Risks and Mitigants in Microfinance Lending
Consultation with Banks

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Hotel Taj Lands End, Mumbai

Summary Paper

SAMRIDHI *(Poorest State Inclusive Growth Programme)is being implemented by SIDBI with support from the Govt. of UK's Department for International Development (DFID) to enhance the income and employment opportunities of poor households in underserved states in India. The purpose of the programme is to improve income and reduce vulnerability of poor people and small producers by expanding their access to finance and markets. The program, inter-alia, aims to reach out to 10 million credit clients during the period of 7 years in the four states of Uttar Pradesh, Bihar, Madhya Pradesh and Orissa by way of capacity building of MFIs, facilitating technology led models, product development and roll-out, setting up risk funds etc.*

ACCESS-ASSIST, a specialised affiliate of ACCESS Development Services for Financial Inclusion, is the consortium partner for SAMRIDHI and has been assigned the task of implementing the critical policy and enabling environment component under the programme.

One of the identified priorities within SAMRIDHI policy mandate is to undertake initiatives for enhancing flow of funds from banks for microfinance, both in the MFI and the SHG channels. Post the AP imbroglio which brought all sector growth and ambition to a standstill, an important consequence has been the drying up of loan funds to the sector. While prior to the October 2010, the sector had witnessed 100% growth in outstanding loans to the MFIs, the period after the crisis saw negative growth. Although feeble signs of recovery are noticeable, this is much less compared to the current demand in view of reasonable growth rates.

A potential strategy suggested by the National Think Tank, a high level advisory body constituted for SAMRIDHI, is to engage with the "Risk and Credit" teams of banks to influence corporate level policy and perception favorably towards lending to MFIs.

As a first step towards this, a consultation of bank risk and microfinance teams with sector stakeholders was organised on 29th April 2013 at Mumbai.

1. CONTEXT

Indian microfinance sector which had witnessed a phenomenal growth for half a decade, after the cataclysmic Andhra Pradesh episode of October 2010 came to a complete standstill. Most banks which had found MFI lending as most favorable risk adjusted avenue for lending under the priority sector stopped fresh lending as large volumes of loans to MFIs became sticky and banks to go through the arduous CDR process. It has been over two years now since most banks stopped lending to MFIs both within and outside AP. Only in the last few months there has been some movement towards fresh lending to the sector. This rebuilding phase is expected to be slow. Given the various systemic, regulatory, operational, liquidity and political risks in lending to the sector, there have been some efforts to fix as well as mitigate these real as well as perceived risks. Microfinance Institutions through their own efforts as well as with support from MFI networks, development institutions and investors such as SIDBI, IFC, World Bank etc have since undertaken specific concrete measures to improve practices related to governance, compliance, transparency, operational and credit risks. Sector level investments have been made in initiatives such as setting up of microfinance credit bureaus, development of rating and assessment tools and methodologies to enable and ensure compliance to code of conduct, client protection principles and the RBI fair practices code.
While the logjam in AP continues, MFIs have slowly begun to expand and diversify their portfolios to new underserved geographies. Banks too have slowly started to enhance levels of lending to MFIs in the last Financial Year, and some MFIs have also received fresh equity funding. However, without adequate fund flow, diversifying operations to new underserved geographies remains a challenge, besides also the impact on the viability of small and medium institutions. Appropriately SAMRIDHI presents an additional opportunity to strengthen sector efforts to influence institutional flow of funds.

As part of this strategy to engage with banks to influence flow of funds to MFIs under SAMRIDHI, a consultation was organised with Risk and Credit Analysis representatives of banks along with their microfinance/priority sector counterparts to interface and interact with sector stakeholders viz. MFIs, credit bureaus, rating agencies, industry associations, investors and other lenders in order to:

- Share information with banks on key trends in MFI growth and portfolio quality
- Understand the concerns and risk perceptions of banks in the current context
- Apprise the bankers regarding the sectoral initiative being undertaken to manage and minimise various risks
- Discuss way forward on specific risk areas to further manage specific risk perceptions of banks
- Build consensus on possible way forward

2. PARTICIPANTS

The consultation was attended by representatives of risk/credit teams of 17 banks. The microfinance sector was represented by MFIs, MFI network (Sa-Dhan), rating agencies (M-CRIL and CRISIL), investors, donors and microfinance/priority sector/rural banking divisions of banks. While DFID participated as the donor agency, SIDBI was represented both as the Apex agency as also the SAMRIDHI consortium leader. The list of participants is provided in **Annexure 1**.

