Microfinance under the microscope

We hosted a conference call with Mr Alok Prasad, CEO of MFIN, to understand the impact of recent regulatory changes on the microfinance sector and its future prospects.

Key takeaways

- Strong growth, irresponsible lending practices, lending for consumption rather than for productive purposes, and high returns generated by microfinance institutions (MFIs) attracted regulatory attention towards the sector.
- Business has dropped significantly in the state of Andhra Pradesh (AP) after the introduction of the Microfinance Bill. Large part of the collections lost over the last 2-3 months is unlikely to be recovered (though quantum cannot be ascertained), leading to an increase provisioning requirements.
- Business in the states neighboring AP has also been impacted. However, collection efficiency in non-AP states has remained stable.
- The AP state government's ordinance is an over-reaction and steps are being taken to create a more adequate regulatory framework for the MFI sector.
- RBI is likely to create a regulatory framework for MFIs post the submission of the YH Malegam Committee report (likely by January 2011).
- The central government is working towards a new Microfinance Bill, which may override all state government regulations.
- Efforts are being made towards greater transparency in grant of loans, customer education and enhancement of financial literacy to prevent exploitation of customers.
- Business of MFIs will enter a new normalcy phase by 1QFY12. While interest rate charged by MFIs is not likely to be capped, return ratios would be benchmarked to certain parameters, leading to some moderation in profitability, going ahead.
- Over the medium term, repayment rate in India would gradually trend towards the global average of ~95% from the current level of 98-99%.

About the speaker

Mr Alok Prasad, the CEO of MFIN, is a veteran banker. Mr Prasad has over 30 years of banking and financial services experience. He was on the boards of CitiFinancial and Citicorp Maruti Finance, and has served the Citi Microfinance Group (India) as Country Director.

Mr Alok Prasad,
CEO of MFIN

About MFIN

Microfinance Institutions Network (MFIN) is a self regulatory organization (SRO), comprising of 37 MFIs. It aims to work with regulators to promote microfinance to achieve greater financial inclusion. It has defined a code of conduct for responsible lending. For the very first time in the MFI sector, MFIN is enabling the process of credit information sharing through High Mark and CIBIL.

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Strong growth, high profitability attracted regulatory attention towards MFI sector

- Extremely rapid growth ~95% CAGR over the last six years - to some extent led to irresponsible lending practices (lack of transparency, high interest rates on loans, inadequate collection systems) followed by MFI's.
- Loans were also given for consumption rather than productive purposes (though exact details are not available, ~20% of MFI loans are believed to be for consumption).
- Higher growth and better returns compared to government initiated program of Self Help Group (SHG) for microfinance customers attracted regulatory attention towards the MFI sector.

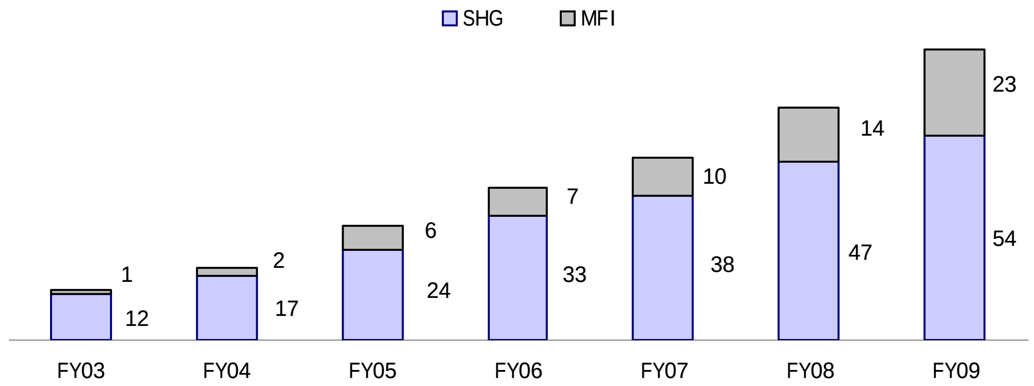
Working model of SHG and MFI

	SHG	MFI
Model	Associations of 10 to 20 women to save small amounts	Associations of 5 or 6 women formed by MFIs
Frequency of meeting	Monthly	Weekly
Savings	Members save for 6 months before loan disbursements	No requirement for savings
Lenders	Banks	MFIs, which in turn borrow from banks
Lending Model	Single loan given to the group	Individual loans but with Joint liability
Loan Tenors	~2.5 years	~1 year

Source: Company/MOSL

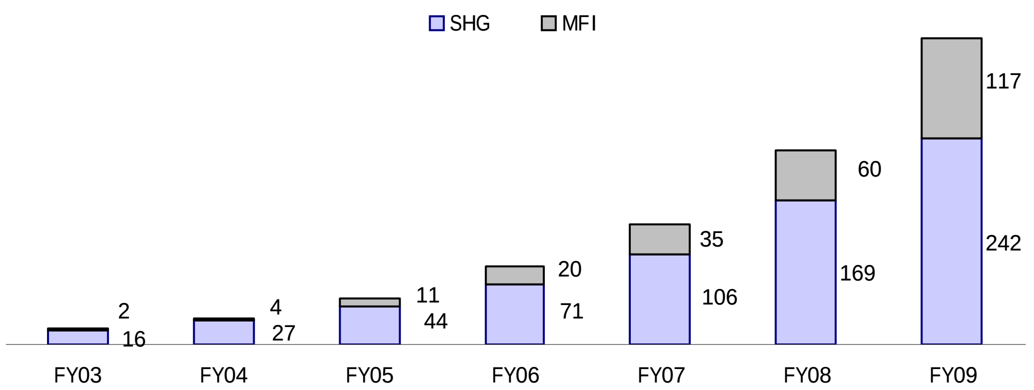
Customer base of MFIs grew at a CAGR of 68% over FY03-09

