Indian Microfinance Sector: An Overview

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7 February 2018

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Abstract

The Indian microfinance sector was one of the largest in the world with full of growth potential. However, series of incidents happened in 2010 and thereafter changed the face of the industry. Though the crisis proved a death warrant for many MFIs, it also brought some good news for the sector. The present study attempts to overview the performance of Indian microfinance sector after the crisis. The main objective is to observe the current state of affairs of the sector and to check if the sector has recovered from that shock. Data have been taken from Mixmarket database.

Key words: Microfinance, Financial Inclusion, Indian economy

JEL Codes: G21, I38, O16

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Introduction

For any economically growing country, it is important that its growth strategy should be inclusive. Financial services play a crucial role in ensuring inclusive growth. They work as a catalyst in bringing improvements in life. However, the financially weaker section of the society from all over the world is either unable or reluctant or being denied of getting financial services from the traditional formal financial institutions. The limiting access to financial services is a major bottleneck for the people wanting to improve their livelihoods. Though the Indian economy is on the high growth trajectory, inclusive growth remains the biggest challenge that the country is facing since independence. Microfinance is about providing financial services (non-financial too) to such financially excluded group in a way that helps them to move out of poverty. This way, it tries to ensure that economic growth reflects improvements in the quality of life of the downtrodden. Therefore, the end objective goes beyond just delivering services in a business-like way.

The idea of extending financial services to all articulated in the policy statement of Reserve Bank of India (RBI) in 2005 (Reddy, 2011). However, microfinance was not the major tool of the financial inclusion until the Rangarajan committee on Financial Inclusion (Reddy, 2011). The RBI understanding of microfinance was that microfinance is a small part of financial inclusion. It was the Andhra crisis which drew the attention of the RBI towards this sector.

The structure of Indian microfinance sector[i] has drastically changed in the recent decades. It started with very small loans mainly dependent on grants and subsidies. Later, observing the initial success and future growth potential, it emerged as a promising sector attracting investors from all quarters. It was also felt that donations and subsidies were not enough to provide the services at a large scale. Therefore, most of the MFIs went for debts and, some big ones went for IPOs. (Sa-Dhan, 2016). However, during this transition and transformation phase, questions were raised on the high-interest rates, governance, transparency and client treatment of these institutions. The sector faced its deepest crisis in 2010, erupted in Andhra Pradesh[ii] which was the crucial hub of microfinance business. The industry witnessed significant declines in all key indicators (MFIN[iii] Annual Report, 2011-12). This incident further posed serious operational challenges for the MFIs due to the introduction of strict regulations by the RBI. The current study attempts to overview the performance of Indian microfinance sector after the crisis. The main objective is to observe the current state of affairs of the sector and to check if the sector has recovered from that shock. Data have been taken from Mixmarket database[iv]. Only MFIs having operations at large scale have been taken for this study[3].

