Institutional Analysis of Microfinance Institutions (MFIs): Status and Measures for Wider and Effective Outreach

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Contents

Foreword		i
List of Tables, Figures, Boxes and Appendices		iv
Executive Summary		ix
1	Microfinance Institutions (MFI) Sector: An Overview	1
2	The Study	19
3	Client Outreach and Loan Portfolio	23
4	Financial and Operational Performance	41
5	Capital Structure	46
6	Social Performance	57
7	Emerging Models and the Best Practices	62
8	Clients' Perspective	72
9	Emerging Issues in the MFI Sector	86
10	Policy Suggestions for NABARD	101
11	Policy Suggestions for Other Stakeholders	109
References		112
Appendices		115

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Executive Summary

The Indian MFI sector has seen rapid changes post 2010 Andhra Pradesh crisis. Reserve Bank of India (RBI) came up with a number of initiatives so as to regulate the sector which was bruised with over-indebtedness, high interest rates and defaults. A new regulatory structure was introduced by RBI for NBFC-MFIs, a legal category which contributes to around 90% of the loan portfolio outstanding in the sector. The market mechanism has driven other legal categories as well to adopt the same guidelines. Approval of network organizations, Sa-Dhan and Microfinance Institutions Network (MFIN) as Self-regulatory Organisations and well-functioning MFIs across different regions as Small Finance Banks, reflect the faith of the central bank in the MFI sector. RBI's coming out with regular modifications in its guidelines for the sector is a testimony of its continuing interest in the sector and the importance of the sector in the larger financial inclusion space.

Indian MFI sector is growing at an increasing rate over the last 3-4 years and has surpassed the pre-crisis growth rate. Further, it has shown improving profitability, portfolio quality, efficiency and productivity levels. The sector is emerging in the way that the bigger and smaller MFIs will have distinct growth paths and strategies. The bigger ones with aggressive growth will have better access to capital and will aspire to be a bank. Some of them have issued stocks and have got listed. Out of the 10 entities which got the in-principle licence for Small Finance Bank, eight are MFIs. At the time of writing of this report all of them, barring RGVN (NE) Microfinance Ltd. and Janalakshmi Financial Services Ltd. have started the Small Finance Bank operations. The smaller MFIs on the other hand will be doing a combination of business on own books and business as Business Correspondents (BCs) of Banks. Some of them are also being taken over by larger NBFCs and/or new generation banks.

Not-for-profit entities like SKDRDP and Cashpor which are not having an easy access to outside capital and are not allowed by the tax authorities to consistently build capital using surplus, find it extremely difficult to scale up the microfinance program. This has prompted not-for-profit entities which were not inclined to transform into for-profit NBFCs to shift their portfolio to the banks and act as BCs. This has enabled them to increase their loan portfolio and offer varied financial services like deposit, remittance and pension. The MFIs are finding the BC model attractive, with 51 MFIs out of the 166 MFIs reporting to Sa-Dhan, operating as BCs of 25 Banks with ₹ 7,191 crore of loan portfolio outstanding and outreach to 54,75,930 loan clients (Sa-Dhan, 2016).

However, in this rapidly changing scenario there are various grey areas which need to be explored. The growth is found to be concentrated in certain geographies and is driven by select large MFIs. With the industry focusing on business parameters (loan portfolio) at the cost of the outreach (number of clients, staff and branches), it may negatively affect the clients and the staff, leading to over-indebtedness of clients and staff turnover. The sector also seems to be excluding the poor, which is the target client for the financial inclusion drive of the

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Government of India. Such issues need to be explored so as to gauge the state of health of the sector and to see where the sector is heading in terms of its objective of providing financial access to the poor. This study aims to examine the performance of the sector and come up with suggestions for the wider and effective outreach of the Indian MFIs, including those which have/are converting into Small Finance Banks. The study also attempts to explore the role which NABARD can play in the sector.

