Banking and Finance

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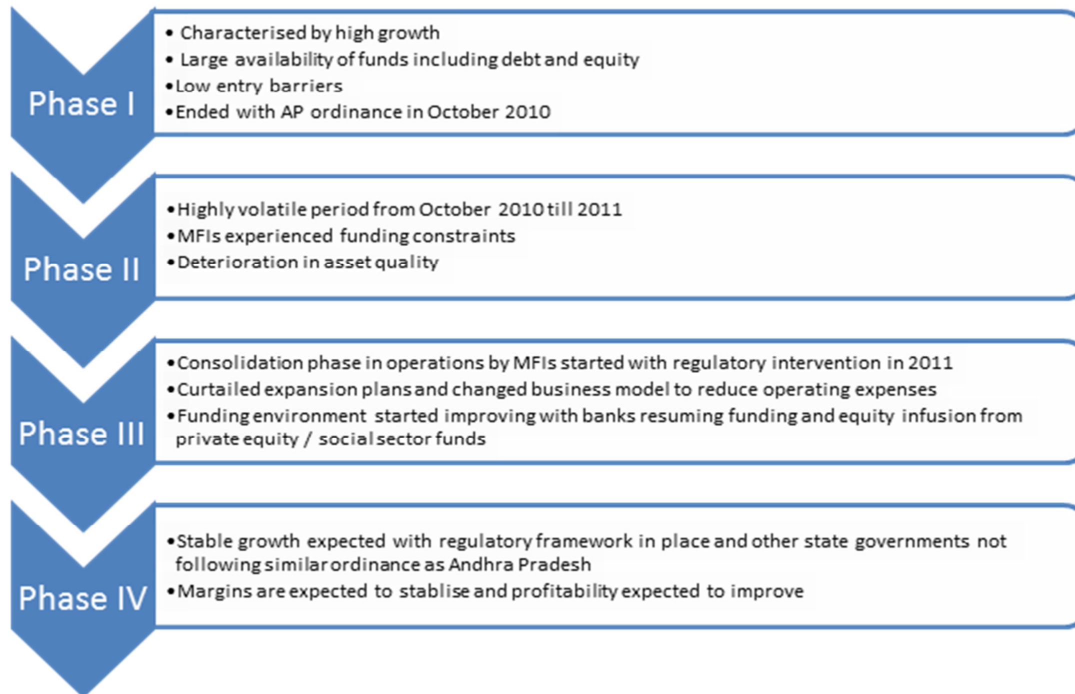
CARE Ratings
Professional Risk Opinion

Indian Microfinance Sector: Entering a phase of moderate credit risk, three years post AP crisis



Summary

- *Microfinance sector in India has gone through 3 broad risk phases in the past – high growth (till 2010), high volatility (2010 – 11), consolidation (2011 – 13) and is now entering a IV phase of relative stability.*

- *Phase I, that ended with the start of AP crisis in 2010, saw high growth in the sector attracting both debt and equity investments to a highly profitable segment. Lack of seasoning of portfolio, high risk of regulatory & political intervention, portfolio concentration risks were some of the key credit constraints then and most of the risks were latent. Phase II beginning with AP crisis and led to bankruptcy of major AP based MFIs due to geographic concentration and funding constraints for the overall sector. With RBI providing a strong regulatory regime starting in 2011, the sector entered Phase III of consolidation with the MFIs adjusting their business model to the new market & regulatory environment.*

- *We believe that the sector is now entering into a Phase IV and the MFIs have adapted to the new business environment more than three years post the AP crisis.* ***This phase is expected to be characterized by a more stable regulatory environment, steady availability of funds, improving profitability with comfortable asset quality & capital adequacy and relatively lesser impact of concentration risk.*** *While we see improvement in credit profiles on account of the above factors, credit ratings in the sector will continue to factor in risks associated with unsecured lending, socio-political intervention, geographic concentration and operational risks related to cash based transaction. Entity specific parameters relating to scale of operations, other operational parameters and financial profile along with above factors will determine credit profiles of individual MFI. Specific reasons why we see a general improved environment given below:*

Outlook on MFI sector- Phase IV

Regulatory support due to recognized financial inclusion role: RBI recognizes this sector as it achieves the objective of financial inclusion by providing access to financial services to the unbanked population of India. With recent introduction of NBFC MFIs guidelines and priority sector lending (PSL) status being retained, RBI has reaffirmed MFI's role in financial inclusion. There have been further amendments in the regulatory guidelines for providing flexibility to MFI players in terms of removal of interest rate, meeting net owned fund requirement and qualifying asset criteria etc. The support to the MFIs either large or small has been at equitable terms looking at the larger goal of financial inclusion with RBI allowing margin cap at 12% for small MFIs and 10% large MFIs.