Customer base of SHGs and MFIs (m)



Aggregate loans by MFIs grew 95% CAGR over FY03-09 v/s 57% for SHGs

Outstanding loan book of SHGs and MFIs (Rs B)



Source: RBI

Business slowed and repayment rate dropped post introduction of ordinance

- Most MFIs have stopped fresh disbursements in AP or have slowed down (if not stopped completely) post the introduction of the ordinance. This is due to the changes required in the business models as per the ordinance issued and the inference of harsh punishment following any complaints against field staff.
- Accessibility to funds got constrained, as banks froze the credit lines for MFIs. It is expected that there would be limited release of funds till clarity emerges on the regulatory framework for MFIs.
- Collection efficiency for MFIs in AP (post introduction of the bill) has remained low at 15-20%. Based on the notification issued by the AP government, MFIs have shifted to a monthly collection cycle from the earlier practice of a weekly collection cycle. This is the key reason for decline in collections.
- Talks are on to restructure collections lost over the last 2-3 months in AP. But it seems impossible for certain customers to repay loans, as chunky repayment is beyond their means. This would lead to certain loss, for which provisioning would have to be made.
- Business in the states neighboring AP has also been impacted. However, collection efficiency in non-AP states has remained stable.

Key aspects of AP state government's ordinance

On 4 December 2010, the AP government passed the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010. Following aspects of MFIs' business model will undergo a change post the Bill:

- Shift to monthly collection against the current practice of weekly collection.
- Interest payment as a whole should not exceed the principal.
- Panchayat office to be the sole collection center against MFIN's demand of a public place for collection. Currently, MFIs conduct center meetings at public locations to collect installments.
- Prevents door-to-door collections, and disallows having loan collection agents who are not on the rolls of the MFI.
- All branches in a district to be registered, against MFIN's demand for single and centralized registration.

AP state ordinance is an over-reaction and efforts are on to create more adequate regulatory framework

- MFIN is challenging the constitutionality of the AP bill on the grounds that a state cannot pass an act on an institution regulated by a central institution. The AP bill is also being challenged on the grounds that it is impacting the right to conduct business in a normal course.
- RBI is likely to create a regulatory framework for MFIs post the submission of the YH Malegam Committee report (likely by January 2011). MFIN is in dialogue with RBI and is providing adequate support to create the necessary framework.
- The central government is working towards a new Microfinance Bill, which is likely to be presented in Parliament in the next 4-5 months. This Bill may override all state government regulations.

MFIN working towards improving transparency in the sector

- MFIN, a self-regulatory body, has laid down a code of conduct to be practiced by its members to ensure responsible lending. MFIN is enabling the process of credit information sharing through High Mark and CIBIL.
- It is also encouraging customer education and financial literacy to ensure that there is no exploitation of customers.
- MFIN is working closely with an NGO called Micro Finance Transparency to increase transparency of loan pricing (since March 2010) and initial results are scary with regards to pricing. ~85 MFIs have participated in this study. The data would be normalized to make it comparable before being put in public domain (expected by February 2011). MFIs have been given time till the end of December 2010 to alter the data submitted.

Business would return to new normalcy by 1QFY12; repayment rate to drop to 95% in medium term

- The AP bill is being termed as a game changer, and it is expected that business of MFIs will enter new normalcy by 1QFY12.
- While interest rate charged by MFIs is not likely to be capped, return ratios would be benchmarked to certain parameters, leading to some moderation in profitability.
- Loans granted by MFIs would continue to get the benefit of being classified as priority sector lending. This is on the back of modest financial penetration in the country and availability of credit to the needy sections of the society.
- Most borrowers generate income on a daily or weekly basis; therefore, a weekly collection cycle suits borrowers. Maintaining the repayment efficiency based on monthly collection cycle would be a key challenge.
- Globally, repayment rate for MFI loans is ~95% while for Indian MFIs, it is currently 98-99%. Over the medium term, repayment rate in India is likely to gradually trend towards 95%.

Appendix: Exposure of banks to MFIs

	MFI Exposure (Rs m)	As a % of loan book
ICICI bank	24,000	1.2
Yes Bank	3,000	1.0
Indusind	3,800	1.6
Andhra	3,000	0.5
ING	2,500	1.2
BoB	1,500	0.1
Axis Bank	13,000	1.2
BoI	4,000	0.2
PNB	9,000	0.4
SBI	8,000	0.1
Syndicate	5,000	0.5
Dena	800	0.2
CBoI	10,000	0.9

Source: Company/MOSL

NOTES

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Disclosure of Interest Statement

The MOSt group and its Directors own shares in the following companies covered in this report: Oriental Bank, South Indian Bank, State Bank of India

MOSt has broking relationships with a few of the companies covered in this report.

MOSt is engaged in providing investment-banking services in the following companies covered in this report: Nil