M-CRIL Microfinance Review 2012:

MFIs in a Regulated Environment

Preface/Access to the full M-CRIL Review

This document is M-CRIL's latest Microfinance Review – of the performance of independent microfinance institutions (MFIs) in India providing microfinance services to low income clients. The **M-CRIL Microfinance Review** has, until now, been published as

Volume	Year	Sub-title
1	2001	
2	2003	
3	2005	
4	2007	*(in association with the MIX)*
5	2009	M-CRIL Microfinance Analytics (*brief review*)
6	2010	Microfinance Contributes to Financial Inclusion
7	2011	Anatomy of a Crisis
8	2012	MFIs in a Regulated Environment

This year's review is Volume 8 of a series that provides an empirical and analytical chronicle of the history of MFIs in India.

In keeping with M-CRIL's tradition of independent research and analysis, this review is published by M-CRIL to promote understanding of the role of microfinance in the Indian economy and to focus on the current performance of the sector in relation to financial services in the country in general.

The is based on an analysis of financial data from the 56 largest MFIs in India (each with more than 20,000 borrowers) for which reasonably reliable data (audited financial statements and credible operational data) was available. It also uses outreach and the limited social performance information provided by these MFIs and uploaded on the MIX Social Reporting platform until end-October 2012. In addition, poverty profile information from M-CRIL's social ratings has been used to round out the still sketchy data available on social performance. The Table of Contents of the main report provides an outline of the report along with the Executive Summary.

The M-CRIL Microfinance Review can be obtained in one of two ways

1. **Soft copy**: Please download from **www.m-cril.com**. *There is no charge for this*.
2. **Hard copy** (colour print): Please send an e-mail with a request to contact@m-cril.com. We will charge Rs500 which incorporates printing and delivery charges within India. Delivery outside the country will incur extra courier expenses.

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Table of Contents

		Page
Executive Summary	**MFIs in a Regulated Environment – a financial and social analysis**	vii
1	**A testing time for microfinance**	1
1.1	A complex, extensive and growing financial system but just 35% inclusion	1
1.2	M-CRIL's 2012 cohort of Indian MFIs...	2
1.3	...sees continuation of the trend to transform to NBFCs and diversify geographically	3
1.4	...as reporting on social performance becomes more common	5
1.5	But, in the meantime, the MFI mantra of growth has been reversed	5
1.6	As the rush to become NBFCs and grow caused over-indebtedness provoking government intervention and the introduction of regulation	7
2	**MFI contribution to inclusion is still significant despite setbacks**	9
2.1	MFI operations continue to be a significant part of the financial system in terms of their implications for financial inclusion	9
2.2	MFIs have various development objectives and operational strategies	11
2.3	And MFI portfolios are still substantial relative to micro-lending by the banks	12
2.4	...though there has been no growth in the real value of average loan balances	14
2.5	Is multiple lending, and consequent over-indebtedness, the villain of the piece?	16
2.6	And deposit services remain a distant dream due to the extremely cautious approach of the regulator	20
2.7	While the rural bias of MFI operations is reducing but, in any case, does not necessarily indicate particular poverty orientation	19
2.8	...but social rating data from a limited number of MFIs does indicate the need for better systems alignment to achieve greater depth of outreach	20
2.9	...though the principle of responsibility in the provision of microfinance services is gradually taking hold	20
	Annex Tables 2.1 & 2.2: State-wise Analysis of Over-indebtedness	23
3	**Operating efficiency has been strongly affected**	25
3.1	Cost efficiency has declined due to the crisis and its aftermath	25
3.1.1	Staff numbers and productivity are comparable with the overall financial system though the MFIs have smaller size accounts that are growing more slowly than the rural banks	
3.1.2	...but there are relatively few women loan officers	
3.1.3	Cost per borrower has risen sharply as MFIs first pursued growth at all costs and now have to put considerable effort into client protection measures and follow up of repayments	
3.2	Operating efficiency has been adversely affected	28
3.2.1	...as portfolio management issues and client protection compliance expenses have increased OER	

3.2.2 ...and the small loan size makes it difficult to lower expenses
3.2.3 Is using women loan officers an appropriate means of lowering expenses?
3.2.4 The composition of operating expenses indicates increased labour intensity
3.2.5 ...so perhaps it would be better to focus on working conditions to reduce staff turnover
3.2.6 ...and watch the yield-OER margin which has declined substantially
3.2.7 Economies in operation are determined partly by loan size but also by MFI scale

4 MFI portfolios outside AP have defied expectations of contagion 35

4.1 The industry was plunged into crisis when clients in AP stopped payments 35
4.2 ...but, defying expectations, portfolios outside AP have resisted contagion 36
4.3 Client satisfaction has an important effect on portfolio quality 37
4.4 Provisioning for loan losses is inadequate for those MFIs affected by the AP default – a Greek style "hair cut " for investors is, therefore, inevitable 38

5 The debt focus of portfolio financing has now reduced 39

5.1 Indian MFIs are now paying the price for their reliance on commercial bank funds 39
5.2 The use of funds has been squeezed by cash constraints 43
5.2.1 ...with the drying up of bank debt in response to the apparent political risk 43
5.2.2 …giving the impression that prudential management has improved 44
5.2.3 …but the implications of securitization for prudential lending need to be monitored 46

6 …and financial performance has moderated 48

6.1 Yields have dropped as MFIs have reduced interest rates in response to political pressure and regulation 48
6.2 ...and returns to MFIs have declined significantly due to increased expenses 49

7 Smart regulatory steps to promote micro-financial inclusion 54

7.1 The Microfinance Bill is yet to catch the fancy of parliamentarians 54
7.2 Summary of the revised Regulatory Framework 55
7.3 Commentary on the revised regulatory framework 56
7.3.1 Income limits for eligible borrowers
7.3.2 Assessing family income and indebtedness
7.3.3 Level of Indebtedness of borrowers
7.3.4 Implications of the margin cap – "smart" regulation can make a difference
7.3.5 Capital Adequacy Ratio – use "smartly" to promote financial inclusion
7.3.6 Other issues – restrictions on loan tenure/repayment frequency and loan purpose can unnecessarily affect the business relationship between the borrower and her lender

Key references and data sources used for this review 63

Glossary of terms 64

Executive Summary

Indian MFIs in a regulated environment

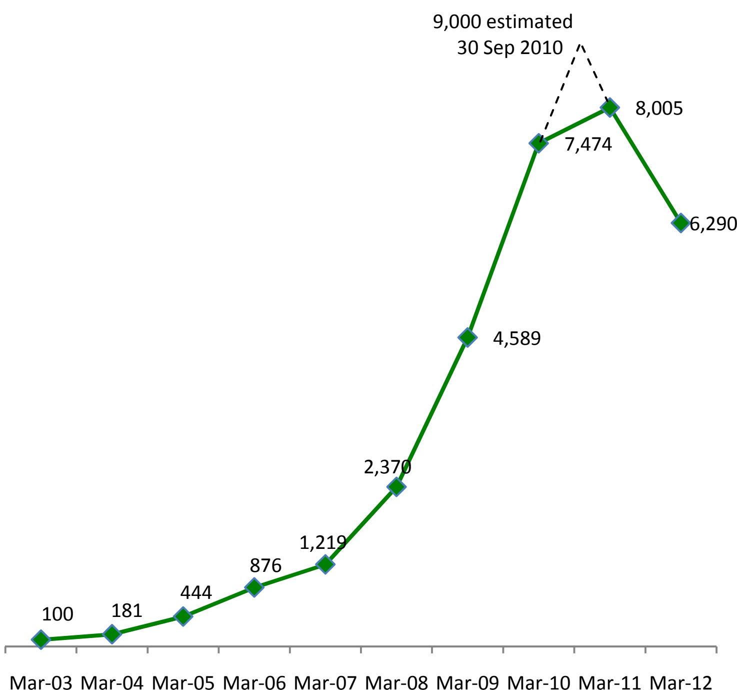
– a financial and social analysis

M-CRIL's 2012 integrated financial and social review presents an analysis of the performance of Indian MFIs in the newly regulated environment that is emerging in response to the crisis since October 2010 in this sub-sector of the Indian financial services industry.

M-CRIL pioneered the now worldwide practice of undertaking country/regional analyses of microfinance performance. The first volume of this series of reviews was published in Year 2001. M-CRIL continues to add value to the information available through its **critical and analytical screening and presentation of data**. **Financial information used for Indian MFIs is taken directly from audited financial statements**. While last year's review focused on the factors that contributed to the crisis – loan size, multiple lending, over-indebtedness, client retention and client protection, staff working conditions – and the early effects of the crisis on the performance of Indian MFIs, this year's review analyses performance in the newly emerging regulated environment. In addition to audited financial statements and information obtained direct from MFIs it uses data on social performance displayed on the MIX – for March 2012. Last year **M-CRIL published the first integrated financial and social review of Indian microfinance. This year we innovate further** not only by casting the analysis in the framework of the emerging regulatory environment but also **by undertaking a dissection of a key regulatory measure: the likely impact of margin caps on the viability/sustainability of Indian MFIs**.

This review concludes that **while MFI operations continue to be a significant component of the financial system in the country** and its contribution to financial inclusion continues to rival, if no longer exceed, that of the rural banking system, **the efficacy of that contribution has been undermined by the crisis and its aftermath**. Emerging from the crisis, the Government of India, through the proposed microfinance law now seeks to accord the sector with a level of importance commensurate with its contribution to millions of citizens. The proposed Microfinance Act would provide the sector with the full attention of the central bank, would enable MFIs to offer at least limited deposit services to low income families (recognising their need for savings facilities) and protect MFIs from the whims of local government by clarifying that microfinance is governed by national laws and is, therefore, not a state-level concern. In so doing it would remove the perception of political risk that is currently causing the sector to shrink (**Exhibit 1**) on account of the hesitation of commercial banks in providing on-lending funds to MFIs. **M-CRIL believes the Bill is a good one with adequate safeguards to help stabilise the provision of microfinance services in India.**

Exhibit 1 CRILEX, M-CRIL's growth index, March 2003=100



Indian microfinance's rush to be regulated and a phenomenal growth spiral cut short by a political action...

With the phenomenal growth recorded by microfinance in India in recent years (**Exhibit 1**) – 62% per annum in terms of numbers of unique clients and 88% per annum in terms of portfolio over the five years 2005-2010 – and around 32 million borrower accounts around October 2010, India had the largest MFI sector in the world. The high growth rate of microfinance over the five year period was fuelled by commercial bank funding which inherently gravitated towards "for-profit" institutional structures. As a result, there was an India-wide trend towards the transformation of MFIs into for-profit non-bank finance companies (NBFCs) so that over 73%, 41 of the 56 MFIs in this year's M-CRIL analysis consist of such institutions. Both the transformed and new, start-up MFIs were able to grow rapidly through easy access to funding and by using the proven methodology of a mono-product offering rolled out over large numbers of branches, in diverse locations using standard processes. This was often achieved in an environment of restricted staff-client interaction.

The current crisis in microfinance is partly the result of the over-simplification of the MFI-client relationship. While large numbers of low income families may have been reached, the lack of commitment on either side led to substantial multiple lending and created an environment of concern about the rights of clients that had been oversold microcredit. Some clients became over-indebted as a result and the media attention generated by the IPO of SKS Microfinance (at the time, by far the largest microfinance NBFC in India) only led to further introspection about the status of microfinance clients. With reports of suicides in rural Andhra Pradesh (something that regrettably happens every year for a variety of reasons) thrown into the mix, microfinance took the blame this time around. Given the populist nature of state-level governance in India, conditions were ripe for intervention and the AP microfinance ordinance of 14 October 2010 was the result.

However, with what is, in effect, a ban on the offering of financial services by microfinance institutions in Andhra Pradesh, the *mantra* of growth in Indian microfinance has come to a halt. The drying up of commercial bank funding to MFIs all over the country in response to the crisis brought about the shrinkage of the sector by nearly one-third from the peak in October 2010; the **CRILEX**, M-CRIL's Index of microfinance growth (**Exhibit 1**) shrank from 9,000 at end-September 2010 to an estimated 6,300 just 18 months later.

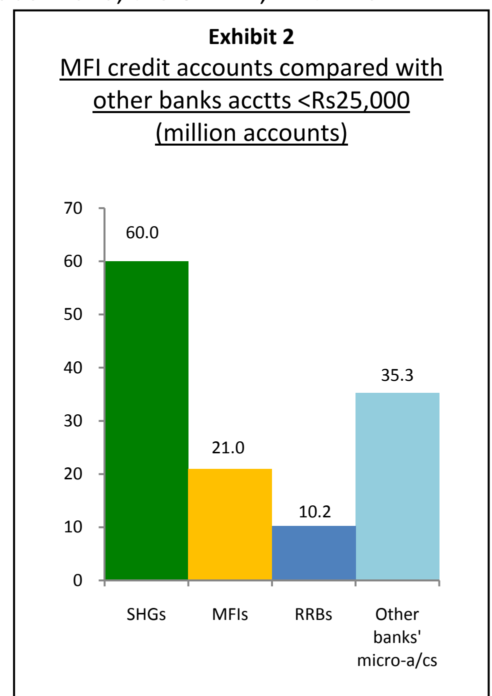


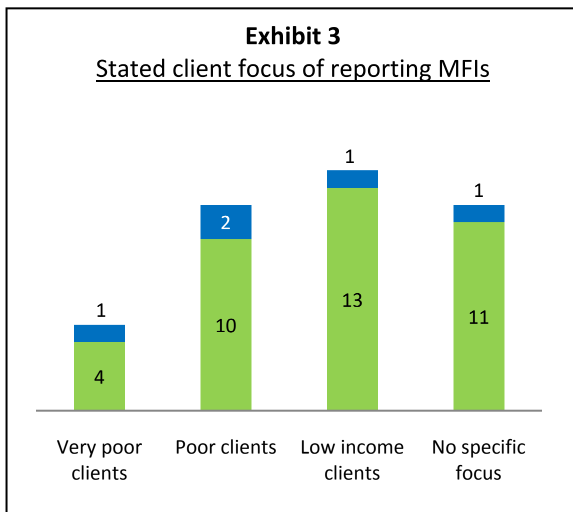
Exhibit 2
MFI credit accounts compared with other banks acctts <Rs25,000 (million accounts)

But, despite recent setbacks, still a significant sector of the financial system

The number of effective client accounts served at end-March 2011 is nearly 35% lower than in the previous year. This is on account of the write off (or dormancy) of a large number of client accounts in Andhra Pradesh due to the collapse of MFI activity there and also due to the reduction by banks of debt funding for MFIs elsewhere as the AP government's action has raised their perception of risk in lending to MFIs.

Even with just 21 million borrower accounts the size of the microfinance sector more than matches significant parts of the Indian financial system in terms of the number of citizens affected. This number is still **more than twice** the number of micro-credit accounts (less than Rs25,000, $500) serviced by the Regional Rural Banks (as shown by the information in **Exhibit 2.4**). In spite of the

loss of all MFI operations in AP, MFI borrower accounts are still more than 60% of the total number of micro-accounts with commercial banks. If allowed to be seen as part of the mainstream financial system, the microfinance sector would have in excess of 30% of the total number of formal micro-credit accounts though (due to the decline of MFIs) it is down from around 45% in March 2011. Including SHGs into the discussion, the total of micro-credit accounts in India held in the formal and semi-formal financial system amounts to around 126 million. **This report contains a detailed analysis of the status of the provision of micro-credit by MFIs vis-a-vis the banking sector and the overall availability of financial services.**



With good outreach to low income families

The intended income profile of MFI clients targeted by MFI managements is collated in **Exhibit 3**. After many years of debate on the feasibility of poverty reduction through microfinance, significant numbers of MFIs have realised the need to focus on low income clients – whose incomes may or may not be below the national or international poverty lines but who are, nevertheless, financially excluded. However, even now systematic poverty targeting is undertaken by relatively few and M-CRIL's client analysis based on social rating data **shows that a significant number of MFI client profiles now are close to matching the national poverty profile but are rarely able to reach lower to the poorest families.**

...though there has been no growth in the real value of average loan balances

However, despite the significant growth of loan size outstanding from MFIs in recent years, analysis in the report shows that **in real terms the MFI contribution to the economic lives of low income families has actually reduced by around 40% over the past decade.**

Is multiple lending, and consequent over-indebtedness, the villain of the piece?

The disruption in Indian microfinance caused by the AP ordinance is substantial. The apparent reasons for the ordinance were

- Excessive lending by MFIs in the state of Andhra Pradesh leading to over-indebtedness which caused distress to low income microfinance borrowers
- Coercive behaviour by MFI staff in collecting from these over-indebted borrowers suffering from the stress of keeping up with their repayment obligations.

Whether or not there was excessive lending in AP (and in other states of India) and who is responsible for it is assessed in this report. The state-wise picture is disquieting. What is interesting here is that in AP, **while the number of MFI loans is just over 80% of the number of eligible financially excluded families, SHG loans are actually 250% of that number**. More importantly, to the extent that microfinance loans are not evenly distributed this means that there were a significant number of financially excluded families in AP that had as many as 5-6 loans at one time and a number of these were SHG loans. *This raises the question whether it was SHG rather than MFI lending that was responsible for multiple lending and the crisis.* The analysis reveals that even if the debt were distributed equally amongst all eligible families there would **just** be a balance of indebtedness in AP (in 2010-11) – assuming that 40% is the maximum reasonable debt servicing capacity at this level of in-

come. At lower assumed levels of debt servicing capacity, there is a significant degree of over-indebtedness. Last year's review first presented **a new approach to the assessment of aggregate over-indebtedness in a region,** and set out the degree of over-indebtedness for all the major states, while discussing where further problems could occur in future unless the typical debt per borrowing client is lowered.

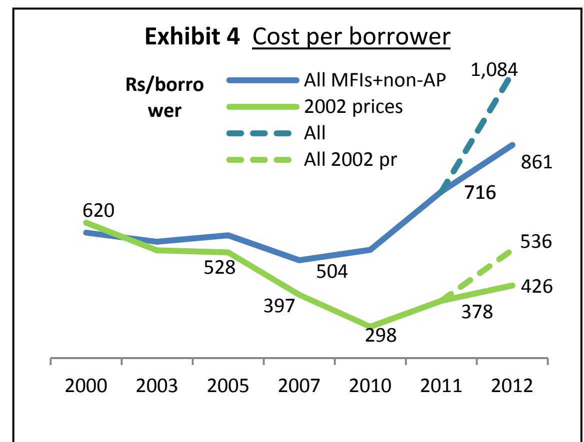
But the principle of responsibility in the provision of microfinance is also now taking hold

The concern for responsible microfinance is reflected in the Codes of Conduct developed by MFIN and Sa-Dhan, and internationally in the client protection principles developed through the Smart Campaign. M-CRIL had already included evaluation of responsibility to clients as part of Social Rating. Starting this year, along with other specialist rating agencies, M-CRIL has launched the Microfinance Institutional Rating (MIR), an enhanced service that incorporates client protection, indebtedness and mission orientation as an integral part of the output. Issues covered include integrity, transparency, governance, competition, client protection, appropriate staff behaviour and resolution of complaints. Most leading MFIs are in the process of taking action to improve performance in all these areas.

Cost efficiency has declined due to the crisis

The cost incurred by MFIs in servicing loan accounts is very low in comparison with the global benchmark of $85 on the MIX. Even when compared with other Asian MFIs, the cost per borrower (Rs1,084, $21) amounts to just 34% of the East Asian median of $61 and is also substantially lower than the median for low end MFIs internationally ($64). Even for non-AP MFIs the Rs861 average cost per borrower for the delivery of micro-loans in India shows a 60% increase over the past two years (**Exhibit 4**). This is attributable to the high "growth at all costs" pursued by MFIs in the first half of 2010-11 as the larger ones chased the chimera of an IPO, while the latter half of the year as well as 2011-12 was spent in "fire-fighting", trying to persuade borrowers in AP to repay and those elsewhere to maintain their payments.

Exhibit 4 Cost per borrower



The weighted average **Operating Expense Ratio** has also risen for sample MFIs but is still significantly lower than those of the 2007 sample. The weighted average is now around 12% for both AP and non-AP MFIs but the typical non-AP MFI – as measured by the simple average across MFIs – had an OER of 17.3%, up from 15.6% last year.

A key determinant of the operating expense ratio is the small loan size. As discussed in the report, the OER shows a very clear downward trend as the loan size increases. In an industry highly dependent on staff for customer satisfaction, **there is also an important positive correlation between the staff turnover rate and OER and a negative one between the proportion of women loan officers and OER**; whether the latter means that women loan officers are more efficient or that they are simply paid less is an open question. The average staff turnover rate of 29% and lack of written HR policies also raise questions about staff working conditions that bear investigation.

...and the widening trend in the yield-OER margin has been reversed

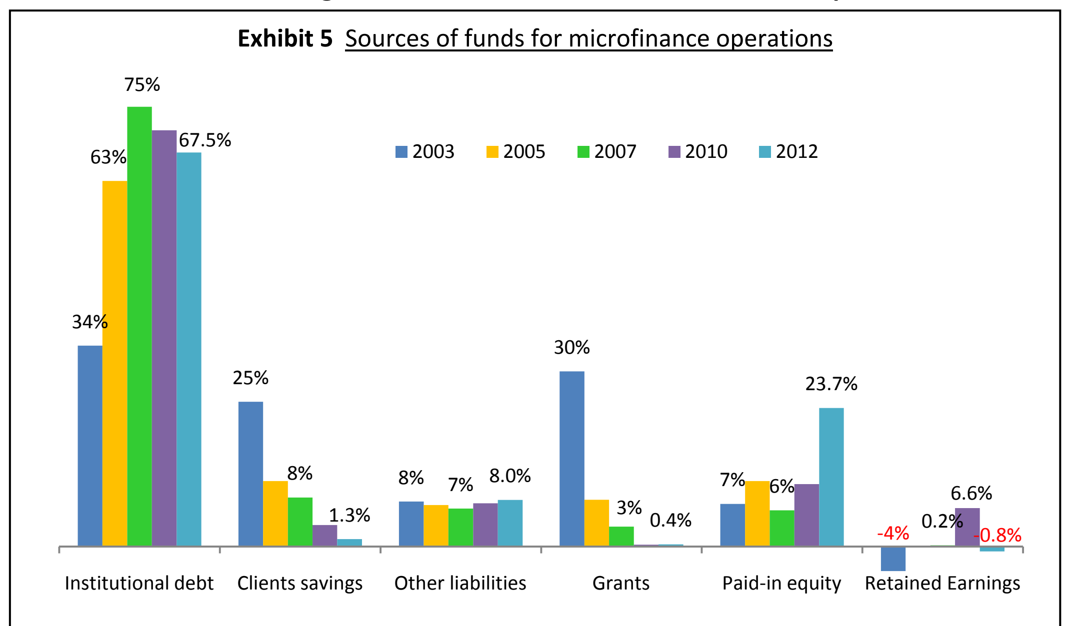
The weighted average yield of 26.5% for non-AP MFIs (compared to 28.3% last year) has declined further in response to the controversy about interest rates in the lead up to and immediately following the AP ordinance. **Exhibit 3.14** in the report shows the trend in portfolio yield and OER over the past 10 years. The portfolio yield increased significantly in recent years largely because of changes in fees charged and sometimes on account of a change in the loan term when, say, a reduction in the term from 50 weeks to 45 weeks can have a significant impact on the yield though the change appears to be small. With the decline in yield over the past two years the average yield earned by MFIs in India continues to be lower than the global median of 28%. On account of the interest and margin caps for microfinance NBFCs, M-CRIL expects the squeeze on margins to continue during the current financial year (2012-13).

While a "hair cut" for both the MFIs caught in the crisis and their lenders is now inevitable, defying expectations, portfolios outside AP have resisted contagion

The unspoken message of the AP ordinance to clients was that MFIs would not be allowed to operate and, therefore, there was no need to repay MFI loans. Analysis indicates that the MFIs in India as a group now have amongst the worst portfolio quality ratios in the world. The sample average of PAR_{30} at 23.7% (after significant write offs) is exceeded by the L-10 group (at 29.5%) – of whom 4 of the 5 largest have their main operations in AP. This is in sharp contrast to the reported portfolio quality ratio of 0.67% for end-March 2010. In practice this presents a bleaker picture than is justified. The graphs in the main report show that the aggregated PAR value for the non-AP portfolio of MFIs is just 1.79% compared with the 90 day PAR of 6.1% for loans from banks to SHGs.

Exceptional circumstances aside, the client retention rate is generally accepted as being a key indicator of client satisfaction. While the correlation between the two, based on the data, is not very strong it indicates a significant relationship between the client retention rate and portfolio quality. It suggests that as client satisfaction increases the portfolio quality also improves as shown in **Exhibit 4.5** of the report. In this context, the **64% average client retention rate for Indian MFIs is quite low**.

Exhibit 5 Sources of funds for microfinance operations



The aggregate write off ratio of 34% for AP MFIs in 2011-12 is as expected and it is now clear that the eventual write-off resulting from the crisis will be far higher. Despite the RBI initiated debt restructuring, a "hair cut" for both the MFIs caught in the crisis and for their lenders is inevitable. It is only the closeness of the cut (the proportion of investment lost) that remains to be determined. M-CRIL estimates that, in addition to the Rs4,270 crore already written off, another Rs4,200 crore of bad debt remains and will need to written off in subsequent years, a total loss of Rs8,470 crore resulting from the crisis – this is nearly 40% of the March 2011 portfolio.

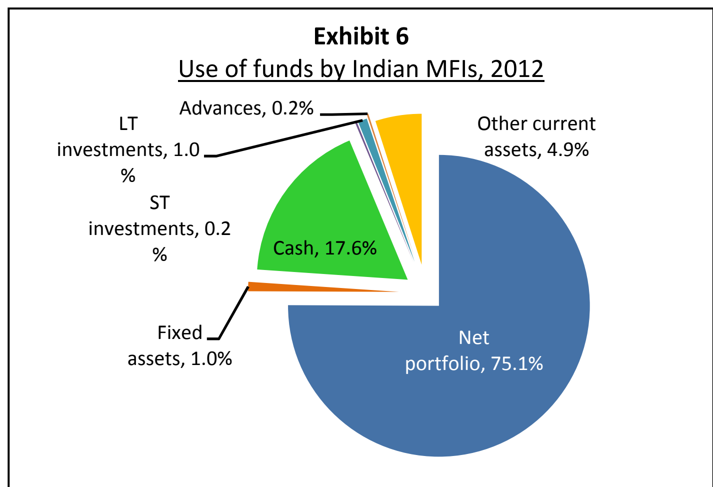
Indian MFIs are now paying the price for their reliance on commercial bank funds

The distribution of sources of funds for microfinance, presented in **Exhibit 5**, shows that the share of debt in MFI finances is still very high. However, the current level of debt, amounting to Rs15,500 crore ($3 billion) or 67.5% of total MFI funds represents a reduction from the highest level of around 80% reached in 2008.

The extent to which commercial debt continues to dominate the financing of Indian microfinance is apparent. Indeed, the domination of commercial bank funds in Indian microfinance is under-played in this analysis since it excludes off-balance sheet financing via portfolio sales and securitisation of portfolios undertaken by some of the leading MFIs with the commercial banks. A separate compilation of the portfolio managed by MFIs for others – securitised portfolios that are not on MFI balance sheets – shows that the amount added some 7.6% to the total portfolio managed by MFIs. The share of net worth/equity in MFI balance sheets and the distortionary effect of inadequate provisioning is also discussed in the report.

The use of funds has been squeezed by cash constraints with the drying up of bank funds in response to the apparent political risk

The allocation of funds by Indian MFIs has conformed fairly well to international best practice norms in recent years. However, the exceptional circumstances of the 18 months to March 2012 resulted in exceptional measures. Of the total resources of Rs22,471 crore ($4.4 billion) deployed in microfinance by sample MFIs, just over 75% was in loans to clients at the end of March 2012 (**Exhibit 6**). Two years ago this was 69% which was below the portfolio allocation level of the MIX international median of 76.8% largely because of the prevalent practice in India of lenders making substantial disbursements of loans to MFIs in the last week of March (the end of the financial year).



As indicated earlier, the effect of the crisis resulting from the AP ordinance spread much more widely than the state of Andhra Pradesh. This effect was not due to any delinquency contagion reaching clients outside the state but rather due to the drying up of bank funds to MFIs. Thus, the manifestation of political risk that they saw in the form of the AP ordinance, resulted in banks as a whole reducing their sanctions during 2011-12 and privately owned banks withdrawing almost completely. This affected MFIs all over the country and is the primary reason for the nearly 35% decline in net portfolio of the leading MFIs during the year. Since there is a limit to the equity it is possible to raise and equity takes longer to mobilise, while deposits are not an option, MFIs were forced to shrink their portfolios. It is remarkable that this shrinking of MFI portfolios did not cause the contagion expected from clients (outside AP) refusing to repay loans based on the assumption that they would not receive fresh loans anyway.

...creating the impression that prudential management has improved

For ensuring prudential management, banks in India are expected by the RBI to maintain Capital Adequacy Ratios (CAR - net worth as a proportion of risk weighted assets) of 9% and NBFCs of 12%

(until March 2010 increasing to 15% by March 2011). While equity was a constraint in the early years of Indian microfinance, the earlier equity constraint eased considerably and, though investors became very cautious after October 2010, the weighted average for Indian MFIs is now in excess of 28% – well ahead of the banking sector. The decline in portfolio over the past 18 months year has been largely responsible for this increase from the 18% weighted CAR of March 2010.
While securitization may offer a short-term solution to the capital problem, it does not resolve the issue in the long term. For commercial banks, as discussed above, it provides the benefit of inclusion in the priority sector lending requirement (though that is now being re-assessed by the Reserve Bank of India in the context of the crisis). A surfeit of lending funds leads MFIs to

- ⇨ induct clients without due care and relationship building
- ⇨ lend beyond the capabilities and means of their clients
- ⇨ resort to coercive practices when the clients' express an inability to pay.