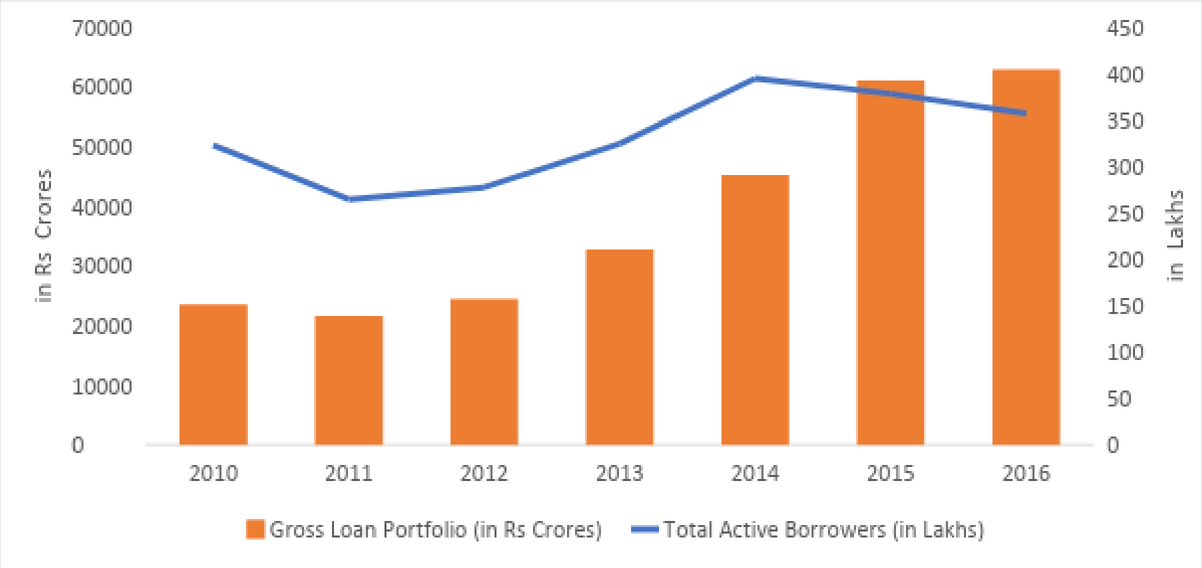

Figure 1: Growth of Indian Microfinance sector, 2010-2016; Data Source: Mixmarket.

Social Performance

The two main indicators of measuring the performance of MFI are the expansion of business in terms of the gross loan portfolio (GLP) and client outreach in terms of a number of borrowers. An initial decline in a total number of borrowers and GLP of MFIs clearly depicts the adverse effect of the microfinance sector crisis of 2010(Figure 1). However, the sector recovered soon and registered a consistent positive growth in GLP since 2011. The number of borrowers has decreased in the last 3 years. Between 2012-16, the growth in GLP is 157% while client outreach grew at about 29%. Furthermore, out of 500 districts where MFIs have their operations, nearly 50% of the GLP is concentrated in 80 districts (IFI Report, 2016). This indicates the MFIs are providing a higher amount of loans per borrowers and also the growing cases of multiples loans from different MFIs. This increase the chances of delinquency and defaults.

Almost all MFIs have poverty alleviation as an explicit objective and so expected to target poor clients. Small loan size is roughly related to the poverty of borrower as better off clients will go for bigger loans. In order to check the depth of MFIs' outreach, the average loan size as a percentage of GNI per capita[v] is generally used. If an average outstanding loan balance is less than 20% of per capita GNI, it indicates that clients are very poor (CGAP, 2009). There is a consistent rise in the loan size given by different forms of MFIs (Figure 2). It means, on average, loan size of the Indian MFIs is large, and they are not reaching to the very poor clients.

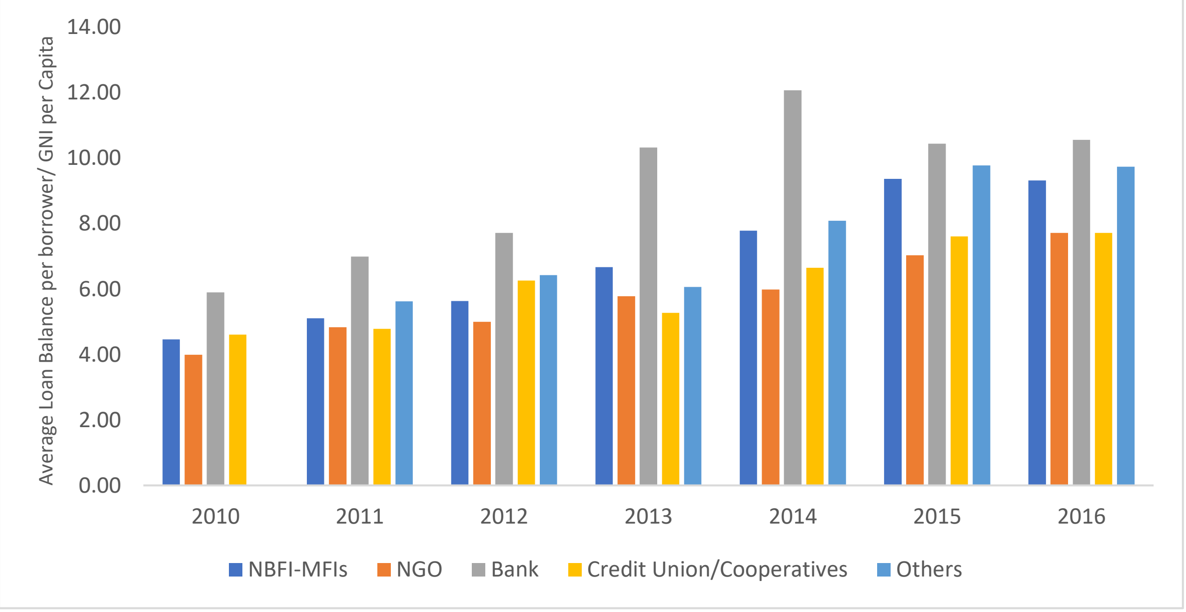

Figure 2: Depth of the Outreach of MFIs; Data Source: Mixmarket.

