Indian Micro Finance

Penetration levels increasing; Borrower – Lender discipline holds the key for sustainable growth

Review for the year ended March 31, 2016 and Industry Outlook

ICRA RESEARCH SERVICES

Financial Sector Ratings

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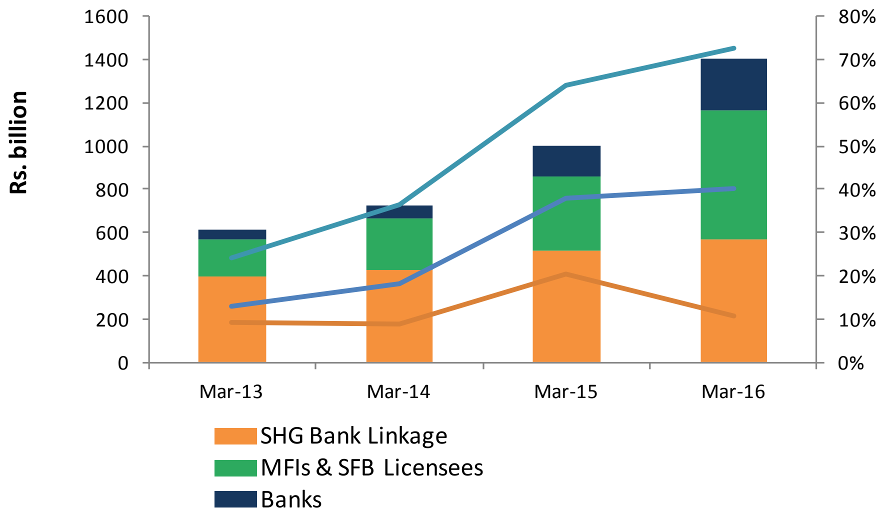
Overall MFI market grows by 40% in FY2016, aided by an increase in client outreach and higher ticket sizes

Chart 1: Trends in size and growth of the MFI market



Source: Basic Statistical Returns (RBI), Status of Microfinance in India (NABARD), Financials of various MFIs, MFIN Micrometer, ICRA estimates and analysis

The Indian Microfinance sector reported an overall growth of 40% in FY2016 (38% in FY2015) with the market size nearing Rs. 1.4 trillion (including Bandhan Bank) as on March 31, 2016. This growth was driven by an impressive ~72% growth in portfolio of MFIs, SFB licensees and banks, while the SHG bank linkage programme grew at only 11% in FY2016. The growth was supported by new entrants, increase in client outreach and higher ticket sizes as well as continued fund flow to the sector.

Potential for further annual growth of ~30%-35% over next three years; but establishing credit culture in new geographies would be the key

With increased client outreach, the penetration levels[1] (clients served as a proportion of target segment) stood at 50%-55% by end of FY2016. However, client penetration levels vary across states, with mature markets such as Karnataka, Tamil Nadu, and West Bengal having high penetration levels and a number of large states such as Uttar Pradesh, Bihar, Jharkhand, and Chhattisgarh still remain underpenetrated. With established markets getting saturated, going forward, MFIs would look to improve penetration in new geographies to support growth along with offering higher loan sizes to existing borrowers (present ticket sizes are around Rs. 20,000-25,000). In ICRA's opinion, if the ticket sizes were to double from the current levels (on account of improving income levels, inflation, higher eligibility of borrowers moving to higher loan cycles) over the next 3-4 years and the MFIs were to increase presence in underpenetrated areas, the microfinance market (across SHGs, MFIs, banks) could reach Rs. 3.3 – 4.3 trillion over the next three to four years. While scope for growth remains good, establishing a credit culture in the new geographies, strengthening the credit appraisal processes, focussing on employee training and retention are likely to remain the critical performance determining factors for sustainable growth.

Increasing competitive intensity; evolving sector landscape

MFI sector is currently evolving. While on one hand Bandhan has become a scheduled commercial bank in FY2016, seven NBFC–MFIs and one Core Investment Company (which has an NBFC-MFI as subsidiary) are slated to transform into SFBs by March 2017. There has also been an increase in new entrants with various banks — especially private sector banks — starting to lend directly in the microfinance segment as well as through Business Correspondents, thus fuelling further competition.