The emergence of client protection issues and the related political risk in Andhra Pradesh and Karnataka (and, by extension, elsewhere in India) can largely be attributed to this phenomenon. In this context, the reduction in the proportion of the managed portfolio from 53% of the owned portfolio in the 2005 to 7.6% now is a welcome development. It is worth remembering, however, that until March 2010 the absolute amounts had increased to such an extent that the proportions become meaningless from the perspective of an over-heated economic sector. In M-CRIL's opinion, securitization is a device that dilutes the prudential effect of the CAR requirement and should be carefully monitored by regulators.

Returns to MFIs have declined significantly due to write-offs and the squeeze on margins

The financial viability of rated microfinance institutions in India, apparent in the 2005 Review, was under threat in 2007. While this situation was dramatically reversed in 2009-10, the current crisis in Indian microfinance has caused another reversal. This is apparent in considering the returns MFIs earn net of all costs – operating and financial. The significant change in MFI returns of the past year has been caused by the substantial write offs necessitated by the collapse of microfinance in Andhra Pradesh. The high efficiency (low OER) of Indian MFIs played a key role in their profitability as did the significantly increased portfolio yield since 2007. However, substantial current write-offs (included partly in operating expenses and partly in loan loss provisioning) have increased the total expense ratio significantly and caused the weighted average return on assets for 2011-12 to register a large loss of 7.4% of assets. MFIs not directly affected by the crisis (non-AP), however, still earned a good 3.9% on assets in the year under review. As discussed earlier, the crisis has not only had the effect of bringing microfinance in AP to a halt, it has also caused a sudden rash of prudence in commercial bank lending to MFIs (at the same time as a hardening in inflationary conditions in the country) resulting in an increase in lending rates.

...and the implications of the crisis for the long term future of financial inclusion by MFIs are still difficult to predict

Given the actions of the Government of Andhra Pradesh and the collapse of portfolio quality in AP as a result, it is quite likely that the write-off and provisioning expenses of MFIs with operations in the state will increase even further. At the same time, M-CRIL expects another decline in portfolio yield on account of the limits set by the RBI on the margins of microfinance NBFCs.

The implications of the drastic intervention of the AP Government and slow progress towards a resolution of the crisis for the long term future of financial inclusion are still difficult to predict. It has already resulted in a substantial decline in capital – both debt and equity – available for microfinance

and has reversed the financial inclusion effect of MFI operations. Whether or not MFIs can continue to contribute to the financial inclusion process in India is now dependent on the passage of the Microfinance Bill by the Indian Parliament – a process that is currently moving very, very slowly. In the meantime, most low income families in AP have been thrown back into the not-so-benevolent arms of moneylenders. As this discussion has shown, many low income families elsewhere have also suffered collateral damage as the drying up of on-lending funds from commercial banks has caused a reduction in MFI operations throughout the country. It is apparent that the economic future of low income families has not received adequate attention from policy makers and needs to be brought immediately to the forefront of financial policy making so that the poor can receive practical support for their lives and livelihoods.

Introduction to M-CRIL

A pioneer and world leader in microfinance ratings

Micro-Credit Ratings International Limited is one of the pioneers of financial performance ratings and the worldwide pioneer of social rating for MFIs. It is the world's leading specialist microfinance rating agency. By September 2011, M-CRIL had undertaken over 1,100 financial and social ratings of over 500 microfinance institutions (MFIs) in 32 countries of Asia, Europe and Africa.

M-CRIL is based in Gurgaon – outside Delhi, capital of India. It has an excellent team of 15 specialist analysts with knowledge and experience of microfinance led by Dr Alok Misra, Director, Microfinance Services. And another 10 analysts for the rating of low cost private schools

M-CRIL also provides sector-wide advisory services and undertakes research and policy studies compatible with its concern to avoid conflicts of interest. Its rating and advisory services have been provided in many countries of Asia including all countries of South Asia and in Cambodia, East Timor, Indonesia, Myanmar, Papua New Guinea and the Philippines as well as in Samoa. In the NIS countries of the former Soviet Union, M-CRIL has experience of Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Russia and Tajikistan. In Africa, M-CRIL has worked in Congo, Ethiopia, Kenya, Malawi, Morocco, Nigeria, Rwanda, South Africa, Tanzania, Uganda.

In keeping with its pioneering tradition,

M-CRIL has introduced a new rating product called

Microfinance Institutional Rating

along with other international microfinance rating agencies
incorporating responsible governance, management parameters and financial performance
along with client protection, transparency and mission orientation assessments

also ratings/assessments of

Microfinance Investment Vehicles (MIV)

(combined financial and social rating)

Low Cost Private Schools

(for children from low income families)

and

Value Chain Initiatives

(to assess their impact on poverty and
the efficiency and effectiveness of such programmes)

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Chapter 1

A testing time for microfinance

1.1 A complex, extensive and growing financial system but just 35% inclusion

Over the past 20 years, the Indian financial system has made significant progress in terms of resource mobilization, geographical and functional reach and financial viability. **Exhibit 1.1** provides a summary presentation of the financial system in India (with particular reference to microfinance). At end-March 2012, the banking sector was comprised of 86 scheduled commercial banks with a consolidated asset base of Rs73 lakh crore (US$1.43 trillion). In addition, there were 82 Regional Rural Banks (RRBs) consolidated from the 196 that originally existed before the amalgamation process started in 2006. In 1996, the RBI mandated the establishment of Local Area Banks – essentially RRBs under private ownership – but only six were ever licensed and just four are functioning today. In addition, there were 12,375 Non-Bank Finance Companies in India in May 2012, out of which just 271 were permitted to accept/hold public deposits.

There is also a network of cooperative banks, with 31 state cooperative banks (SCBs) and 371 district central cooperative banks (DCCBs). The main aim of the rural cooperative banks is to provide crop and other working capital loans, primarily for short term purposes to farmers and rural artisans. The cooperative banks do this either directly or by financing those of the 93,400 primary agricultural cooperatives functioning in their operational areas. In urban areas, the financial services of the banks and NBFCs are supplemented by the operations of over 1,645 urban cooperative banks.

Exhibit 1.1
The Indian financial system

Type of financial institution	Institutional ownership	Regulated by	Number of institutions
Commercial Bank	Government Private – Indian Foreign	RBI	26 20 40
Regional Rural Bank (RRB) Local Area Bank	Government Private – Indian	RBI/NABARD RBI	82 4
State Cooperative Bank District Cooperative Bank Primary Agricultural Cooperative Societies	DCCBs/State government PACS/individuals Individuals	State government/ NABARD State government	31 371 ~93,400
Non-Bank Finance Company (NBFC)	Private – Indian, some partly or wholly foreign	RBI	12,375
Business correspondents of banks	Mainly private individuals or business establishments	RBI via the banks	95,767
Microfinance institutions as…			**Estimated numbers**
NBFCs Section 25 companies Cooperatives, MACS and others Societies/trusts	- as above - Private – Indian Individuals No ownership structure	RBI State government Central/state government	~50 5 100 500
Self help groups	Unregistered – member equity	Self, some supported /guided by NGOs	with outstanding bank loans – 4.35 million with bank savings accounts – 7.96 million

In recent years, the Reserve Bank of India has attempted to promote financial inclusion by introducing the device of business correspondents, individuals or business outlets in diverse locations, providing basic banking services to small account holders. By end-March 2012, the number of business correspondents in India grew to nearly 96,000. These were in addition to the 83,000 branches of scheduled commercial banks and over 14,000 branches of RRBs as well as 93,000 rural PACs and around 2,000 branches of UCBs.[1]

Yet, according to the Human Development Report, 2011 of the UNDP, 41.6% of India's population, or around 500 million people, live on less than the poverty benchmark of $1.25 a day (at PPP). The proportion of population below the $2 a day benchmark is 75.6% or (nearly 900 million people). In this context, while the importance of financial inclusion for facilitating peoples' lives is apparent, the level of inclusion achieved is not great. While accurate information on financial inclusion is not available, at least 65% of the adult population is said to be unbanked (or lacking an account with a formal financial institution).[2]

With 747 deposit accounts with commercial banks per 1,000 population and another 69 with cooperatives in India, amounting to little more than 1.5 accounts per adult (a large proportion in multiple holdings), India is well behind the 3.2 accounts per adult average of the developed world. It is not surprising, therefore, that over the past few years the Indian microfinance industry, both the bank-financed self help group programme and the microfinance sector served by NBFCs and NGO MFIs engaged in providing micro-credit services, grew very substantially with a peak of some 75 million credit accounts by March 2011. As a result, India was said, by 2010, to be the world's largest microfinance market having surpassed Bangladesh's total of around 30 million accounts around 2006.

1.2 M-CRIL's 2012 cohort of Indian MFIs...

The group of institutions used for this analysis consists of Indian MFIs whose detailed Annual Financial Statements were available for 31 March 2012, excluding MFIs with less than 20,000 borrowers. This resulted in a total of 56 MFIs for the current review. As in earlier years, for the purpose of this analysis, the classification of information available to M-CRIL has been undertaken, where relevant, by

- form of legal registration,
- portfolio size, and
- the region of operation of the MFI.

In addition to the above classification for analysis, M-CRIL reviews have compared the largest 10 institutions (L-10) based on the number of active borrowers, with the overall cohort. Given the traumatic developments in the MFI sector over the past two years, five of the L-10 have shrunk significantly in terms of the number of borrowers served. As a result, there is one change in the 10 largest institutions selected for the purpose of comparison with all MFIs and their ranking has also changed. This is discussed further in **Chapter 2**.

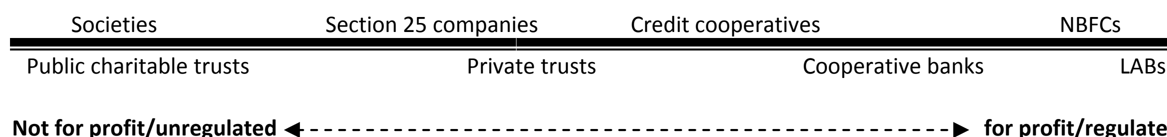
MFIs have various institutional frameworks ranging from not-for-profit Societies/Trusts and Companies registered under Section 25 of the Companies Act to Non Banking Finance Companies (NBFCs) licensed by the Reserve Bank of India. The microfinance models and institutional framework

[1] The data in **Exhibit 1.1** and in the text is culled from various publications of the RBI and from cooperative federations. Microfinance information is from M-CRIL's own knowledge of the sector; SHG information is from NABARD.

[2] Demirguc-Kunt, Asli and Klapper, L, 2012. "Measuring Financial Inclusion", **Policy Research Working Paper, 6025**. Washington: The World Bank, April; according to a survey that showed only 35% of the adult population in India had an account with a formal institution and the number of women was significantly lower at around 24%.

adopted by MFIs and used in this analysis are illustrated in **Exhibit 1.2**. For this analysis, portfolio outstanding data includes **managed portfolios** of MFIs in the sample. Managed portfolios are not included in the balance sheets of MFIs and have been added for the purpose of this review by M-CRIL to provide the true picture of microfinance activity undertaken by MFIs in India.

Exhibit 1.2 Institutional Framework



As microfinance in India grows towards maturity, many MFIs have spread their operations geographically making it difficult to base analysis on operations by region. A number of MFIs in the group are currently operating in ten or more states of the country and do not fall into any regional category. This change reflects the expansion of the sector that took place from 2005 to 2010. MFIs that operate extensively across regions have been categorized as "All India" in the regional analysis. For other MFIs, their regional categorization depicts the predominance of their operations in that region (North, South, East & NE or West).

1.3 ...sees continuation of the trend to transform to NBFCs and diversify geographically

Historically, the NGO legal form dominated the microfinance landscape but with the commercialisation of the sector, there has been a growing tendency for these to transform to NBFCs.

Exhibit 1.3
Distribution of sample by legal form

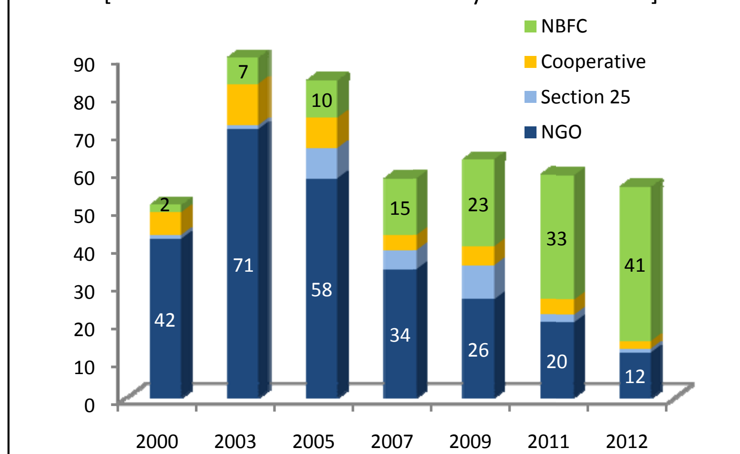
Profit orientation	Legal Type	Leading MFIs		L-10
		Frequency	**%**	**[Largest 10]**
Not for profit	NGOs-societies/trusts	12	21.4%	1
	Section 25 companies	1	1.8%	1
Other commercial MFIs	Cooperatives	2	3.6%	0
For profit	NBFC	41	73.2%	8
Sample		**56**	**100.0%**	**10***

* These service 76% of all client accounts (see **Chapter 2**).

Despite recent setbacks in the sector, there are now even more NBFCs as transformations of NGOs set in motion during 2009 and 2010 have recently reached fruition. As a result, 73% of all institutions in the 2012 sample are NBFCs. With the replacement of an NBFC by a Section 25 company in the 2012 L-10, 8 of the largest 10 MFIs in India are currently NBFCs (**Exhibit 1.3**).

The evolution of the distribution of sample MFIs across legal forms (**Exhibit 1.4**) over

Exhibit 1.4 Transformation of the legal structure of MFIs in India
[number of Indian MFIs covered by M-CRIL Review]



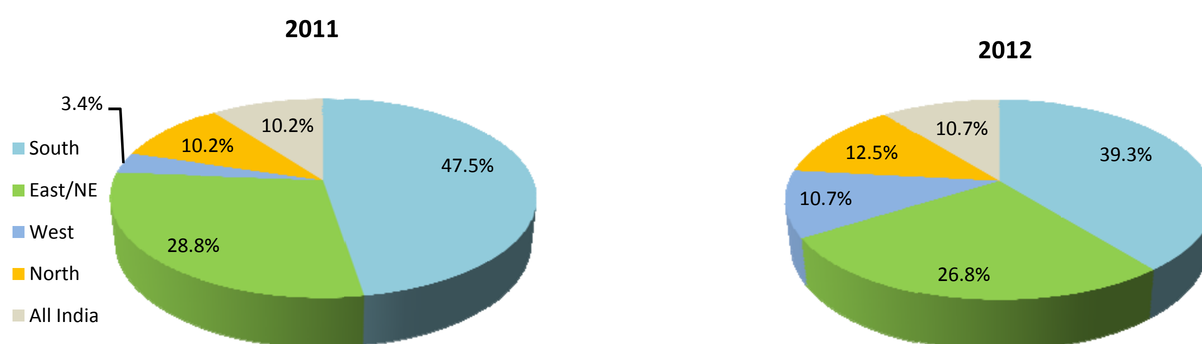
the M-CRIL Reviews of the past dozen years illustrates this transformation.

Over the past decade the southern region has dominated the provision of microfinance services in terms of the concentration of MFIs (as well as in terms of clients). The proportion of MFIs with their head offices in the South was roughly constant around 57% between 2003 and 2011 but, as shown in **Exhibit 1.5**, a number of these have established a nationwide presence (listed as All India in the figure), representing over 10% of the sample. These are the largest MFIs and operate predominantly in the South. With the growth of microfinance in other parts of the country (particularly the historically underserved West) the share of southern MFIs has declined.

Exhibit 1.5

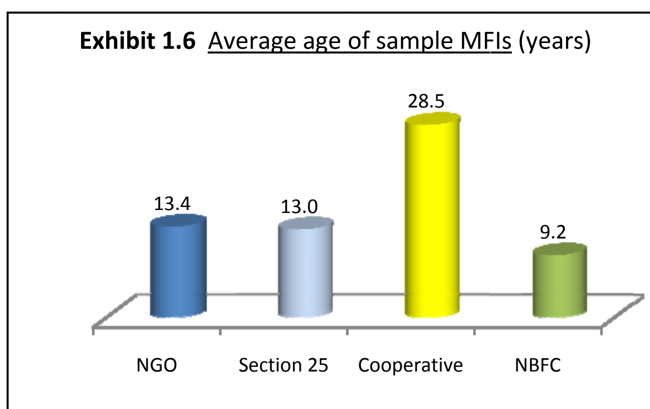
Region wise distribution of leading MFIs in India

(proportion of total number of MFIs covered by this analysis)



Cooperatives have been practising microfinance in India for long periods and the earliest MFIs in the country were cooperatives whereas NBFCs and Section 25 companies have not been in operation for so long as illustrated in **Exhibit 1.6**. However, since there are only two cooperatives in this year's sample, the average age of all institutions computes to a much lower 11 years. The average age of the L-10 institutions (12.7 years) is not much more than the average of the group, indicating that longevity is not the main contributor to the growth profile of MFIs.

Exhibit 1.6 Average age of sample MFIs (years)



1.4 ...as reporting on social performance becomes more common

Concerns about the commitment of MFIs to the fulfilment of their social mission started to be expressed around 2005 as the mantra of growth and financial sustainability established a firm grip on the world of microfinance. M-CRIL was the first international technical agency in microfinance to introduce a social assessment framework through its social rating undertaken at the end of that year. Since then, other specialist microfinance raters have also introduced social ratings, the MIX has developed a social performance reporting platform and the CGAP-sponsored MIV reporting framework has incorporated social along with outreach and financial performance indicators. Though the MIX social reporting platform started as a pilot in 2008 and launched as a full platform in 2009, it is yet to take hold; while many MFIs have started to take the social reporting indicators

more seriously, most have not yet incorporated all of the indicators into their MIS. As a result reporting on social performance remains incomplete.

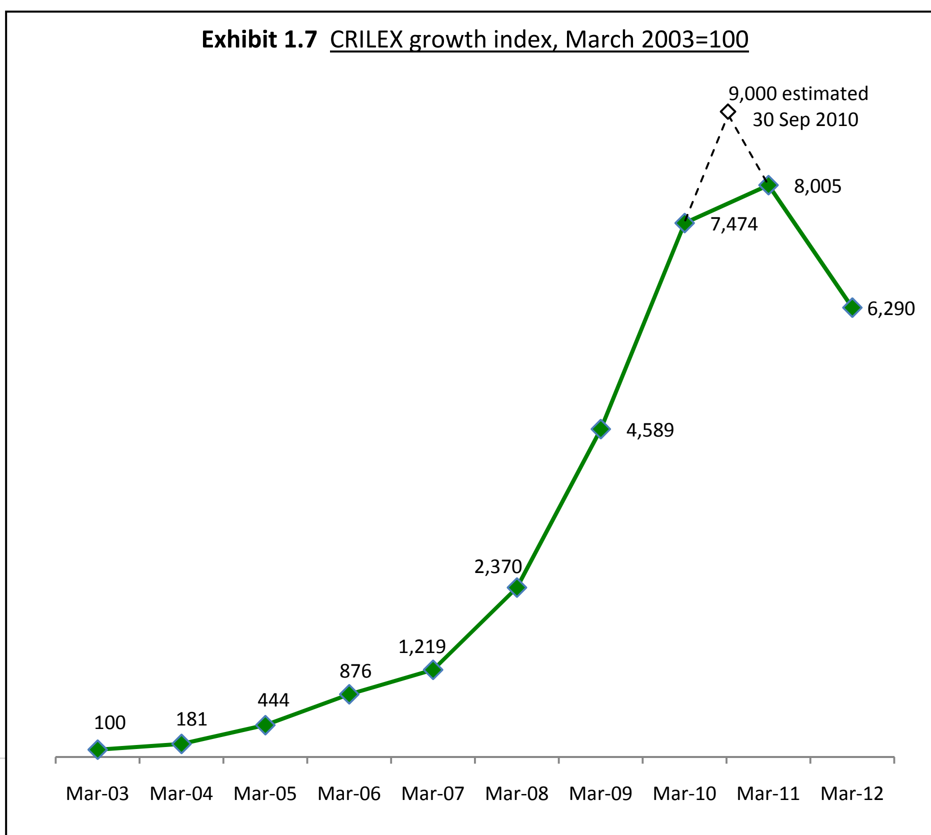
As a pioneer in this field, M-CRIL regards social performance as key to the MFIs' development outcomes. For this reason, this review incorporates as much relevant information as is available from those Indian MFIs that have reported to the MIX social platform (since at present that is the only collective source of data on these indicators). While to begin with the quantum of social performance information available was very limited, over time MFIs are providing increased information on their outreach, retention rates and social profile of their borrowers, though the quantity of social performance data available continues to be well below the ideal. Information on client retention rates is particularly lacking with only 33 of the 56 MFIs in this sample having provided information. Information on the crucial issue of depth of outreach – the poverty profile of clients – is all but non-existent. Analysis of the data that is available is integrated into this analysis in the next and subsequent chapters.

1.5 But, in the meantime, the MFI *mantra* of growth has been reversed

Over the past few years, and particularly from 2007 until October 2010, the Indian microfinance industry pursued growth with a vengeance as some of the leading MFIs set a blistering pace in fund mobilisation – both debt funds and equity investments required to provide comfort to lenders – staff recruitment and, ultimately, client acquisition. The pursuit of growth by the largest MFIs created the mirage of substantial increases in revenue and profit over the next few years leading to fabulous valuations of equity paid by investors of the order of 7-11 times book value. This set the example for others in the industry to follow, such that virtually all MFIs chanted the mantra of growth and more and more new ones were established while (as shown by **Exhibit 1.4**) already functioning NGO MFIs transformed into NBFCs in the search for quick commercial success.

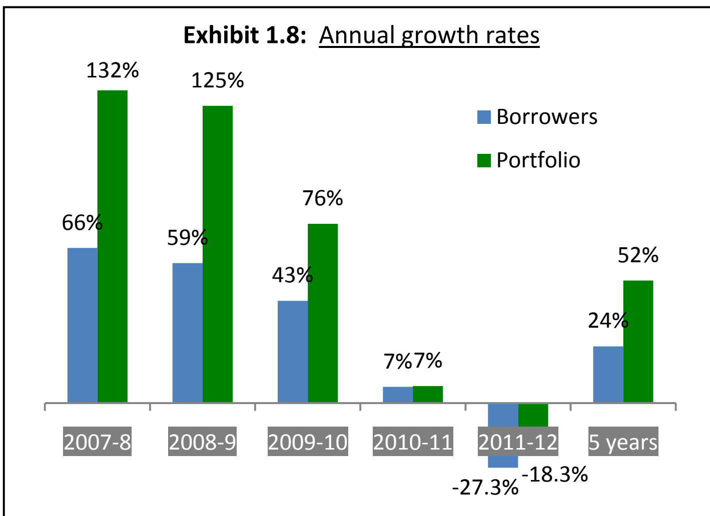
Thus it is that the microfinance industry in India emerged as perhaps the fastest growing microfinance sector in the world. No other country of significant size has paralleled the 81.9% per annum growth rate of clients and 98.6% annual portfolio growth of the 24 largest MFIs in India (tracked by M-CRIL through its CRILEX Microfinance Index) for the five years to March 2010. [The number of clients claimed by the MFIs is more correctly described as client accounts since there was substantial multiple lending (by more than one MFI to the same end-client)]. However, following the AP Ordinance of 14 October 2010 the practice of microfinance came to a virtual standstill in the state and most MFIs elsewhere were also affected by the subsequent reluctance of banks to lend to them.

Exhibit 1.7 CRILEX growth index, March 2003=100



[The overlap in client accounts is estimated by M-CRIL to be of the order of 40% for March 2011 but perhaps no more than 20% for March 2012 after the elimination of the AP portfolio].

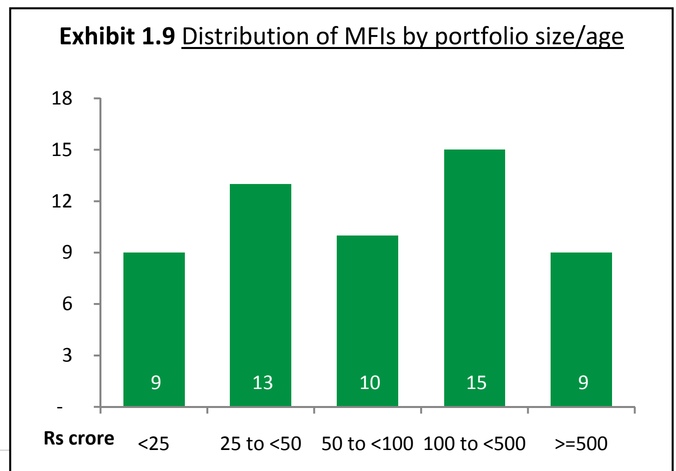
Exhibit 1.7 presents CRILEX for the 9 year period, 31 March 2003 to 31 March 2012. Since accurate information is not available, an estimate for 30 September 2010 (when industry outreach is thought to have peaked) is also provided. CRILEX is a composite index of the growth of microfinance institutions in India and uses information on the number of borrowers as well as the size of loan portfolio of the 24 largest MFIs (each with more than 100,000 active client accounts). It adjusts the client numbers by the most conservative estimates for multiple lending by M-CRIL analysts. By 31 March 2010, CRILEX had reached the level of **7,474** (with March 2003=100), up from 4,589 in the previous year registering a composite growth of 63% in the financial year April 2009 to March 2010 and continuing the trend of the previous years. However during the year to 31 March 2011 there was a slowdown to just 7.3% composite growth and the index reached **8,005**. More significantly, the annual growth figure masks the dramatic developments during that year; until early October 2010 MFIs continued to grow at a blistering pace with the index estimated by M-CRIL to have peaked at **9,000**. However, during the two years since the onset of the ongoing crisis in Indian microfinance there has been a considerable decline with CRILEX estimated to have fallen **well below 6,000** by end-September 2012 representing a decline from the peak of well over 33% in the microfinance services of the largest Indian MFIs.



Disaggregated annual growth rates of client acquisition and portfolios of Indian MFIs are presented in **Exhibit 1.8** showing that portfolio growth was faster than real client acquisition (after adjusting for multiple lending). However, in 2010-11 both growth rates declined to just over 7% and then became substantially negative in 2011-12 as the nationwide ramifications of the AP Microfinance Act became evident. The growth of microfinance for the 2012 cohort of 56 MFIs and the detailed reasons for the decline in the Indian MFI sector is discussed in **Chapter 2**.

1.6 As the rush to become NBFCs and grow caused over-indebtedness provoking government intervention and the introduction of regulation

As a result of the high growth of the largest Indian MFIs, there were 10 institutions with portfolios in excess of Rs500 crore (~$100 million) at the end of March 2011 and 27 with portfolios in excess of Rs100 crore ($20 million). However, with the collapse of portfolios in AP and the overall decline in the sector, on 31 March 2012 there were 24 MFIs with portfolios in excess of Rs100 crore (**Exhibit 1.9**). Since one of these is an NGO and another a "not for profit" company, there are now just 22 MFIs that satisfy the Reserve Bank of



India's criterion for "systemically important NBFCs". Such companies are generally subject to more stringent reporting and inspection requirements than the smaller NBFCs. However, since the creation of the NBFC-MFI as a separate category (by the December 2011 regulations) all microfinance NBFCs have tended to converge and it has become apparent that all such institutions will be treated equally in future. MFIs with portfolio sizes greater than Rs50 crore (>$10 million) constituted 20% of the sample in 2007 but are currently over 60%.

The main characteristic of the era when growth became the *mantra* of MFIs, is that managements realised that the legal form of their institutions (as NBFCs) enabled better access to commercial funds on the presumption (by commercial lenders) that such an institutional form entailed better governance structures, greater management oversight and more systematic planning leading to organisational efficiency. The rush to transform from NGOs to NBFCs (and be regulated by the RBI) resulted from the experience that commercial lenders were more willing to provide large sums of money to NBFCs than to NGOs. The NBFC was also seen to be the legal form most appropriate for investment by private equity firms and, in the long run, for a public share offering.

Over the past few years, therefore, there developed a trend for professionals and other promoters to establish new MFIs directly as NBFCs rather than to start as NGOs. Generally these were able to grow rapidly and expand their portfolios. They did so without spending the time that was earlier invested in relationship building with clients through careful client selection, training, staff orientation and systems development by the pioneers (NGOs or NBFCs) of the microfinance revolution in India. Both the transformed and new, as well as start-up MFIs were able to grow rapidly through better access to funding and by using the proven methodology of a mono-product offering rolled out over large numbers of branches and in diverse locations using standard processes. This was often at the cost of staff-client interaction which, thereby, became very limited.

The current crisis in microfinance resulted partly from this over-simplification (even "dumbing down") of the MFI-client relationship. While large numbers may have been reached, the lack of commitment on either side led to substantial multiple lending and created an environment of concern about the rights of clients that had been oversold microcredit. Some clients became over-indebted as a result and the media attention generated by the IPO of SKS Microfinance (at the time, by far the largest microfinance NBFC in India) only led to further introspection about the status of microfinance clients. With reports of suicides in rural Andhra Pradesh, a regrettable annual feature with or without microfinance, thrown into the mix, microfinance took the blame this time around. Given the populist nature of state-level governance in India, conditions were ripe for intervention and the AP Microfinance Ordinance of 14 October 2010 was the result.