The consultation was moderated by **Mr Royston Braganza, CEO, Grameen Capital.**

3. Summary of Proceedings

3.1 Opening session

The session provided an overview of the sector in terms of trends in growth, salient milestones and developments and overview of risks from the perspective of an investor and a rating agency in order to provide a contextual background for the discussions. The highlights of the Opening presentations are provided below:

Opening remarks, P K Saha, CGM, SIDBI
SAMRIDHI is a unique programme that aims at enhancing income and employment opportunities for the poor in underserved states in India. Although the programme focuses on the underserved states of Bihar, UP, Odisha and MP, the policy influencing and sector convergence agenda of the programme has a national remit. The programme is unique given its comprehensive strategy of capacity building of institutions in the focus states, supporting innovations in delivery of financial services to the poor, enhancing flow of funds into the sector and supporting policy efforts. This meeting is an effort to engage with banks towards better understanding of their risk perception and influence more fund flow to MFIs.

In the last one year, SIDBI has undertaken several critical initiatives to support Responsible microfinance and catalyse flow of funds to MFIs.

- INR 104.35 crores of the IndiaMicrofinance Equity Fund (IMEF) has been committed. The Fund set up with a corpus of INR 100 crores in 2011 received an additional allocation of INR 100 crores in 2013 from Govt. of India, and offers equity, quasi-equity and subordinated debt to smaller MFIs to help them maintain growth and achieve scale and efficiency in their operations.
- SIDBI has supported development and implementation of Code of Conduct Assessments to measure compliance and adoption of the industry Code of Conduct by MFIs.
- SIDBI has been coordinating the Microfinance Lenders' Forum to promote cooperation among MFI lenders to help manage risks through sharing of information and exploring mechanisms for joint monitoring of MFIs etc.
- SIDBI is now commissioning a Study of Viability of Indian MFIs and design of a financing framework in the current context of the Indian microfinance sector that will provide evidence based analysis of viability of MFIs and will be useful for banks and investors in making funding decisions, and also provide sector level strategy for financing of microfinance.

Overview of Microfinance Sector – Radhika Agashe, ED, ACCESS-ASSIST
The presentation highlighted the trends and key developments in microfinance sector for the last three years. The year 2010 was marked with the high growth phase in Indian microfinance peaking with the first MFI IPO, followed by the sector in AP coming to a standstill in October with the enactment of the Andhra Pradesh Microfinance Institutions (regulation of money lending) Ordinance. The following two years have witnessed negative growth, high delinquency and drying up of funds. Given the crisis, based on the Malegam Committee Report, RBI issued a comprehensive set of Regulations for "NBFC-MFIs", and there has been great deal of emphasis by MFIs and other sector players on transparency, client protection and social performance

management including setting up of credit bureaus, client protection and code of conduct compliance assessments etc. The financial trends suggest that the sector (non-AP) is gradually settling down with improved investor interest and flow of funds from banks.

Risks and Mitigants in Microfinance Funding – BamaBalakrishnan and Rakesh Das, IFMR Capital

2012-13 has been a very good year in terms of capital flows and portfolio growth for Indian MFIs. Following the revised regulations, issuance of securitization guidelines and the ensuing clarity in the sector, banks have been actively participating in securitization transactions. Better regulatory coverage has also provided greater transparency and reporting. Access to debt has improved with many public sector banks at the forefront. Bank lending to microfinance has risen by 40% in 2012-13 over the previous fiscal, to INR 180 billion, as per industry estimates. Equity deals have continued despite the margin cap for MFIs, with at least 10 large and medium MFIs being able to raise equity funding. Increased capitalization of MFIs has resulted in lower counterparty credit risk. The portfolio quality of MFIs has also shown consistent improvement in the wake of the regulation mandating information sharing with credit bureaus.

Top Risks Facing the Sector

1. **Political Interference :** Risk has reduced with regulatory intervention:
   - RBI clearly established as a regulator for the sector
   - Comprehensive regulations to address pricing, multiple lending, improve customer protection, ensure adoption of fair practices
   - Pending Microfinance Bill will further improve the regulatory environment
   - Industry still vulnerable to event risk
2. **Regulation :** Risk reduced as industry has taken significant steps towards compliance:
   - Regulatory uncertainty resolved largely on major issues such as registration, pricing etc.
   - Implementation of regulatory requirements such as credit bureau, margin cap in progress
3. **Liquidity:** More of a risk for smaller MFIs:
   - Debt and equity flowing back to the sector but significant gaps still remain