A rise in average loan size is good for a financial institution as it reduces the operating costs. However, MFIs cannot be treated only as a substitute of the traditional financial institutions. Such treatment will hide the uniqueness of the sector. The true beauty of microfinance does not lie in just holding the clients, but in pushing them up to the next level of income, where they can enjoy a wide range of financial services. This distinct feature of microfinance makes the operations of the MFIs complicated. They have to reach to the poor clients living in the remote areas of the country, often illiterate, and are extremely vulnerable to external shocks. Here, directly jumping on financial services will not prove beneficial for both the parties. A moderate and systematic rise in average loan size is good for a client also. But, if clients are not able to manage the loan amount properly, microcredit can put them further deep in the vicious cycle of poverty.

Portfolio Quality

The ability of an MFI to collect repayments of their loans on time is very critical for its existence. High repayment rates increase the revenue and liquidity position of the institution and, also reflect the competence of the management. Furthermore, high repayment rate reflects that the loans are of real value to the clients and they desire to preserve their future access to a loan service. The current study measures the portfolio quality of the MFIs through Portfolio at Risk (PAR) > 30 days[vi]. Rising PAR reflects the weaknesses of management and systems. Overall PAR for the MFI sector has been decreasing since 2010, but has shown an increase in 2015-16 (Figure 3 & 4). This indicates Indian MFIs are bearing more credit risk. This is mainly due to the steep rise in PAR level of NBFI-MFIs and banks. The PAR level remains relatively high for NBFI-MFIs throughout the period in comparison to other types of MFIs.

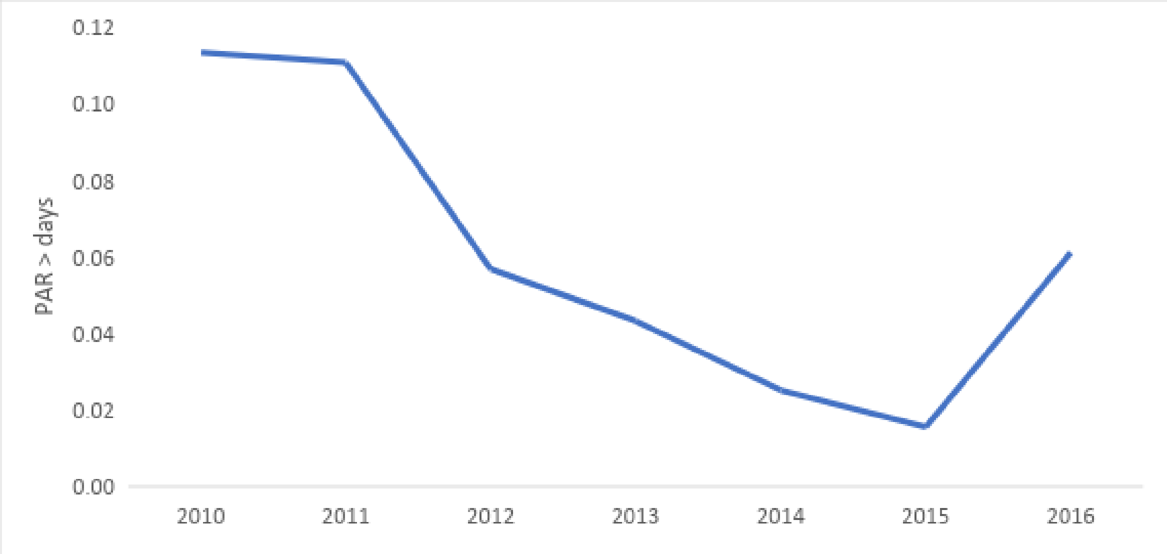

Figure 3: Loan Portfolio at Risk (PAR>30) of Microfinance sector; Authors' calculation based on Mixmarket database.