Continued efforts towards MFI bill re-emphasize regulatory support: Government of India has also recognised the role of MFI in financial inclusion and has introduced draft MFI bill which is to be considered for approval in Parliament. Other state governments have also not introduced similar regulation like AP state government indicating likelihood of a stable regulatory environment going forward.

Improving funding environment: Total debt of the MFIs has increased to Rs.11,001 crore in FY13 from Rs.6,661 crore in FY12. The sector has also been attracting regular equity infusion from private equity investors reflecting the increasing confidence of the investors regarding growth potential in the sector.

Overall improvement in financial parameters: Overall the credit profile of the MFIs has shown improvement with improving profitability as stable margins are expected from FY14 onwards on account of removal of interest rate cap and control in operating expenses. The players in the sector are also adequately capitalised with overall gearing increasing moderately in-spite of good growth in the loan portfolio in FY13. Overall gearing has been at comfortable levels mainly on account of equity infusion from the private equity investors post AP crisis.

Based on our view and outlook, our rating actions were positive with six upgrades and two retentions since improvement in regulatory environment in May 2011.

Background

Microfinance is seen as an important tool for poverty alleviation and over the years, microfinance institutions (MFIs) have placed themselves as fulfilling this developmental goal. The microfinance movement was initiated by NABARD in collaboration with Banks and Non-Government Organisations (NGOs) for unbanked population known as Self Help Group (SHG) - bank linkage program in 1992. The program was government initiated program with refinancing to banks from NABARD. SHG bank linkage program involved NGOs to form Self Help Group (SHGs) and train them. Each SHG typically consists of a group of women/men members interested in accessing financial services including savings, credit insurance etc. Post the training, NGOs provided SHGs access to funds by linking them to banks which provided financial services (including thrift, credit etc) to them directly. NGOs' role was to ensure financial discipline of the SHGs. Apart from this there were state government run SHG programmes. Thus microfinance in this phase was government driven.

The microfinance sector started evolving with private sector participation leading to formation of microfinance institutions (MFIs). The MFIs accessed bulk funds from banks and did on-lending to the end borrowers (either SHG members or joint liability group[1]JLG members). From thereon the microfinance activities were being implemented by the two channels including MFI model and SHG bank linkage model.

The sector witnessed high growth rate during the period from 2006 to 2010 supported by funding availability and potential demand in the sector. The growth was mainly driven by the MFIs due to large scale availability of funding in terms of both debt and equity. The overall loan portfolio increased from Rs.13,950 crore as on March 31, 2007 to Rs.38,186 crore as on March 31, 2010 which included growth from SHG bank linkage and MFI model.

However focus of the microfinance sector is mainly on micro-credit with other products still evolving including thrift, insurance and remittance.

AP crisis an Event Risk

The growth witnessed during the period 2006 to 2010 was more intensive with certain geographies (including Andhra Pradesh) becoming saturated as compared to other geographies leading to high competition and aggressive lending. In October 2010, Andhra Pradesh (AP) state government implemented an ordinance to regulate MFIs operating in the state on concerns that MFIs were

[1] JLG typically consists of 5 member group

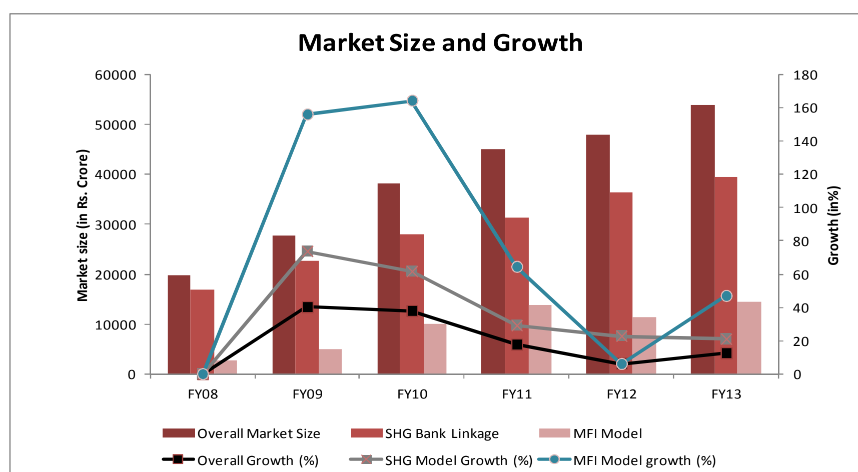
charging higher interest rates, using coercive recovery practices and multiple lending was leading to higher over-indebtedness amongst the borrowers. The AP ordinance required that the MFIs operating in the state had to register with the local district authorities pending which the MFIs had to put hold on the collections and disbursements. Realignment of the process and extension in timelines for getting approvals from the state government, led to deterioration in asset quality of MFIs having exposure in AP as the operations were stalled.