The study has assessed outreach of the MFIs at three levels viz., breadth, depth and scope. Breadth of outreach is measured in terms of the number of states and districts served, number of branches and the number of borrowers per branch. Depth of outreach in the sample is measured in terms of both poverty outreach as well as the rural outreach. Scope of outreach shows the variety of financial and non-financial products offered. It includes microcredit, micro-insurance, micro-pension and other social and development activities.

The geographical spread in terms of number of states and districts served is better for larger NBFC-MFIs like Ujjivan. In terms of the number of branches, organizations like Ujjivan, Sonata and Cashpor perform well and in terms of the number of borrowers served per branch, the performance is better for Ujjivan, NABFINS, Sanghamithra and SKDRDP. It has been found that the outreach performance is not linked to the legal status of the institution or the size of the institution, but is related to the delivery model adopted. Sonata which is one-fifth the size of SKDRDP is serving four times the number of states and districts and is having around 2.5 times the number of branches, but having only one-thirteenth the number of borrowers served per branch. Similarly, Ujjivan which is almost the same size as SKDRDP serves 12 times the number of states, eight times the number of districts and has 3.5 times the number of branches, but has only about one-fourth the number of borrowers served per branch.

Poverty outreach is measured using Progress out of Poverty Index (PPI) of Grameen Foundation. The poverty outreach of the sample MFIs is much lower than the National Poverty Line estimates based on Tendulkar committee recommendations. The performance is found to be worse in Assam where the gap between the poverty outreach of MFIs and the state poverty incidence is the highest. The Cashpor and Bhartiya Micro Credit are found to be the best performers in terms of poverty outreach. The poverty outreach of Ujjivan is worse than its peers in different states.

Rural outreach is better for not-for-profit institutions like Sanghamithra (94%), Cashpor (97%) and SKDRDP (85%) in comparison to the for-profit institutions like Ujjivan (29%), Sonata (67%) and RGVN (71%). The only exception being NABFINS (92%) which being a NABARD promoted organization, has a mandate to reach in rural areas. An important highlight of the analysis is that section 8 companies are having much better reach in rural areas in comparison to the comparatively bigger NBFC-MFIs like Ujjivan and Sonata.

In terms of the scope of outreach, it was found that non-NBFC-MFIs like SKDRDP, Cashpor and Annapurna are the only institutions among the sample to provide the full range of financial services to their clients. Annapurna and Cashpor are providing insurance coverage to a larger

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client base and much beyond its existing loan clients with insurance outreach as a percentage of borrower base as 338% and 146% respectively. Only four MFIs viz., Annapurna, Cashpor, SKDRDP and Ujjivan facilitate deposit services to their clients and only Annapurna, Cashpor and SKDRDP are providing the pension product to their client base with pension outreach of 20%, 21% and 10% respectively. Six out of ten MFIs are also providing non-financial services to their clients.

The study of the client age of the borrowers in the sample shows that there are certain development oriented organizations like Cashpor, Sanghamithra and RGVN which are not growing very fast in client outreach and are focusing more on the existing client base in terms of offering a comprehensive bouquet of non-financial services in addition to the financial services. They have a majority of the borrowers in the third or higher loan cycles. The MFIs are enhancing their engagement with the clients by offering them varied non-financial services in addition to the financial services. It is seen that 64% of the clients in the sample have availed at least some type of "microfinance plus" service from the MFIs. The focus of most of the organizations is on providing training on financial literacy followed by health and women empowerment services which covers 26%, 14% and 12% of the sample client base respectively. Thus, in terms of the scope of outreach, non-NBFC organizations like SKDRDP, Cashpor and Annapurna are performing better.

A significant proportion of borrowers (97%) in the sample are having saving account with the banks. However, only 2% borrowers are having access to the bank loans and only 1% borrowers are having the loans under the SHG Bank Linkage Program (SBLP). Thus, the study shows a very low level of overlap between the SBLP and the MFI lending. This highlights the importance of the MFI lending as the reach of banks to such clients is highly insignificant even under SBLP.

