. The data utilized has been for the financial year ending

March, 2007 owing to availability constraints. However, as can be seen, data set is too small to lend itself to rigorous multivariate analysis. Therefore the methodology used is difference of means test (t- test) for the purpose of comparing the performance of these star performers.

Data Analysis

The application of difference of means test has been done at $\alpha = 0.05$. For various categories the analysis is as follows:

BALANCE SHEET AGGREGATES:

	Sig.	High Disclosure Firms	Low Disclosure Firms
Gross Loan Portfolio	**	24	35
Total Assets	**	24	35
Total Equity	*	24	35

* sig. at 10% level, ** sig. at 5% level.

Three balance sheet aggregates show that there is significant difference in the book size and equity base of the firms with differing degrees of disclosures. The book size represented by gross loan portfolio in case of high disclosure firms is higher on average ($t =$

2.045). This is also in line with the finding that the total assets of the high disclosure firms is significantly higher than that of low disclosure firms ($t = 2.048$). However the firms seem to differ less significantly with each other on equity base ($t = 2.055$).

FINANCING STRUCTURE

	Sig.	High Disclosure Firms	Low
Capital / Asset Ratio	-	23	33
Debt / Equity Ratio	**	23	33
Gross Loan Portfolio / Total Assets	-	23	33

* sig. at 10% level, ** sig. at 5% level.

The three ratios reflecting the financing structure of these MFIs show that only the debt equity ratio is significantly different ($t = 2.034$) whereas the capital to assets ratios and gross loan portfolio to total assets are not statistically different. Now this means that

the firms with high disclosure ethic have huge debt obligations. This may be due to their high capacity to borrow debt from organized lenders owing to their disclosure practices. Lenders would always prefer a firm with high disclosure to a firm with low disclosure.

However there is no difference between the firms on capital assets ratio only indicates that the firms are uniform in their risk management practices and maintain like proportion of capital to total assets. However in case of gross loan portfolio to total asset,

both the components of this ratio are significantly different across firms as discussed earlier, but their ratio is not different that again points towards similar risk appetite of the firms.

OVERALL FINANCIAL PERFORMANCE

	Sig.	High Disclosure Firms	Low
Return on Assets (%)	-	20	31
Return on Equity (%)	-	20	31
Operational Self-Sufficiency (%)	-	24	31

* sig. at 10% level, ** sig. at 5% level.

There does not seem to be significant difference in the overall financial performance of the firms. It is captured by three ratios in the MIX market database.

The return on Assets (t = 2.036), return on equity (t = 2.039) and operational self sufficiency (t = 2.009) are not found to be significant.

REVENUES

	Sig.	High Disclosure Firms	Low Disclosure
Financial Revenue Ratio (%)	-	21	31
Profit Margin (%)	-	21	31

* sig. at 10% level, ** sig. at 5% level.

The ratios reflecting revenues are also not significantly different from each other in case of high disclosure and low disclosure firms. The financial revenue ratio

representing financial revenue as a proportion of average total assets is found not significant (t = 2.009). Profit margin is also not significant (t = 2.016).

EXPENSES

	Sig.	High Disclosure Firms	Low
Total Expense Ratio (%)	-	20	31
Financial Expense Ratio (%)	-	20	31
Loan Loss Provision Expense Ratio (%)	-	18	30
Operating Expense Ratio (%)	-	20	31

* sig. at 10% level, ** sig. at 5% level.

The expenses ratios are found to be similar for both the group of firms. In some cases the data are missing and therefore the number of firms varies between ratio to ratio. Total expenses ratio is not significant for both the group of firms (t = 2.03). Financial expenses ratio representing the proportion of debt

service charges to total expenses is also similar for both the group of firms (t = 2.01). Provision for loan losses and operating expenses ratio is also not statistically different for both types of firms (t = 2.01 and 2.03 respectively).

EFFICIENCY

	Sig.	High Disclosure Firms	Low
Operating Expense/Loan Portfolio (%)	-	20	31
Cost per Borrower	-	20	31

* sig. at 10% level, ** sig. at 5% level.

On the efficiency parameter the firms in both the high disclosure and low disclosure groups are found to be performing in a similar fashion. The operation expenses to loan portfolio ratio is found to be not

significant in case of both the types of firms (t = 2.03) whereas the cost per borrower is also not significant with t = 2.01.