Overall it led to crisis in the microfinance sector as it faced funding constraints due to regulatory uncertainty. The regulatory uncertainty was high on account of likely occurrence of such similar regulation in other states thereby disrupting the operations of the MFIs operating in other states of India.

The impact of such event which led to the crisis was so high that from credit risk perspective the microfinance evolution can be divided into three phases- pre, during and post AP crisis.

The microfinance sector evolved post the AP crisis with regulatory intervention in 2011. External environment improved with RBI guidelines being put in place for NBFC MFIs and MFI bill being considered by the Central Government. This enabled the microfinance sector to revive its growth and come back on track.

As per the report "Status of Microfinance in India" by National Bank for Agricultural and Rural Development (NABARD), the overall microfinance sector in terms of loan portfolio stood at Rs.53,801 crore including SHG bank linkage model (Rs.39,375 crore) and MFI model (Rs.14,425 crore) as on March 2013. As per the report overall growth in the microfinance sector including the SHG bank linkage program and MFI model has been growing at good pace till the AP crisis in October 2010 and post that has witnessed moderation in growth.



Source: NABARD Report "Status of Microfinance in India" from FY09 to FY13

Regulatory Environment

Post the AP ordinance in October 2010, there was regulatory uncertainty over the microfinance activities undertaken by the MFIs. To overcome or reduce uncertainty and bring MFI activities under single regulator and avoid multiple regulations, Government of India initiated Microfinance bill. The MFI bill aims to address the concerns and regulate the MFI sector and it is with the parliament.

Furthermore, in May 2011, the Reserve Bank of India (RBI) issued guidelines to regulate NBFC MFIs and retain priority sector lending status for micro-finance institutions. It issued specific guidelines for NBFC MFIs, to ensure that the clients are offered services in a transparent manner including clear communication of lending rates, tenure of loans, repayment flexibility etc. The guidelines further ensure that NBFC MFIs assess the indebtedness level of the clients and disburse loans. In addition to this it also mentions that MFIs need to have customer redressal mechanism in place to address customer grievances. In totality the guidelines were aimed at customer protection principles by the NBFC MFIs.

Recently RBI has given recognition status to self-regulatory organisations which adhere to set of functions and responsibilities prescribed by RBI. The table below shows the timelines and amendments of guidelines by RBI for the microfinance sector:

Dates	Key Developments
October 2010	Formation of Malegam Committee by RBI to study the issues and concerns in microfinance sector
January, 2011	RBI released Malegam Committee recommendations for the Microfinance sector
May, 2011	Acceptance of broad framework of Malegam Committee recommendations in Monetary Policy Statement 2011-12 including: Retention of priority sector lending status for bank loans to MFIs, margin cap at 12% and interest rate cap at 26%.
December, 2011	RBI introduced new category of NBFC and termed as 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs). Some of the key points include • Minimum Net Owned Fund of Rs.5 crore for new NBFC MFIs and for existing NBFC MFIs w.e.f. April 1, 2012 • Capital Adequacy Ratio of 15% (relaxation for AP based MFIs for FY12 and for NBFC MFIs with loan portfolio less than Rs.100 crore) • Margin cap at 12%, interest rate cap at 26% and processing charges at 1%
August, 2012	Amendment to NBFC MFI guidelines by RBI which included • Registration compulsory for NBFCs intending to operate as NBFC MFIs by October 2012

	• Relaxation in meeting norm of Minimum Net Owned Fund of Rs.5 crore for existing NBFC MFIs. It has to be met in tranches with Rs.3 crore NOF by March 2013 and Rs.5 crore by March 2014 • Removal of interest rate cap and linked to borrowing rate plus fixed margin. Margins are capped at 10% for large MFIs and 12% for others
July, 2013	Amendment to NBFC MFI guidelines by RBI which included • Relaxation in margin cap for all NBFC MFIs irrespective of size at 12% till March, 2014. However from April, 2014,margins are capped at 10% for large MFIs and 12% for others
Nov, 2013	RBI has allowed recognition of industry association of NBFC MFIs as Self-Regulatory Organisation (SRO).
Feb, 2014	Amendment to NBFC MFI guidelines by RBI with respect to pricing of credit: it would be lower of two ➢ The cost of funds plus margin ➢ The average base rate of the five largest commercial banks by assets multiplied by 2.75

