ICRA

INDIAN MICROFINANCE SECTOR
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Good growth prospects for the Indian microfinance sector, however rising borrower leverage poses challenge to asset quality

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Executive Summary

HIGHLIGHTS

- Market size reaches Rs. 2.9 lakh crore; portfolio growth remained robust at 36% during the 12 months ended September 2019
- Higher growth seen by larger entities led to increased share of larger entities as smaller entities faced more challenges on fund raising, post the liquidity squeeze
- Ticket sizes and individual loans continue to rise significantly
- Field visits indicate overleveraging in some areas and weakening client connect
- Stable asset quality indicators; strong performance of microloan pools rated by ICRA
- Securitisation remains a prominent funding tool propelling the growth of NBFC-MFIs
- Investors continued to support the industry with equity infusion of around Rs. 5,400 crore in FY2019 and Rs. 600 crore in H1 FY2020 (~Rs. 3,100 crore in FY2018)
- Comfortable liquidity position
- Profitability improves, supported by lower credit costs

OVERVIEW

Despite the liquidity squeeze post September 2018, which led to a dip in the growth of the NBFC sector, the MFI sector's growth remained robust at 30% in FY2019 (25% in FY2018) and 36% YoY for the period ended September 2019, taking the overall market size (including the SHG Bank Linkage Programme) to Rs. 2.9 lakh crore as on September 30, 2019. The robust sectoral growth was driven by the good growth of banks, small finance banks (SFBs) and larger NBFC-MFIs that were relatively well placed on the liquidity front. While the market is fragmented with many players and a rising number of new entrants operating in different forms, the mid-to-large-sized players were able to increase their market shares, supported by better access to funding (both equity and debt).

In November 2019, the Reserve Bank of India (RBI) modified the qualifying assets criteria for NBFC-MFIs. The limit on the total indebtedness of a borrower has been increased to Rs. 1.25 lakh from Rs. 1 lakh earlier. In ICRA's opinion, the increase in the overall indebtedness limit of the borrower could increase the ticket sizes and borrower leverage further, especially in overcrowded districts. With the increase in the overall indebtedness limit of the borrower, the ticket sizes are expected to grow at a faster pace. While this may help MFIs reduce operating costs and enhance client retention to some extent, microlenders such as banks and SFBs are also serving the same customers and are not covered by these guidelines. This risk would need to be addressed through the comprehensive assessment of the debt-servicing ability of the borrowers and more evolved risk management practices on the part of the lenders. To avoid overleveraging of the end borrower and maintain credit discipline in the sector, the Code of Responsible Lending (CRL) has been launched by the self-regulatory organisations (SROs). The CRL is sector specific and entity agnostic and applicable to unsecured micro-credit loans given to the microfinance segment by all providers. It caps the total indebtedness of the borrower at Rs. 1 lakh and the number of lenders per customer at 3. While the CRL is not mandatory, it could help maintain credit discipline in the sector if it is implemented properly and followed by the majority of the industry.

ICRA conducted field visits in 12 states in CY2019. During these visits, ICRA's analysts interacted with more than 3,000 borrowers. ICRA's focus during these interactions was mostly on understanding the field discipline and operations. Some of the key observations are low to moderate centre meeting attendance in some states, under-reporting of indebtedness by borrowers, and presence of more than two loans outstanding in the case of some members.

As per data collated by ICRA, NBFC-MFIs and SFBs together were present in around 600 districts as on September 30, 2019. The overall district and state-level diversification has improved over the last few years post demonetisation. However, the share of the top 5 districts (Bangalore, followed by Chennai, Mysore, Cuddalore and Mumbai) increased to 6% as on September 30, 2019 from 4.6% as on March 31, 2019. This is largely attributable to the exclusion of Bharat Financial Inclusion Limited (BFIL) data from September 2019[1]. Nevertheless, only a few MFIs have high district-wise diversification in their loan portfolios. ICRA has analysed the district-wise portfolio in relation

[1] *Post its merger with IndusInd Bank*

to the net worth of MFIs/SFBs accounting for over 80% of the MFI and SFB portfolio. The proportion of the top 10 districts in relation to the net worth was less than 100% for only 6 of the 28 entities analysed, indicating concentrated portfolios for most players. Further, ICRA has analysed the portfolio of over 30 MFIs and SFBs with an AUM of over Rs. 87,000 crore and classified the portfolios of MFIs across districts based on the number of MFIs operating in the district. ICRA has observed that all the overcrowded districts (defined as districts where more than 15 MFIs were present) are in Bihar, Madhya Pradesh, Odisha and Uttar Pradesh (UP).

