The Micro Impact: MFIs' Changing Gears

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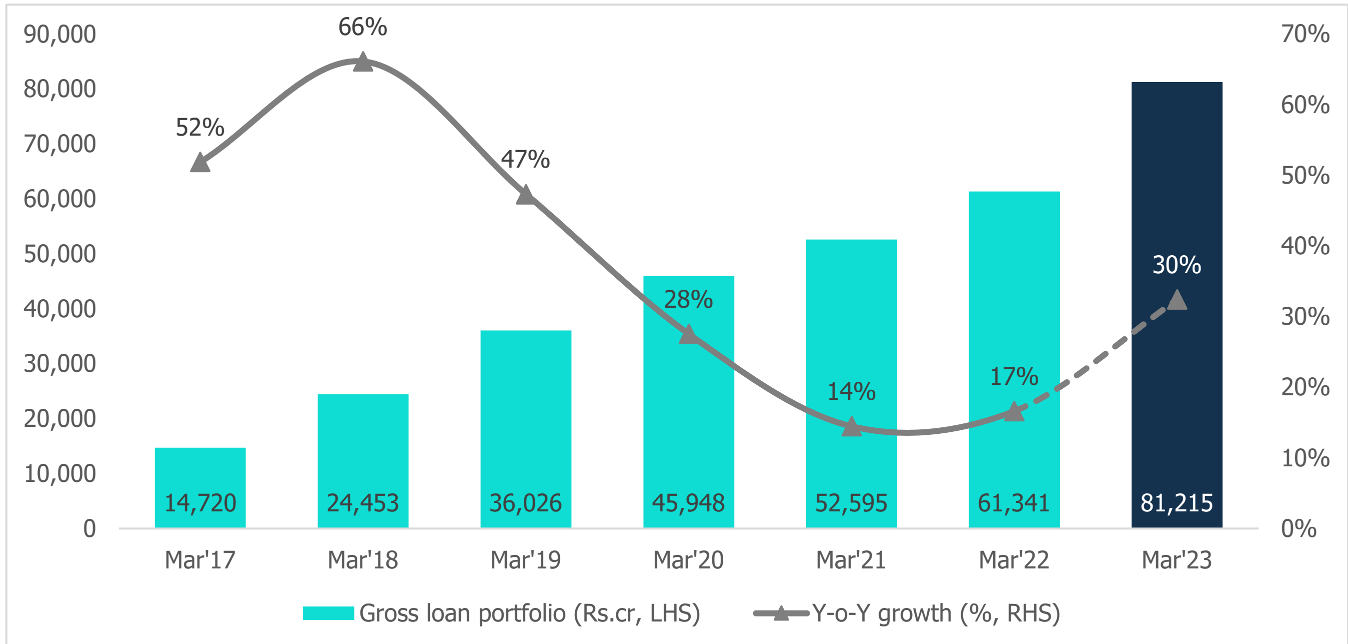
CareEdge RATINGS

Synopsis

- Non-banking financial companies-microfinance institutions (NBFC-MFIs) in India registered a growth of 17% y-o-y in gross loans in FY22, shrugging off the negative loan book growth witnessed in Q1FY22 owing to the Covid-19 pandemic. With a resurgence in demand for micro-loans, especially from Tier-III cities, CareEdge Ratings expects the loan book to grow at around 30% y-o-y in FY23.
- With an improving macroeconomic environment along with the rising loan base, the PAR 90+ for the NBFC-MFI industry is expected to improve. That said, for some NBFC-MFI players who carry a substantial amount of restructuring book coming out of moratorium, the headline asset quality metrics and credit costs may remain elevated for the coming few quarters. Also, NBFC-MFIs with a high share towards flood-affected states such as Assam, Bihar, and Telangana, among others, may witness an increase in delinquencies in the near term.
- The new regulations for NBFC-MFIs announced by the Reserve Bank of India (RBI) are expected to result in positive growth and improved margins for the sector.

Pick-up in Loan Book Growth for NBFC-MFIs

Figure 1: Growth in loan portfolio of NBFC-MFIs*



*Source: Data from CARE Ratings' sample of NBFC-MFIs; based on CARE Ratings' estimates; March 2023 figures as per CARE Ratings' estimates.

In FY22, the gross loan portfolio for CareEdge Ratings' sample set of NBFC-MFIs registered a 17% y-o-y rise, supported by strong disbursements in the latter part of the fiscal, shrugging off negative growth and the halt in business operations witnessed in Q1FY22 owing to the second wave of the COVID-19 pandemic. Although

disbursements in Q1FY23 were impacted by revised regulations, CareEdge Ratings expects NBFC-MFIs to record a healthy loan growth of around 30% y-o-y in FY23.

Joint liability group (JLG) loans continued to dominate the loan book profile, however, with the growing ticket size across loan products and the new RBI guidelines, which deregulate the maximum cap on interest rates and lower the minimum required share of MFI loans in the portfolio to 75%, the share of individual and the micro, small, and medium enterprises (MSME) and other non-MFI loans may gradually increase in the portfolio mix in the medium term.