Efforts underway to strengthen credit bureau database and improve effectiveness of bureau checks

While the two operational credit bureaus have been key enablers for maintaining asset quality in the sector, certain issues such as limited coverage of SHG bank linkage programme data, issues related to multiple Identity cards being used by borrowers for availing loans from more than two MFIs, interlinking of retail credit and MFI credit databases as well as inclusion of smaller players (NGO/Societies/Trusts) need to be addressed so that MFIs are able to comprehensively assess the leveraging status of their borrowers. To integrate SHGs into the mainstream financial landscape, NABARD has initiated the digitization of SHG

[1] On a national level. For the purpose of target segment sum of Below Poverty Line population, 30% of non BPL population in urban areas, 40% of non BPL population in rural areas with an average household size of five have been assumed. SHGs assumed to have 12 members and along with MFI borrower base, the customers currently being served are estimated.

database. Additionally, RBI (through a circular in January 2016) requires banks to report individual SHG member level data to the credit bureaus. In ICRA's opinion, the digitization programme would strengthen SHG record keeping, which would further improve the reporting of data to credit bureaus. However, the implementation of the programme remains to be seen. RBI also made it mandatory for all lenders to share information with all credit bureaus and the entire retail banking – MFI credit bureau database is expected to be linked to each other. To address the issues of multiple identity cards, and improve the effectiveness of credit bureaus, MFIN has mandated the use of Aadhaar as a mandatory identity proof from July 2016 for credit bureau checks. Further, MFIN has also mandated the use of a minimum of two KYC (know your customer) to generate the credit bureau reports. These initiatives are likely to plug the existing gaps in the credit bureau database, which would help the MFIs in assessing the aggregate leveraging status of a borrower from all formal sources of credit.

ICRA's field visits indicate good borrower awareness about loan caps; however, some dilution of lending processes evident

Based on its experience from field visits of over 170 centres (both urban and rural) across 10 states, covering more than 22 MFIs across India, ICRA gathers that while borrowers are largely aware of the RBI norms on multiple borrowing and loan caps, the general field discipline for some players has reduced owing to increased number of members in the centres. Further, there has been a shift in focus to the collection of instalment from the earlier focus on developing group dynamics. A number of borrowers with more than two loans and utilisation of loans for non-income generation purpose were noticed. Additionally, the attendance levels in urban centres were materially lower than in rural centres.

Asset quality remains healthy; could witness some deterioration with declining field level discipline and increasing focus on individual loans

MFI asset quality indicators continue to be healthy (0 days past due (dpd) of ~0.35% as on March 31, 2016), supported by the safeguards put in place by the regulators, including data sharing through credit bureaus, restrictions on overall leveraging of Rs. 100,000 per borrower (MFIN directive caps the same at Rs. 60,000), and stipulation that not more than two MFIs can lend to the same borrower. Some pressure on asset quality was witnessed in FY2016 due to communal and political issues in certain pockets of Madhya Pradesh, Uttar Pradesh, Bihar, Jharkhand and Karnataka while some other states were impacted by environmental issues like drought and floods. However, timely action by MFIs with support from self-regulatory organisations (SROs) and government bodies helped arrest delinquencies in most cases. Nevertheless, the segment remains vulnerable to asset quality shocks owing to the risks associated with unsecured lending business, political risks, and operational risks arising out of cash handling. Given the rising competition, high pace of growth, increased focus of some players on individual loans without group guarantee, asset quality indicators could deteriorate from present levels. In ICRA's opinion, discipline at both the borrower and MFI level, and tactful interventions by stakeholders in tackling field level issues would be the key determinants of asset quality going forward.