The average loan amount per client varies from ₹23,412 for Midland Microfin to ₹97,800 for SKDRDP. The MFIs like SKDRDP, NABFINS and Sanghamithra which are following the SHG lending model and lending to groups instead of individuals within groups are having higher average loan amounts viz., ₹97,800, ₹47,100 and ₹45,850 respectively. It is seen that majority (55%) of borrowers were using the loan for services followed by trade/retail (24%), agriculture and allied activities (21%) and manufacturing (4%).

The financial and operational performance of the MFIs is assessed in terms of profitability, sustainability, efficiency, productivity and portfolio quality. It has been found that the measures of profitability and sustainability viz., Return on Assets (ROA), Return on Equity (ROE) and Operational Self-Sufficiency (OSS) are significantly higher for NBFC-MFIs in comparison to section 8 and NGO-MFIs (Sanghamithra and NABFINS are exceptions). MFIs like Sanghamithra and NABFINS which are working on the SHG lending model through BC/BF partners have lowest operational expense ratio. The loan officer productivity is found to be a significant determinant of efficiency. In spite of working in North-East, RGVN has been successful in maintaining lower operational expense ratio (5.66%) due to very high loan officer productivity. It was found that highly scaled up institutions like SKDRDP and Ujjivan have

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lower operational expense ratio than smaller MFIs like Bhartiya Micro Credit, Midland and Annapurna. MFIs in the sample have very good portfolio quality in terms of Portfolio at Risk (PAR) 30 days, Non-Performing Asset (NPA) and write-off ratio. Only Sanghamithra with 1.02% NPA and NABFINS with 4.24% NPA have problems in their portfolio quality.

The debt equity ratio and Capital to Risk Weighted Asset Ratio (CRAR) were used to analyze the capital structure of the MFIs. It has been found that the not-for-profit MFIs have high debt equity ratios [Cashpor (5.41), Bhartiya Micro Credit (5.95)] and have comparatively lower CRARs [Cashpor (17.90%), Bhartiya Micro Credit (17.77%)] in comparison to NBFC-MFIs, owing to the difficulty they face in generating equity as they cannot distribute dividends to the shareholders. However, SKDRDP has transferred its portfolio to the banks and is working as a BC and hence has a low debt equity ratio (2.30) and high CRAR (35.60). It has been found that all the sample MFIs have CRAR higher than RBI prescribed limit (15%). However, some of the MFIs like Cashpor and Sonata are not or merely able to achieve this limit using Tier I capital and have high reliance on Tier II capital like subordinated debt and optionally convertible preference shares. In such a situation, CRAR should be looked at with caution. For sample NBFC-MFIs, the foreign shareholding ranges from 55.68%-77%. This shows the reliance of for-profit MFIs on the foreign capital owing to the lack of availability of patient domestic capital in India.

Overall, it is seen that borrowings (79%) constitute the major portion of the total funds available with the MFIs. Shareholders' funds are 21% of the total funds available. Deposits are negligible and available only with the cooperative MFI. In the total borrowings, term loan comprises of 85% followed by debentures (11%), short term borrowings (3%) and subordinated debt (1%). On an average, it has been found that the financial expense ratio is higher for the medium sized and small NBFC-MFIs in comparison to the not-for-profit MFIs which have access to grants, revolving funds and low cost funds from development finance institutions like NABARD and SIDBI.

In addition to the client feedback, client retention rate, staff turnover rate, Code of Conduct Assessment scores and social ratings are used to assess the social performance of the MFIs. The client retention rate of the sample MFIs varies from 62%-95%. Sanghamithra has the lowest (62%) and SKDRDP has the highest (95%) client retention rate in the sample. Staff turnover is a major risk faced by the MFI sector. The turnover rate ranges from 5%-35.46%. Cashpor has witnessed the highest staff turnover rate (35.46%) and SKDRDP is having the lowest (5%) turnover rate. Midland (27.53%), Sanghamithra (21%) and Ujjivan (18.40%) are the other MFIs having significant staff turnover rates. Ujjivan, Cashpor and Sonata are the three MFIs in the sample which are Smart Campaign's Client Protection certified. They have also got the social rating through the external agency. Barring NABFINS, all the others have undergone the Code of Conduct Assessments by external agency at least once.