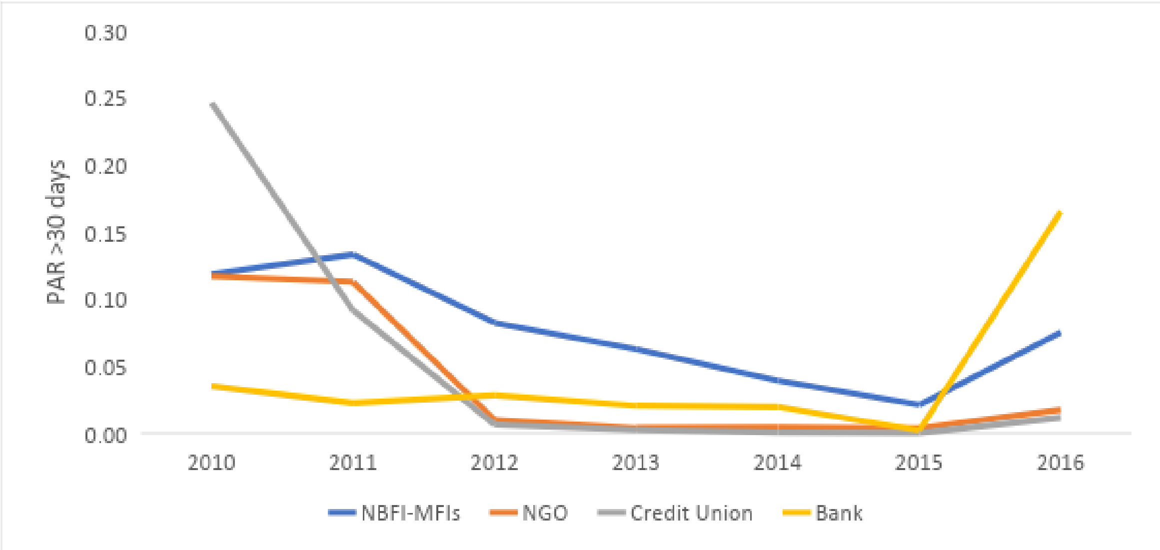

Figure 4: Loan Portfolio at Risk (PAR>30) of MFIs; Authors' calculation based on Mixmarket database.

Financial Performance

Financial performance of MFIs is a crucial means to achieve social objectives. Financial sustainability becomes more crucial when MFI becomes mature. The financial performance of MFIs as a whole is shown with the help of return on assets (ROA) (Figure 5 & 6).

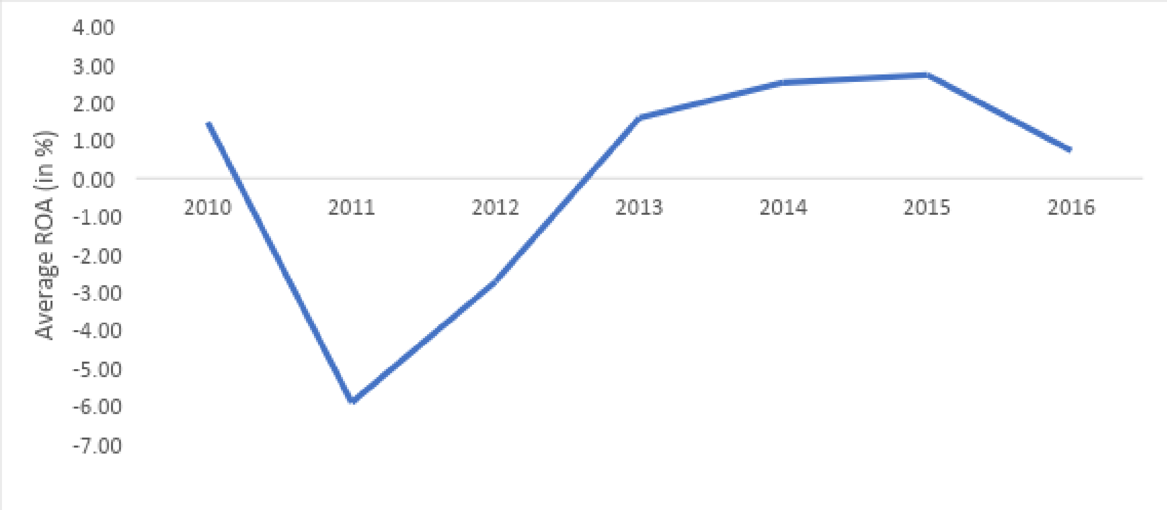

Figure 5: Financial Performance of Microfinance sector; Authors' calculation based on Mixmarket database.