The RBI, in March 2022, announced a revision in the regulations applicable to NBFC-MFIs and other regulated entities (RE) operating in the microfinance paradigm. Key features of the revised regulations are given below:

Sr. No.	Change	Likely Impact
1.	Pricing de-regulation (removal of 10% margin cap)	Improved margins for NBFC-MFIs
2.	50% fixed obligation to income ratio (FOIR) for all RBI entities	Relatively conservative lending norm, however, CareEdge Ratings notes that income calculation for microfinance borrowers is largely assessment-based and the impact of the new norms on asset quality and operations remains to be seen
3.	A minimum required percentage share of MFI loans in the overall book was reduced from 85% to 75%	Room for a rise in the share of non-MFI loans
4.	Household income limit enhanced to ₹3 lakh pa	Broaden the market; however, income calculation for MFI borrowers is largely assessment-based
5.	All not-for-profit entities above ₹100 crore outstanding will have to convert to NBFC-MFI and be under the RBI ambit of regulation in the business	Increased supervision; may lead to some consolidation in the sector

The said revision in regulations by the RBI, making standard applications for all MFI lenders, is expected to foster growth for NBFC-MFIs, as well as result in improved margins for these companies.

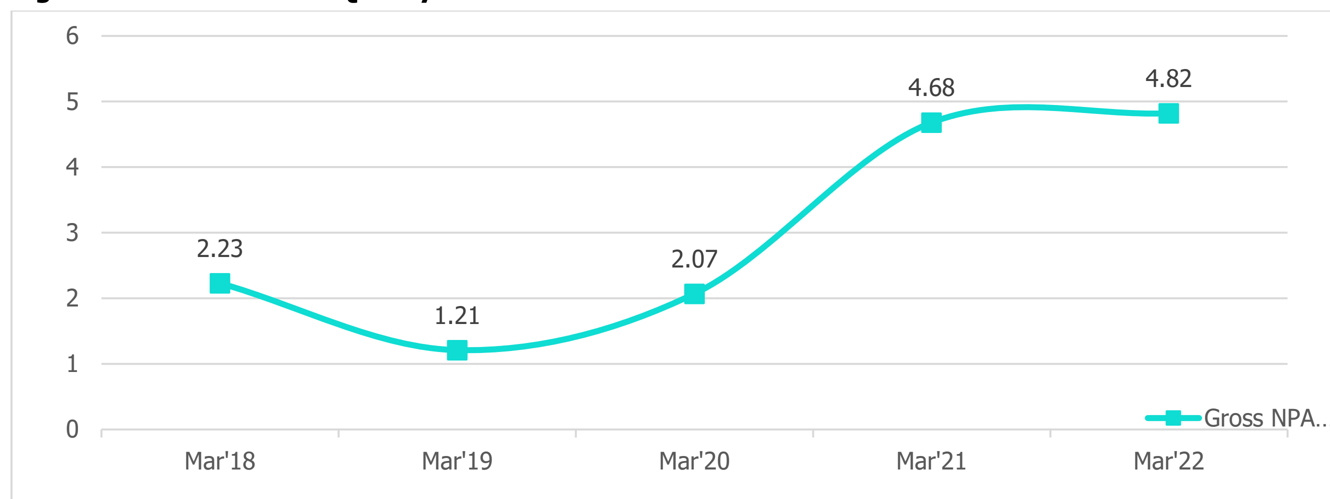
Improved macroeconomic environment to aid collection efficiency, although the restructured book may keep headline asset quality metrics elevated in the near term

Post the exacerbating impact of the Covid-19 pandemic on the income profile of low-income groups of the economic society and the resultant rise in delays in debt servicing by the end borrower, asset quality stress spiked for the sector. The PAR 90+, ie, the loan delinquent for more than 90 days for CareEdge Ratings sample set increased to 4.82% as on March 31, 2022, as compared with 2.07% as on March 31, 2020.

However, supported by a resurgence in economic activity post Q2FY22, the collection efficiency for micro-loans improved substantially, with the average collection efficiency rising from 75% during Q1FY22 to 92% during Q3FY22 and further to 96% during Q4FY22.

Going forward, CareEdge Ratings expects the recovery trend to continue, although, for some of the NBFC-MFI players, headline asset quality metrics and credit costs may remain elevated in the near term, owing to a substantial part of a restructuring or top-up book coming out of moratorium. Also, players with a high share in the states affected by floods may see higher delinquencies in the near term.

Figure 2: Trend in Asset Quality of NBFC-MFIs



*Source: Data from CARE Ratings' sample of NBFC-MFIs; based on CARE Ratings' estimates.