As part of the study, client responses were taken on questions related to the adherence to the client protection principles. Assessing the level and the impact of the over-indebtedness, it was found that 31% of the clients in the sample had faced the problem of timely repayment

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of loans with almost the same proportion of clients (32%) who resorted to other sources of loan to repay their previous loans. An alarming finding from the study is that 8% of the clients had to forego or reduce their meals so as to arrange for the repayment. This shows the level of over-indebtedness prevalent in the MFI sector and its negative impact on the clients.

A significant proportion of the clients (20%) experienced intimidation or mistreatment by their loan officers and 1% had been asked for a commission in return for a favour. Nearly one in every ten clients reported that their loan officer have taken money without providing a receipt. These measures point to the fact that there are still issues of staff interaction with the clients in the field which needs to be resolved for better client satisfaction.

A majority of clients reported satisfaction with the loan pricing with 78% and 74% of the clients finding processing fees and interest rates on the loan as reasonable and affordable. An important finding of the study is that only 17% clients found the loan pricing as inappropriate while 27% considered loan disbursement as a problem, which shows that for an MFI client timely access to the loan is more important than the price of the loan.

As far as the complaint resolution mechanism is concerned, a vast majority (97%) of the clients reported being aware of the existence of at least one type of complaint mechanism. Eleven percent of the sample had submitted a complaint. Of the clients who submitted complaint (n=66), 85% reported satisfactory resolution and 86% reported receiving prompt response to their complaint. One of the important factors in the client satisfaction is the time taken for the complaint to be resolved. For the majority of the clients (54 out of 66) the complaint turnaround time was less than 10 days. However, in some exceptional cases, the complaints have lingered on for more than 30 days as well. The average turnaround time for the sample of 66 clients who had lodged a complaint is 8.36 days which was reasonably good.

A significant proportion of clients (37%) expressed their dissatisfaction with the variety of products offered. A number of their requirements remain unfulfilled due to lack of product variety. Very few MFIs are offering education, housing and water, sanitation and hygiene (WASH) loans. In terms of loan amount also 33% clients were dissatisfied, which reflects their unfulfilled demand. In addition, even after the introduction of the RBI guidelines, 31% and 18% of the clients were not satisfied with the loan tenure and repayment frequency. An important observation from the field is that none of the MFIs have given the option of the choice of repayment frequency to the clients. It was seen that almost all the clients of the MFIs have a single repayment frequency. Overall average level of satisfaction on the product design is due to the fact that around 55% clients reported that they have not been asked for their feedback on the products and services. This needs to be corrected for the better client satisfaction levels in the sector.

In terms of the socio-economic outcome of the services, it was found that a vast majority of clients (86%) feel that the microfinance services have helped them in mitigating risk and coping with emergencies and 78% of the clients feel that microfinance services have helped in increasing the financial condition and overall well-being of the household. This shows the significance of the services offered by MFIs for the clients and their households.

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In addition to this a highly significant number of clients had acquired the assets/facilities post their first loan disbursement. There is a 440% increase in the number of clients having toilet facility and 535% increase in the number of clients having water connection. Similarly, the number of clients using motorcycle, television and mobile has increased by 111%, 759%, 2233% respectively. Thus, the MFI clients have seen a significant rise in their basic household assets/facilities. A surprising finding is that the increase in households with mobile phones is manifold than the increase in households with toilet facility and water connection. Thus, the MFIs should focus on and WASH loans as part of their strategy to create an improvement in the quality of life of their clients.