CARE's Study on the Performance of the Microfinance Sector

This report analyses the performance of 13 MFIs[2] in the last three years (2011 to 2013). The objective is to understand the performance of the MFIs and understand the trends for future growth and development of the microfinance sector. The report does not consider the MFIs having large exposure in AP and which have entered into the CDR. The report covers around 70% of the total loan portfolio[3] in the microfinance sector.

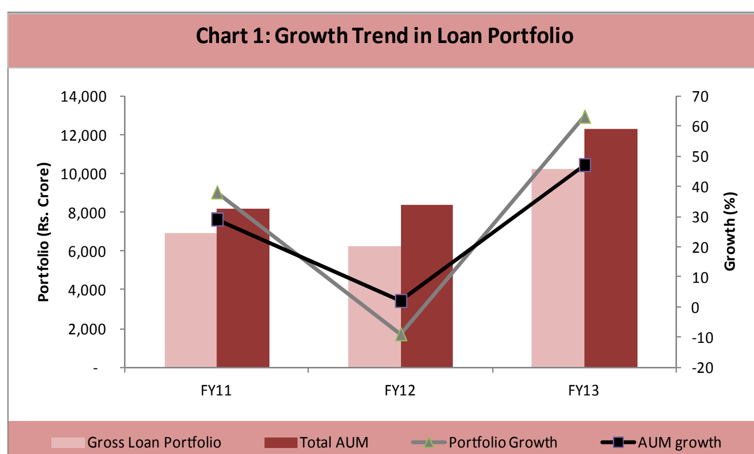
LOAN PORTFOLIO

The microfinance sector until the AP crisis was growing at a faster pace due to easier access to funds and potential demand existing in India.

Phase II (high volatility) was marked by funding constraints, interest rate cap by regulator and negative perceptions which remained as real challenges to the growth of the industry post AP crisis in October 2010. These constraints lead to a decline in growth for the MFIs covered in this study in FY12.

[2]For this study, key players operating currently in the microfinance sector are covered.

[3] Considering the total loan portfolio for the MFI model at Rs.14,425 crore as per the NABARD report " Status of Microfinance in India" 2013



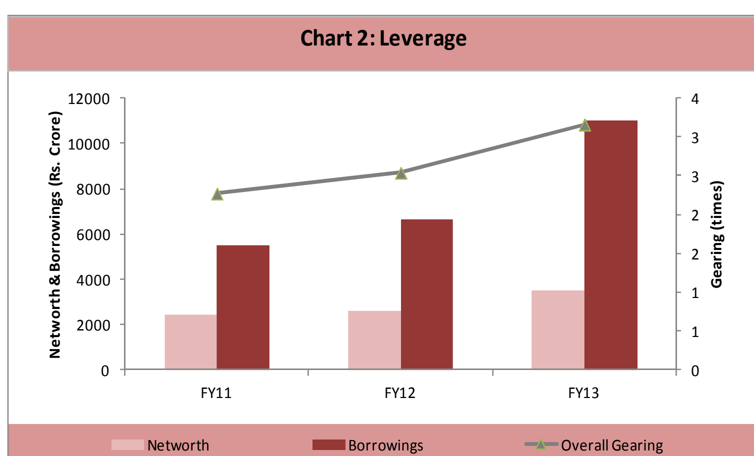
Source: CARE estimates

In phase III, MFIs witnessed good growth on the back of improvement in funding profile. Loan portfolio grew at 63% y-o-y in FY13 as compared to 9% fall in FY12. During FY13, total outstanding loan portfolio of the MFIs covered in this study (Including managed portfolio) increased to Rs.12,289 crore in FY13 from Rs. 8,384 crore in FY12.

FUNDING & LEVERAGE

During phase I, microfinance sector was successful in accessing funds from various private/public sector banks, NBFCs, development funds and other financial institutions for onward lending to the borrowers. Major source of external funding has been term loans from banks and FIs. Some of the MFIs also accessed funds from diversified sources including capital market instruments (non-convertible debentures (NCDs) and commercial paper) and assigned/securitization route.

Post AP Act in October 2010, banks and financial institutions were cautious in funding to the microfinance sector due to regulatory uncertainty which affected the overall growth of MFIs.