Mitigants for the 3 Top Risks

1. **Political Interference :**
   - The investor should strive for an optimum portfolio diversification to minimise the negative impact due to any localized political event
   - A robust monitoring framework to monitor MFI operations on ground
   - A monitoring framework to identify the stress signals
2. **Regulation :**
   - Engaging with the MFI to assess management intent and process, systems to ensure compliance with regulations
   - Due diligence framework to evaluate the efficacy of the internal audit framework of the MFI
   - Assessment of customer protection measures and compliance with norms under the fair practice codeThe monitoring framework to identify the stress signals
3. **Liquidity**
   - Demonstrated ability of the MFI to manage operations efficiently
   - Assessment of overall funding available

The Rating Agency Perspective - Sanjay Sinha, MD, M-CRIL

While overall, the microfinance sector is not risky right now, there are some positives and causes of concern in the current scenario. The key observations are summarised below:

Positive signs

- Credit bureau is a very positive development and most MFIs are using the CB reports to make lending decision.
- Growth rate has been reduced to a more responsible level largely due to reduction in funding from banks.
- The RBI guidelines have provided a regulatory framework for MFIs.

Risks and concerns

- However, the political risk is not over yet, since the Bill is still pending legislation.
- RBI guidelines for MFIs:
    - Income limits do not serve any purpose
    - Limits on total borrowings by clients are only marginally effective since the SHG loans are not part of the credit bureau reporting.
    - Margin cap has introduced an incentive for growth. Smaller MFIs need to grow to take advantage of economics of growth and economise on costs.
- The trend of increase in size of loans to clients, implying that non-poor are being served is disturbing from a development perspective.
- Few MFIs still continue to grow at rates that are close to borderline in terms of risks. Growth rates of over 30% are not favourable for responsible growth and more concern should be shown at sector level regarding high growth rates
- The reaction of stakeholders such as the banks is critical at the time of a political crisis. Banks should continue to support the sector in a balanced manner, as distancing themselves from MFIs further accentuates the risks.
- There is still very high emphasis on low Portfolio at Risk (PAR). The low PAR benchmarks in microfinance are unrealistic and indicate that there are issues in client dealing and/or data reporting. 2-3% is a reasonable PAR for the sector.
- India should learn from other regional examples such as Nepal and Pakistan where microfinance regulation has evolved and improved over time.

3.2 Open Discussion

The discussion was focussed on Risks and concerns of banks regarding lending to the microfinance sector. The discussion sought to solicit views of banks on the reasons for significantly reduced levels of lending post the AP crisis.

In general, the banks felt that there are few lendable MFIs currently in the sector and all banks are lending to them. This however is possibly leading to the issue of very few institutions growing at high rate, which presents a major future risk. While political risk will continue to be a significant issue, its influence is expected to reduce with more clarity on regulation, compliance by MFIs of RBI guidelines and client protection principles and better engagement by the sector with external stakeholders.

Some of the major concerns and considerations highlighted by banks and responses of sector stakeholders to those are summarised below:

Regulation - Microfinance Bill

The most important issue that emerged as a dominant risk was the inordinate delay in passage of the Microfinance Bill pending in Parliament. Most banks felt that once the Bill is in place, it will help them internally to institute a policy for lending to MFIs and influence senior management.

The microfinance network Sa-Dhan reported that it is a positive sign that an Interim report has been submitted by the Parliamentary Committee, which is not a regular practice. All stakeholders should now come together to create positive opinion in public space in order to push for its passage in the Parliament before Monsoon.

Regulation - Compliance with RBI guidelines

While the Bill is pending legislation, the RBI guidelines for NBFC-MFIs have provided recognition to the NBFC-MFI category and laid out a legitimate framework for their operation. This does gives banks some comfort. The compliance by MFIs to RBI guidelines is now of utmost significance since it is a compliance issue for banks as well.

- Margin cap – MFIs are still not complying with the stipulated Margin cap. The group was informed that the format for calculating the borrowing cost for calculation of margin has been changed to also include costs other than interest. This has an impact of 1-1.5% on the calculation of margin. As a result of this recommendation, which has recently been acknowledged by the RBI, many MFIs will come closer to the stipulated cap, but they are not fully compliant yet. MFIs on the other hand feel that RBI needs to provide more time for compliance which is being considered.

- Limit on borrowing and number of loans by clients – The progress on microfinance client data on the two credit bureaus operating in the sector, Highmark and Equifax, is very encouraging and helps mitigates risk of multiple lending and over indebtedness among clients to some extent. Banks and MFIs however raised concerns over the credit bureau data being inadequate in the absence of reporting of data on loans from SHGs to these clients. Monitoring of SHG data through credit bureaus is important for KYC as well as for full compliance with RBI guideline of maximum number of outstanding loans to a client, which includes JLG and SHG loans.
  SIDBI and DFID expressed the intent and agenda of the SAMRIDHI programme to support pilots on SHG data reporting to credit bureau.
- Income criteria – Income criteria have undergone revision once and could undergo further change as a process of evolution of the regulation. This continues to be one of the advocacy issues.