It is not the purpose of this review to discuss the actual and proposed policy moves of India's central bank, the Reserve Bank of India, and of the Government of India that have been announced since October 2010 (largely after 31 March 2011). The impact of these moves is now gradually becoming clearer as the measures are starting to affect MFI operations. But the MFI sector still awaits the passage of the Microfinance Bill (currently before Parliament). The appropriateness of these declared measures (the Reserve Bank of India's (RBI) circular of 3 May 2011 on the definition of priority sector lending by MFIs), the creation of NBFC MFIs as a separate legal form (RBI circular of 2 December 2011), and the Government of India's Microfinance Bill have been commented on by M-CRIL; these comments are available in the public domain.[3] The implications of the interest rate/margin caps and of client income limits in RBI's priority sector circular have also been analysed

[3] M-CRIL's Submission to the Malegam Committee, 11 January 2011; M-CRIL's Comments on the Malegam Committee Report, 23 January 2011; M-CRIL's Supplementary on the Malegam Committee Report, 10 February 2011; M-CRIL's views on the Microfinance Policy of RBI, 6 May 2011. See **www.m-cril.com**.

and the paper circulated by M-CRIL.[4] First, while the interest/margin caps do not have substantial implications for the leading MFIs, their main effect will paradoxically be to constrain lending in difficult-to-reach areas and to the poorest clients. This is contrary to the declared intentions of policy makers and, therefore, needs to be reviewed. Second, the client income limits announced do not affect urban clients but place a limitation on the equivalent upper stratum of rural clients, another paradoxical result.

The Microfinance Bill drafted by the Ministry of Finance, Government of India with support from the two networks of MFIs is likely to provide a good legal framework for the development of microfinance in India. It sets out the principles for the regulation of Indian MFIs, clearly specifying the RBI as the regulator, enabling the provision of deposit services by the MFIs and taking microfinance out of the ambit of state-level laws. All the details of prudential requirements and other rules are left to the regulator to formulate. This is as it should be; returning to Parliament for the specification of each detailed measure would be unwieldy and impractical. M-CRIL believes the bill is a good document and, at least as a starting point for comprehensive microfinance regulation. When passed into law the new Microfinance Act will enable the stable provision of micro-financial services by Indian MFIs without fear of whimsical interventions by state governments.[5]

Unfortunately, the Microfinance Bill currently languishes as Parliament is more concerned with issues of greater public prominence including corruption in high places and the implications of economic liberalisation. But exclusive focus on such concerns ignores the implications of the parlous state of MFIs for tens of millions of low income families. Does throwing them back into the welcoming arms of exploitative moneylenders serve the welfare interests of the country? It is too easy to ignore the poor while shouting about their interests on every TV news channel. There is a need for greater application to understanding the real issues and a greater sense of enabling and facilitating the lives of low income families than has been seen so far.

The following chapters analyse and discuss the implications, until now, of the MFI approach to growth and the subsequent AP ordinance/law for microfinance outreach, MFI efficiency, the cost of loans and other services to clients and the impact of these measures on the profitability, sustainability and provision of financial services by MFIs.

[4] M-CRIL, 2011. **Of interest rates margin caps and poverty lending: How the RBI policy will affect access to microcredit by low income clients.** Gurgaon, India: Micro-Credit Ratings International, July 2011 and M-CRIL, 2012. **Responsible and viable micro-lending needs smart regulation: Some suggestions from EDA & M-CRIL.** Gurgaon, August.

[5] M-CRIL's Comments on the Draft Microfinance Bill, July 2011. See **www.m-cril.com**.

Chapter 2

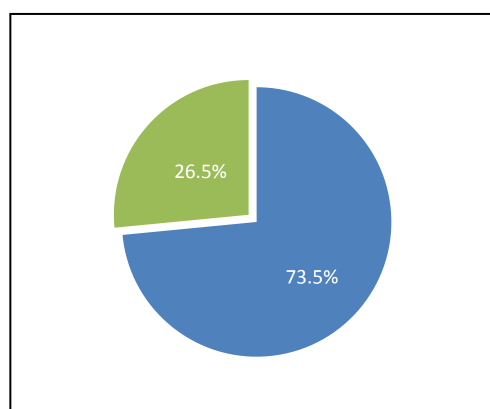
MFI contribution to inclusion is still significant despite setbacks

2.1 MFI operations continue to be a significant part of the financial system in terms of their implications for financial inclusion

Exhibit 2.1

Active borrower accounts of 56 leading Indian MFIs, March 2012

Legal Type	Reported		Revised	
	Number	%	Number	%
NGO	2,723,190	10.5%	2,414,129	12.1%
Section 25 Co.	460,403	1.8%	460,403	2.3%
Co-operative	67,091	0.3%	67,091	0.3%
NBFC	22,601,298	87.4%	16,975,294	85.2%
India	**25,851,982**	**100.0%**	**19,916,917**	**100.0%**
L-10	19,548,876	75.6%	14,633,770	73.5%



As a result of the high growth rate of Indian microfinance, the nominal number of clients served by MFIs grew dramatically until October 2010 as shown by the information in **Chapter 1**. As discussed there, the client numbers represent a significant overlap amongst unique clients and are, therefore, referred to henceforth as the number of borrower accounts or credit accounts since an individual borrower could have a credit account with 2 or more MFIs. The total number of credit accounts at sample MFIs was reported at 31 million at the end of March 2011 but reduced to under 26 million by end-March 2012 (**Exhibit 2.1**). Of these, 22.6 million (or over 87%) were reported by NBFCs.

The number of credit accounts reported is, however, misleading. The AP-based MFIs have adjusted their client numbers after March 2011 but only to the extent that outstanding portfolios have been written off. Accounts long overdue (some by over 12 months) but not yet written off remain on their books and have been reported as existing borrower accounts. M-CRIL does not regard such accounts as "active". Much of the analysis in this report has, therefore, been undertaken with revised client and portfolio numbers that treat all accounts for AP-based MFIs that are more than 90 days overdue as "inactive". The **revised** number of borrower accounts in the table above provides a better indication of the impact of the AP government's action on Indian MFIs. The total for the sample falls below 20 million, a reduction of more than 36% compared to March 2011. Active borrower accounts of the L-10 reduce from 23.9 million in March 2011 to just 14.6 million on 31 March 2012, down nearly 39%.

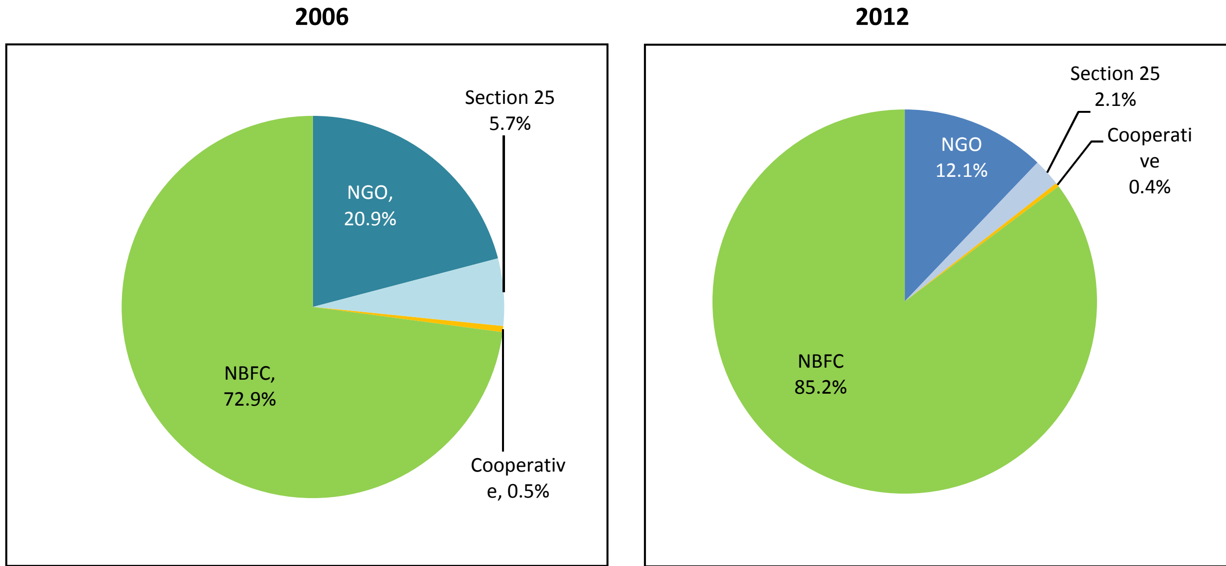
This compares with growth during 2010-11 in the number of client accounts served being nearly 20%; a significant growth, but a climb down from the 43% growth in client accounts that occurred during 2009-10. Information from MFIs indicates that the 2010-11 increase was the result of very high growth during the period April to mid-October 2010 followed by a gradual decline on account of the drying up of commercial bank funding after the promulgation of the AP ordinance. Sadly, even some of the best regarded MFIs in India were bitten by the bug of high growth during the heady days of early 2010 (before and immediately after the, very successful, SKS IPO).

The L-10 MFIs continue to dominate Indian microfinance, representing 73.5% of all borrower accounts in the sample MFIs compared to just 59% in 2006. NBFCs catered to over 85% of all borrower accounts (**Exhibit 2.2**) in March 2012 up from 73% in 2006. The shares of all other types of MFIs have declined significantly as the fastest growing institutions have transformed into NBFCs. The

NGO share has reduced from 21% in 2006 to just 12.1% now. The average active borrower accounts for the L-10 is now 1.46 million per MFI, over four times the sample average of 356,000 accounts. For all NBFCs together, the average active number of borrower accounts is 414,000. The average for the 46 MFIs not part of the L-10 amounts to 114,000 well above the MIX international average of the order of 70,000 for year 2011 (going in to 2012 for India).

Exhibit 2.2

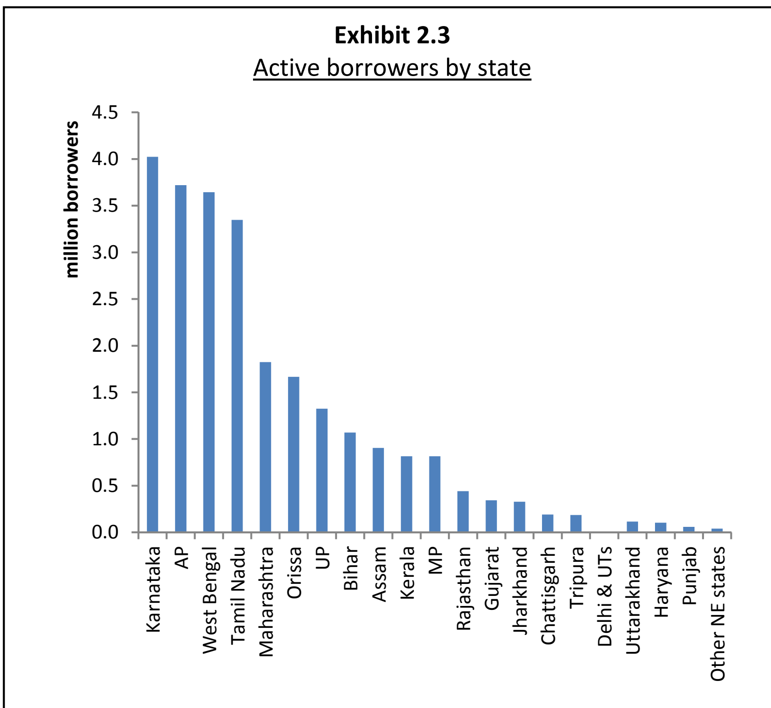
Active borrowers by legal type of MFI



The bar chart in **Exhibit 2.3** shows the state-wise disaggregation of borrower accounts for 2011. The total number for March 2011 has been distributed based on Sa-Dhan data collected from 266 MFIs for 2010.[1] It shows the historical importance of the states of Andhra Pradesh, Tamil Nadu and Karnataka in the microfinance landscape of India though the numbers in AP now notional since virtually all are defaulters. It also shows the importance of West Bengal, and the relatively recent spurt of growth in Maharashtra, Uttar Pradesh, Madhya Pradesh and Bihar which are increasingly relevant in the microfinance landscape.

Exhibit 2.3

Active borrowers by state



The other interesting aspect of the borrower numbers is that the 25.85 million borrower accounts reported by the 56 MFIs in the M-CRIL analysis increases to 26.82 million for the 184 MFIs of the Sa-Dhan report. This shows that the average size of the 128 small MFIs not in the M-CRIL sample (with its 20,000 account cut-off) average just 7,400 borrowers. It is also interesting to note that the Sa-dhan report incorporated data from 266 MFIs for 2011 but has information for only 184 MFIs this year. This suggests that

[1] Sa-Dhan, 2012. **The Bharat Microfinance Quick Report 2011.** New Delhi: Sa-Dhan.

dozens of small MFIs are now too shy to report either due to shrinkage in their operations or total collapse of their microfinance portfolios.

More importantly, even with just 21 million borrower accounts the size of the microfinance sector more than matches significant parts of the Indian financial system in terms of the number of citizens affected. This number is still over **twice** the number of micro-credit accounts (less than Rs25,000, $500) serviced by the Regional Rural Banks (as shown by the information in **Exhibit 2.4**). In spite of the loss of all MFI operations in AP, MFI borrower accounts are still around 60% of the total number of micro-accounts with all commercial banks. If allowed to be seen as part of the mainstream financial system, the microfinance sector would have a share of the total number of formal micro-credit accounts in excess of 30% (though due to the decline of MFIs) it is down from around 45% in March 2011. Including SHGs into the discussion, the total of micro-credit accounts in India held in the formal and semi-formal financial system amounts to around 126 million. The collapse of MFI operations in AP means there are roughly 7-8 million fewer financially inclusive borrower accounts than there would have been otherwise.

Exhibit 2.4

MFI credit accounts compared with other banks' accounts <Rs25,000 (million)

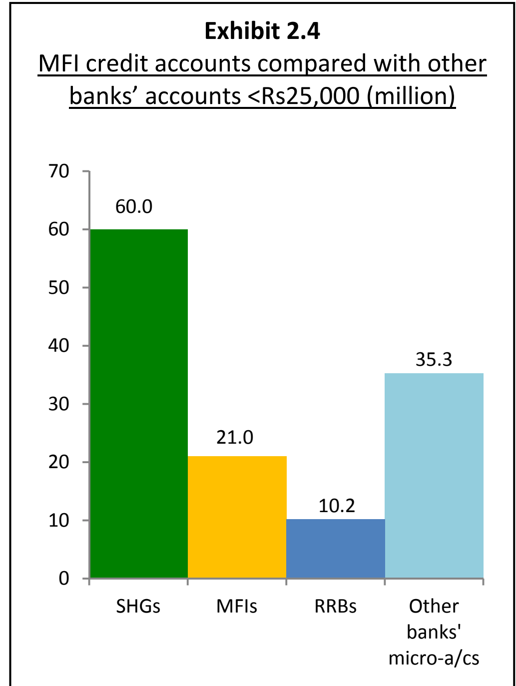
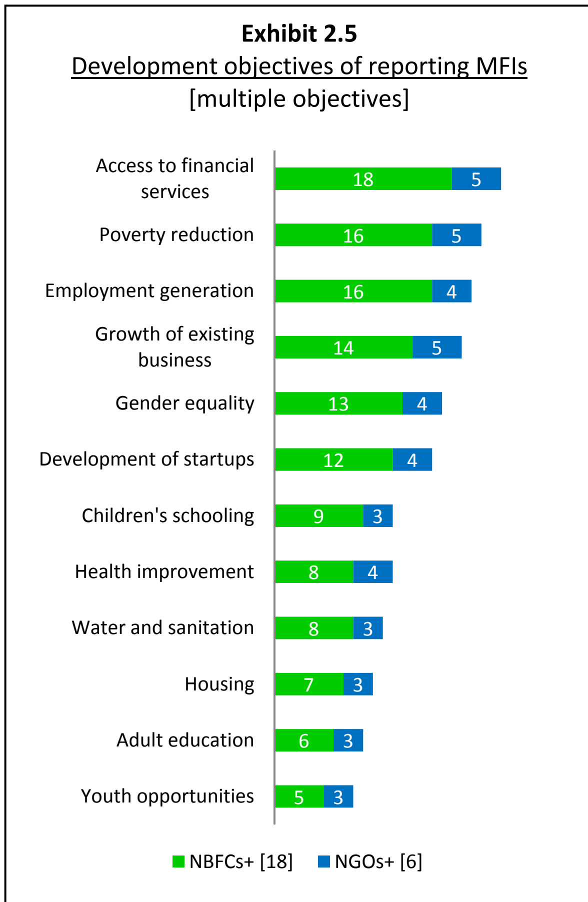


Exhibit 2.5

Development objectives of reporting MFIs

[multiple objectives]



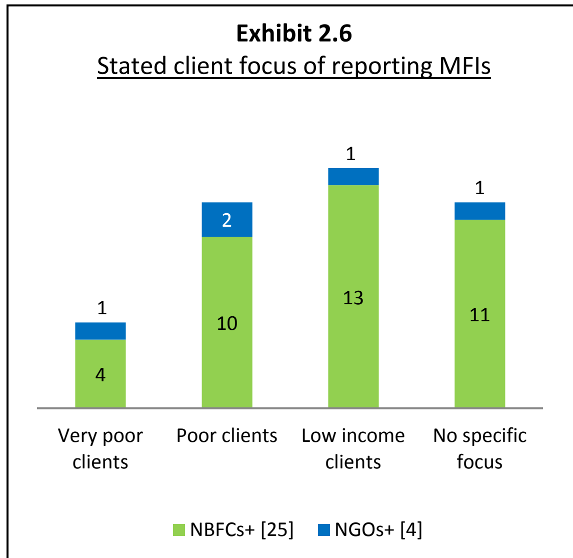
While it is well known that there is substantial multiple counting of borrowers in the microfinance sector, equally there is multiple holding of credit accounts in the banking sector. Even with an allowance for a 20% overlap of borrower accounts in the MFI sector, M-CRIL's estimate of around 16.7 million unique MFI borrowers means that MFIs currently serve around 6% of the total population of around 280 million families in India (and 9% of financially excluded families). The total number of MFI credit accounts (21 million) is a substantial proportion of the number of small credit accounts (~105 million) served by all commercial banks.[2] The number of "no-frills" accounts with commercial banks is now reported to be 139 million but it is well known that 85-90% of these are dormant so effectively still provide less of a service to low income families than do MFIs.

2.2 MFIs have various development objectives and operational strategies

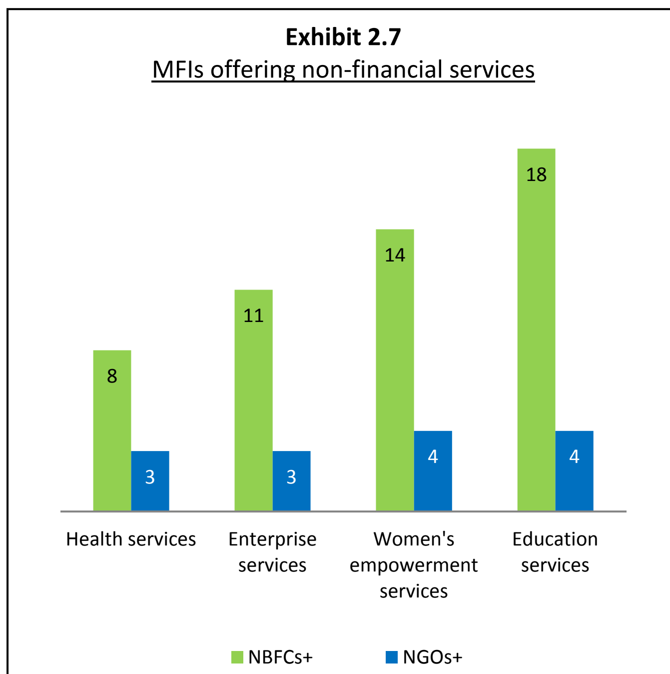
While MFIs generally subscribe to development objectives, the articulation of those objectives tends to be quite variable. **Exhibit 2.5** presents an analysis of the multiple objectives that 24 of the MFIs reporting social

[2] All banking information used in this analysis is taken from RBI, various. **Statistical Tables Related to Banks in India.** Mumbai: Reserve Bank of India. Information for 2007, 2008, 2009, 2010, 2011 has been extrapolated to obtain the 2012 figures (not available currently). Banks' small credit accounts have limits less than Rs2 lakh ($4,000).

performance metrics have selected. As expected, virtually all MFIs include access to financial services and poverty reduction in their statements of objectives. Employment generation, growth of existing businesses of target clients and movement towards gender equality are the other main objectives. Discussion of social and financial performance in this review is based upon these stated objectives.



Progress towards achieving the first two objectives, in particular, is dependent on the selection of clients. This begins with a statement of the target profile of clients for staff to use during the identification process. The income profile of clients stated to be targeted by MFI managements is collated in **Exhibit 2.6**. After many years of debate on the feasibility of poverty reduction through microfinance, significant numbers of MFIs have now realised the need to focus on low income clients – whose incomes may or may not be below the national or international poverty lines but who are, nevertheless, financially excluded. However, systematic poverty targeting is still undertaken by relatively few and ***only four MFIs have provided information on the income profile of their clients*** to the MIX social performance platform. This data is insufficient to justify aggregation or analysis.



Further, increasingly recognising that microfinance alone is insufficient for achieving their development objectives, MFIs aim to offer non-financial services to their target clients. **Exhibit 2.7** summarises the offering of non-financial services by the 25-30 MFIs that have chosen to report on these factors. While a few have well developed add-on services of this type, however, most are in the early stages of developing their non-financial offerings while others provide these as relatively minor add-ons to the financial services that are their main business.

2.3 And MFI portfolios are still substantial relative to micro-lending by the banks

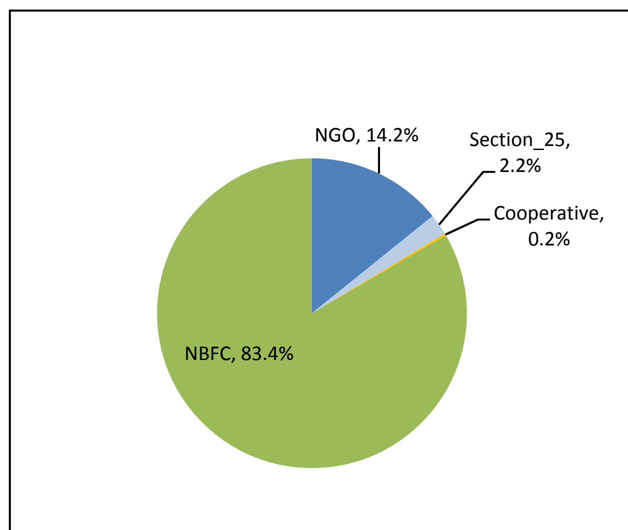
The current sample of Indian MFIs reported a total portfolio outstanding (owned + managed) of Rs18,909 crore ($3,708 million) on 31 March 2012. This was down by 16% on the previous March portfolio of Rs22,521 crore ($5,005 million at the time). However, as discussed earlier, this year's reported portfolio includes a significant proportion of inactive loans on the books of large AP-based MFIs. Removing all the PAR_{90} loans of such MFIs results in an active portfolio of Rs14,702 crore ($2,883 million) implying a decline of 34.7% since the previous March.[3]

[3] It is apparent that some of the portfolios of AP-based MFIs will already have become inactive by 31 March 2011 but

The largest 10 (L-10) MFIs now manage around 69% of the total portfolio of sample MFIs (while serving 73% of all active borrowers); 83% of the portfolio is managed by NBFCs with NGOs accounting for another 14.2%.

Exhibit 2.8

Distribution of outstanding portfolio by legal type



Legal Type	Outstanding Portfolio Rs crore Reported	Outstanding Portfolio Rs crore Revised	Outstanding Portfolio US$ mn Revised	% of total
NGO	2,354	2,089	410	14.2
Section 25	323	323	63	2.2
Cooperative	33	33	6	0.2
NBFC	16,199	12,257	2,403	83.4
India	**18,909**	**14,702**	**2,883**	**100**
L-10	13,763	10,253	2,010	69.7

end of	March 2012* Rs crore	March 2012* MFI portfolio as % of bank	Mar-10 MFI portfolio as % of bank
Scheduled banks	51,60,000	0.29%	0.64%
– a/cs <Rs25,000	49,800	29.9%	41.2%
RRBs	119,000	12.5%	27.6%
– a/cs <Rs25,000	16,600	89.8%	**159.8%**
DCCBs	138,000	10.8%	19.5%

* all data for 2012 is extrapolated from RBI numbers for 2011 & earlier years

While MFI operations remain a small proportion of the overall financial system in terms of money, as already discussed, it is not so in terms of clients served. Even in terms of money, MFI portfolios did (until the onset of the current crisis) grow much faster; bank credit grew by around 21% in 2009-10 when microcredit provided by MFIs grew by 76%. As a result, in terms of portfolio size as well as clients served it was becoming an increasingly significant part of the financial system. As the analysis in **Exhibit 2.8** shows the end-March 2012 portfolio of the MFIs accounts for just 0.29% of the total credit outstanding from the banking system (0.64% in March 2010), but it was still nearly 30% of the micro-credit portfolio of the banking system (41% in 2010), still significantly around 90% of the micro-credit portfolio of the RRBs and around 12% (27%) and 11% (19%) of the total credit outstanding of the RRBs and cooperative banking system respectively.[4]

Two years ago, the **M-CRIL Microfinance Review 2010** suggested that,

"At its current rate of growth the microfinance sector will match the RRBs and exceed the total portfolio in micro-accounts of all scheduled commercial banks within the next three years. [Whether the current rate of growth is sustainable is discussed later in this review]."

The lack of sustainability of this rate of growth was evident to any dispassionate observer for a couple of years before the crisis and became manifest a few days before the publication of the 2010 review; the AP Government stepped in with its ordinance in effect imposing a ban on MFI operations in the state and leading to the drying up of funds for microfinance all over the country as commercial banks responded to the political risk by halting the flow of wholesale loans to MFIs.

there is insufficient information to allow for an adjustment to be made as on that date.

4 All banking data from RBI, 2010. **Statistical Tables Related to Banks in India, 2010-11**. Mumbai: Reserve Bank of India.

As depicted in **Exhibit 2.9**, the average size of an NBFC MFI's portfolio is now down to just Rs299 crore though the L-10 group exceeds Rs1,025 crore (over $200 million). Thus, the L-10 MFIs are still comparable in size to many of the recently amalgamated RRBs. The average portfolio of the 82 RRBs in March 2012 is estimated at Rs1,450 crore. Six MFIs had larger portfolios than the RRB average in March 2011 and 10 MFI portfolios exceeded Rs500 crore ($100 million). Thus, there were 10 MFIs with a portfolio size comparable to RRBs and their combined number of borrower accounts (23.2 million) exceeded the total for all RRBs. ***Since the AP debacle, there are now just 2 MFIs with active portfolios in excess of the RRB average***. The impact on financial inclusion of this reduction in the availability of financial services for low income families needs to be considered.

Exhibit 2.9: Average loan portfolios and loan balance

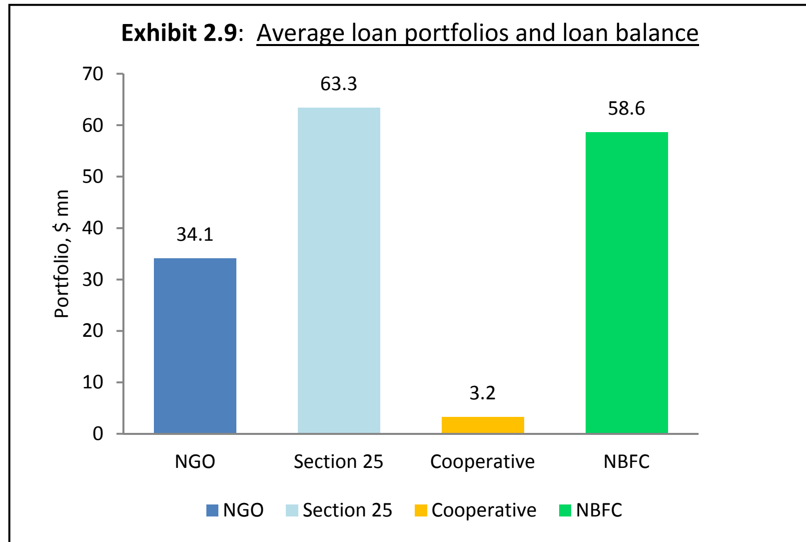


Exhibit 2.10 presents the portfolio size distribution of Indian MFIs. There are 24 institutions with portfolios in excess of Rs100 crore. These large NBFCS account for over 91% of the total outstanding portfolio of MFIs (and 89% of the borrower accounts).