Source: CARE estimates

However, funding environment became positive with RBI intervention in May 2011 and bank funding registering an increasing trend. Total debt of the MFIs has increased to Rs.11,001 crore in FY13 from Rs.6,661 crore in FY12. Bank borrowings form a major source of funding for the MFIs, which formed around 86% of the total debt in FY13. The securitisation route has evolved as an important source of funding for the sector, with the rated securitisation transactions volume increasing from Rs.582 crore in FY10 to around Rs.3,386 crore in FY13.

The players in the sector are also adequately capitalised with overall gearing increasing moderately in-spite of good growth in the loan portfolio in FY13. Overall gearing has been at comfortable levels mainly on account of regular equity infusion with the sector attracting equity funds from the private equity investors mainly social funds. Some of the equity investments post AP crisis is shown in table below:

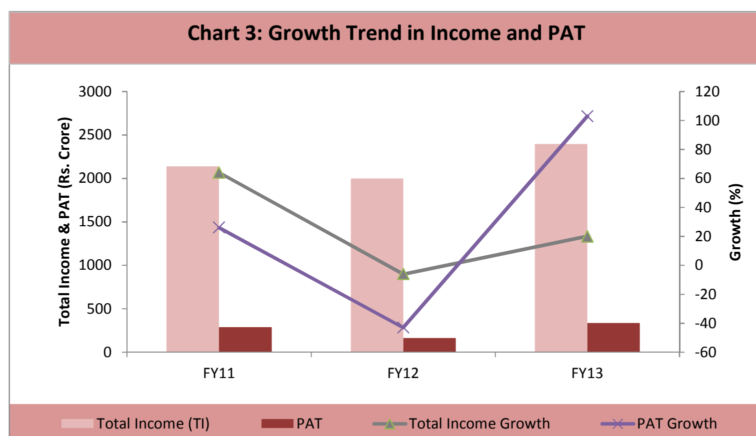
Table 1: Equity Infusion in the microfinance sector

Year	Name of the MFI	Amount of equity infusion (Rs. Crore)
2011	Bandhan Financial Services Pvt Ltd	135
2011	Janalakshmi Financial Services Pvt Ltd	65
2011	Satin Creditcare Network Ltd	42.4
2012	SKS Microfinance Ltd	263
2012	Equitas Microfinance Pvt Ltd	140
2012	Annapurna Microfinance Private Limited	17
2012 and 2013	Ujjivan Financial Services Pvt Ltd	127.9 and 47.3
2013	Utkarsh Microfinance Pvt Ltd	20
2013	Grameen Financial Services Pvt Ltd	53.20
2013	Arohan Financial Services Pvt Ltd	48.7
2013	Janalakshmi Financial Services Pvt Ltd	325

Going forward the ability of the MFIs to remain well capitalised to maintain growth and also provide cushion during turbulent times would be important credit parameter.

INCOME and PROFITABILITY

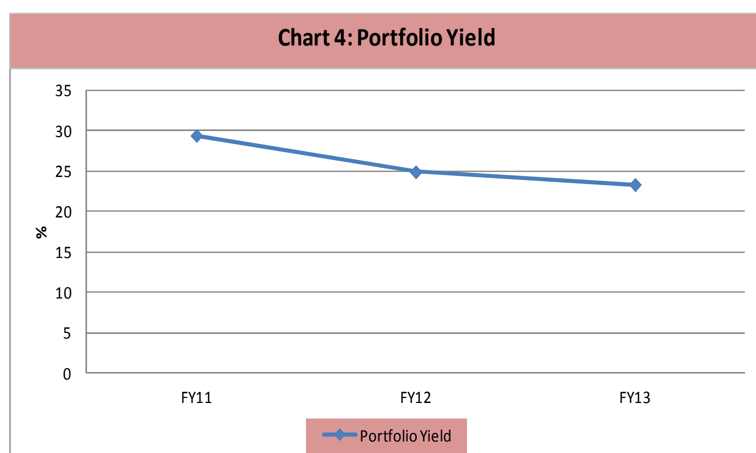
Major portion of the income earned by the MFIs is through interest income. During Phase I and Phase II, there were no restrictions on the interest rates being charged by the MFIs. However broadly lending rates were fixed to cover the operating costs, interest costs, credit losses and generate comfortable margins. Hence there was wide variation in interest rates (15% to 32%) being charged by the MFIs across India.