PRODUCTIVITY

	Sig.	High Disclosure Firms	Low
Borrowers per Staff member	-	20	31

* sig. at 10% level, ** sig. at 5% level.

In case of both the groups of firms the productivity parameter measured by borrowers per staff member

is found not to be significantly different (t = 2.01).

RISK COVERAGE

	Sig.	High Disclosure Firms	Low
Portfolio at Risk > 30 days Ratio (%)	-	20	31
Loan Loss Reserve Ratio (%)	-	20	31
Risk Coverage Ratio (%)	-	13	23
Write Off Ratio (%)	-	19	31

* sig. at 10% level, ** sig. at 5% level.

In risk coverage area the four ratios again have shown insignificant differences between the performance of firms from both the low and high disclosure groups. Portfolio at risk for more than thirty days ratio is similar for both the groups ($t = 2.06$). In case of the loan loss reserve ratio the performance of firms is again found to be similar ($t = 2.05$). In case of risk coverage and write off ratio too the firms do not exhibit significant difference in performance ($t = 2.03$ and 2.01 respectively.)

Discussion

We may conclude that the 59 firms differentiated on the dimension of disclosure have shown following characteristics:

1. All the firms in high disclosure group are having larger gross loan portfolio than firms in low disclosure group.
2. The firms in high disclosure group have bigger balance sheets and a larger equity base.
3. The most important differentiator in financing structure of high disclosure and low disclosure firms is the debt equity ratio which is higher for the high disclosure firms. It is likely that owing to their better disclosure they are able to attract more debt capital than low disclosure firms.
4. There is no significant difference in the overall financial performance of high disclosure and low disclosure firms. They have similar Return on Assets, Return on equity and Operational Self Sufficiency.
5. Their revenues and profit margins are also not significantly different pointing that the firms are operating with similar business models and have identical expenses too.
6. The expenses of the firms also are not very different from each other as measured by their total expenses, financial expenses, loan loss provisions and operating expenses as a proportion of their total expenses.
7. The firms also exhibit similar level of operating efficiency.
8. In line with efficiency of operations the firms exhibit similar level of business productivity as measured by number of borrowers per staff member.

9. The risk management practices are also more or less uniform across the firms as reflected in various risk coverage ratios.z

Therefore, it's the bigger and more aggressive firms that are opting for more voluntary disclosure than the smaller and mostly closely held firms that are shying away from disclosure. It may be interesting to note here that since disclosure is mandatory for firms seeking the aids and grants they should have low debt equity ratio to start with. However as they grow bigger in size with infusion of grants their debt equity ratio should rise and so should their obligations of disclosure. This is confirmed by our findings.

Another important finding is that it is not the performance of these firms which induces or for that matter discourages them about disclosure. Firms in both the groups have shown similar performance indicators.

Limitations

The study has been conducted on the star rated performers of Mix-market database. This is possible that the similarities observed in various parameters emanates from their belonging to the group of firms with identical reasons and ethic about disclosure. If the study is conducted with a broader sample (however there is a dilemma here, if we want to include more firms here to broaden the database the data needed would not be available since many firms are not disclosing their financial data) the results may be different. Also the data analyzed has been taken from 2007 statements owing to reasons given earlier. Availability of more current data may be more useful. Again an average of past two to three years if taken might throw in more insights into the study.

Appendix 1.

Definitions of ratios and other terms used in the study (www.mixmarket.org)

Average Loan Balance per Borrower
Gross Loan Portfolio / Number of Active Borrowers

Average Loan Balance per Borrower/ GNI per
Capita (%)

Average Loan Balance per Borrower/ GNI per capita

Average Number of Active Borrowers
(Beginning year Number of Active Borrowers + Year
end Number of Active Borrowers)/ 2

Average Savings Balance per Saver
Voluntary Savings/ Number of Voluntary Savers

Average Savings Balance per Saver/ GNI per Capita
(%)
Average Savings Balance per Saver/ GNI per capita

Borrowers per Staff Member
Number of Active Borrowers / Number of Personnel

Capital / Asset Ratio
Total Equity/ Total Assets

Cost per Borrower
Operating Expense/ Period Average Number of
Active Borrowers

Debt / Equity Ratio
Total Liabilities/ Total Equity

Deposits to Loans
Voluntary Savings/ Gross Loan Portfolio

Deposits to Total Assets
Voluntary Savings/ Total Assets

Financial Expense Ratio (%)
Financial Expense/ Average Total Assets

Financial Revenue Ratio (%)
Financial Revenue/ Average Total Assets

Gross Loan Portfolio

All outstanding principal for all outstanding client
loans, including current, delinquent and
restructured loans, but not loans that have been
written off. It does not include interest receivable.
It does not include employee loans.