The average ROA fell sharply from 1.48% in 2010 to -5.91% in the year 2011. This reflects the severity of the Andhra crisis 2010. The NGO-MFIs were the worst affected. Things improved in 2012, though the MFIs were still bleeding. Since then, the ROA become positive with consistent rise till 2016. In 2016, the average ROA fell by 73%. All except Credit Union/Cooperative types MFIs registered a decline in their net income. Rising ROA of an MFI attracts private capital as well as potentiality to become a formal financial institution

Table 1: Average Return on Assets (ROA)

Year	NBFI-MFIs	NGO	Banks	Credit Union / Cooperative	Others
2010	1.30	1.70	1.70	0.59	5.71
2011	-3.13	-16.91	1.53	-5.37	5.95
2012	-4.99	0.03	2.27	1.71	2.82
2013	1.09	2.98	2.62	2.22	-1.33
2014	1.91	4.02	2.65	2.60	0.58
2015	2.01	4.52	2.90	1.90	4.45
2016	1.00	1.09	-2.46	2.51	0.11

Source: Authors' calculation based on Mixmarket database.

Productivity & Efficiency

It is very important that MFIs should maximize their use of resources as it will boost their ability to provide micro-credits to a large number of clients without any additional hike in the rate of interest. This is only possible if they are highly productive and efficient. Here an attempt is made to check the productivity and efficiency of the MFIs through borrowers per loan officer and operating expenses-to-loan portfolio, respectively.

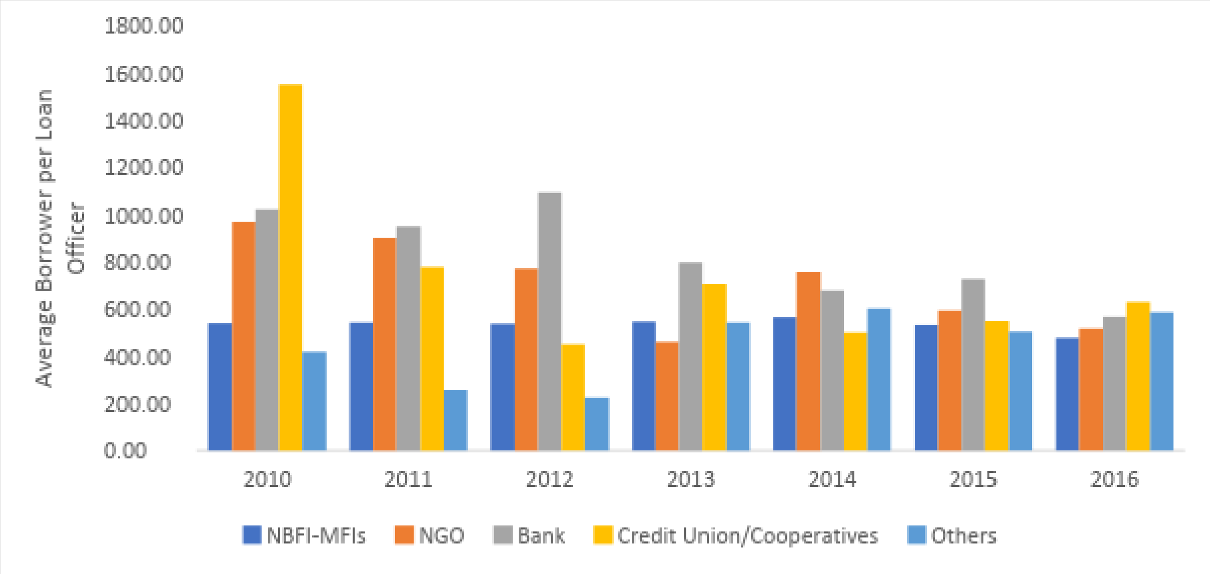

Figure 6: Productivity of MFIs; Authors' calculation based on Mixmarket database.

The diverse nature of Indian microfinance sector is well reflected in loan officers' productivity among diverse MFIs (Figure 6). The declining trend is quite visible in all types of MFIs. The trend is quite strong for Credit Unions/ Cooperatives, NGOs and Banks. Still, these figures are higher than the level recommended by Sa-dhan performance standard (Ghate, 2008). Low ratio of clients per loan officer improves the service quality and improve the portfolio quality, however, it increases cost. It seems that after the Andhra crisis, MFIs have become more careful and spend more time with clients. There is also a possibility that more and more MFIs are going for individual lending in place of group lending.