On the basis of the findings, the study comes up with suitable suggestions for NABARD and other stakeholders. The study suggests NABARD to support MFIs for technology upgradation through its Financial Inclusion Fund (FIF). The support may be extended to not-for-profit and smaller MFIs in the form of software and hardware infrastructure for new initiatives like micro-ATMs and Aadhaar linked E-KYC.

In order to create an alternate model of microfinance in India which carries the mandate of NABARD by working with rural poor, NABARD needs to develop an ecosystem of section 8 companies. This can be done by providing them capital support by revising the existing refinancing framework which does not permit extending support to section 8 companies. NABARD may come up with a new rating tool (like Harmonized Code of conduct Tool of SIDBI) having both financial and social parameters. This will permit refinance to microfinance companies with good financial and social performance, irrespective of the legal constitution. In addition to this, low cost subordinated debt and direct financing for on-lending at lower rates of interest can be offered to section 8 Companies, which will help them in negotiating with the other lenders for low cost debt.

NABARD may consider designing the eligibility norms for refinancing according to the size of the MFIs as in case of MUDRA. This will allow well-managed smaller MFIs to have access to low cost funds. In order to enhance the funding opportunities for the smaller MFIs, NABARD may also deliberate on relaxing the eligibility norms for NBFCs which are having significant wholesale microfinance portfolio like Ananya Finance. In all NABARD needs to take the ownership of smaller MFIs and section 8 companies so as to support the sector post the transformation of bigger MFIs into Small Finance Banks.

NABARD may consider collaborating with MFIs in number of areas like co-partnering in design for products like marriage loan, education loan and business loans for rural areas like loans for fertilizer dealers. It may also extend the technical handholding for specific sectors such as dairy, poultry etc., particularly in North-East which is a mono-crop region. NABARD may also examine collaborating with Annapurna for taking community-based insurance model to its SHG members through the SHG federations. For poverty reduction of the MFI clients on a sustainable basis, NABARD may extend grant for imparting health and education services to the clients through NGOs. Mentoring support to the clients in the form of training, business ideation and market linkages can also be extended by involving well-performing NGOs.

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The study also makes suggestions for other stakeholders like Government, regulator, self-regulators, financial institutions and practitioners. The study suggests that the partners of MFIs which are working on the SHG model may be provided capacity building support as in the case of NGOs involved in SBLP. Further, the interest rate subvention scheme extended to the SHGs linked to the banks under the NRLM program may be extended to the SHGs linked to the MFIs like Sanghamithra and NABFINS.

The study also highlights the need for developing saving culture among the poor and well-designed saving products for the poor. The study also singles out the need for a uniform regulation in the microfinance space, irrespective of the constitution of the lender. It says that RBI regulation needs to be extended to the SHG/JLG lending by the banks and the Small Finance Banks. The study suggests that the penetration and concentration of the BCs need to be increased in the system so as to reduce the transaction cost for the borrowers, thus making transitioning to the cashless system efficient and convenient for the borrowers.

With the bigger MFIs transforming into Small Finance Banks and Universal Banks, they will be focusing on "missing middle" and space will be created for the smaller MFIs. Support by financial institutions to smaller MFIs will help in enhancing outreach to the poor in the group loan segment. Financial institutions can identify over-concentrated areas and limit their lending in those areas so as to tackle the risk of over-lending and improve reach in under-served areas. They can collectively drive the responsible finance practices in the sector. SIDBI has come up with the Harmonized Code of Conduct Assessment Tool (HCT) which has merged both MFI grading tool and the Code of Conduct Assessment tool. It can act as a single social performance rating tool in the sector. Financial institutions can make it mandatory for the MFIs to do HCT for any funding support and can also consider the performance on this tool to determine the interest rate to be offered to the MFIs.

Overall the study finds that the sector has got immense potential for reaching out to the unbanked and also making positive contribution in their lives. Further, it points out various measures which could lead to the development of the sector. MFI sector as a whole needs to focus on image building and be more proactive in communicating good work done to local administration, state administration and public in general. This will build up the awareness and acceptance of the sector.

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