Exhibit 2.10: Portfolio size distribution of MFIs

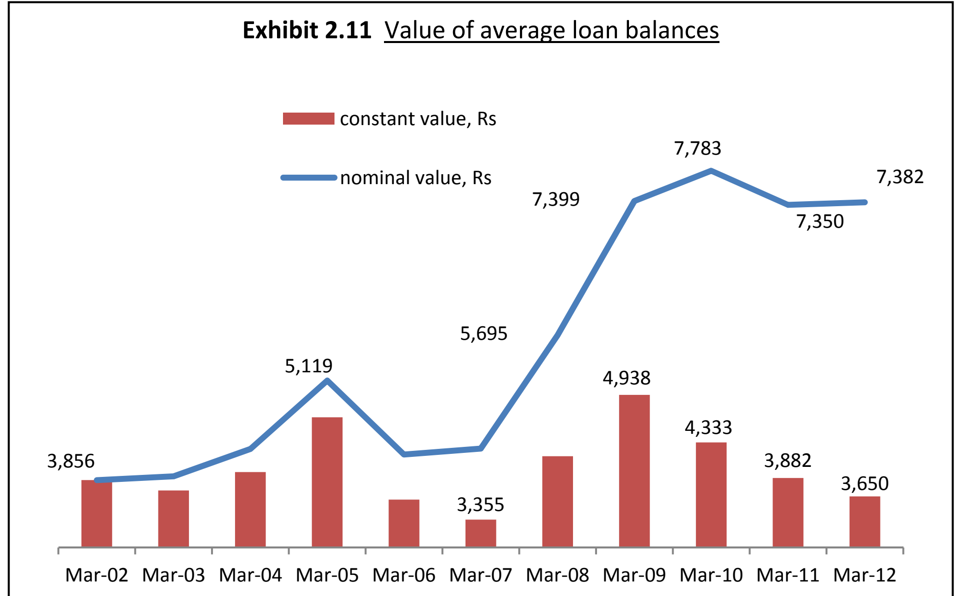
Portfolio Size, Rs crore	Number of MFIs	Rs crore		Proportion of total	
		Portfolio	Average	Portfolio	Borrower accounts
<25	12	170	14	1.2%	2.3%
25 to <50	10	365	37	2.5%	3.1%
50 to <100	10	720	72	4.9%	5.5%
100 to <500	15	2,850	190	19.4%	21.4%
>=500	9	10,597	1,177	72.1%	67.6%
Sample	**56**	**14,702**	**263**	**100.0%**	**100.0%**

2.4 ...though there has been no growth in the real value of average loan balances

In terms of their exposure to individual clients shown in **Exhibit 2.9** (above), at Rs7,221 ($142) NBFCs no longer have the highest outstanding loan balance per borrower at the end of March 2012. Borrowers of not-for-profit MFIs had average outstandings of Rs8,652 ($170) per borrower. Since those most affected by the AP ordinance were mainly large NBFCs, these MFIs have lost large numbers of borrowers in their third or higher cycles (in AP), leaving them with relatively recent borrowers in other states. Since these MFIs started operations in other states more recently, the average loan balances of their clients there are somewhat smaller. NGOs were less affected by the crisis and therefore retain many of their older borrowers.

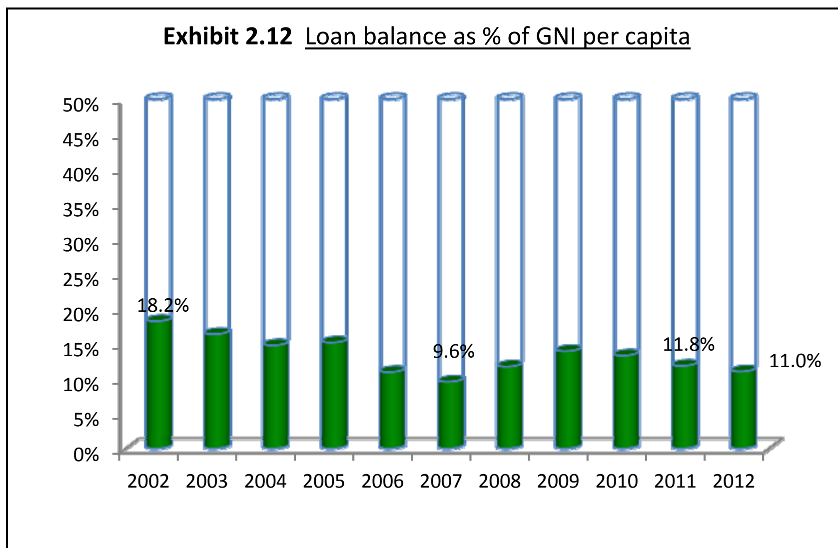
From the perspective of client graduation to higher value activities, the most interesting aspect of loan balances is whether these increase over time in terms of real value. **Exhibit 2.11** presents the real and nominal values of average loan balances of the leading MFIs in India over the 10 year period March 2002 to March 2012.

Exhibit 2.11 Value of average loan balances



As the figure shows, the nominal value of average loan balances was more or less flat for a number of years until March 2007; after that it increased quite significantly as MFIs entered a high growth phase, becoming more liberal with disbursements in the search for efficiency (a reduced OER) enabled by higher loan balances. The process was fuelled by larger sums of money being made available by the banking system for on-lending by MFIs. However, the events of the past two years have resulted in a reversal of this trend on account of the seizure suffered by microfinance in AP and shrinkage elsewhere. Thus the average outstanding loan balance reduced by 5.5% during the year to March 2011 to Rs7,350 ($144) and has stayed flat to March 2012 at Rs7,382 ($145). Given the reduction in the supply of commercial bank funds for on-lending by MFIs since the start of the crisis, it is not surprising that this amount has not increased much over the past year.

Exhibit 2.12 Loan balance as % of GNI per capita



The increase in loan size over the 2007-10 period seems to suggest that MFI clients would be able to undertake higher value economic activities. However, using the Consumer Price Index for Agricultural Labour (CPI_{AL}) to deflate the nominal values provides a less optimistic picture; over the ten year period to March 2012 there was a decline of 5% in the real value of loan balances over the base year (**Exhibit 2.11**). This is during a period when India's GNP per capita increased by nearly 220% from $470 in 2002 to $1,489 in 2012. The decline in 2010-11 wiped out the 12% increase in real value there had been until then. **Exhibit 2.12** illustrates the extent to which MFI loan balances have not kept pace with the increase in GNI per capita. Average loan balance as a proportion of GNI per capita fell from 18.2% in 2002 to just 9.6% in 2007 before increasing to 12-14% over the next few years and then falling back again against the background of the microfinance crisis. Thus, **in real terms the MFI contribution to the economic lives of the low income families they serve has actually reduced around 40% over the past decade** and the crisis has had a further dampening effect on that contribution.

2.5 Is multiple lending, and consequent over-indebtedness, the villain of the piece?

[The discussion in this section is revised from the 2011 Review and uses information for end-March 2011. Refinements include a revision of average family size to 4.4 from 5.0, financial exclusion to 65% from 60%. As before, the poorest 10% are assumed not to be eligible for microfinance loans – excluded from borrower groups by the joint liability principle].

As the discussion in this section shows, the disruption in Indian microfinance caused by the AP ordinance is substantial. The apparent reasons for the ordinance were

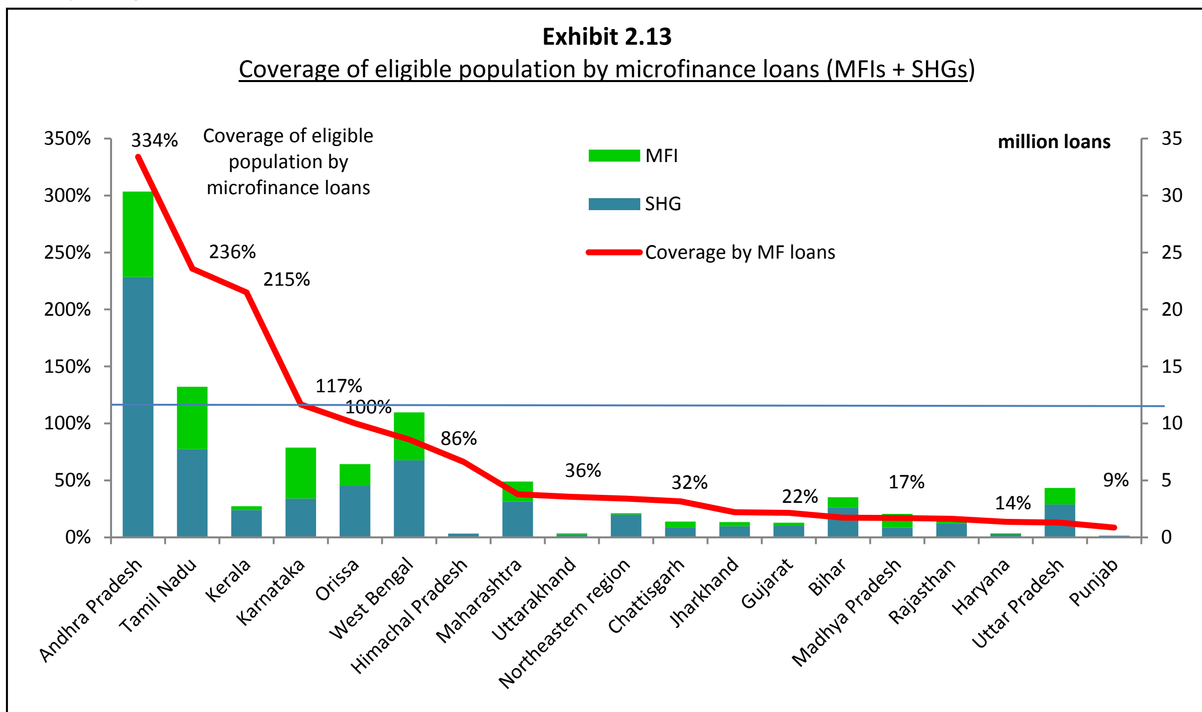
- Excessive lending by MFIs in the state of Andhra Pradesh leading to over-indebtedness which caused distress to low income microfinance borrowers
- Coercive behaviour by MFI staff in collecting from these over-indebted borrowers suffering from the stress of keeping up with their repayment obligations.

Whether or not there has been excessive lending in AP (and in other states of India) and who is responsible for it is assessed in the analysis in Annex Tables 2.1 & 2.2. **Annex Table 2.1** collates the numbers of SHG loans outstanding in various states on 31 March 2011 alongside MFI loans outstanding. The number of SHG loans is obtained from NABARD's now excellent data on the subject and the number of MFI loans is extrapolated using the all India information available for the M-CRIL sample for March 2011 and the state-wise information collated last year by Sa-Dhan. State-wise MFI data for March 2011 is not available presumably on account of the reluctance of many MFI managers to report substantially reduced portfolios as a result of the ongoing crisis.

This analysis assumes that it is only financially excluded low income families that would want microfinance loans. While precise data is not available, it is estimated (as discussed in **Section 1**) that the degree of financial exclusion at the national level is of the order of 65%. Relating this to the 55% poverty rate (based on the latest multi-dimensional poverty index, MPI)[5] suggests that 17% more people are financially excluded than can actually be classified as poor based on the index. Using the state-wise MPI poverty rates, therefore, the table shows the financial exclusion ratio for each state. Comparing the number of microfinance loans (whether from MFIs or SHGs) to the number of finan-

Exhibit 2.13

Coverage of eligible population by microfinance loans (MFIs + SHGs)



[5] Oxford Policy and Human Development Initiative, 2010. **Country Briefing: India**. http://www.ophi.org.uk/wp-content/uploads/Country-Brief-India.pdf

cially excluded families then yields the extent of microfinance coverage of those excluded families. As the table shows, assuming a one-to-one correspondence between the number of microfinance loans and financially excluded families, the extent of coverage nationwide amounts to 61%. However, it is clear that a one-to-one correspondence amounts to an assumption of heroic proportions; the best that can be said is that financially excluded families are covered by micro-loans from the SHG or MFI sectors to the extent of 40-50%. To the extent that the amount of each loan is also inadequate for most families' needs, the scope for further expansion of microfinance in India remains substantial.

The state-wise picture is, however, much less sanguine. The states have been arranged in the table (and in **Exhibit 2.13**) by the extent of microfinance coverage of their financially excluded families in 2010-11. **Andhra Pradesh had**, by far, the highest coverage of 334% – **for every excluded family** (eligible for microcredit) **more than three microfinance loans outstanding** at end-March 2011. All the other main southern states –Tamil Nadu (290%), Kerala (236%) and Karnataka (117%) – also had high coverage ratios along with Orissa (100%) and West Bengal (86%).[6] Since distribution across districts and across families is well known not to be even, it is apparent that there is significant multiple lending in all of these states. What is interesting here, however, is the fact that, particularly in AP, **while the number of MFI loans was just over 80% of the number of eligible financially excluded families, SHG loans were actually 250% of that number**. More importantly, to the extent that microfinance loans are not evenly distributed this means that there were a significant number of financially excluded families in AP that had as many as 5-6 loans at one time and a number of these were SHG loans. The results of the analysis are presented in the exhibit above. *This raises the question whether it was SHG rather than MFI lending that was responsible for the crisis.*

Annex Table 2.2 presents an analysis of indebtedness in microfinance. It shows that the average outstanding SHG loan at end March 2011 was Rs4,831 nationwide and Rs5,847 in AP. The national average for MFI loans was Rs7,350 (for which state-wise averages are not available). This means that the average microfinance debt per eligible family was over Rs21,000 for AP[7] compared with the national average of Rs5,664. At an effective interest rate of around 28% this translates to average monthly repayment amounts of Rs3,400 for each eligible family in AP compared with Rs930 for the country. Taking into account the fact that perhaps no more than 60-70% of the national population has been reached by microfinance (through either SHGs or MFIs), this means a national average monthly instalment of the order of Rs1,500 for each borrowing family while in AP it is likely to be over Rs4,500 for most borrowing families and in excess of Rs7,000 for some. An instalment of over Rs4,500 per month amounts to around 55% of the average annual income of around Rs103,000 for each eligible family in AP and a clear indication of over-indebtedness in that state in 2010-11.

For this analysis, each eligible family is assumed to earn an average of 40% of the state per capita income (see Column 9 of the table). This is a crucial assumption but it corresponds to average income estimates at between \$1.5 a day and \$2 a day for India,[8] roughly the expected level of income for financially excluded families in India since 75% of the population is estimated to live on less than \$2 a day. **At lower levels of income since income and**, along with it, **debt servicing capacity decreases, the extent of over-indebtedness actually increases**.

As the table shows, even if the debt were distributed equally amongst all eligible families there would **just** be a balance of indebtedness in AP (in 2010-11) – assuming that 40% is the maximum

[6] This analysis takes into account the fact that the bottom 10% of the population (by income) is perceived by the rest of the population as near-destitute and is, therefore, unlikely to be included in microfinance where the joint liability principle creates an inherent disincentive to include people who are unlikely to be creditworthy.

[7] Calculated as 3.1 times the average SHG loan + the average MFI loan since there is one MFI loan outstanding per eligible family in the state.

8 By Mark Schreiner, developer of the Progress out of Poverty Index (PPI), sponsored by the Grameen Foundation.

reasonable debt servicing capacity at this level of income. [This analysis assumes that the debt servicing capacity (as a proportion of family income) declines with lower incomes as families need larger proportions of their incomes to meet their basic needs]. Given that debt is clearly not distributed equally amongst eligible families, this analysis points to some over-indebtedness in the state.
Who is responsible for over-indebtedness in the country is a question that needs to be addressed. Information on the proportion of microfinance debt provided by MFIs is presented for the major states in **Annex Table 2.2**. This shows that, of the six leading states in microfinance, the SHG portfolio actually exceeds the MFI portfolio (in 2010-11) in four states. In AP the SHG portfolio amount is 2.4 times the MFI portfolio and in Kerala it is more than 6 times the MFI portfolio. It is apparent that, if there is over-indebtedness in AP it is not purely on account of the MFIs, contrary to the assertions of much of the establishment; lower levels of outstanding debt (relative to incomes) in the other major microfinance states means that over-indebtedness has not yet emerged as a major issue there.

As is apparent from the table, there are also indications of over-indebtedness in Bihar, Madhya Pradesh and Uttar Pradesh – three of the largest states in the country on the basis of population. Each of these states has much lower per capita incomes and, therefore, lower proportions of family income available for debt servicing (as shown in **Annex Table 2.2**). The reason this has not led to a crisis in those states is that the microfinance penetration there is just 16-21% and it is likely that the outreach of both SHGs and MFIs is mainly to the upper strata of eligible families. Further expansion of microfinance in these states could cause more serious repayment problems than the few incidents that have come to light so far, unless the average debt is lowered.

2.6 And deposit services remain a distant dream due to the extremely cautious approach of the regulator

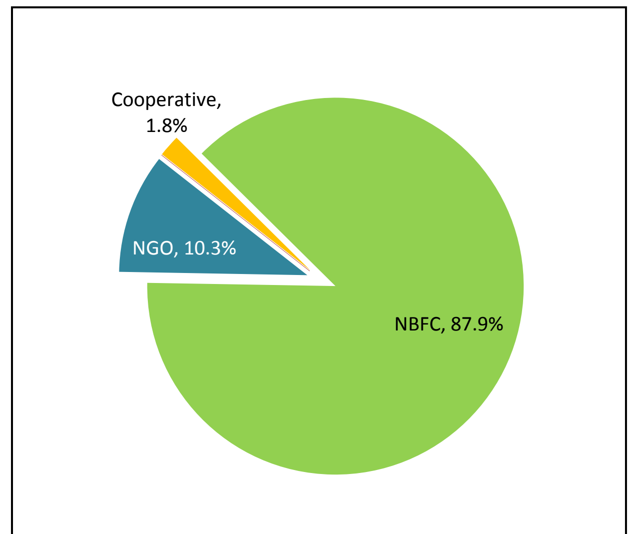
Thrift deposits are accepted formally by MFIs from their members and are recorded as part of their balance sheets wherever these are legally permitted. The magnitude of MFI deposit services in India is limited by the fact that very few MFIs are allowed by the regulator to offer such services. Those registered as non-bank finance companies (NBFCs), regulated by the RBI, may offer such services only after obtaining an investment grade rating from a recognised corporate rating agency. Only two NBFC MFIs have been able to get such ratings so far and even these can only accept deposits under highly restrictive conditions.

Approximately half of the MFIs in the analysis (including all Section 25 companies) have not provided data on savings since such services are technically illegal under the RBI Act. In addition, many NBFCs have not reported on deposits. The deposit amount may be greater than reported given that NBFCs generally collect security deposits/cash collateral (usually interest free) from their clients up to a certain (around 10%) proportion of the loan. Some of these deposits do not show on the balance sheet of the MFI, being collected, in practice, by the MFI staff but deposited with structures such as client federations and mutual benefit trusts that benefit from regulatory forbearance.

Whether or not the deposit is on the MFI balance sheet, the amount is refunded at the end of the loan term or when the client exits from the programme. According to the available information, the sample of 56 Indian MFIs raised a total of Rs925 crore ($205 million) in thrift deposits as of 31 March 2012, a small increase of 10% over the previous year. **Exhibit 2.14** presents savings mobilised on the basis of legal forms of MFI.

Exhibit 2.14
Savings/Deposits by legal form

Legal Form	Savings/ Borrower (Rs)	Deposits (Rs crore)	Deposits/ Loans (%)
NGO	269	95.3	4.1%
Section 25	-	-	0.0%
Cooperative	1,615	17.1	27.9%
NBFC	304	813.3	4.1%
Sample	**298**	**925.7**	**4.1%**
L-10	257	613.2	3.5%



Due to the lack of regulatory tolerance of deposit mobilisation, development and innovation in the provision of deposit services has been negligible. From **Exhibit 2.14** the average savings from NGOs and NBFCs represent a paltry 4% of the loans outstanding compared to levels of 30-40% in Bangladesh and Indonesia (though the data for India, as indicated above, is incomplete and the real figure is likely to be 8-9%). Growth in deposits would not only bolster the availability of funds to MFIs it would also assist in reducing default risk by increasing the proportion of average loan balance secured by member deposits. This rounding out of the relationship between MFIs and clients – as suppliers as well as users of funds – would help to reduce the risk of coercive collection practices by MFI staff. This is a matter that lies at the centre of the microfinance crisis since it is allegations of coercion leading to suicides by MFI borrowers that led to the AP Government's action against the sector. A two way relationship incorporating deposits as well as loans would be much more wholesome, requiring a greater investment by MFIs in customer satisfaction than has been seen so far.

2.7 While the rural bias of MFI operations is reducing but, in any case, does not necessarily indicate particular poverty orientation

Exhibit 2.15
Rural/Urban breakdown

Area	MFIs	% of active borrower a/cs
Rural	45	57.6%
Urban	47	42.4%

Unlike much of Latin America and Eastern Europe, in particular, MFIs in India (and much of Asia) do not necessarily operate in urban areas. On the contrary, many of the leading MFIs started as rural institutions having located there on the assumption that poverty was largely a rural phenomenon. It is only the MFIs formed in recent years that have placed emphasis on urban operations seeing this as an easy way to limit costs and maximise profits. Though these latter institutions have been amongst the fastest growing, they have not been able to work exclusively in urban areas. Thus, 45 of the 52 MFIs reporting disaggregated outreach data work in rural areas while 47 work in urban areas; there are only 7 MFIs that do not have rural operations and 5 do not operate in urban areas at all (**Exhibit 2.15**). This aggregates to 57.6% of all MFI borrower accounts being held by rural-based clients (in March 2012) while urban clients held 42.4%. Over time, the rural-urban imbalance is declining as MFIs have shifted their developmental focus from more remote rural areas to easier-to-reach urban areas. That this rural-urban mix has nothing to do with the poverty profile of microfinance clients is part of the rating experience of M-CRIL. Hopefully, the recent heightened concerns for social performance will see more extensive client profile information becoming available – as a routine part of MFI reporting. In any case, it is apparent that rural location alone is not a good proxy indicator of poverty orientation, contrary to popular assumption in international discussion.

2.8 ...but social rating data from a limited number of MFIs does indicate the need for better systems alignment to achieve greater depth of outreach

Though a large volume of information on depth of outreach is not available, **Exhibits 2.16 & 2.17** summarise the information collected by M-CRIL from the social ratings of Indian MFIs over the past two years. It uses the depth of outreach below the $2 a day income level of clients for 11 MFIs with predominantly rural clients and another 4 MFIs with mainly urban clients and one with both rural and urban that spans both sets. The data used is either for entry level clients or for all clients since consistent data purely on entry-level clients is not available. Comparing client outreach to the state population with income below '$2 a day' shows that MFI client profiles are getting close to matching the proportion of state population below this level. However, the wording of MFI mission statements on poverty reduction suggests that their client profile should have deeper outreach than the state average, something they have yet to achieve consistently in a significant number of cases. Thus, it is apparent that MFIs need to work harder – in terms of aligning systems for client selection, ensuring the design of products serves the actual needs of poorer clients and aligning staff incentives – to achieve the depth of outreach that will enable them to make a greater contribution to financial inclusion for the poorer sections of the population.

Exhibit 2.16: Outreach to clients with incomes <$2 a day - rural

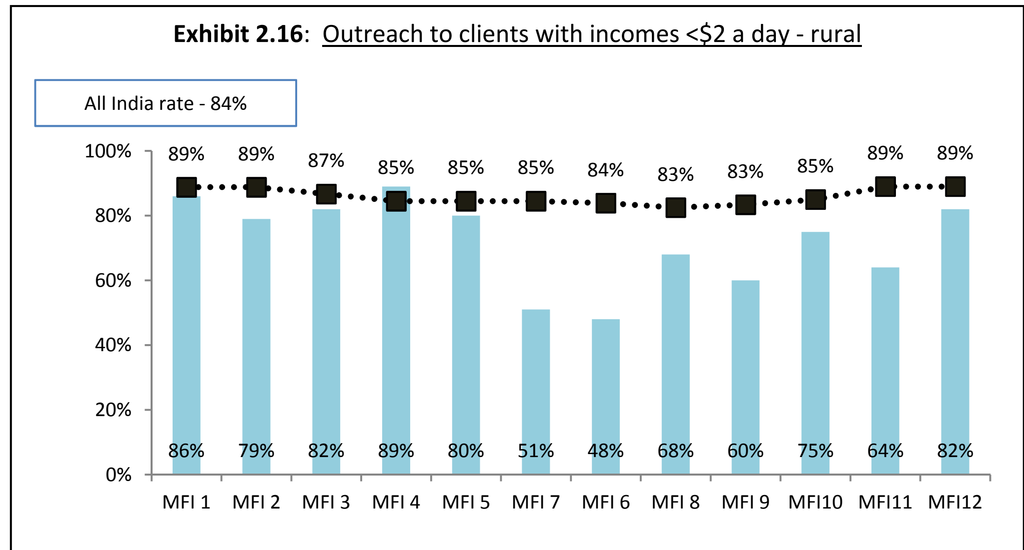
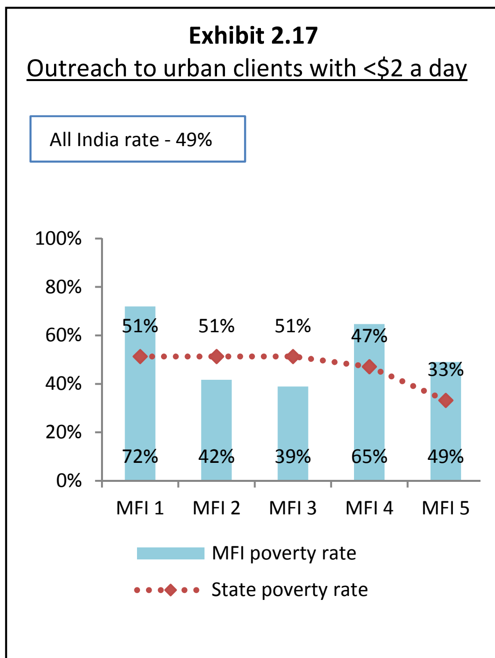


Exhibit 2.17

Outreach to urban clients with <$2 a day



2.9 ...though the principle of responsibility in the provision of microfinance services is gradually taking hold

The concern for responsible microfinance is reflected in the Codes of Conduct developed by MFIN and Sa-Dhan, and internationally in the client protection principles developed through the SMART Campaign. M-CRIL has, until now, included evaluation of responsibility to clients as part of Social Rating. During 2011, along with other specialist rating agencies, M-CRIL piloted a Responsible Finance Rating product, now renamed and launched as the Microfinance Institutional Rating (MIR). The MIR evaluates responsible performance including governance, client protection and responsibility to staff as well as a balanced level of profit as part of the overall rating of sustainability and risk. In India, M-CRIL has also undertaken Code of Conduct Assessments (COCAs) for Sa-Dhan and for SIDBI. M-CRIL's approach is to rate elements across the Codes of Conduct jointly agreed by the two

industry associations, incorporating the guidelines that have evolved around the international client protection principles and including compliance with the RBI's code of Fair Practices for NBFCs, the July 2011 RBI guidelines for priority lending to microfinance and the circulars on regulations for NBFC MFIs – 2 December 2011 and 3 August 2012.

The **following is a summary of some of the main issues** from the COCAs, RFR/MIRs and Social Ratings of leading MFIs in India, undertaken during the past two years.

Integrity: The microfinance networks expect member MFIs to adopt a Code of Conduct through formal adoption by the Board. Leading MFIs have started to do this since late 2010. Some have also signed on to the global Client Protection Principles. There has been some confusion as MFIs have tried to combine features from the different documents. Within the past year, efforts (by the two networks and SIDBI) to converge the Codes for the India microfinance sector have resulted in the emergence of a single code of conduct that guides the practice of responsible microfinance.

For MFIs, following adoption by the Board, the next essential step is to introduce specific guidelines as part of operations: in the operations manual, in training for staff and in monitoring compliance through internal audit. These steps are still works in progress, and it takes time, especially for large MFIs, to introduce systematically as part of their operating culture. Overall, the incorporation of standards in the Codes of Conduct remains relatively weak. However, some MFIs have made an exceptional effort to ensure that their practices conform to the codes of networks and guidelines of regulators, to the extent of commissioning agencies like M-CRIL to validate the process.

Governance: Good governance has always required having a number of independent directors, with relevant professional skills, and their engagement through regular meetings and access to information. Responsible microfinance adds involvement of the Board in defining and reviewing sustainable rates of growth, responsible level of profit and allocation, remuneration of the CEO, and understanding and regular review of compliance with standards of client protection. MFI Boards are beginning to apply this part of their role of safeguarding stakeholder interests, depending on their exposure to expected standards.

Competition: There is increasing awareness of the need to deliver microfinance services to underserved regions and areas. At the same time this requires a systematic method to identify underserved areas. District level outreach being reported to Sa-Dhan this year may help to do this. Nevertheless, there is some indication of the over-stretching of management systems as MFIs seek to expand into different states. MFIN guidelines limiting recruitment of staff from other MFIs have low application in a situation where MFIs are having to consolidate if not cut back their operations. However, the principle is recognised and will require internal monitoring as part of HR systems.

Client protection: Of the seven principles of client protection, two - **appropriate product design** and **responsible financing** – are to some extent covered, at least for credit, under the new RBI guidelines, including more flexible options for repayment of loan instalments and a cap on interest rates, which MFIs now expect to implement. Apart from these, the direct appraisal of household cash flows and existing liabilities (to **prevent over-indebtedness**) as well as ensuring **effective transparency** with clients are major challenges for MFIs who have relied on standard loan products, peer assessment and the role of group leaders within the group methodology. A focus on these aspects requires different operational formats, training of field staff to apply them and to communicate – and ultimately sufficient time for field staff to engage effectively with clients. Most MFIs have printed details of fees, interest and instalments due on individual loan cards of group members; though sometimes this remains group based (kept by group leaders) and individual members do not have copies. Receipts for repayments are usually provided. Credit-life insurance details are not al-

ways provided along with the loan information – either the premium or details of coverage and process to claim, in the local language.

In general, in the group based model, MFIs have relied on the initial Group Recognition Test training – which consists of introductory sessions of up to 1 hour over 3 days. Feedback from clients during rating indicates that this needs to be reinforced by follow up explanations and communication. MFIs also prefer to ensure that clients know the repayment instalment, without ensuring understanding of the Effective Interest Rate – and it remains a moot point as to what clients find most relevant, though this is related to financial education (below).