Margins to Improve; Profitability may Remain below the Pre-Covid Levels

As on March 31, 2022, CareEdge Ratings' sample set of NBFC-MFIs witnessed improvement in profitability, with a return on average assets of 1.01% vs 0.49% in FY21, which in turn, was severely impacted by a rise in credit and provisioning costs in FY21.

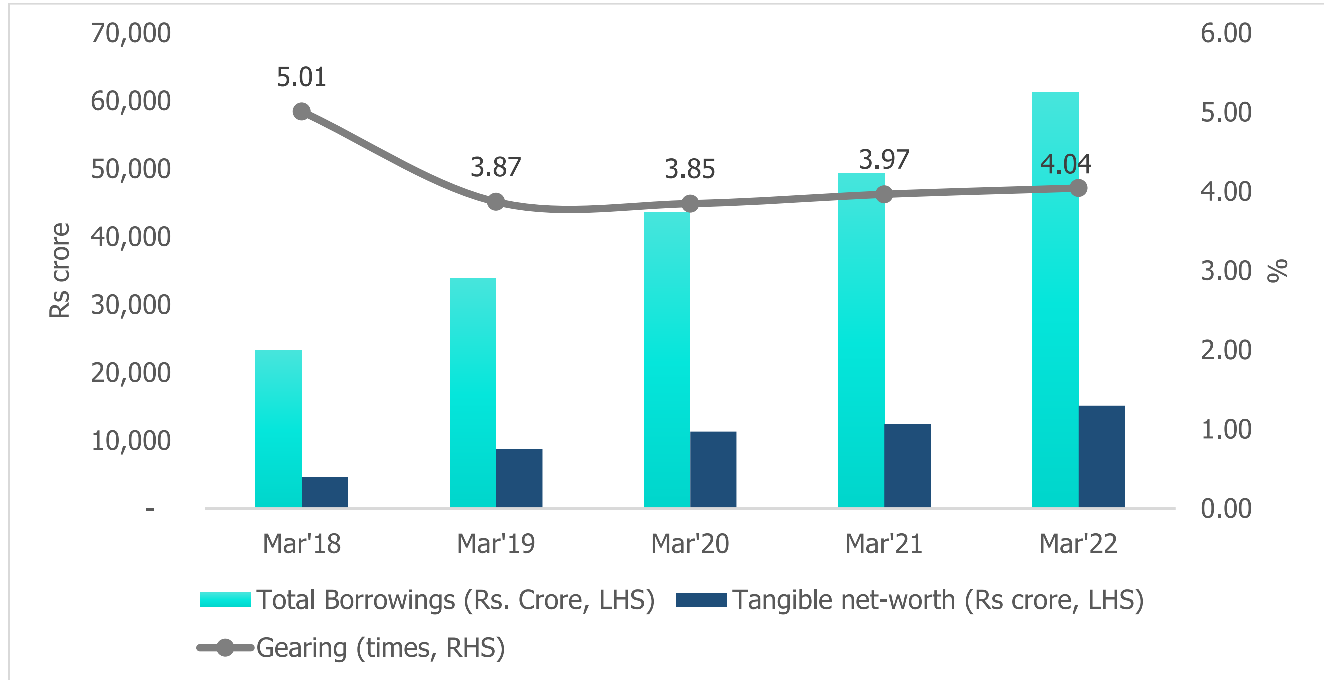
The net interest margins (NIMs) compressed to around 8.5% in FY21 as compared with the pre-COVID level of 9.5-10% due to interest rate reversals caused by a sharp rise in delinquencies and excess liquidity maintained by most of the entities. The NIMs, although slightly improved in FY22, continued to remain low at around 8.7%. With the removal of the interest cap regime in the revised regulations stated by the RBI and the improved collection efficiencies, the average yield on advances is slated to improve gradually, leading to a margin boost, albeit will continue to be impacted by the rising interest costs on borrowings.

The operational expenses for the industry will continue to remain elevated (FY22: 5.6% of the average assets). The credit costs, after increasing significantly in FY21 to 4.1% of the average assets, continue to remain high at 3.5% in FY22. Overall, small improvements in margins along with reduced credit costs led to an improvement in the profitability indicators, with a return on average assets of 1.0% in FY22 (vs 0.5% in FY21), although it continues to remain below the pre-COVID level of a return on assets (RoA) of 2-3%. Going forward, profitability is expected to improve with higher margins and improved collection efficiency, however, with a substantial restructured book coming out of the moratorium, the profitability is likely to remain lower than the pre-COVID level in FY23.

Adequate Capitalisation Profile

Despite the rising borrowing level requirement of NBFC-MFIs, the overall leverage profile of the industry has remained comfortable for the last four fiscal years, supported by two consecutive years of substantial equity and preference capital infusion, i.e., in FY19 and FY20, respectively, and relatively lower disbursements in FY21 and

FY22. However, going forward, with disbursements picking up and equity-raising plans still being in the pipeline for major players, the leverage may increase, although it is expected to remain at manageable levels.



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