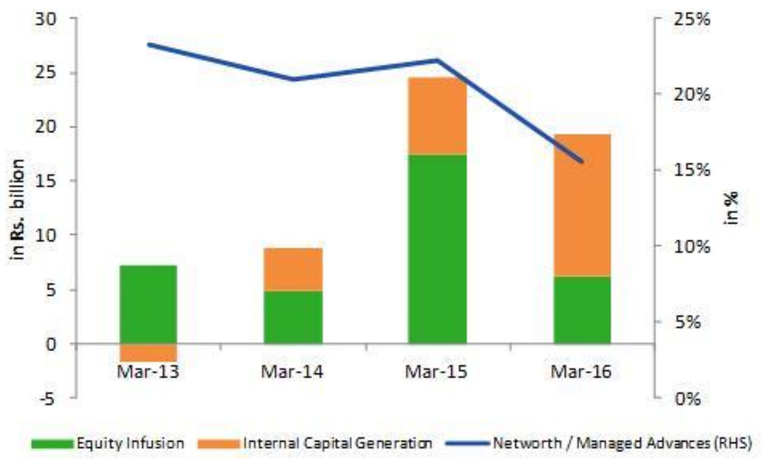
Improved fund flow from banks and debt market, some moderation in cost of funds

During FY2016, banking credit to NBFC-MFIs grew by 60%[2], supported by continuation of priority sector lending status for the sector. Improved access to debt markets for the larger players and increasing share of funding from niche foreign portfolio investors (FPI) through non-convertible debentures (NCDs) led to the share of debt instruments in overall funding mix increasing from around 9% as on March 31, 2014 to around 16% of the total borrowings as on March 31, 2016. The off balance-sheet funding book also remained sizeable at 16% as on March 31, 2016.

Funding cost witnessed a moderation of around 75-100 bps in FY2016 (at around 11-13% for the larger MFIs and 13.5-16% for the small to medium sized ones). As per ICRA's estimates, MFIs (excluding Bandhan and SFB licensees) would need to raise incremental debt of Rs. 790-860 billion over the next three years to support a 30-35% growth. ICRA expects fund availability to be good for MFIs over the medium term.

Moderation of capitalisation indicators owing to higher pace of growth and lower equity infusion

Chart 2: Trend in internal capital generation and equity infusion



Source: Financials from various MFIs, ICRA analysis

Capitalisation (net worth relative to managed advances) moderated from 23% as on March 31, 2015 to 16% as on March 31, 2016 owing to the higher pace of growth in comparison to internal capital generation and capital infusion. In FY2016, MFIs raised Rs. 6.3 billion of equity (Rs. 7.8 billion, including Bandhan) as compared to Rs. 17.0 billion in FY2015. However, the internal accruals of these MFIs improved considerably to Rs. 12.5 billion in FY2016 as compared to Rs. 6.7 billion in FY2015, reducing the need for external infusion. In YTD FY 2017, the SFB licenses (MFI focussed) have already raised/ tied up Rs. 25 billion of equity.

[2] This refers to direct loans from banks. Apart from this, banks also invest in assignment/securitisation transactions of MFIs.

The volume of external capital required to support MFIs (except Bandhan and eight MFI focussed SFB licensees) achieve a CAGR of 30%-35% over the next three years would be large at Rs. 16-47 billion (41%-119% of the existing net worth).[3] Nevertheless, in ICRA's opinion, given the supportive regulatory environment, past track record of MFIs in raising capital, and the continued investor interest in the sector, the MFIs should be able to raise the required capital for growth.

Healthy profitability profile, supported by improving operating efficiencies and low credit costs

Over the last one year, MFIs[4] have been able to improve their profitability indicators mainly on account of moderation in operating expenses, improvement in employee productivity, and stable credit costs. Thus, return on managed assets (ROA) for MFIs improved from 2.6% in FY2015 to 2.8% in FY2016, while the ROE went up from 15.8% to 19.8% over the same period. However, going forward, the net interest margins of MFIs could decline following the reduction in interest rates. However, operating expenses are likely to moderate from the current 7.6% of managed advances to around 7.0% supporting the overall profitability. During FY2017, MFIs are expected to report ROA of 2.3%-2.5% and ROE of 13%-15%, provided discipline at both borrower and lender levels is maintained and hence credit cost is maintained.

[3] Assuming gearing of 5-6 times and internal capital generation of 15%
[4] Non-CDR MFIs excluding Bandhan

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