Most MFIs are now sharing data with the Credit Bureaus that are active in microfinance – particularly with High Mark (the bureau in which MFIs have invested jointly), mostly addressing issues of matching Client IDs, though Household IDs are not covered which may be a gap in future to the extent that liabilities are a household characteristic, not only relating to an individual woman client.

MFIs are developing guidelines for **appropriate staff behaviour**, including procedures in case of default. These appear most effective when specific practices – do's and don'ts – are listed, and when there is a formal phasing of action in case of default, which includes distinguishing reasons for default, and the option for rescheduling loans in cases where clients are facing temporary and genuine difficulties in repayment – only using peer pressure and social collateral to a limited extent in the group model.

Mechanisms for client feedback and **resolution of complaints** are receiving more systematic attention – with many MFIs now including telephone numbers on the loan cards as well as having a designated person to receive and register complaints. In a few MFIs, senior management or Board members are asking for regular reports with complaints categorised together with action taken – which is a positive development.

MFIs are beginning to consider opportunities for **financial education** of clients, going beyond the basic details of financial products offered to a wider consideration of financial planning, budgeting and managing debt.

The overall growth of outreach in terms of borrowers, portfolio outstanding, loan sizes, and savings discussed in this section inevitably affects operating expenses and portfolio performance of MFIs. These issues are discussed in the next chapter.

Annex Table 2.1

Coverage of financially excluded population by microfinance service providers

States of India	Population (million)		Poverty rate (based on MPI)	Calculated rate of financial exclusion	Financially excluded families (mn)	Microfinance loans (million)			
	persons	Families				SHGs	MFIs	Total	% coverage of excluded families*
		Family size = 4.4		117.3%	eligible for microcredit				microfinance penetration
Andhra Pradesh	84.7	19.25	44.7%	52.4%	10.10	22.87	7.48	30.34	334.0%
Tamil Nadu	72.1	16.39	32.4%	38.0%	6.23	7.75	5.47	13.22	235.8%
Kerala	33.4	7.59	15.9%	18.7%	1.42	2.41	0.34	2.74	215.1%
Goa	1.5	0.33	21.7%	25.5%	0.08	0.13		0.13	167.7%
Karnataka	61.1	13.89	46.1%	54.1%	7.51	3.41	4.47	7.89	116.6%
Orissa	41.9	9.52	64.0%	75.1%	7.15	4.52	1.91	6.44	100.0%
West Bengal	91.3	20.75	58.3%	68.4%	14.19	6.77	4.21	10.98	85.9%
Himachal Pradesh	6.86	1.56	31.0%	36.4%	0.57	0.34		0.34	66.4%
Maharashtra	112.4	25.55	48.1%	56.4%	14.42	3.14	1.76	4.90	37.8%
Uttarakhand	10.1	2.30	40.3%	47.3%	1.09	0.25	0.10	0.35	35.6%
Northeast region	45.0	10.22	57.6%	67.6%	6.91	2.01	0.11	2.12	34.1%
Chattisgarh	25.5	5.80	71.9%	84.4%	4.89	0.85	0.55	1.40	31.7%
Jharkhand	33.0	7.50	77.0%	90.3%	6.78	0.98	0.37	1.35	22.1%
Gujarat	60.4	13.73	41.5%	48.7%	6.68	1.01	0.29	1.29	21.5%
Bihar	103.8	23.59	81.4%	95.5%	22.53	2.62	0.90	3.52	17.4%
Madhya Pradesh	72.6	16.50	69.5%	81.5%	13.45	0.85	1.21	2.06	17.0%
Rajasthan	68.6	15.59	64.2%	75.3%	11.74	1.22	0.51	1.73	16.4%
Haryana	25.3	5.75	41.6%	48.8%	2.81	0.26	0.08	0.35	13.7%
Uttar Pradesh	199.6	45.36	69.9%	82.0%	37.20	2.89	1.45	4.34	13.0%
Punjab	27.7	6.30	26.2%	30.7%	1.94	0.15	0.00	0.15	8.7%
Jammu & Kashmir	12.5	2.84	43.8%	51.4%	1.46	0.03	0.00	0.03	2.2%
All India	**1,210.0**	**270.29**	**55.4%**	**65.0%**	**175.69**	**64.62**	**31.93**	**96.56**	**61.1%**

*Assumes 10% of all excluded families are destitute and, therefore, ineligible for microfinance debt.

Annex Table 2.2

Assessment of likely overindebtedness/Scope for further lending by microfinance service providers

Amounts in Indian rupees unless otherwise stated

States of India	SHG outstanding Rs/member	Microfinance outstanding Rs million	MFI debt as % of total	Average mf debt/ excluded family	Monthly payments due	...or weekly payments	To be paid from daily wage	40% of average family income	Annual payment, % of family income	Estimated debt servicing capacity	Scope for further lending
		Rs7,350 per MFI loan			Avge 7 instalments	...or 30 instalments	300 working person days/family	Average income financially excluded			% of family income
Column (1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Andhra Pradesh	5,847	188,655	29.1%	20,763	3,411	796	136	102,050	40%	40%	0%
Tamil Nadu	5,837	85,452	47.0%	15,242	2,504	584	100	124,998	24%	45%	21%
Kerala	6,537	18,190	13.5%	14,272	2,345	547	94	118,358	24%	45%	21%
Goa	3,605	460	0.0%	6,046	993	232	40	265,438	4%	60%	56%
Karnataka	6,586	55,352	59.4%	8,188	1,345	314	54	101,352	16%	40%	24%
Orissa	3,492	29,866	47.1%	4,641	762	178	30	66,452	14%	20%	6%
West Bengal	2,215	45,948	67.4%	4,185	688	160	28	82,938	10%	30%	20%
Himachal Pradesh	4,717	1,599	0.0%	4,717	775	181	31	100,730	9%	35%	26%
Maharashtra	3,324	23,376	55.3%	4,768	783	183	31	148,054	6%	50%	44%
Uttarakhand	4,248	1,773	39.7%	5,102	838	196	34	111,754	9%	40%	31%
Northeast region	3,426	7,674	10.3%	3,625	596	139	24	59,890	12%	15%	3%
Chattisgarh	2,224	5,925	68.3%	4,245	697	163	28	76,118	11%	25%	14%
Jharkhand	3,293	5,946	45.9%	4,409	724	169	29	61,438	14%	15%	1%
Gujarat	1,545	3,665	57.6%	2,834	466	109	19	127,922	4%	45%	41%
Bihar	3,036	14,556	45.3%	4,136	679	159	27	32,238	25%	10%	-15%
Madhya Pradesh	4,442	12,678	70.1%	6,146	1,010	236	40	54,500	22%	10%	-12%
Rajasthan	3,650	8,236	45.9%	4,747	780	182	31	68,378	14%	20%	6%
Haryana	7,582	2,598	23.7%	7,526	1,236	288	49	157,562	9%	50%	41%
Uttar Pradesh	5,844	27,551	38.6%	6,346	1,043	243	42	46,264	27%	10%	-17%
Punjab	5,249	794	0.0%	5,249	862	201	34	124,306	8%	45%	37%
Jammu & Kashmir	3,970	116	0.0%	3,970	652	152	26	61,164	13%	15%	2%
India	**4,831**	**546,931**	**42.9%**	**5,664**	**931**	**217**	**37**	**102,994**	**11%**	**35%**	**24%**

Chapter 3

Operating efficiency has been strongly affected

3.1 Cost efficiency has declined due to the crisis and its aftermath

As financial service agencies operating in a low technology arena, microfinance institutions are heavily dependent on staff for ensuring efficient and effective operations. Staff productivity measured by the number of clients served per staff member is, therefore, an important factor determining the efficiency of MFIs and feeds directly into the determination of the average cost per borrower served.

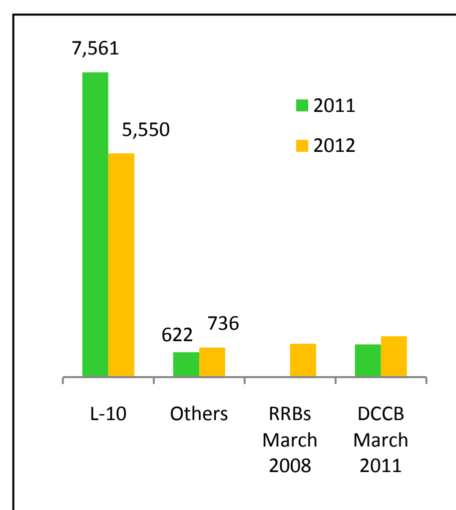
3.1.1 Staff numbers and productivity are comparable with the overall financial system though the MFIs have smaller size accounts that are growing more slowly than the rural banks

The 56 MFIs in this analysis have a staff strength ranging from 58 to 16,194; with a total of 89,372 – a decline of nearly 30% for the largest MFI. The average number of staff in the cohort is now 1,596, down from 1,798 per MFI in the previous year. Given the degree of concentration, it is appropriate to consider the L-10 (average 5,550 staff compared to 7,561 last year) separately from the other 46 MFIs. The latter group has an average of 736 (622 last year) staff members, substantially higher than the MIX benchmark 324 for East Asia/Pacific but lower than the 890 average for South Asia (though on a lower reporting base of large MFIs). As **Exhibit 3.1** shows, as for loan accounts and portfolio, the MFIs are comparable with the RRBs and DCCBs employing 30% more staff than the 68,000 employed by RRBs in March 2008 and nearly a quarter of the 378,500 persons employed by the financial cooperative system (DCCBs + PACS) in 2010-11.

Exhibit 3.1

Average staff employed by sample MFIs

Legal Type	Total staff	Average number of staff /institution
NGO	14,710	1,226
Section 25 Company	1,406	1,406
Cooperative	216	108
NBFC	73,040	1,781
All MFIs	89,372	1,596
L-10	55,499	5,550
Others	33,873	736
RRBs, March 2008	68,124	831
DCCB + PACS, March 2010	378,468	1,020



For measuring the efficiency of human resource utilisation, staff productivity ratios – clients per member of staff and outstanding portfolio per member of staff – are the two key indicators. This Review does not use the client-to-loan officer ratio and portfolio-to-loan officer ratio. The reason for this is the difficulty of classifying staff as loan officers across MFIs. Many MFIs give field officers responsibility for all functions related to microfinance groups. In this situation the definition of who is a loan officer is clear. In other MFIs, however, field officers are responsible for group formation and record keeping but branch-based tellers make disbursements and collect repayments as well as performing other branch office functions. This is just one example where the distinction between loan officers and other staff is unclear.

Exhibit 3.2
Staff productivity

Legal Type	Accounts/ staff member		Portfolio ser-viced/staff member	
	2011	2012	Rs Lakh	$ '000
NGO	242	164	14.2	27.8
Section 25 Company	267	327	23.0	45.1
Cooperative	362	311	15.3	30.0
NBFC	301	232	16.8	32.9
All MFIs	293	**223**	**16.5**	**32.3**
L-10	316	264	18.5	36.2
RRBs	282	n.a.	136.8	268.2
DCCBs/PACS, 2011	138	n.a.	23.2	45.5

Staff productivity by legal type/form of registration is depicted in **Exhibit 3.2**. The current level of average portfolio per staff member, Rs16.5 lakh or nearly $33,000, is significantly lower than last year's Rs21 lakh/$47,000. Due to the substantial write-offs in their portfolios in AP, NBFCs are no longer ahead of the other legal forms.

Staff productivities, (average 223 clients per staff) lower than last year, are now comparable with the Asian bench-marks of the MIX (250 for South Asia and 232 for East Asia/Pacific). Here, a comparison with the rural banking system shows that MFIs are no longer more productive than the RRBs (average 282 credit accounts per staff member) but still substantially more so than the cooperative system, though is not entirely an appropriate comparison since bank/primary agricultural cooperative (PAC) staff also service deposit accounts.

The sample average of 223 borrowers per staff member is somewhat lower than the L-10 average of 264 which represents a reduction in productivity to the same levels as the 231 borrowers per staff member of the 2007 review. The portfolio serviced by average MFI staff Rs16.5 lakh ($32,000) represents a 33% improvement in productivity (in real terms/at constant prices) over the Rs7.8 lakh per staff member in 2007. This amounts to a 5.8% annual improvement in productivity over 5 years though it is a substantial reduction from the 16% per annum productivity increase recorded until the previous year.

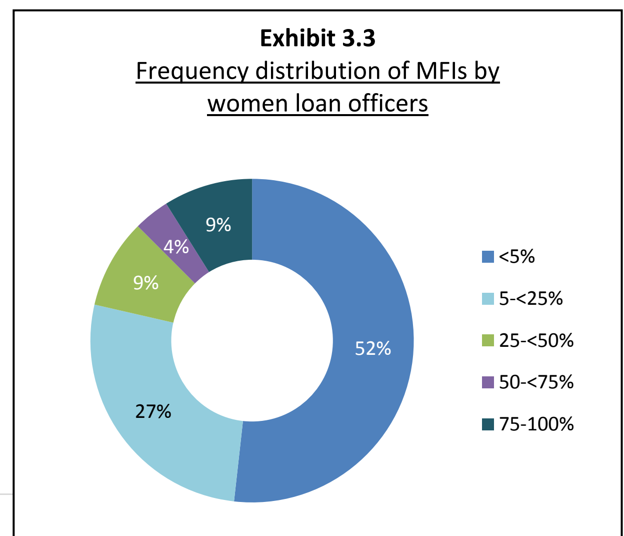
In comparison with the MFIs, RRBs with their much larger average loan size of Rs45,500 are at a substantial advantage servicing Rs136 lakh ($267,000) worth of loan portfolio per staff member and over Rs300 lakh worth of business (including deposits). As discussed in **Chapter 2**, the average MFI outstanding per account has been more or less constant over the past three years. However, according to the RBI data, the average micro-credit account with the RRBs (<Rs25,000) has increased by 19% during this period. In real value terms (at constant prices) this represents a decline of 12% in the average value of an RRB micro-credit account compared to a (greater) 26% decline in the average value of MFI accounts over the same period.

The DCCBs have a level of business per account that is much closer to the MFI average, the portfolio serviced per employee being just 25% more than the average for the L-10 MFIs.

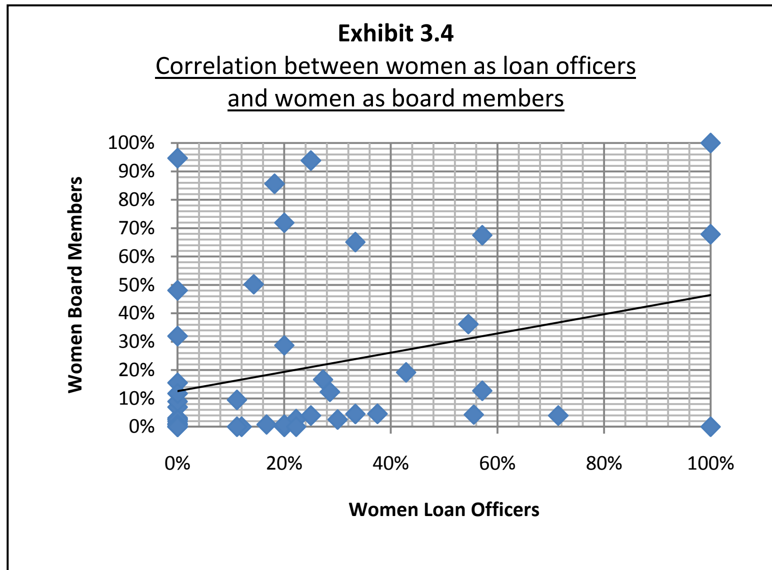
3.1.2 ...but there are relatively few women loan officers

The number of loan officers employed by the 56 MFIs in the sample is 50,575 of whom just 5,300 or 10.5% are women. **Exhibit 3.3** shows that as many as 52%

Exhibit 3.3
Frequency distribution of MFIs by women loan officers

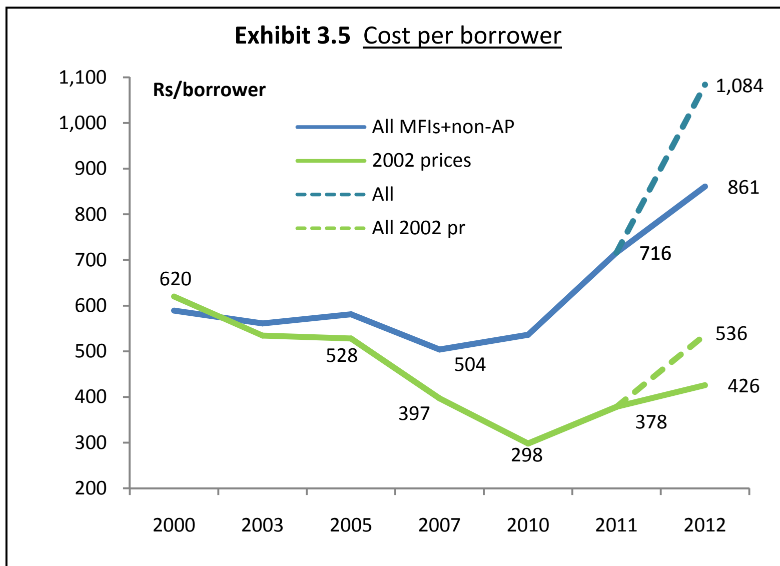


of the MFIs have less than 5% women and just 7 MFIs (12.5%) have more than 50% women loan officers. This is despite the fact that 96.3% of all clients are women (based on data from 53 reporting MFIs). Many MFI managers feel that the loan officers' job of staying in constant contact with clients in their communities, on the one hand, and with branch offices on the other requires long hours of work and much field travel, an arduous task that is difficult for women to perform. The effect of women loan officers on the cost profile and portfolio performance of MFIs is also analysed in this chapter. While there is a positive relationship between women Board members of MFIs and the proportion of loan officers who are women, the correlation is rather weak (**Exhibit 3.4**). Thus, as shown, MFIs with 100% women loan officers could have anything from 0 to 100% women as board members. The weak correlation is apparently related to the challenges faced by MFIs in employing women for a difficult task entailing considerable (if local) travel to field areas and often long working hours.



3.1.3 Cost per borrower has risen sharply as MFIs first pursued growth at all costs and now have to put considerable effort into client protection measures and follow up of repayments

The cost incurred by Indian MFIs in servicing loan accounts is very low in comparison with the global benchmark of $85 global average on the MIX.[1] Even when compared with other Asian MFIs, the cost per borrower (now up to Rs1,084 for all MFIs, $21 up from Rs716, $16 in the previous year) amounts to just 34% of the East Asian median of $61 and is also substantially lower than the MIX median for low end MFIs internationally ($64). It is greater than the average cost of Rs956 ($19) incurred by the L-10 institutions during 2011-12. The trend in the average cost per borrower for the delivery of micro-loans in India is shown in **Exhibit 3.5**. The Indian numbers make international microfinance seem extravagant with only Bangladesh and Nepal at lower levels. These numbers are, however, in absolute terms and do not take into account differences in standards of living across the region. Nevertheless, it is notable that there has been a 100% increase in the average cost for all MFIs over the past two years from Rs536 per borrower in 2009-10. This is attributable to the high "growth at all costs" pursued by MFIs in



[1] Calculated by M-CRIL from regional data on the MIX since the website does not facilitate access to global averages.

the first half of 2010-11 as the larger ones chased the chimera of an IPO, while the latter half of the year was spent in "fire-fighting", trying to persuade borrowers in AP to repay and those elsewhere to maintain their payments. In 2011-12 the focus shifted to ensuring adherence to codes of conduct and other regulatory requirements such as credit reference and other indebtedness checks. This had the impact of increasing the average cost even for non-AP MFIs over 60% to Rs861.

Equally interesting is the change in the cost of serving the average microfinance borrower in India in real terms (at constant prices). The cost of serving microfinance borrowers declined from Rs620 in 1999-00 to just Rs298 in 2009-10 (at 2002 prices) – less than half before rising to Rs426 this year for non-AP MFIs (Rs536 for non-AP MFIs). This could indicate the growing efficiency of microfinance until 2009-10 but whether this was on account of real productivity increases or a decline in lending standards is a question that bears consideration. Certainly the increase of the past two years, represents a greater application by MFIs to relationships with and follow up of clients than was evident in the years of high growth.

3.2 Operating efficiency has been adversely affected

3.2.1 ...as portfolio management issues and client protection compliance expenses have increased OER

For the purpose of analysis, operating expenses include four components – personnel expenses, travel costs, depreciation and other administrative expenses – with the **operating expense ratio (OER) measuring the total of these expenses as a proportion of average outstanding portfolio over a one year period**. *The operating expense ratio does not include the financial expenses or risk costs (loan loss provisions and write off expenses) incurred by an MFI.*

As indicated above, the average Indian microfinance client continues to be served by MFIs that are significantly more efficient than those internationally. The weighted average OER for sample MFIs has increased from 8.8% in 2009-10 to 12.0% in 2011-12 but is still significantly lower than the 15.9% of the 2007 M-CRIL sample. The OER for the L-10 MFIs in the sample has risen from 8.1% in 2009-10 to 10.9% for 2011-12 (**Exhibit 3.6**). These expense ratios are well below the global median of the order of 20.0%. The MIX average for India does not take managed portfolios into account and, therefore, overstates the OER.

Exhibit 3.6

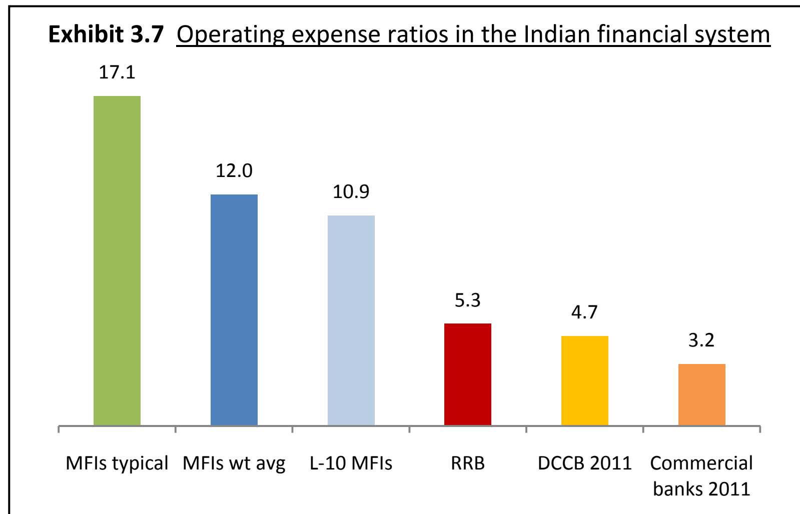
Operating expense ratios as a proportion of gross loan portfolio of Indian MFIs

Model	Weighted average (%)	Typical MFI ~median (%)	Operating Expense Ratio				Total MFIs
			<10%	10-15%	15-25%	>25%	
NGO	12.9	18.7	2	4	5	1	12
Section 25	8.3	8.3	1	0	0	0	1
Cooperative	13.3	13.2	1	0	1	0	2
NBFC	12.0	17.0	10	11	15	5	41
India 2011-12	**12.0**	**17.1**	**14**	**15**	**21**	**6**	**56**
– non-AP	11.7	17.3					
2010-11	10.3	15.6	17	19	15	8	59
2009-10	8.8	14.3	26	17	18	5	66
2008-9	11.9	13.7	25	23	13	1	62
2007	15.9	20.7	13	13	17	11	54
2003	20.5	36.5		23	21	46	90
L-10 2011-12	10.9	12.6	6	1	2	1	10
MIX averages	**India**	**Bangladesh**	**Nepal**	**South Asia**	**EAP**	**Africa**	**LAC**
	13.2	13.6	9.2	12.8	14.1	29.3	20.2

The typical Indian MFI – as measured by the simple average across MFIs – had an OER of 17.1%. This performance represents a long term improvement in efficiency of Indian MFIs but a decline over the past two years. These changes in operating efficiency are reflected in a not-so-good distribution of MFI OERs across performance categories compared to earlier years.

Comparing the performance of MFIs with that of the banking sector in **Exhibit 3.7**, shows the real difference in MFI operations relative to the rest of the financial system. As indicated above, Indian MFIs continue to be amongst the most efficient in the world; yet their OERs are substantially higher than those of the rural banks with the weighted average OER being more than twice the OERs of both the RRBs and the DCCBs.

Exhibit 3.7 Operating expense ratios in the Indian financial system



It is apparent that the village/slum level service delivery model of the MFIs cannot compete with the branch based business model of the rural and commercial banks. The 10.9% operating expense ratio for the L-10 MFIs is clearly still a "best practice" ratio for microfinance where transaction costs relative to loan sizes are well known to be substantially higher than the 3.0-4.0% (of advances) reported as operating expenses by the commercial banking sector in the country.

The higher expenses incurred by the RRBs, relative to the commercial banks, are partly attributable to the extra effort these "policy financial institutions" are required to put into village level outreach to farmers and in delivering government mandated credit programmes to low income families. DCCBs, are subject to the double disadvantage of being treated as "policy financial institutions" and being subject to bureaucratic control by the cooperative departments of states. Thus, their expense ratios are higher than the commercial banks even though a significant proportion of their expenses are borne by their primary cooperatives; institutions that routinely incur losses.[2] The substantially higher average loan size of the banking system is another factor in the cost efficiency of banks relative to MFIs. This is discussed in more detail below. The continuing efficiency of Indian MFIs relative to international benchmarks needs to be noted and should dispel the popular impression of Indian MFIs as being "too costly".

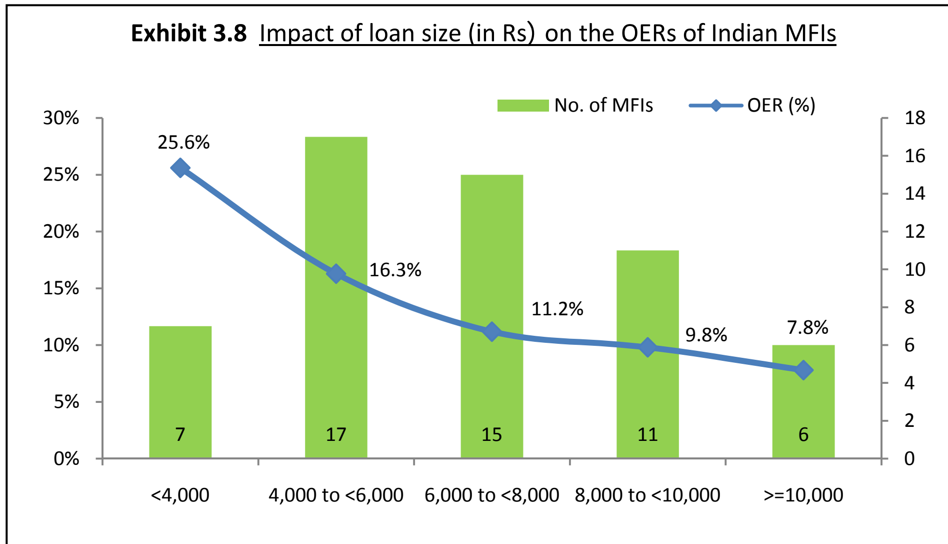
3.2.2 ...and the small loan size makes it difficult to lower expenses

Another key determinant of the operating expense ratio is the small loan size. The OER shows a very clear downward trend as the loan size increases (**Exhibit 3.8**). MFIs with the smallest size of loan (less than Rs4,000, $78) record a weighted average OER of 25.6% whereas larger categories reduce to under 8% for the largest, above Rs10,000 ($200), category. There is some correlation with the age of an MFI here since the newer MFIs tend to have smaller loan sizes but an even stronger correlation with the rate of growth of institutions since fast growing ones both incur higher costs in their growth phase and have lower loan sizes on account of having a large proportion of new clients.

[2] Out of 94,647 primary agricultural credit societies on 31 March 2010, financial performance information was available only for 81,615 societies. Of these, 41,679 (51%) reported losses. RBI,2011, **Trend and Progress of Banking in India 2010-11**, Mumbai: Reserve Bank of India. M-CRIL note: Those that did not report their financial performance can be assumed to be either very heavily in deficit or even non-functional.

As MFIs stabilize in terms of growth and become older institutions, their OER declines as the costs of growth (training staff, opening new branches, reaching new geographical areas) are more limited while their average loan size increases as the number of clients getting the fourth or fifth repeat loan becomes quite high (perhaps 50-60%).

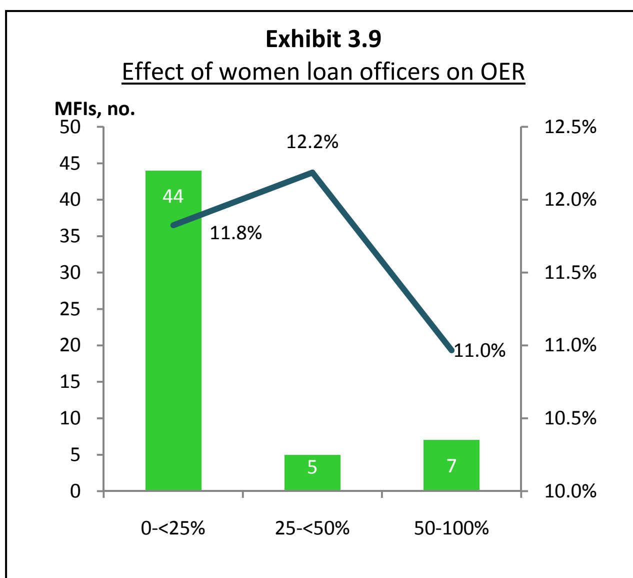
Exhibit 3.8 Impact of loan size (in Rs) on the OERs of Indian MFIs



Conversely, MFIs operating with larger loan sizes are able to limit their operating expense ratios partly on that account. Similarly, the "weaker sections" lending of the commercial banks (with average loan sizes almost 5-6 times those of MFIs) is, inevitably, substantially cheaper to service than that of MFIs and, thus, represents a different asset class altogether. The average loan size of Rs54,600 ($1,070) for an RRB account contrasts with the Rs7,382 ($145) outstanding for an average MFI account at the end of March 2012. Thus, the 12.0% average OER for MFI loans compares quite favourably with the 5.4% OER of RRBs. DCCB servicing expenses are a lot lower on account of the support provided by the village level primary cooperative societies. It is clear that MFI operating expenses in India are at a low level both by the standards of international MFIs and in comparison with banks (relative to average loan size). It would be difficult to lower expenses further. As discussed above, expenses have actually risen over the past year, in particular, increasing on account of new regulatory requirements such as credit bureau checks and indebtedness and income assessment of clients as well as the cost of compliance with more rigorous client protection standards than earlier.