The asset quality of NBFC-MFIs (including SFBs) remained similar to March 2019 levels with 90+dpd delinquencies at 1.6% as on September 30, 2019 (1.5% as on March 31, 2019) driven by good collection efficiencies and portfolio growth. It is pertinent to note that around 1.50% of the portfolio remained in the 0-90 dpd bucket over the last one year owing to increase in delinquencies in areas affected by the floods and cyclones in Kerala, Tamil Nadu and Odisha. Also, ICRA is of the view that the recent protests by local organisations against microlenders and reports of unrest in various districts of Assam (Dibrugarh, Golaghat, Jorhat, Sibsagar and Tinsukia) may weaken the asset quality of the major players operating in the state.

The share of loans with ticket sizes of >Rs. 48,000 increased to 28% as on September 30, 2019 from 12% as on December 31, 2018. If a factor is applied here, assuming 30-40% of these borrowers had multiple loans, around 10-11% of the portfolio could be at overall leverage of Rs. 1 lakh or more, higher than what is prescribed by the CRL. Further, the share of individual loans has also increased. Additionally, the proportion of the portfolio in the first loan cycle remains high at 49% as on September 30, 2019, which indicates low client retention rates. While some first-cycle borrowers may be new to credit, a few of them may also have a prior track record with other MFIs. Discussions with various MFIs/SFBs show that client attrition rates have gone up with the increase in competition, especially in areas where penetration is high. In most cases, lenders approach and fund clients, who already have loans from other lenders, a few months before their loan is about to be repaid and they become eligible for the subsequent loan cycle. Therefore, the client becomes ineligible for a loan from the existing lender if the leverage crosses the threshold amount, leading to the client being dropped from the subsequent loan cycle. This leads to pressure on the field staff to continuously acquire clients and penetrate newer geographies for maintaining the client growth rates.

Banks have been the key debt capital providers for the sector, largely because of the continuation of priority sector status for NBFC-MFIs. While the overall debt raised by the MFIs was lower than envisaged owing to the liquidity squeeze, the mid-to-large-sized MFIs were better placed and continued to get funding support from banks. However, the smaller MFIs, which had higher dependence on NBFCs for meeting their funding requirements, faced some constraints in meeting their business plans. As a result, they raised higher volumes of funds through the securitisation route. The MFIs have been able to maintain a favourable asset liability maturity (ALM) profile, given the relatively short tenure of the advances. In addition to the capital flow, the liquidity profile is supported by the priority sector benefit that the banks get for funding these entities, either through the on-balance sheet route or the off-balance sheet (largely assignment of microloans) route. However, the incremental funding requirement of the MFIs is likely to remain a challenge, given their significant growth aspirations as well as for servicing the existing client requirements.

Investors continued to support the industry with equity infusions of around Rs. 5,400 crore in FY2019 (~Rs. 3,100 crore in FY2018) and Rs. 1200 crore in YTDFY2020. However, more than 90% of the capital raised in FY2019 was by MFIs with AUMs exceeding Rs. 1,000 crore, inferring that raising capital has been easy for MFIs that have reached a certain scale while the smaller entities continue to struggle to raise equity. Given their growth targets of 25-30% p.a. over the next three years, in ICRA’s opinion, these players would need external capital of Rs. 3,900-5,300 crore during this period. There could also be a change in the business model of the smaller MFIs, which may originate more portfolio through the BC model, as partners to larger lenders, to conserve capital. Alternatively, there could be further consolidation in the industry with the smaller MFIs being acquired by larger NBFCs/banks.

While the growth prospects remain good and the industry is expected to grow by 25-30% in FY2020, MFIs need to conduct a more involved and thorough credit analysis/ assessment of the actual debt repayment capacity of the borrower. Further, the risk management policies of the lenders in the sector need to be aligned to ensure responsible and sustainable growth. On the positive side, the asset quality indicators should be supported by ensuring stringent group selection/elimination norms and adequate credit discipline at the borrower level by enforcing joint group liability (JGL), wherever applicable and required. Nevertheless, the segment shall always remain vulnerable to income shocks, political interference, and event risks. Accordingly, ICRA expects the credit costs for the sector to remain volatile with a mean level of 1.5-2.0% (annualised). The credit cost could vary among players and across cycles depending on the risk management practices and exposure to relatively overcrowded areas. This underscores the need for MFIs to enhance their operating efficiencies for sustaining profitable growth in the long term. If the annualised credit costs remain at 1.5-2%, ICRA expects the sector to report a return on equity (RoE) of 13-15% in FY2020.

ICRA

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

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- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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