The average operating expense ratio (OER) is shown to measure the efficiency of the MFIs (Figure 7). Except for the sudden rise in operating expenses for Banks for the year 2016, the operating expenses for all the types of MFIs have decreased. For NBFIs, this reduction is more pronounced. It reflects that Indian MFIs are controlling their operating costs well enough even when their staff productivity is declining.

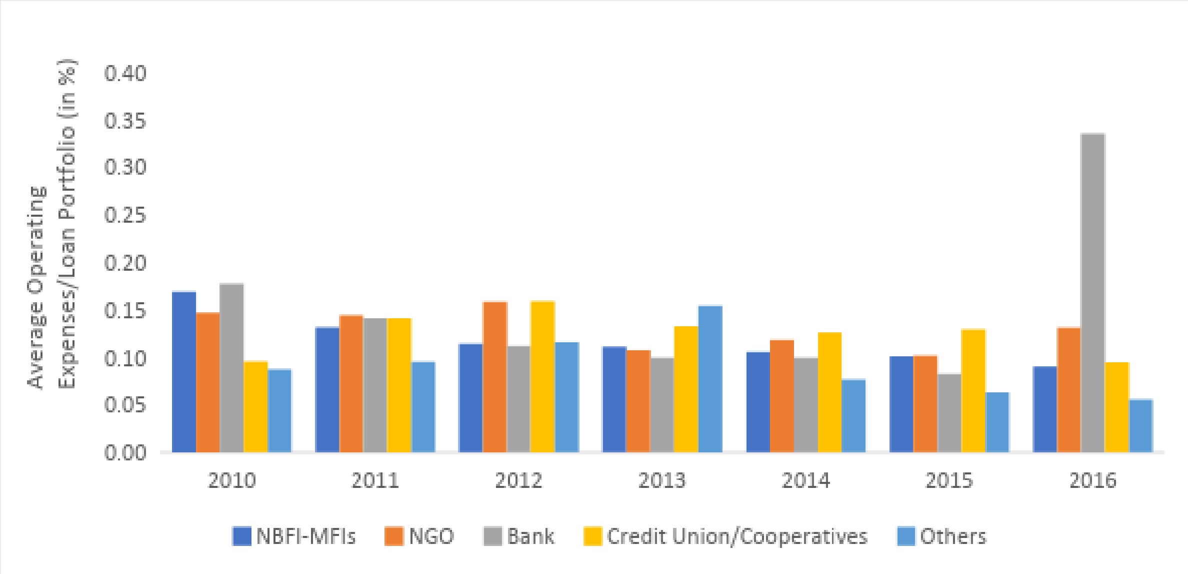

Figure 7: Efficiency of MFIs; Authors' calculation based on Mixmarket database.

Conclusion

The Indian microfinance sector was one of the largest in the world with full of growth potential. However, series of incidents happened in 2010 and thereafter changed the face of the industry. Though the crisis proved a death warrant for many MFIs, it also brought some good news for the sector. Unlike in 2010, microfinance today is a highly regulated industry with the purpose, segment of clients, size of loans, and even price being regulated. As now it is regulated by the RBI, the political risks are also reduced. The RBI has also set up a licensing system. This also All these steps have brought confidence in the sector which is reflected in the performance indicators measured here. The microfinance business has expanded in the last 6 years with the rise in loan disbursement. During this period, MFIs have also gained efficiency. However, there are indications of business concentration and chances of multiple loans. The rise in the average loan size granted by the MFIs raises doubts, whether they are reaching to the very poor clients. In 2016, the overall earning capacity of the MFI has declined with the rise in the portfolio at risk. All these developments increase the chances of loan defaults. Though the situation does not seem to be very grave and profound, preventive measures should be taken to avoid any financial turndown in the future.

Endnotes

[i] Currently, there are 71 NBFC-MFIs registered with. In addition to this, there are 95 non-NBFC-MFIs operating across the country RBI (IFI Report, 2016). These MFIs are incorporated as trusts, societies, cooperatives, and not-for-profit companies
[ii] *The Economist* (2000) stated Andhra Pradesh as "the state that would reform India".
[iii] Microfinance Institutions Network (MFIN) is a self-regulatory body of NBFC-MFIs in India.
[iv] About 78 MFIs of different legal status having operations at large scale have been taken for the study.
[v] the average loan size as a percentage of GNI per capita used as a proxy to indicate the type of clients reached and their level of poverty. This indicator serves as quantifiable proxy of the extent to which an MFI has reached its social objective.
[vi] In microfinance, 30 days is a common breakpoint for portfolio overdue.

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