3.2.3 Is using women loan officers an appropriate means of lowering expenses?

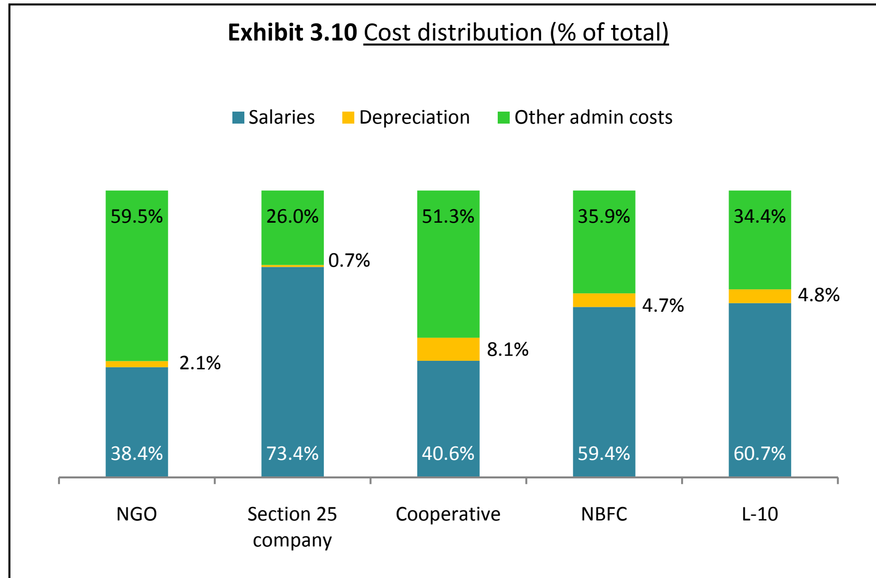
Exhibit 3.9
Effect of women loan officers on OER



As discussed above, Indian MFIs employ relatively few women loan officers; just 7 of the 56 organisations in the sample have more than 50% loan officers who are women while as many as 34 have fewer than 25% loan officers who are women. This is in spite of the fact that more than 96% of clients are women. The correlation between the proportion of women loan officers and OER is illustrated in **Exhibit 3.9**. The numbers are not particularly high (and the self-reported social reporting data on the MIX is not entirely reliable) so it is difficult to see a significant correlation. However, rating experience suggests that MFIs with higher proportions of women loan officers have lower operating expense ratios; here, the 7 MFIs with more than 50% women loan officers have an average OER of 11.0% while those with less than 25% women loan officers have a combined

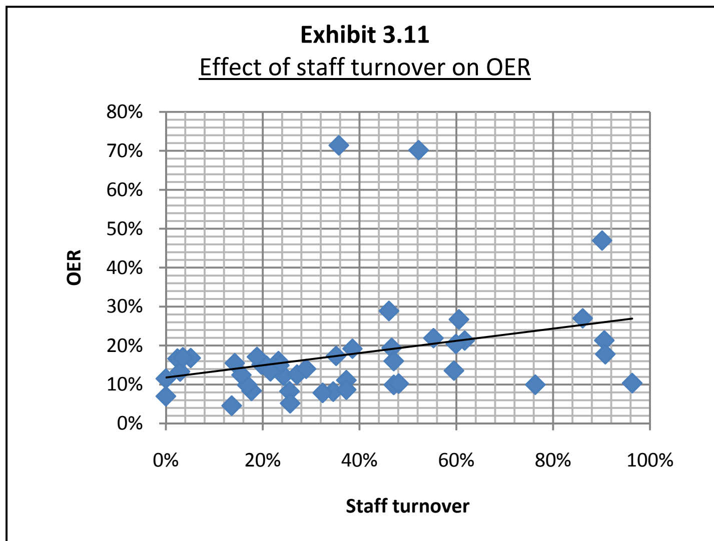
OER of nearly 12%. Whether or not the difference means MFIs with more women loan officers operate more efficiently or whether this means that women loan officers are actually paid less on average than men (if not necessarily in the same institution), bears investigation. However, this is not possible with the data available at present.

3.2.4 The composition of operating expenses indicates increased labour intensity

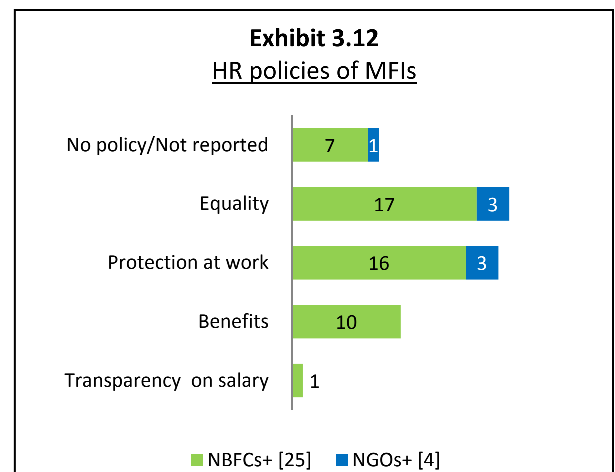


The major components of operating expense are disaggregated into the three main categories in **Exhibit 3.10**. The Indian MFIs' salary allocation of 40-60% is well within the global best practice range (Asia, 53.6%; global, 44.5%) though the Section 25 company – well known to have better staff compensation levels than many MFIs has a higher staff expense level. While the proportion of expenditure incurred on staff by NBFC MFIs is slightly higher than the 56.9% ratio for the wage bills of commercial banks as a proportion of their total expenses, this is inevitable given the MFIs' community level services versus the branch-based service of the banks.

3.2.5 ...so perhaps it would be better to focus on working conditions to reduce staff turnover

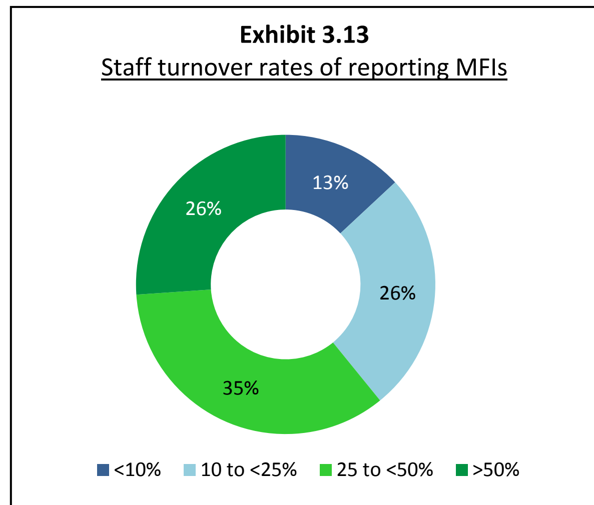


Since the labour intensity of microfinance is quite high it is apparent that staff conditions have an important impact on the expense ratio. In theory, low wages and long working hours would reduce operating expenses and a few (but by no means all) of the leading MFIs in India are known to follow this approach. Yet, it is bound to increase the staff turnover rate as over-worked, underpaid people seek and obtain better opportunities. With the caveat about the accuracy of the social performance information (reported by MFIs to the MIX), mentioned earlier, it appears to show, in **Exhibit 3.11**, that MFIs with higher staff turnover rates generally have higher operating expense ratios (though another way to limit the staff turnover is to pay high salaries



at relatively low levels of productivity). Amongst other reasons for the higher OER is the fact that high staff turnover increases recruitment expenses as well as the expenses of training new staff. The social performance information on the MIX website (summarised in **Exhibit 3.12**) shows that not all MFIs have written HR policies though many do aim to apply key conditions of protection and equality while medical and retirement benefits only apply to permanent employees. Those on temporary or contract employment may not be provided the same conditions. Data reported in 2011 shows that 25% of the 32 MFIs that provided data on this indicator had fewer than 40% permanent employees and only 25% had more than two-thirds of their staff on their rolls on a permanent basis. [This indicator does not appear to have been included on the MIX for 2011-12].

Exhibit 3.13
Staff turnover rates of reporting MFIs

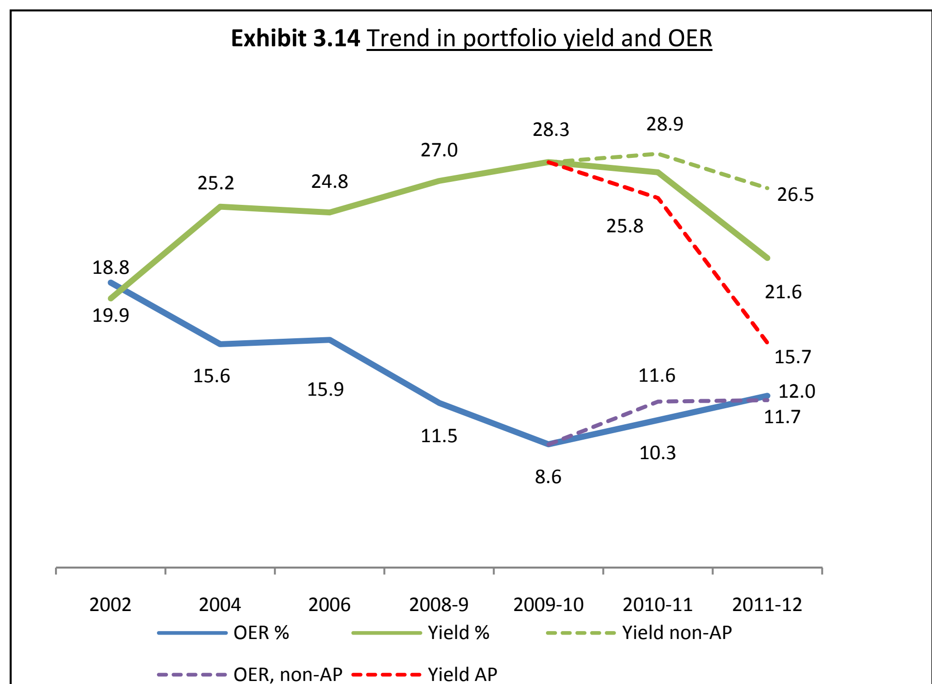


It is apparent that while some MFIs have excellent conditions for their staff there are a number of others that still need to do more to create a stable and supportive working environment for their employees. Not surprisingly the average staff turnover rate of the reporting MFIs is high at 29%. The frequency of MFIs reporting various staff turnover rates is presented in **Exhibit 3.13;** as many as 12 of the 46 MFIs reporting on this indicator have staff turnover rates in excess of 50%.

3.2.6 ...and watch the yield-OER margin which has declined substantially

Besides looking at the contribution of various components to an MFI's operating expenses it is also instructive to compare OER – the cost incurred on servicing loans – with the yield (interest income earned from the portfolio outstanding for a given period) to ascertain the margin before accounting for the cost of funds and risk expenses. The weighted average yield of 21.6% (compared to 27.6% last year) is a drastic decline that has occurred in response to the controversy about interest rates in the lead up to and in the period immediately following the AP ordinance. This has been reinforced by regulatory pronouncements on margin caps that (now) prohibit large MFIs from charging a margin (over the cost of funding liabilities) in excess of 10% for large MFIs and 12% for small ones. Most of the large MFIs (based in AP) had already reduced their interest rates drastically in response to pressure from the state government. **Exhibit 3.14** shows the trend in portfolio yield and OER.

Exhibit 3.14 Trend in portfolio yield and OER



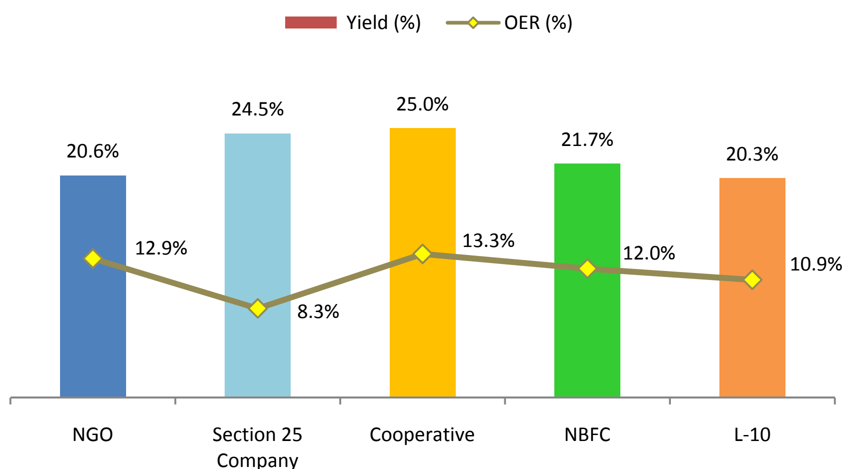
The portfolio yield increased significantly from 24.8% (around 2006 based on the 2007 Review) to

27.0% (including the managed portfolio) in 2008-09 and 28.3% in 2009-10. This happened largely because of changes in fees charged and sometimes on account of a change in the loan term when, say, a reduction in the term from 50 weeks to 45 weeks can have a significant impact on the yield though the change appears to be small. With the drastic decline in yield in 2011-12 the average yield earned by MFIs in India is now substantially lower than the Asian and global medians of 25.8% and 28% respectively. While non-AP MFIs have still recorded yields at comparable levels, with a weighted average of 26.5%, this is unlikely to hold up in 2012-13 as the effects of regulation become fully apparent.

When compared with moneylender rates of 30-72% in different parts of India and consumer finance rates of around 24-30% charged even by large commercial banks for much larger loans, Indian MFI interest rates appear to be far from exorbitant.

Since the weighted average (OER) declined dramatically over the years 2006 to 2010 from around 15-16% in the middle of the decade to just 8.6% in 2009-10, there was a substantial widening in the margin available to the average MFI for covering financial expenses, loan loss provisions and surplus. In the previous year, this margin has declined by as much as 2.4% from 19.7% in 2009-10 to 17.3% in 2010-11. As the exhibit shows, the squeeze on margins during the current financial year (2011-12) is far greater. While non-AP MFIs recorded weighted average yields of 26.5% and marginally increased OERs of 11.7%, the AP MFIs earned only 15.7% yield while spending 12.3% on operations. With such a low margin, the parlous state of the AP MFIs is clear. This situation is discussed further in the chapters that follow.

Exhibit 3.15 Typical operating expenses in relation to portfolio yield



Legal Type	OER (%)	Yield (%)
RRBs	5.3%	10.6%
DCCBs, 2010-11	4.7%	(net) 9.2%
Commercial banks 2010-11	3.2%	9.2%

Amongst Indian MFIs the highest margins have historically been earned by the L-10 MFIs in particular and the NBFCs in general. As shown by the information in **Exhibit 3.15**, these margins are much higher than those earned by banks.

Region	Yield*	OER*
South Asia	23.4	12.8
EAP	25.8	14.1
Africa	31.7	29.3
LAC	30.1	20.2

* MIX medians

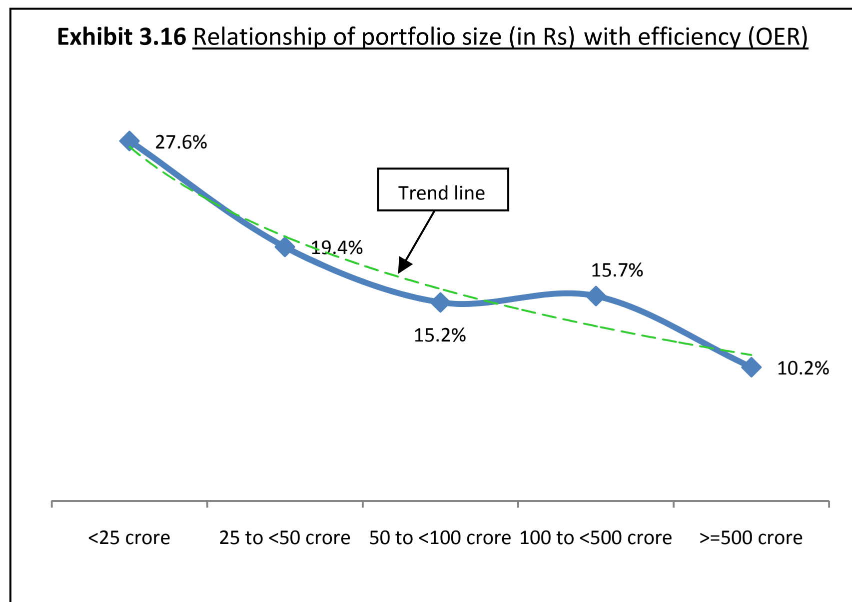
The different levels of OER and yield are related to loan size and the very different business models of the banking system relative to microfinance. Thus, for instance, banks enjoy much lower financial expense ratios than MFIs.

3.2.7 Economies in operation are determined partly by loan size but also by MFI scale

Economies of scale are generally expected in any economic activity. The relationship between the OER and overall portfolio size of individual MFIs is illustrated in **Exhibit 3.16**. Though the correlation

is not perfect, a rough inverse relationship between portfolio size and operating expense ratio emerges from the sample information in the figure for portfolios ranging from <Rs25 crore ($4.9 million) to >Rs500 crore ($98 million). It goes down to around 10% as the portfolio increases beyond Rs500 crore ($98 mn). However, this also depends on the methodology adopted by the MFI and is related to the concern of the management for achieving sustainability. [There is a high variation in OERs for MFIs of every size class but the broad trend is clear]. The variation from trend in the graph, where the OER is higher than expected, results from relatively new, fast growing MFIs that want to achieve scale as soon as possible even as they sacrifice short term sustainability. These are MFIs established directly as NBFCs by professionals who have become involved in microfinance within the past five years.

Exhibit 3.16 Relationship of portfolio size (in Rs) with efficiency (OER)



However, M-CRIL always had reservations about the manner in which cost efficiency was achieved by the largest MFIs. M-CRIL's assessment is that "improvement" over the years was achieved not so much through economies of scale as via an oversimplification of the relationship between MFIs and clients resulting in little time spent on group formation or group development processes. In the late 1990s a self-help group was expected to be in existence for a minimum of 6 months before it became eligible for an MFI loan. Even a Grameen type solidarity/joint liability group was required to meet regularly for a minimum of 8 weeks before it became eligible and, crucially, members were required not to have a loan from any other source.

By the time the race for growth became the norm in Indian microfinance around 2007, MFI loan officers had abandoned all concern for group processes and single source lending; the situation was reached where, in the extreme, an MFI loan officer waited outside a group meeting organized by another MFI in order to offer the same group another loan or to collect from the same group (since it had been previously enrolled by him). In the short term, this created a win-win situation for both MFIs and clients: it helped the MFI loan officer to meet his targets as easily as possible thereby helping his MFI to maximize its growth and it helped the client to gather ever larger sums of money in relatively short periods of time in order to meet her investment (and, in many cases, consumption) needs – whether or not she was in a position to repay.

This effectively reductionist approach meant that the relationship between the MFI and the client became one that was little different from consumer goods retailing; the development solidarity, preventive health and basic literacy objectives of the MFI group meetings of the 1990s were abandoned in the rush for growth. The effect of the resulting crisis on portfolio quality, margins and profitability follows.

Chapter 4

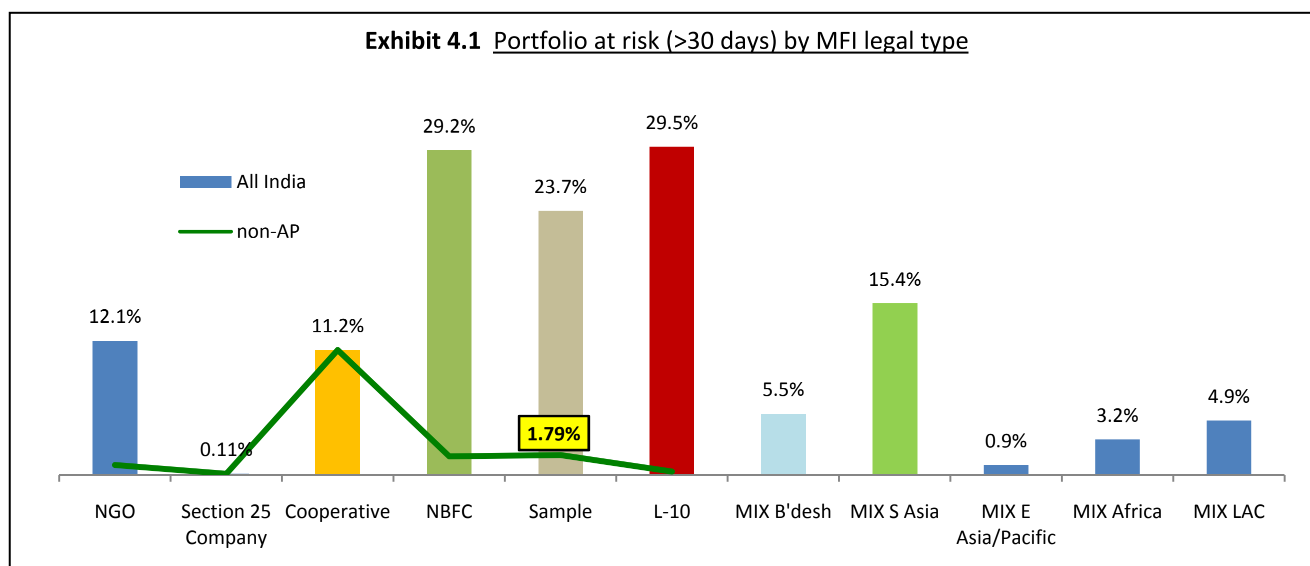
MFI portfolios outside AP have defied expectations of contagion

4.1 The industry was plunged into crisis when clients in AP stopped payments

The AP Government's ordinance on lending by MFIs made it virtually impossible for them to continue their operations in the state. The unspoken message to clients was that MFIs would not be allowed to operate and, therefore, there was no need for them to repay their MFI loans. Given the populist nature of (particularly) local level politics in India, this message became "spoken" when politicians actually went around the state with the message that MFI borrowers no longer had to repay their loans. Discouraging borrowers from repaying their loans is an irresponsible act since it makes clients ineligible from receiving further loans and thereby disrupts their lives and economic activities even as it destabilises the financial market. There can be problems in the functioning of any market; concern about such problems should lead to corrective actions and reforms, not to the destabilisation and total shut down of whole segments of economic activity.

Analysis of portfolio quality data from M-CRIL's sample of 56 MFIs (presented in **Exhibit 4.1**) indicates that the MFIs in India as a group have amongst the worst portfolio quality ratios in the world. The sample average of PAR_{30} at 23.7% is exceeded by the L-10 group (at 29.5%) – of whom 4 have their main operations in AP. This is in sharp contrast to the reported portfolio quality ratio of 0.67% for end-March 2010. In practice this presents a bleaker picture than is justified. As the figure shows, after excluding the AP portfolio (treating the AP portfolio and the PAR_{90} portfolio of two

Exhibit 4.1 Portfolio at risk (>30 days) by MFI legal type



other large MFIs as a write-off as before in this review) PAR_{30} for the sample was just 1.79% on 31 March 2012. It is apparent, that there has been no contagion effect of the events in AP on microfinance clients and MFIs in other parts of India. [Though there are two relatively large ones, one each in Orissa and Rajasthan that have been affected by issues of control and fraud, but these are management rather than client issues]. The quality of operations of MFIs outside AP has defied expectations of a contagion effect, albeit at a shrinking scale on account of the reluctance of commercial banks to replenish on-lending funds (mentioned earlier and discussed in more detail in **Chapter 5**).

By comparison, NABARD data indicates that, even using a more liberal 90 day criterion, the non-performing assets of the banking system resulting from loans to SHGS were of the order of 6% at end-March 2012.[3] This is significantly below the portfolio performance of MFIs outside AP.

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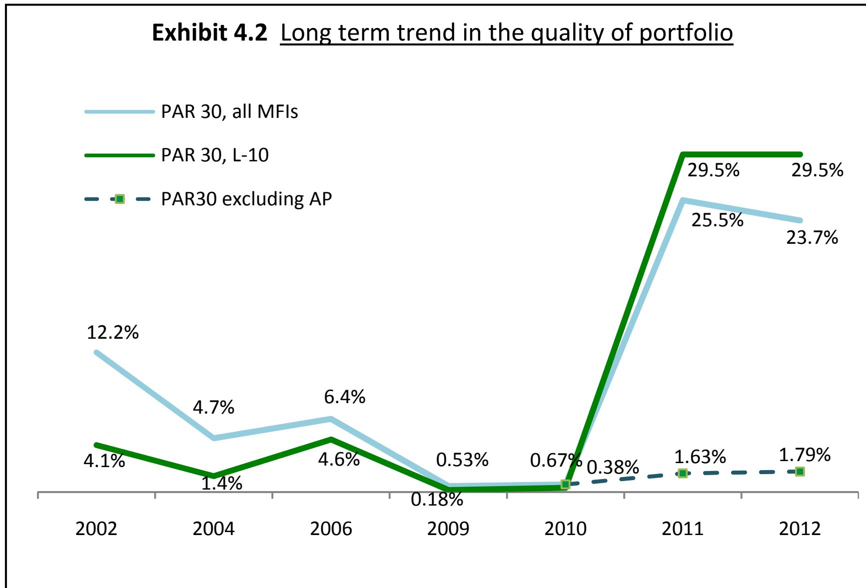
[3] NABARD, 2012. **Status of Microfinance in India**. Mumbai: National Bank for Agriculture & Rural Development.

4.2 ...but, defying expectations, portfolios outside AP have resisted contagion

Even before the current crisis, some of the MFIs operating in south India had suffered a setback on account of AP Government concerns about consumer protection issues in 2006-07. As a result of local government actions, clients in Krishna, one of the most microfinance intensive districts of Andhra Pradesh, stopped paying their dues and the repayment culture in other districts was also affected as shown by the increase in PAR for 2006 in **Exhibit 4.2**. More recently, there was a significant delinquency crisis in southern Karnataka in 2009 (in Kolar and 3 neighbouring districts) and growing issues with portfolio quality even in states like UP and Rajasthan with relatively recent microfinance activity.

Exhibit 4.2 Long term trend in the quality of portfolio

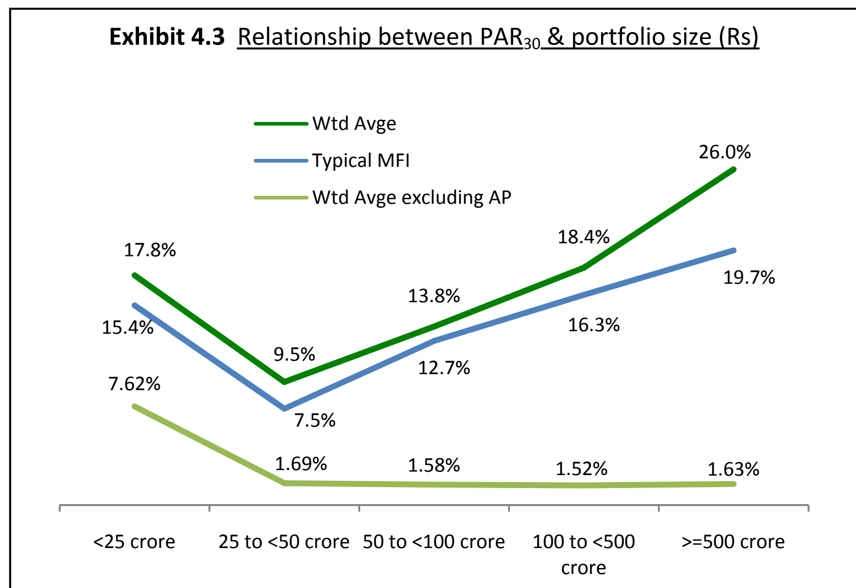


It is apparent that the heavy handed October 2010 ordinance of the Government of Andhra Pradesh has resulted in a delinquency crisis of huge proportions. The resolution of the current crisis now awaits the restoration of confidence of the commercial banks and other investors in the microfinance industry. A minimum condition for this is the passage by Parliament of the Microfinance Bill tabled by the central government. The bill clearly specifies that the regulation of microfinance is the responsibility of the RBI and no state level legislation can overrule it.

At the same time, the crisis has prompted greater introspection on issues of multiple lending, the quality of internal control systems, how to improve portfolio quality and, above all, how to manage growth. The implications of high growth rates for the issues that have emerged are obvious: unbridled growth leads to untrained staff, an increase in multiple lending, a deterioration in control systems, and the potential for malpractices in loan collection. It is M-CRIL's belief that a lower growth rate – perhaps of the order of 40-60% per annum for smaller MFIs and 25-30% for the large ones – would be more effective in ensuring the quality of microfinance provision.