Source: CARE estimates

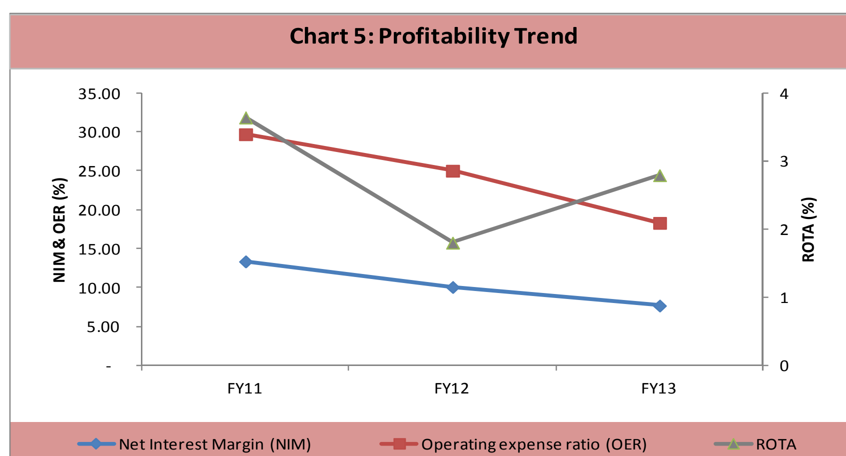
Phase III saw introduction of margin cap and interest rate cap in May 2011 by RBI lead to lowering of interest rates being charged to the borrowers. The decrease in interest rates (portfolio yield) coupled with lower disbursements due to funding constraints resulted in lower growth in total income in FY12. These restrictions put downward pressure in terms of growth in income and margins on the MFIs in the short term as they had to consolidate their growth plans and also make efforts to reduce their operating expenses to maintain margins at healthy levels. On the other side, with margin cap in place, it was expected that MFIs have to reduce lending rates during declining interest rate scenario thereby benefiting the borrowers.

Profitability indicators of the MFIs covered in this study in FY12 were under pressure with the introduction of interest rate cap, margin cap and higher borrowing costs. Net interest margins (NIM) reduced sharply in FY12 due to interest rate cap for MFIs and higher borrowing costs due to increasing interest rate scenario. Return on total assets (ROTA) also declined during the period due to high operating costs due to the past expansion plans and compression in NIM.



Source: CARE estimates

Based on feedback from various stakeholders and experience gained from implementation of guidelines, RBI removed interest rate cap on August 2012 and linked interest rate charged by the MFI to the borrowing cost plus margin. The removal of interest rate cap in FY13 was neutral to the MFIs under study as borrowing cost of the MFIs were around 13% to 14% plus the margin of 10%, they were already below 26%. However going forward this allows flexibility to MFIs in maintaining their margins during an increasing interest rate scenario.



Source: CARE estimates

During FY13 with improvement in the funding environment the disbursements increased leading in increase in total income of the MFIs covered in this study from Rs.2,000 crore in FY12 to Rs.2,398 crore in FY13. MFIs were also able to reduce operating expense ratio[4] by altering their business model (change collection period from say weekly to fortnightly, increase staff productivity by increasing number of borrowers per loan officer, close low productive branches, curtail expansion plans and provide higher ticket size loans etc). ROTA in FY13 has increased as compared to FY12 due to decrease in operating cost ratio. However with reduction in margin cap from 12% to 10% for large MFIs from March 2014, it is expected profitability would be impacted to that extent.

On a long term basis, technology would be the enabler for controlling operating costs and would help the MFIs to maintain margins.

[4]Operating expense ratio is calculated by dividing operating expense to average loan portfolio. It indicates the operating efficiency of the MFI and lower the operating cost ratio better is the operating efficiency of the MFI.

Asset Quality

Prior to AP crisis asset quality was consistently good with low NPAs except for a few regional events (refer Box 1):

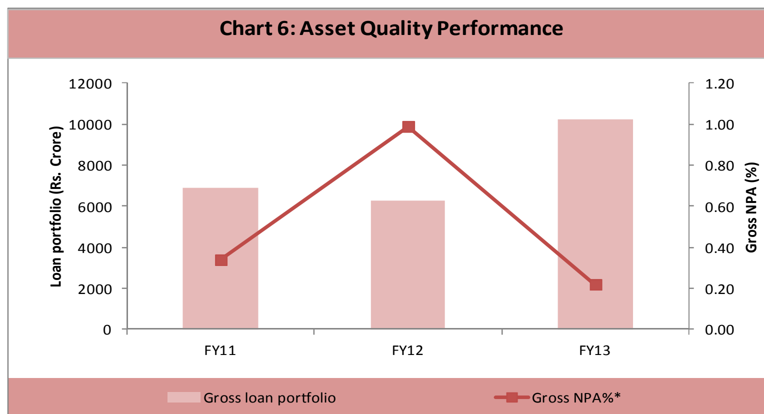
Asset Quality Stresses prior to AP crisis