Gross Loan Portfolio / Total Assets
Gross Loan Portfolio/ Total Assets

Lending Rate

Lending Rate is the bank rate that usually meets
the short and medium term financing needs of the
private sector. This rate is normally differentiated

according to creditworthiness of borrowers and
objectives of financing. *Source: IMF/International
Financial Statistics, 2003.

Loan Loss Provision Expense

A non-cash expense that is used to create or
increase the Loan Loss Reserve on the balance
sheet. The expense is calculated as a percentage of
the value of the Gross Loan Portfolio that is at risk
of default.

Loan Loss Provision Expense Ratio (%)
Loan Loss Provision Expense/ Average Total Assets

Loan Loss Reserve

The portion of the gross loan portfolio that has
been expensed (provisioned for) in anticipation of
losses due to default. This item represents the
cumulative value of the loan loss provision expense,
less the cumulative value of loans written off.

Loan Loss Reserve Ratio (%)
Loan Loss Reserve/ Gross Loan Portfolio

Net Income (After Taxes and Before Donations)
Net Income (Before Taxes and Donations) less any
Taxes paid by the institution.

Net Income (After Taxes and Donations)
Net Income (After Taxes and Before Donations) plus
any Donations recognized by the institution.

Net Income (Before Taxes and Donations)
Net Operating Income plus Net Non-operating
Income, before Taxes and Donations.

Net Operating Income

Financial Revenue (Total) less all expenses related
to the MFI's core financial service operations,
including Operating Expense, Financial Expense,
and Loan Loss Provision Expense. It does not
include Donations, or revenues and expenses from
non-financial services.

Non-operating Expense

All expenses not directly related to the core
microfinance operation, such as the cost of
providing business development services or training
(unless the MFI includes training as a requirement
for receiving loans).

Non-operating Revenue

All revenue not directly related to core microfinance operations, such as revenue from business development services, training, or sale of merchandise.

Number of Active Borrowers

The number of individual who currently have an outstanding loan balance with the MFI or are responsible for repaying any portion of the Gross Loan Portfolio.

Number of Personnel

The number of individuals who are actively employed by the MFI. This includes contract employees or advisors who dedicate the majority of their time to the MFI, even if they are not on the MFI's roster of employees.

Operating Expense

Expenses related to operations, such as all personnel expenses, rent and utilities, transportation, office supplies, and depreciation.

Operating Expense / Loan Portfolio (%)
Operating Expense / Period Average Gross Loan Portfolio

Operating Expense Ratio (%)
Operating Expense/ Average Total Assets

Operational Self-Sufficiency (%)
Financial Revenue (Total)/ (Financial Expense + Loan Loss Provision Expense + Operating Expense)

Portfolio at Risk > 30 days
The value of all loans outstanding that have one or more installments of principal past due more than 30 days. This includes the entire unpaid principal balance, including both the past due and future installments, but not accrued interest. It does not include loans that have been restructured or rescheduled.

Portfolio at Risk > 30 days Ratio (%)
Portfolio at Risk > 30 days/ Gross Loan Portfolio

Profit Margin
Net Operating Income/ Financial Revenue (Total)

Return on Assets (%)
(Net Operating Income, less Taxes)/ Period Average Assets

Return on Equity (%)
(Net Operating Income, less Taxes)/ Period Average Equity

Risk Coverage Ratio (%)
Loan Loss Reserve/ PAR > 30 Days

Savers per Staff Member
Number of Voluntary Savers/ Number of Personnel

Total Assets
Total of all net asset accounts.

Total Equity
Total of all equity accounts, less any distributions.

Total Expense Ratio (%)
(Financial Expense + Loan Loss Provision Expense + Operating Expense) / Average Total Assets

Total Liabilities
Total of all liability accounts.

Write Off Ratio (%) Write Offs for the 12-month period / Period Average Gross Loan Portfolio

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