Exhibit 4.3 presents a cross-sectional analysis of the trend in PAR relative to portfolio size. Historically, there was a trend for the larger organisations to have better portfolio quality. However, the high PAR of the Rs50-100 crore category for 2009-10 was on account of four organisations, traditionally NGOs, that became NBFCs in order to take advantage of the banks' greater willingness to lend to NBFC MFIs. The high PAR of these organisations was

Exhibit 4.3 Relationship between PAR_{30} & portfolio size (Rs)

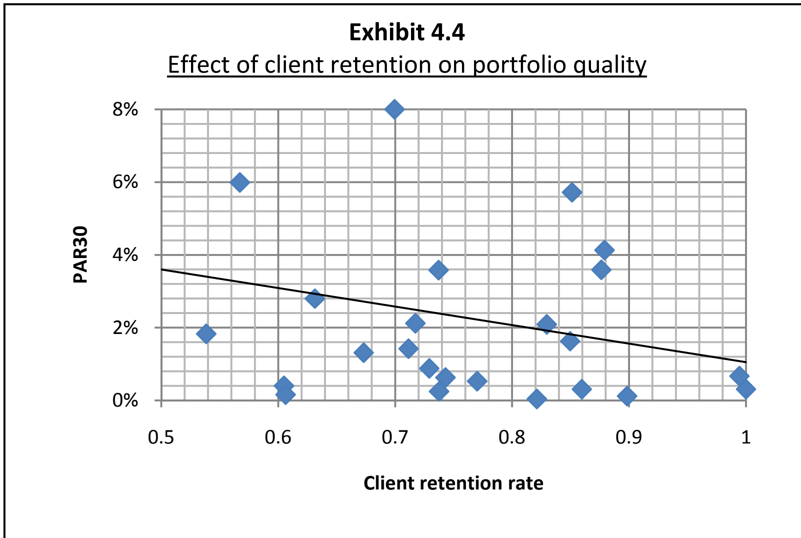


attributable to a more relaxed approach to delinquency resulting from their NGO origins. Borrowers, aware of the traditional welfare orientation of such institutions take repayment discipline less seriously and the MFIs themselves are not as strict in follow up as some of the more professionally oriented NBFCs. While this is an approach which is client friendly, recognising the possibility of genuine repayment difficulties faced by some clients, it could, in some cases, also lead to clients taking undue advantage of what could appear to be a relaxed approach. In the current situation, it is apparent that the largest MFIs are the ones worst affected by the crisis. However, upon neutralising the effects of the crisis (portfolio excluding AP) there is little difference between MFI performance except in the case of a few of the smaller MFIs in the sample, mostly on account of relatively weak control systems resulting from the lack of an appropriate professional orientation

4.3 Client satisfaction has an important effect on portfolio quality

Exhibit 4.4

Effect of client retention on portfolio quality



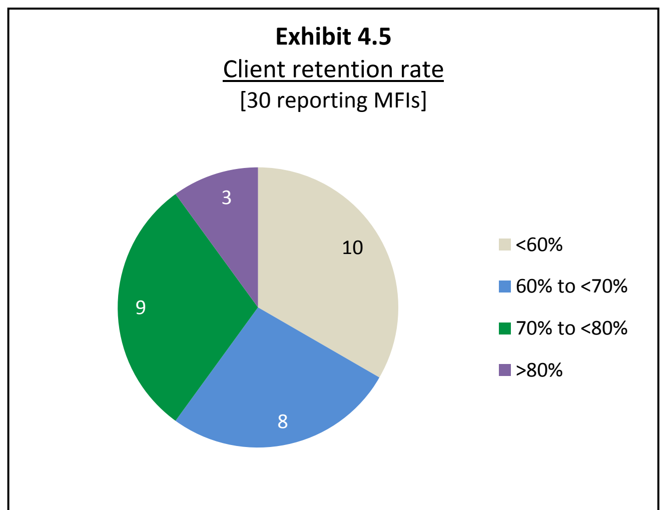
Exceptional circumstances aside, the client retention rate is generally accepted as being a key indicator of client satisfaction which has an impact on portfolio quality. **Exhibit 4.4** relates the client retention rates of the 25 non-AP MFIs for which this information is available to their portfolio quality. AP has been excluded here due to the exceptional circumstances prevailing there.

While the correlation is not very strong in the figure it indicates a significant relationship between the two variables. Thus, it suggests that as client satisfaction increases the portfolio quality also improves with PAR_{30} generally falling below 2% as the client retention rate rises above 80%.

Exhibit 4.5

Client retention rate

[30 reporting MFIs]



In this context, the **average client retention rate of 64%** of 30 reporting Indian MFIs is somewhat low. This relatively low client retention rate is partly on account of the shrinking of portfolios. It is worth noting that while last year over 40 MFIs reported on this indicator, the number has reduced to 30 for 2011-12. It is apparent, in addition, that at least 6 MFIs have misreported their data since it is either 0% or 100%! While again there may be definitional issues in the reporting of this information, the low average retention rate is another indicator of the fact that MFIs need to increase their focus on relationships with clients. Since trend information on this indicator is not systematically available it cannot, for now, be related to the historical performance of MFI portfolios. The distribution of the 30 MFIs over various levels of the retention rate is presented in **Exhibit 4.5**.

4.3 Provisioning for loan losses is inadequate for those MFIs affected by the AP default – a Greek style "hair cut " for investors is, therefore, inevitable

In 2006, on account of the government's action in AP, loan loss reserves had to be increased considerably as the PAR of some leading MFIs had increased suddenly. More recently, the zero delinquency culture of the MFIs took over and PAR dropped to very low levels, though in some cases, M-CRIL believes this may have been on account of "ever-greening" (unauthorised refinancing by branch managers of weakly performing loans) resulting in under-reporting by branches to head office.

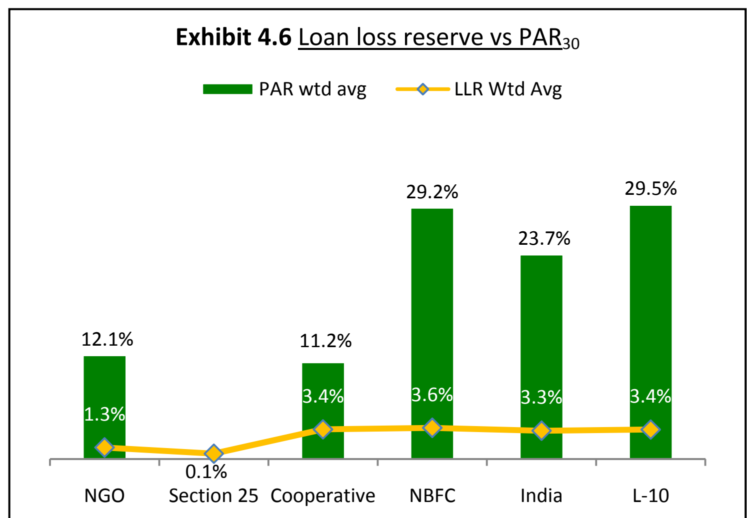
Exhibit 4.6 shows that NBFCs typically now have average loan loss reserve (LLR) rates of around 4%, while the typical PAR is 15% and weighted average substantially higher than that. Given the present unfortunate situation of the MFI sector, this is nowhere near enough. Even before the crisis, M-CRIL had a concern that some PAR at branch level was not being reported to head office and, for this reason, the loan loss reserve rates of MFIs as a whole – especially of L-10 MFIs – were inadequate.

as per cent of portfolio

Models	LLR typical	PAR typical	LLR wtd avg	PAR wtd avg
NGO	2.0	16.7	1.3	12.1
Section 25	0.6	0.1	0.6	0.1
Cooperative	3.8	12.7	3.4	11.2
NBFC	4.6	15.6	3.6	29.2
India	**4.0**	**15.1**	**3.3**	**23.7**
L-10	2.8	18.1	3.4	29.5

Write-offs			All	AP MFIs
2009-10			0.5	0.8
2010-11			4.0	6.6
2011-12			20.0	34.4

Exhibit 4.6 Loan loss reserve vs PAR_{30}



For 2011-12, the leading MFIs operating in AP have both made higher provisions and have already written off significant proportions of their portfolios (of the order of 30-40% of the total, average 34%). This has been done from current income resulting in very high losses for most of them (discussed in **Chapter 6**). Their provisioning requirements have now been eased by the RBI's relatively liberal provisioning norms that allow for assets up to 6 months overdue to be classified as "standard" while only loans more than two years overdue are classified as "loss" assets requiring 100% provisioning.

The aggregate write off ratio across the sector for 2011-12 is 20.0% amounting to a sum of roughly Rs4,270 crore while for the AP MFIs it increased from just 0.8% in 2009-10 to 34.4% (~Rs4,200) crore now. It is apparent from the adjustments made for the analysis in this review, however, that this is still an interim measure and that the eventual write-off resulting from the crisis will be far higher. According to our calculations, roughly another Rs4,200 crore remains to be written off. Based on this, the total write-offs of the past two years resulting from the AP crisis (though not all in AP) amount to around Rs8,470 crore. In any case a "hair cut" for both the MFIs caught in the crisis and for their lenders is inevitable. It is only the closeness of the cut (the proportion of investments lost) that remains to be determined.

The following section examines the financing of microfinance – sources of funds and the efficacy of fund utilization by MFIs providing financial services to low income clients in India.

Chapter 5

The debt focus of portfolio financing has now reduced

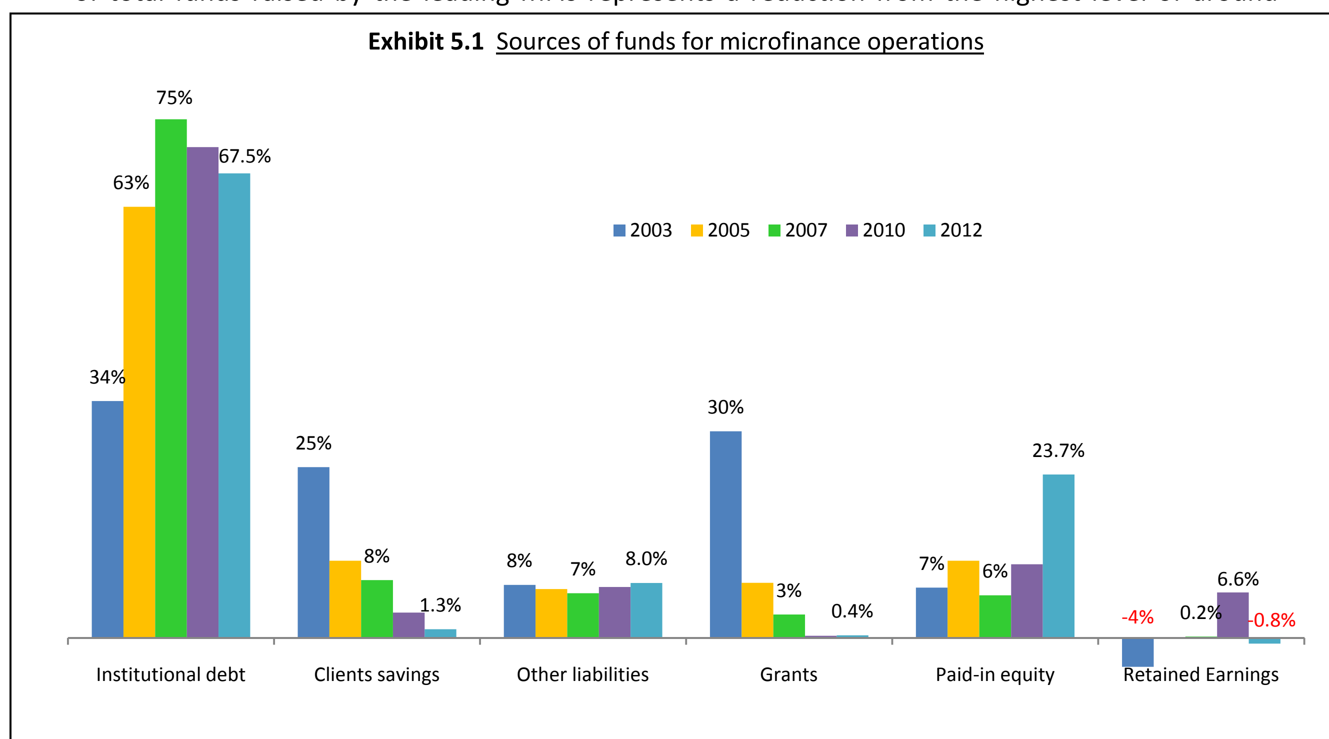
5.1 Indian MFIs are now paying the price for their reliance on commercial bank funds

The financing pattern of microfinance in India increasingly focused on debt until about 2008. Encouraged by the example of SIDBI and stimulated by the inclusion of lending to MFIs in the approved list for priority sector lending, a few (mainly private) commercial banks such as ICICI Bank, Axis Bank and ABN Amro Bank (now RBS) started to lend to MFIs in the early part of the last decade. In the latter part this gradually transformed into a flood of lending to microfinance institutions as more foreign banks such as Citibank, Standard Chartered and HSBC joined the party. Finally, towards the end of the decade, the public sector banks – especially State Bank of India, Punjab National Bank and Bank of India – became more interested in providing funds to MFIs. By then the flow of funds from commercial banks to MFIs had become a virtual flood, reaching around Rs17,000 crore ($3.75 billion) by end March 2010. This will have increased further until October 2010 but, as reported by most MFIs it fell back in the latter half of that financial year, closing at around Rs17,400 crore ($3.87 billion) on 31 March 2011.

During 2011-12, the private sector banks were in full flight from the microfinance sector, dismayed at the prospect of huge losses on the AP portfolio. It was only the continued support of SIDBI and the public sector commercial banks (albeit in a much more cautious way than before) that prevented a complete funding withdrawal and attendant disaster in the sector. By end-March 2012, institutional lending to MFIs had declined to Rs15,136 crore ($2.97 billion), down by over 20% from the estimated peak of around Rs18,000 crore in October 2010.

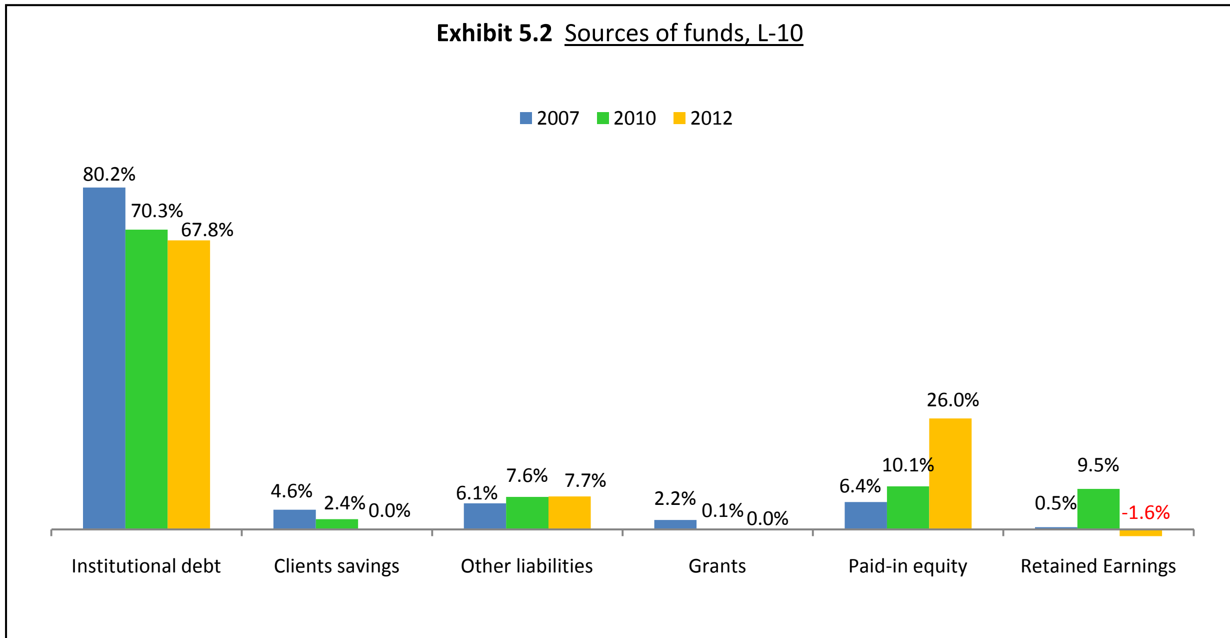
The distribution of sources of funds for microfinance, presented in **Exhibit 5.1**, based on a consolidation of information for the 56 leading MFIs covered by this study, shows that the share of debt in MFI finances climbed sharply from 34% of total liabilities (Rs375 crore, $83 million) in the 2003 sample to 75.4% (Rs1,713 crores, $418 million) in 2007. The current level of debt, amounting to 67.5% of total funds raised by the leading MFIs represents a reduction from the highest level of around

Exhibit 5.1 Sources of funds for microfinance operations



80% reached in 2008. If the additional write-off of Rs4,200 crore required in the sector were to be reduced from institutional debt, this ratio would come down to under 60%. The focus on institutional debt is about the same for the L-10 MFIs (as shown in **Exhibit 5.2**).

Exhibit 5.2 Sources of funds, L-10



The extent to which commercial debt continues to dominate the financing of Indian microfinance is apparent from **Exhibit 5.1**. Indeed, the domination of commercial bank funds in Indian microfinance is under-played here since it excludes off-balance sheet financing via portfolio sales and securitisations of portfolio undertaken by some of the leading MFIs to the commercial banks. A separate compilation of the portfolio managed by MFIs for others – securitised portfolios that are not on MFI balance sheets – shows that this off-balance sheet portfolio was Rs1,434 crore ($280 million), just 7.6% of the portfolio on the MFIs' balance sheet. It had reduced from Rs2,143 crore (~$480 million) or 10.5% of the balance sheet portfolio of MFIs in March 2011 and down from around Rs4,000 crore ($890 million) of March 2010. As discussed in **Section 2**, this means the total MFI portfolio was around Rs18,900 crore ($3.71 billion) serviced/managed by the leading MFIs in India on 31 March 2012. When managed loans are added back to the balance sheets of these sample MFIs, the leverage ratio increases to 3.7, far exceeding the global median of 2.75.[1]

The share of net worth (grants + paid in equity + retained surplus/deficit) on MFI balance sheets declined from 33% in 2003 to 19% in 2005 to just 9.8% in 2007. This increased to 17.7% in March 2010 and rose further to 21.5% in March 2011 as the equity mobilisation efforts of the good times of 2007-10 continued to bear fruit for some of the leading MFIs seeking to increase their capacity to expand operations. During 2011-12 this increased to 22.9% but its composition changed dramatically; equity now amounts to over 23% of total funds while the losses of the past year mean that retained earnings have turned negative. It is likely to fall further as the full effect of the AP portfolio collapse becomes apparent through more write-offs during 2012-13.

There has been a halt in the flow of grants into Indian microfinance (with its share on MFI balance sheets declining from 30.0% in 2003 to 8.0% in 2005, 3.4% in 2007 and a negligible amount now. This is as it should be; with the commercialisation of microfinance, grants are required neither for operations nor capacity building. It is only in very exceptional and difficult physical conditions (such

[1] The global figure is derived from regional median data on the MIX website.

as in hill or forest regions) or in particularly stressed economic conditions such as in the north-east states of India that grants should ideally be provided for microfinance.
Given the increase in the number of corporate entities amongst the large MFIs it is not surprising that the role of equity in MFI financing increased significantly from 7% in 2003 to over 11% in 2005. It then fell back to 6.2% in 2007 on account of the substantial growth of debt financing. This has continued to increase since then and is now at 23.5% as NBFC MFIs made concerted efforts to raise equity and private equity (PE) funds, in particular, became increasingly interested in tapping into the "fortune at the bottom of the pyramid". The MFIs, in turn, needed to increase their capital adequacy ratios and enhance the willingness of banks to lend to them to finance their expansion plans.

Equally important, the share of client savings has declined considerably from 25% in 2003 to 11.2% in 2005 and 8.4% in 2007 as the larger MFIs have increasingly transformed into regulated entities (NBFCs) – as discussed in **Chapter 1** – and have withdrawn from offering thrift deposit facilities since these are both technically illegal and specifically prohibited for NBFCs that do not have an investment grade rating from a corporate rating agency. Deposit services are confined to community-based institutions such as SHGs and cooperatives. The decline in savings orientation of MFIs has continued and savings constituted just 3.7% of total funds by March 2011. Since the remaining deposits were essentially in the form of compulsory security deposits required by MFIs, the proportion of deposits has fallen further in 2011-12 (**Exhibit 5.3**) as the loan-linked savings have been adjusted by AP MFIs against the unpaid loans of AP borrowers. The high savings orientation of cooperative MFIs continues to demonstrate the potential for providing deposit services to low income clients. It also shows that, if an appropriate regulatory framework were in place, microfinance could be undertaken to a large extent with resources raised from clients.

Exhibit 5.3
Deposit-portfolio ratios

Legal type	Client deposits as % of portfolio					
	2005	2007	2010	2012		2011*
NGO			8.0	0.1%	Bangladesh	36.5
Section 25			0.0	0.0%	Indonesia	55.1
Cooperative			41.0	43.0%	Philippines	68.7
NBFC			3.8	1.7%	RRBs, 2010-11	165
India	**14.6**	**10.6**	**4.3**	**1.5%**	DCCB, 2009-10	126
L-10	5.7	5.6	2.8	0.0%	Comm'l banks	127

*weighted average country data from MIX website

The 1.5% savings orientation of Indian MFIs is clearly very low by global standards. The L-10 – more visible and, therefore, more vulnerable – have a negligible savings ratio, down substantially from the 23.7% of the 2003 M-CRIL sample. All Asian countries with flourishing microfinance sectors – Bangladesh, Indonesia and Philippines – have deposit ratios that account for substantial proportions of portfolio – see exhibit above. Also, the rural banking system in India undertakes all its lending from deposits (portfolio deposit ratios >100%). Given that MFIs have 30% of all micro-accounts in the financial system even now, in spite, of the decline caused by the crisis, the unwillingness of the regulator to permit MFIs to generate deposits is a significant impediment to financial inclusion. It has forced MFIs into a uni-dimensional relationship with clients, a feature that limits their relationship with clients, in M-CRIL's view, a proximate cause of the events that led to the crisis.

The pattern of funding sources also varies with the size of the portfolio. **Exhibit 5.4** shows that as MFIs grow, they are able to leverage their equity to a greater extent and, thus, have a relatively higher level of institutional debt. However, over the past year, the largest MFIs have received the largest amounts of equity (and have suffered the greatest reverses in terms of portfolio losses). As a

result their overall portfolios have reduced significantly and their need to borrow is less. The smaller MFIs, being mainly cooperatives and NGOs, have more significant volumes of deposits than they are able to use for on-lending.

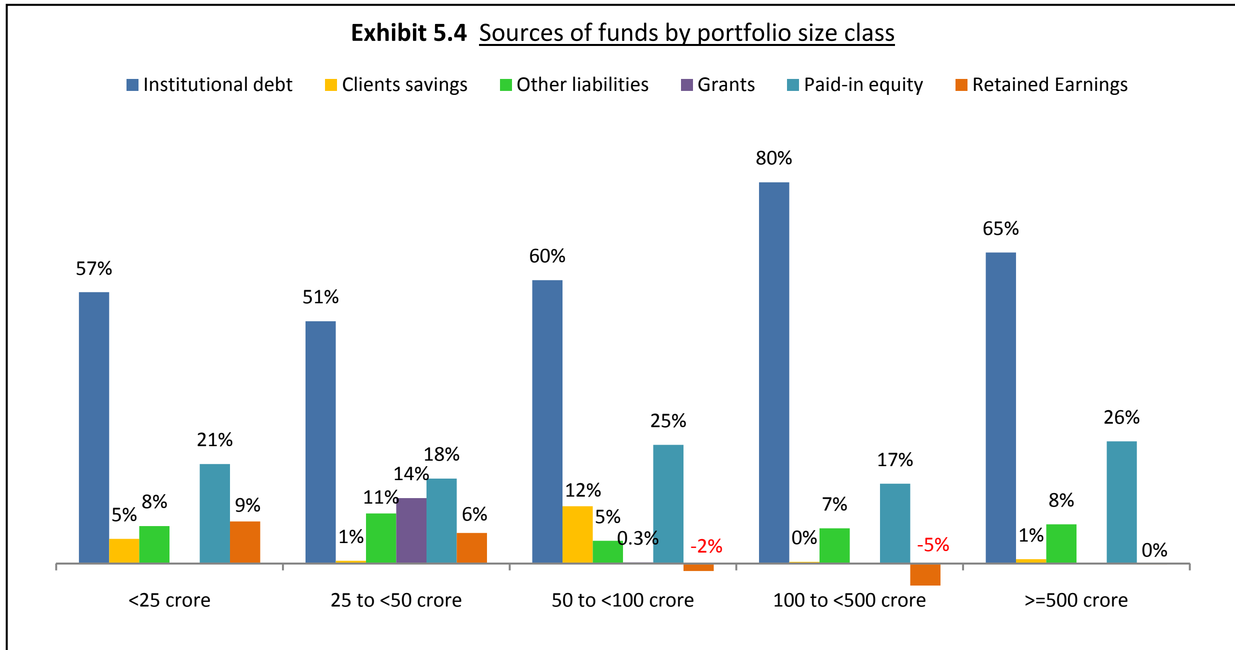


Exhibit 5.4 Sources of funds by portfolio size class

Over the years, the importance of donor funds in Indian microfinance has declined as MFI managements have increasingly been able to obtain more resources, from both institutional lenders and equity investors, even as regulatory restrictions have reduced their ability to raise client deposits. While some institutional debt is still available at concessional rates – partly because banks are able to classify such lending as 'priority sector' directed credit – in recent years much of this debt has been at near-commercial rates in the range 10-14% per annum for wholesale lending. Over the past year, however, the RBI has kept interest rates in Indian financial markets at a high level in a bid to keep inflation under control. The impact of this increase in the price of credit has been accentuated by a dramatic rise in the risk perception of banks vis-a-vis MFIs. The result has been a substantial increase in lending rates by banks to MFIs, with price of loans taken by MFIs rising to 14-18% p.a.

The extent to which legal recognition of deposit taking makes a difference to the fund mobilisation of MFIs is apparent also from the funding pattern depicted in **Exhibit 5.5** classified by form of legal

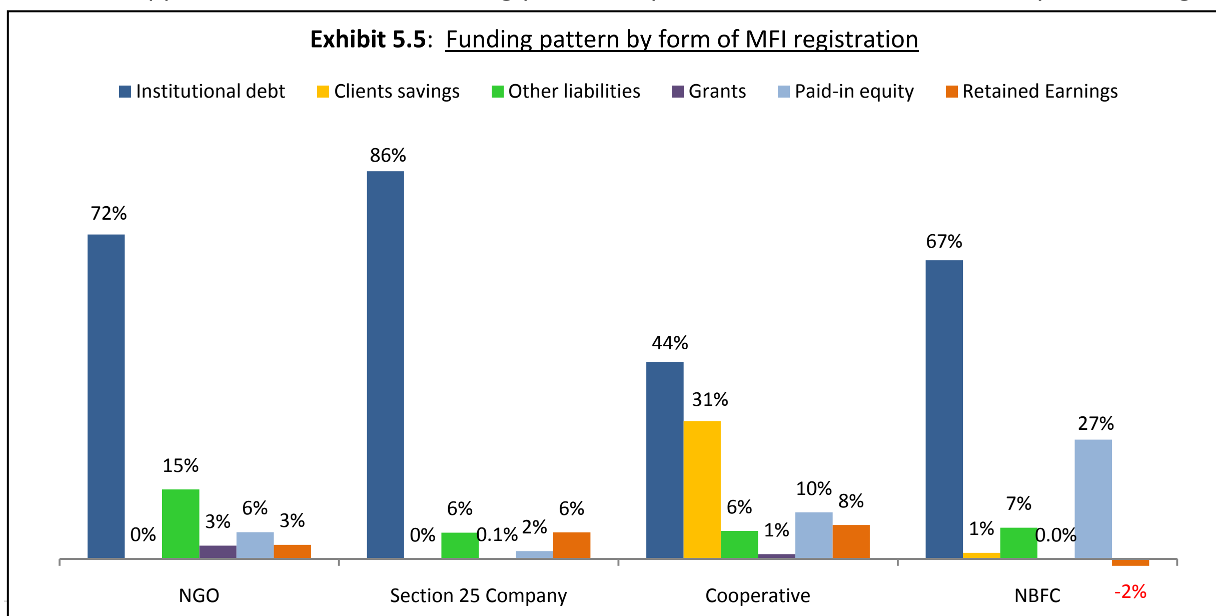


Exhibit 5.5: Funding pattern by form of MFI registration

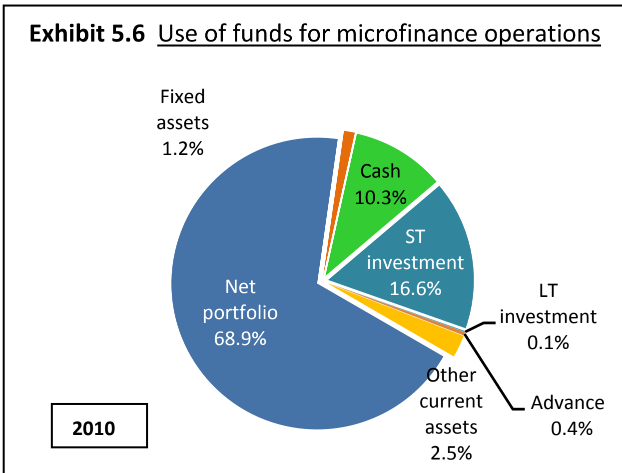
registration. The two cooperative MFIs in the sample generate over 30% of their funds from member savings while deposits in the "for profit" NBFCs account for less than 1% of total funds. As discussed earlier, to the extent that deposits figure at all on their balance sheets this consists mainly of cash security on loans given to clients. Apart from cooperatives, the financing of activities of all types of institutions is dominated by institutional debt though grants only figure on the balance sheets of NGOs (societies/trusts) in any significant way. The high levels of paid-in equity in the case of NBFCs is largely a function of the high levels of share premium they were able to command over the past few years, given the substantial equity valuations accorded to Indian MFIs by private equity investors. Those days are now over; while a small amount of equity continues to flow, average levels of valuation have fallen from 7-11 times book value over the 2007-10 period to the saner levels of par to two times book value now. MFIs in trouble have recently even been taken over at a discount to book value.