- Closure of MFI branches in Krishna district of Andhra Pradesh by the district collector in 2006 on the concerns that the MFIs were charging high interest rates. The operations of the MFIs were closed for some months leading to sharp decline in recoveries by MFIs operating in that district. However intervention by RBI helped the MFIs to resume their operations.
- In 2010 local religious organisation in Kolar district of Karnataka issued instructions to its followers to stop repayments to MFIs, which led to decline in collections for the MFIs operating in this district for months. There were large scale defaults with MFIs writing off their portfolio and had to bear losses. During this period asset quality of MFIs deteriorated sharply.

More recently in October 2010, implementation of AP ordinance required that the MFIs operating in the state had to register with the local district authorities pending which the MFIs had to put hold on the collections and disbursements. Realignment of the process and extension in timelines for getting approvals from the state government, led to deterioration in asset quality of MFIs having exposure in AP as the operations were stalled. This resulted in sharp deterioration in asset quality of AP MFIs with recovery going down to 10-15% from 99% before the AP ordinance. For some of the AP based MFIs put together the gross NPA increased from approximately 2% during pre-crisis to 50% amidst crisis. The higher the concentration in AP, higher was the overall deterioration in asset quality of those MFIs.

Hence geographical diversification is an important parameter for reducing socio-political, religious or regulatory risks and help MFIs to maintain asset quality at comfortable levels.

The impact of AP ordinance was not evident in other states and the non-AP based MFIs continued to have good asset quality performance with gross NPA remaining below 1% in the past three years (FY11-FY13). However on a comparative basis, during FY12 there was increase in gross NPA to 0.99% mainly on account of reduction in aggregate loan portfolios as fresh loan disbursements fell due to lack of funding to the sector. In addition to this, amidst regulatory uncertainty, there were challenges in collections in few states including Tamil Nadu, West Bengal and in other states in the bordering of Andhra Pradesh. However Gross NPA has improved in FY13 to 0.22% with improvement in funding profile and good growth in loan portfolio.

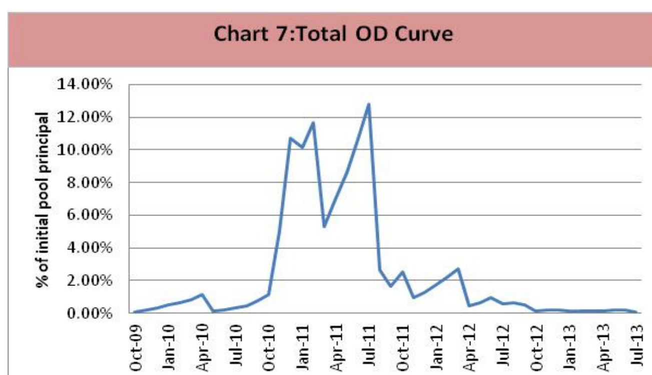


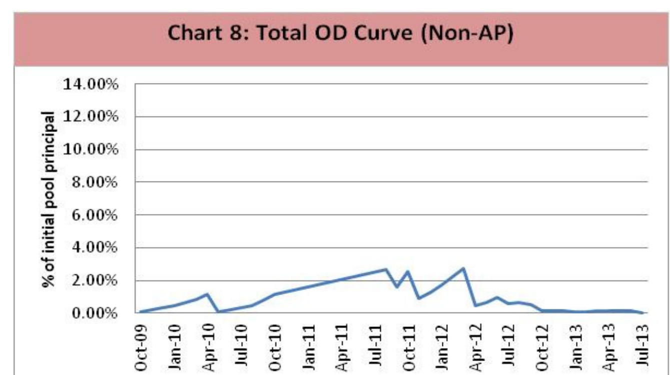
Excluding AP

Source: CARE estimates

CARE has rated more than 35 microfinance pools across 7 Originators and pools aggregating to around Rs 3,000 crore. We have studied the pool performance for all CARE rated transactions from Oct-2009.