Corporate Governance

This was raised as an important concern by most banks. The standards for Governance are different for small and large MFIs since the risks and challenges are different. Equitas was cited as an example of the only MFI to have undergone the Governance and Value Creation Rating by CRISIL.
It was however highlighted that the corporate governance benchmarks for MFIs should be specific to microfinance sector. "A good Corporate Board composition is not the same as a good MFI Board composition"- Sanjay Sinha, MD, M-CRIL. Having a minimum number of Independent Directors is not a good enough standard for MFIs. It is important to follow some guidelines for the background of the Directors regarding their experience and exposure to microfinance principles and operations.

Promoter profile

A critical factor that drives the decision making is the profile and commitment of the MFI promoter. "MFI systems are now fairly standardised. So most critical aspect is the Vision and values of the promoter; where is the person going to take the institution in the next few years" – Aseem Gandhi, Ratnakar Bank.

Financial documentation

Every bank has its own risk assessment model. However, common financial statements and disclosure standards are important for credit/risk team for details on margin, benefit accruing to promoters etc. MFIs should therefore invest in improving the quality and transparency of financial reporting, statement and compliance and other disclosures to match the corporate standards.

MFI systems and Credit Processes

A continuous dilemma in the minds of bankers specifically in case of smaller MFIs is whether to trust their systems. Banks agreed that the reports of Code of Conduct Assessments and Financial and Social Ratings are helpful in taking decisions as part of due diligence of MFIs, as these provide information on the MFI systems and procedures which are important from risk perspective. Overall banks emphasised that MFIs need to further institutionalise better systems and credit processes including appropriate use of technology to enhance efficiency and transparency.

Concentration risk

Regional concentration risk still continues to exist in states like West Bengal and others. Related to that are concerns of whether or not MFIs are incrementally reaching out to new clients in substantial numbers and therefore helping to cater to the large un-served market for microfinance services. With too many MFIs in one region, there are possibilities of the same set of clients dropping out of one MFI and being recruited by another, in addition to risk of multiple lending to the same clients.

Monitoring of MFIs

IFMR Capital shared their experience of regular monitoring of their MFI partners that helps in managing the portfolio risk to a large extent. Ratnakar Bank also pointed out that the RBI emphasised a lot on the bank setting up systems for monitoring of MFIs being funded by the bank right at the time of initiating microfinance portfolio.

3.3 Conclusion and Way forward

The key points of the discussion were summarised by the moderator Mr Royston Braganza followed by concluding remarks by Mr Brij Mohan, Senior Sector Expert and Member, SAMRIDHI National Think Tank and Ms Meenakshi Nath, Deputy Head, DFID India. A primary concern is that the sector needs to quickly move from 15 'lendable' MFIs to at least 50 so that bank funding shifts from financing high growth rates of few MFIs to supporting responsible growth of more number of MFIs. This will need investments and improvements in systems and governance structures of these other MFIs. The SIDBI study on viability of MFIs is also expected to provide substantial inputs in this regard.

Banks need to support the sector by lending consistently through the year (rather than concentrating the lending in last quarter of FY) to a wider set of MFIs and should continue to support in the event of a crisis.

The following points emerged as recommendations for the sector as a way forward:

- SHG data reporting in Credit bureau needs immediate attention and action to ensure client protection and compliance to RBI guidelines.
- A comprehensive risk framework based should be developed to guide MFIs as well as provide a template for banks.

- A holistic institutional assessment rating tool that address all concerns of banks and investors in the current context should be developed and promoted to replace multiple assessments and rating techniques (Credit rating, social rating, Code of conduct assessments, Client protection assessments, Governance rating etc).
- Investments in building a consensus on most effective and cost efficient technologies available in the sector by co-opting service providers
- Mechanisms of sharing information and data among banks through Lenders' forums as well as forums for engagement such as these between bankers and the sector players will facilitate bringing comfort of banks in MFI lending
- Coordination in lending and monitoring by banks can be explored by banks since effort and resourced required for monitoring of each MFI individually by banks can be too intensive and cost of funds for MFIs can also be reduced through such mechanisms
- The overdependence on banks for funding MFI growth should be reduced through development of more innovative funding mechanisms
- As a sectoral programme SAMRIDHI has some resources to invest in public goods such as Credit bureau for SHGs, appropriate technologies etc. The new resources that are expected to be available from the Corporate Social Responsibility funds can also be leveraged to support investments in the ecosystem.