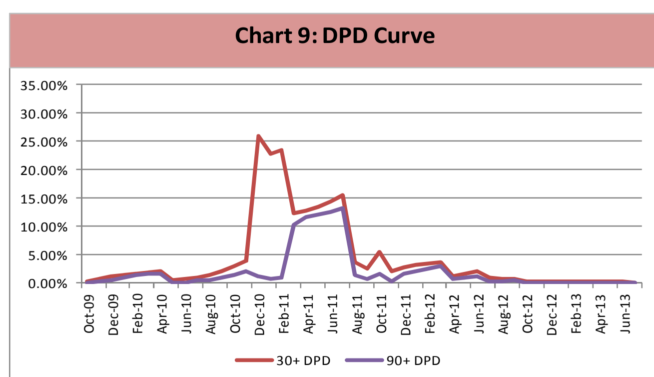
Post AP ordinance the delinquencies in the microfinance sector has increased. The total OD curve (overdue) peaked in the period between October-2010 to July-2011 on account of AP crisis. The pool performance for the period between Oct-10 to Jul-11 including AP portfolio shows maximum total OD across all pools in the afore-mentioned period at 12.78%. After removing the live and AP pools during the period Nov-10 to Jul-11, maximum total OD was observed at 2.71%. The situation has normalized as can been observed from the total OD at 0.04% for the month of July 2013. Also, the overdue curve has registered downward movement since its peak.

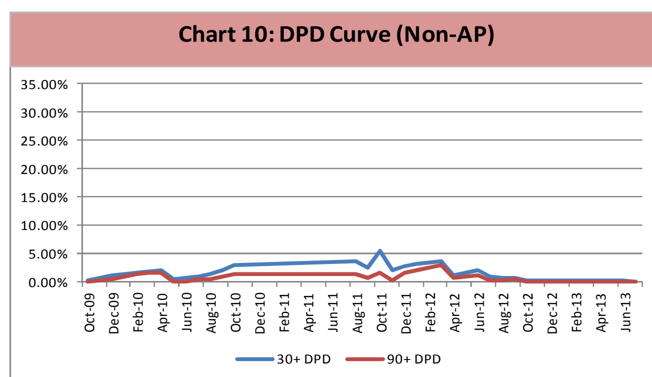




Source: CARE estimates

Similarly, both 30+ DPD curve and 90+ DPD curve (DPD: Days past due) spiked during the period Oct-10 to Jul-11. However, the DPD curves have gradually normalized with July’13 30+ DPD and 90+ DPD being 0.04% and 0.01% respectively. Without considering the live and AP pools during the period Nov-10 to Jul-11, maximum 30+ DPD is observed at 5.42% and 90+ DPD at 3.01%.





Performance of MFIs during 9MFY14

Based on the results of 9MFY14 performance of five MFIs (which comprise more than 50% of market size), financial performance continued to show improvement as indicated below:

- The good growth in the portfolio continues with increase in portfolio from Rs.7,741 crore as on March 31, 2013 to Rs.10,615 crore as on December 31, 2013.
- Improvement in profitability continues with NIM and ROTA at 9.5% and 3.4% respectively as compared to FY13.
- Overall gearing remains comfortable at 3.7 times.

Credit Outlook on Microfinance Sector

Post the AP crisis and regulatory intervention by RBI, the microfinance sector has seen growth in loan portfolio but with consolidation in expansion plans. Overall the credit profile of the MFIs has shown improvement with increasing loan portfolio on account of improving funding profile, control in operating expenses, improving margins post removal of interest rate cap and moderate leverage levels.

Current focus of the microfinance sector is mainly on micro-credit with other products still evolving including thrift, insurance and remittance. However the potential demand for microfinance sector is huge, with The Global Findex Database (February 2013) by World Bank stating that in India only 35% of adults have formal account and 8% have borrowed from a formal financial institution (including microfinance institutions). It further states that this 8% coverage in India is higher than the other BRIC economies (7%) and one of the factors is relatively well developed microfinance industry in India. Going forward, MFIs are likely to expand their client base and reach out to more underserved areas of the country.

We believe that the sector is now entering into a Phase IV from a credit risk perspective and the MFIs have adapted to the new business environment more than three years post the AP crisis. **This**

phase is expected to be characterized by a more stable regulatory environment, steady availability of funds, improving profitability with comfortable asset quality & capital adequacy and relatively lesser impact of concentration risk. While we see improvement in credit profiles on account of the above factors, credit view will continue to factor in risks associated with unsecured lending, socio-political intervention, geographic concentration and operational risks related to cash based transaction. Entity specific parameters relating to scale of operations, other operational parameters and financial profile along with above factors will determine individual MFI credit views.

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