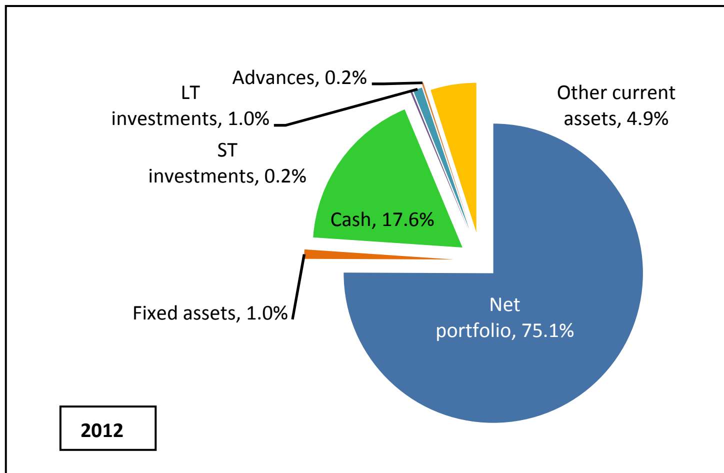
5.2 The use of funds has been squeezed by cash constraints

5.2.1 ...with the drying up of bank debt in response to the apparent political risk

The allocation of funds by Indian MFIs has conformed fairly well to international best practice norms in recent years. However, the exceptional circumstances of the 18 months to March 2012 resulted in exceptional measures. Of the total resources of Rs22,471 crore ($4.4 billion) deployed in microfinance by sample MFIs, just over 75% was in loans to clients at the end of March 2012 (**Exhibit 5.6**). Two years ago this was 69% which was below the portfolio allocation level of the MIX international median of 76.8% largely because of the prevalent practice in India of lenders making substantial disbursements of loans to MFIs in the last week of March (the end of the financial year). This enabled the banks to include the disbursed amount in their priority sector lending achievements but did not leave time for the MFIs to disburse the funds to their end-clients before the closing of accounts for the financial year.

Exhibit 5.6 Use of funds for microfinance operations





Model	Amount, Rs cr	2012	2011
Net portfolio	16,870	75.1%	80.6%
Fixed assets	226	1.0%	1.2%
Cash	3,960	17.6%	13.5%
ST investments	43	0.19%	0.02%
LT investments	221	1.0%	1.0%
Advances	40	0.2%	0.5%
Other current assets	1,112	4.9%	3.2%
Total sample	**22,471**	**100.0%**	**100.0%**

As indicated earlier in this report, the effect of the crisis resulting from the AP ordinance spread much more widely than the state of Andhra Pradesh. This effect was not due to any delinquency contagion reaching clients outside the state but rather due to the shrinking of bank funds to MFIs. Thus, the manifestation of political risk that they saw in the form of the AP ordinance resulted in banks overall reducing their sanctions in 2011-12 significantly. This affected MFIs all over

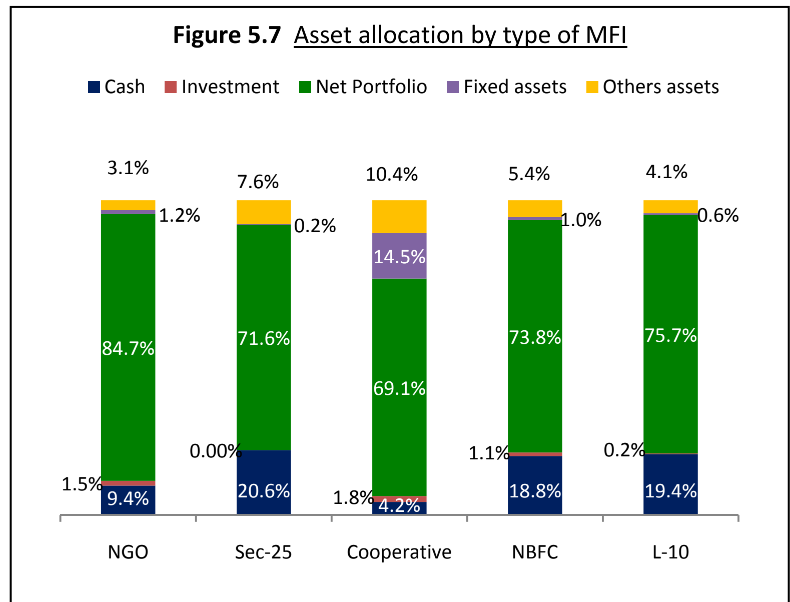
the country (irrespective of where they operate) and was the primary reason for the 16% decline in the net portfolio of leading Indian MFIs during the year. [Excluding the non-functional but not yet written off portfolio of MFIs in AP increases this decline to over 34%]. It is remarkable that this shrinking of MFI portfolios did not cause the contagion expected from clients (outside AP) refusing to repay loans based on the assumption that they would not receive fresh loans anyway.

Given that total funds have only declined by 10%, the 16% decline in portfolio has resulted in a significant increase in cash to 17.6% from last year's 13.5% (again partly resulting from last minute releases of bank funds at the end of the financial year). With the advent of the crisis, MFIs have become conscious of liquidity risk and wary of placing their funds in short term investments lest these be seized upon by banks against risk of portfolio default. As a result short term investments that were at high levels (21% in March 2010) reduced to just 0.02% last year and continue to be at negligible levels. The L-10 have felt the impact of the crisis more acutely with their asset utilisation ratios similar to the overall sample but deployment in fixed assets at just 0.6%, very low by international standards.

The efficient, effective and prudential management of these assets is dependent on a number of factors including

- minimisation of the need for fixed assets relative to total assets
- maximisation of investment of financial resources either in the loan portfolio or, at least, in high return investments, and
- asset-liability matching in order to limit the risk associated with the MFIs' financial assets to levels consistent with the organisation's own funds or net worth.

Figure 5.7 Asset allocation by type of MFI



The allocation of assets varies to some extent between different types of MFIs (**Exhibit 5.7**). Apart from the 14.5% fixed asset levels of the cooperatives, however, the stacked bar diagram shows that asset allocation levels are very similar in the different legal forms of MFI.

5.2.2 …giving the impression that prudential management has improved

Most MFIs aim to mobilize long term sources of funds such as equity, long-term loans (repayable in 3-5 years), locked member savings (when possible) and, very seldom, grants in order to finance their portfolios. On the other hand, the loans they extend are, usually for a period of one year, sometimes less, thus becoming short-term assets.[2] This translates into short term assets (maturity less than one year) accounting for 83.6% of the total while 93.2% of liabilities are long-term. This is an area in which traditional MFI fund management is highly appropriate to their financing structure and has contributed to the relative stability of microfinance in India. This is in contrast to the asset-liability management problems of MFIs in some other Asian countries.

For ensuring prudential management, banks in India are expected by the RBI to maintain Capital Adequacy Ratios (CAR - net worth as a proportion of risk weighted assets) of 9% and microfinance

[2] Though with regulation now requiring 2-year terms for loans disbursed amounts >Rs15,000, this is starting to change.

NBFCs, now of 15%. **Exhibit 5.8** provides information on the capital adequacy ratios of MFIs covered by this analysis.

Exhibit 5.8
Capital adequacy ratios of Indian MFIs

Models	Weighted CAR (%)	Typical MFI (%)	Banks, 2012	Weighted CAR
NGO	13.6%	18.5%	RRBs	9.9
Section 25	9.8%	5.4%	DCCBs 2011	13.2
Cooperative	21.7%	13.8%	Commercial	14.2
NBFC	31.2%	19.9%	**MFI debt-equity ratios**	
India, 2012	**28.6%**	**19.1%**	**India, 2011**	**2.9**
L-10	30.5%	18.5%	L-10	2.8
India, 2010	**18.0%**	**24.7%**	**India, 2010**	**7.2**
L-10	16.0%	18.4%	L-10	8.6
India, 2007	**12.7%**	**13.4%**	**India, 2007**	**4.0**
L-10	11.1%	9.4%	L-10	4.4

Until the mid-2000s, with substantial historical grant funding and more recent operating surpluses accompanied by relatively small portfolios, the Indian microfinance sector was well provided for in terms of owned funds. More recently, the growth aspirations of MFI managements, competition and the relative paucity of grant funds, on the one hand, and the liberal availability of commercial debt funds, on the other, took their toll. By 2007, the aggregate figures suggested that capital adequacy was an issue as even the L-10 MFIs were only just at acceptable levels and below the 12% norm being introduced then. The debt-equity ratios emerging were far higher than the 5:1 norm in such lending by commercial banks. However, as noted earlier, the advent of social investment and private equity funds into microfinance started to correct this situation for the leading MFIs from early 2007.

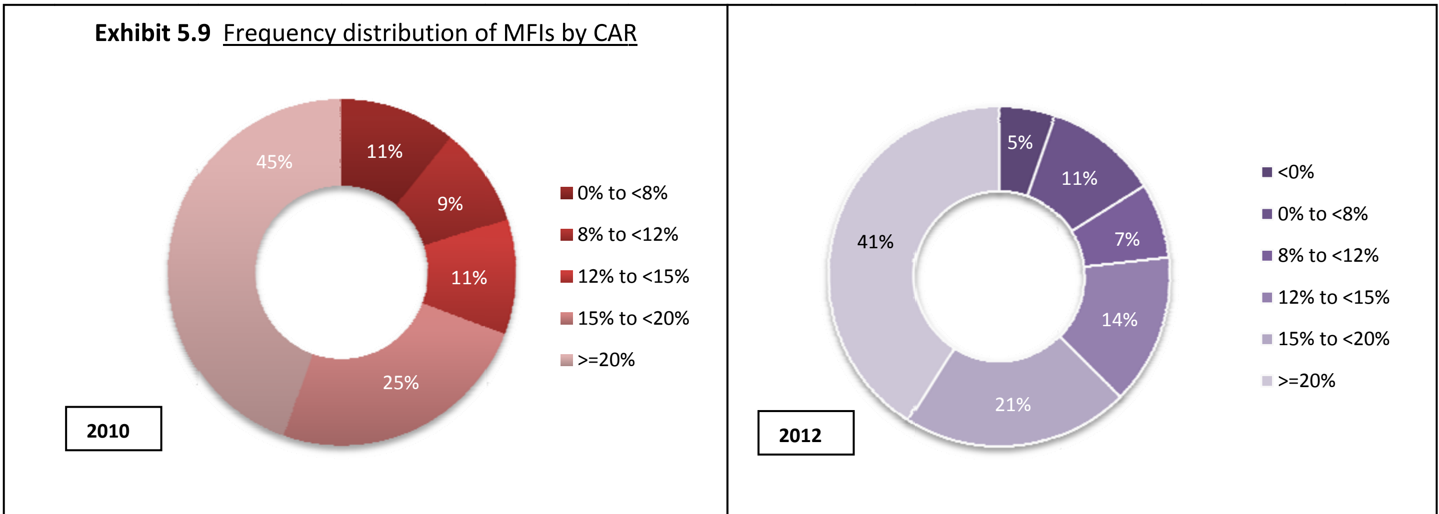
To begin with, the growth of the smaller MFIs depended on the indulgence of bankers, to provide them funds and on the ability of managements to organise operations and generate adequate surpluses to attract further financing. Later, bank financing of MFIs caught on and, but for a brief hiccup caused at the end of 2008 by the global financial crisis, carried on growing to the extent that, in 2009, the sense of competition amongst the banks to provide funds to MFIs resulted in public sector banks becoming keen participants in the process.

At the same time, from 2007 onwards, the private equity funds joined the microfinance focused social investment funds – Bellwether, Lok Capital, Unitus, Aavishkar Goodwell and others – in making investments in the Indian microfinance sector. Even the International Finance Corporation (IFC) became involved. As a result, the equity constraint eased considerably, particularly for start-up MFIs established by professionals. However, the institutional framework and the minimum capital requirements for transformation continue to require convoluted by-passing mechanisms which became a problem from an ethical perspective. Yet, there are now some 50 NBFC MFIs – many transformed and others formed as new institutions – and, in the super-charged environment that prevailed in the MFI sector until October 2010, all were able to find equity investors of one sort or another. Overall, the earlier equity constraint eased considerably and, though investors started to become cautious after October 2010, as **Exhibit 5.8** shows, the weighted average CAR for Indian MFIs is now in excess of 25% – well ahead of the banking sector. The slowdown and reversal of portfolio growth over the past 18 months has also been responsible for the substantial increase from the 18% weighted CAR of March 2010.

This picture is reinforced by **Exhibit 5.9**: in March 2010 45% of MFIs had CARs in excess of 20% and another 25% had CARs above the 15% level that was being introduced from April 2011. The picture at end-March 2012, was similar except that on account of the losses resulting from an increasingly

level of write-offs of the AP portfolio, 3 MFIs now report negative net worth and (over the next year) more are likely to suffer this fate.

Exhibit 5.9 Frequency distribution of MFIs by CAR



5.2.3 …but the implications of securitization for prudential lending need to be monitored

In the context of managed portfolios, this analysis is misleadingly favourable to MFIs. The securitization model was devised for the purpose of avoiding the capital constraint. In some cases, the capital requirement related to risky "on-balance sheet" portfolios has been replaced in the partnership model by a "First Loss Deficiency Guarantee" (FLDG) secured by a fixed deposit or other investment instrument (usually of the order of 10-15% of the managed amount). In these situations, the MFI managements' effective stake in the risk carried by their operations can go down to 5% and lower. However, for the purpose of CAR, even these security deposits with banks carry a 50% risk weight and, in any case, may not have been sourced from the MFI's own resources (since social investors will sometimes provide the necessary funds).

While securitization may offer a short-term solution to the capital problem, it does not resolve the issue in the long term. For commercial banks, as discussed above, it provides the benefit of inclusion in the priority sector lending requirement. This inclusion of bank securitization in the priority sector lending requirement was recently re-assessed by the Committee on Guidelines for the Priority Sector Lending Requirement set up by the RBI (Nair Committee). The committee, perhaps more attuned to the needs of banks than the risk status of MFIs, recommended that the status quo be maintained.

From the MFI perspective, a surfeit of lending funds leads them to

- ⇨ induct clients without due care and relationship building
- ⇨ lend beyond the capabilities and means of their clients
- ⇨ resort to coercive practices when the clients' express an inability to pay.

The emergence of consumer issues and the related political risk in Andhra Pradesh and Karnataka (and, by extension, elsewhere in India) can largely be attributed to this phenomenon. In this context, the reduction in the proportion of the managed portfolio from 53% of the owned portfolio in the 2005 sample to 44% in 2007, down to 20% in 2010 and 7.5% now is a welcome development. It is worth remembering, however, that until March 2010 the absolute amounts had increased to such an extent that the proportions become meaningless from the perspective of an over-heated eco-

nomic sector. In M-CRIL's opinion, securitization is a device that dilutes the prudential effect of the CAR requirement and should be carefully monitored by regulators.

In this context, the next section undertakes a closer examination of the sector's financial performance.

Chapter 6

…and financial performance has moderated

6.1 Yields have dropped as MFIs have reduced interest rates in response to political pressure and regulation

The income earned by an organisation's major asset – in the case of MFIs, the outstanding portfolio – is its main means of attaining viability. Portfolio yield measures the income actually earned by MFIs on their portfolios. It is apparent from **Exhibit 6.1** (and the information in **Chapter 3**, **Exhibit 3.14**) that, on a weighted average basis, this income has grown significantly in recent years increasing the yield steadily from 24.2% in 2007 to 28.3% in 2010 before falling back significantly to 22.1% this year. The decline is substantially on account of the political pressure imposed on the large Andhra-based MFIs. The weighted average yield for non-AP MFIs has not declined by as much but is nevertheless lower at 26.8% as the new regulatory pressures on MFIs start to take effect. These yields compare with the MIX median yield of 25.8% for East Asia Pacific and 23.2% for South Asia in 2011. The average interest paid by Indian microfinance clients is not exorbitant by global microfinance standards; more than 52% of MFI borrower accounts are now with MFIs that have a yield less than 24% and over 83% borrower accounts pay less than 30%. These interest rates are comparable with those paid by users of consumer finance from commercial banks (financing costs of credit cards) and other formal financial service providers.

Exhibit 6.1

Trends in portfolio yield, %

Models	Wt avge yield	Typical yield
NGO	20.6	24.2
Section 25	24.7	24.7
Cooperative	25.0	24.8
NBFC	22.2	28.8
India 2011	**22.1**	**27.6**
– non-AP	26.8	29.7
L-10	20.8	22.3
India 2010	**28.3**	**28.2**
L-10	29.0	27.7
M-CRIL 2007	**24.1**	**26.8**
L-10, 2007	23.5	30.6

Frequency distribution - number of MFIs

Interest (%)	Yield			% of MFI borrowers served		L-10	
	2007	2010	2012	2010	2012	2010	2012
<24	43	21	23	14.7	52.1	1	6
24-30	7	18	16	37.6	31.5	5	2
30-36	4	17	10	44.1	10.3	4	1
>36		9	7	3.6	6.1		1
	54	**65**	**56**	**100.0**	**100.0**	**10**	**10**

From the MFI perspective though, there was a significant decline in weighted average APRs from 29.3% in 2005 to 26.1% in 2007 though these increased again over the past few years as more commercial considerations came into play resulting from private equity investments in microfinance and

the presumed demands of equity markets. According to Microfinance Transparency, APRs have been in the range 30-33%. Typically, yields achieved in microfinance are significantly different from the Annual Percentage Rates (APRs) – the expected interest rate – of MFIs[1] and tend to be lower by 3-5 percentage points on account of inefficiencies and delays in collection, the predominance of early stage loans in portfolios in a growing microfinance market[2] and the prevalence of delinquent loans that do not yield any income either temporarily or permanently. This is why the weighted average yield of AP-based MFIs is as low as 16%.

A comparison of the weighted average and typical yield (simple average) for the different legal types of MFI in the sample is presented in **Exhibit 6.1**. The frequency distribution in the exhibit indicates that compared to last year's 50% of MFIs (including six of the L-10 MFIs) with yields in excess of 30%, now just 30% have yields at that level. Whereas last year 42.2% of clients were covered by such MFIs, now just 16.4% of clients are covered by MFIs obtaining in excess of 30% yields.

Compared to the 36-50% real costs of bank loans for small borrowers (including all transaction costs) and moneylender interest rates ranging from 36% to 120% in various parts of the country, average yields less than 27% (outside AP) represent a substantial benefit for low income MFI clients. This is significant in the context of the intensified debate in India over the past two years about the suitability of interest rates charged by MFIs.

6.2 ...and returns to MFIs have declined significantly due to increased expenses

The financial viability of rated microfinance institutions in India, apparent in the 2005 Review, was under threat in 2007. While this situation was dramatically reversed in 2009-10, the current crisis in Indian microfinance has caused another reversal. **Exhibit 6.2** provides an analysis of Returns on Assets to Indian MFIs in comparison with the past, with global MFIs and relative to the banking sector. The 2.1% weighted average return on assets of the 2005 sample had been reduced to zero by 2007, less than the 0.8-1.2% returns on assets reported by the commercial banks in the country at the time.[3] The L-10 in the sample just broke-even collectively in 2007, well behind the 3.9% median return on assets of Bangladeshi MFIs that led in regional profitability at the time.

As the information for *typical* MFIs in the table below indicates, there were a large number of loss making organisations and relatively few, if large, viable ones. The frequency information in the table shows that only 20 of the 53 MFIs (38%) were making profits and just 8 of these (15%) had returns greater than 2% of their assets during the period 2005-07. Essentially, while the microfinance sector generally improved its performance from a typical loss of 13% in 2003 to a loss of 5% in 2005, this deteriorated again to a loss of around 10% by 2007.

The profitability performance of Indian MFIs had changed dramatically by 2009-10. The weighted average return on assets (RoA) of 6.8% for Indian MFIs was well above the global and Asian medians (around 1.5-2.0%) for microfinance and also substantially higher than the (1.0-1.2%) RoA of the banking sector (including rural banks). Only 6 of the 65 leading MFIs reported losses whereas 37 out of 65 (57%) recorded good profitability (with more than 2% RoA).

1 The APR is the highest income or yield that an organisation can earn from its portfolio based on the terms of its loans. The APR depends on the interest, fees and other charges, the loan term and the frequency of repayment.

2 In a flat interest rate regime the effective interest charged in the early stages of loan repayment (when the outstanding principal is high) is less than that in the latter stages when the principal outstanding is less, resulting in a higher yield. Thus, the more rapid the rate of growth of portfolio, the greater the difference between APR and yield.

3 Bandopadhyay, T, 2006. "Our pygmy banks", **Business Standard**, 21 September.

Exhibit 6.2

Return on total assets of MFIs

Models	Weighted average	Typical MFI	Region/country	
	%, 2011-12			%, 2011
NGO	1.2	1.1	Bangladesh	-15.9
Section 25	2.3	2.3	Nepal	2.7
Cooperative	2.3	2.3	S Asia	-8.2
NBFC	-8.6	-2.6	East Asia/Pacific	0.8
India 2012	**-7.4**	**-1.5**	Africa	4.0
– non-AP	3.9	1.3	Latin America	3.6
L-10	-9.9	-6.0	RRBs, 2011-12*	0.82
India – 2010	6.8	2.6	DCCBs, 2010-11*	0.35
– 2007	0.0	-9.8	Commercial banks, 2007	1.00
– 2005	2.1	-5.2	2010	1.05
– 2003	-1.5	-13.6	2012	1.08

* Source: RBI, 2012. **Trend & progress of banking in India 2011-12**. Mumbai: Reserve Bank of India

RoA - frequency distr.	MFI nos. 2007	2010	2012
<-2%	27		12
-2-0%	6	6	3
0-1%	7	12	14
1-2%	5	10	5
2-5%	8	17	17
>5%		20	5
	53	**65**	**56**

The significant change in MFI returns of the past year has been caused by the substantial write offs necessitated by the collapse of microfinance in Andhra Pradesh. Historically, it was the high efficiency (low OER) of Indian MFIs that played a key role in their profitability as did the significantly increased portfolio yield since 2007. However, substantial current write-offs (included partly in operating expenses and partly in loan loss provisioning) have increased the total expense ratio significantly and caused the weighted average return on assets for 2011-12 to register a large loss of 7.4% of assets. MFIs not directly affected by the crisis (non-AP), however, still earned a good 3.9% on assets in the year under review. These earnings were expected by M-CRIL (in the 2011 Review) to fall to around 2.0% in 2011-12 while earnings on all MFIs combined were expected to be significantly negative (2.5%) on account of the substantial write-offs AP MFIs would have to make at the end of the year. It turns out these estimates were too conservative.

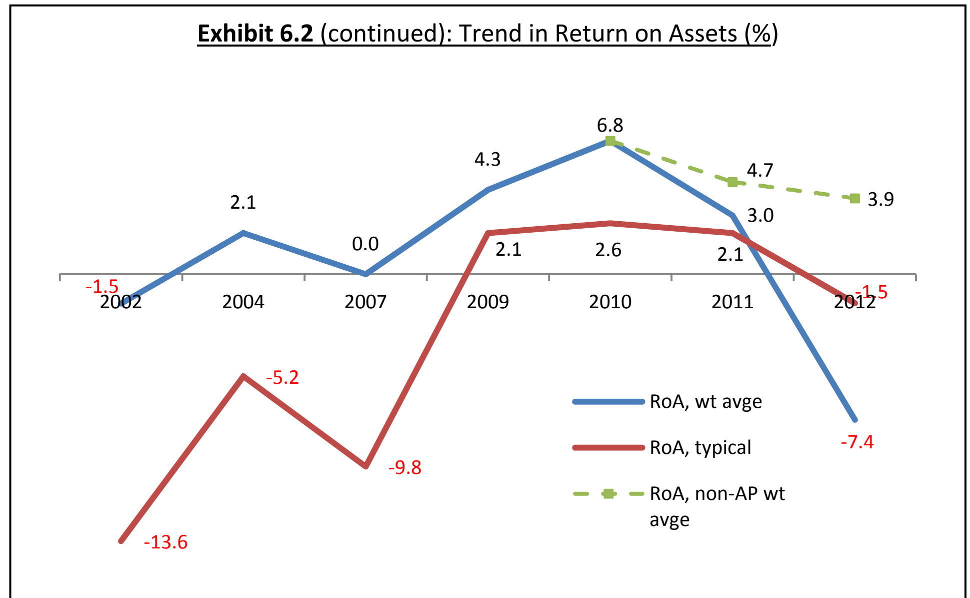


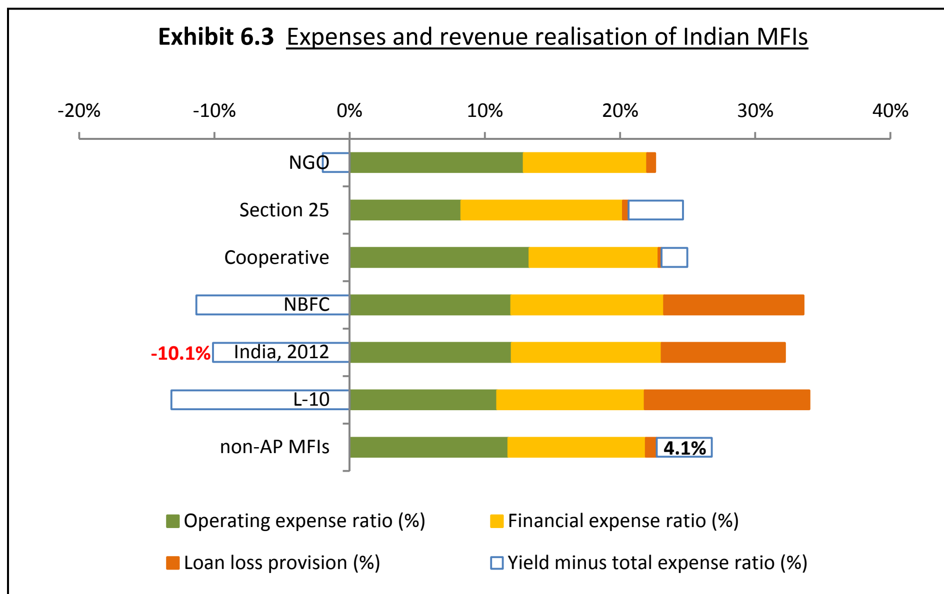
Exhibit 6.2 (continued): Trend in Return on Assets (%)

As discussed earlier, the crisis has not only had the effect of bringing microfinance in AP to a halt, it has also caused a sudden rash of prudence in commercial bank lending to MFIs (at the same time as a hardening in inflationary conditions in the country) resulting in an increase in lending rates. Thus the traditionally high borrowing cost for Indian MFIs became even higher with the financial expense

ratio rising from 9.2% in 2009-10 to over 10% for 2011-12 (**Exhibit 6.3**). These financial expenses are significantly higher than the South Asia norm of 9.2% and the 4.1% of East Asia/Pacific (according to the MIX database). The average loan loss provisioning ratio has, as expected, risen sharply from the 0.8% of last year to as much as 9.1% average for 2011-12 and even higher to 12.2% for the L-10 – 5 of which are based in AP and faced with substantial write-offs.

The weighted average typical expenses of non-AP MFIs in India (22-23% of portfolio) are still just below global ratios of around 24-26% and subtracting total expenses from the yield results in a surplus for these MFIs of 4.1% – substantially lower than the previous year but still reasonably positive. The situation of AP MFIs is, of course, unfortunate and results in a weighted average loss equivalent to over 10% of portfolio for the sample. Thus, while Indian MFIs continue to deliver microfinance to low income clients at a reasonable operating cost by the standards of typical international MFIs, they are now under considerable pressure resulting from loan losses (in AP) and the risk premium on funds on account of the loss of reputation that led up to the crisis.

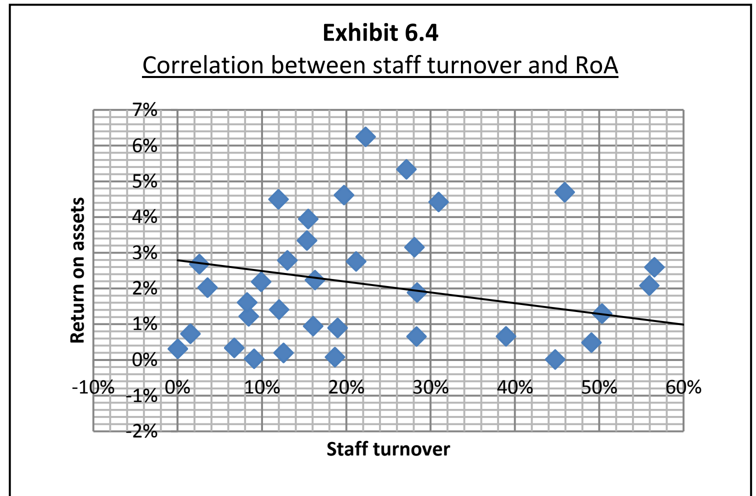
Exhibit 6.3 Expenses and revenue realisation of Indian MFIs



Models	Operating expense ratio (%)	Financial expense ratio (%)	Loan loss provision (%)	Total expense ratio (%)	Yield (%)	Yield minus total expense ratio (%)
NGO	12.9	9.1	0.6	22.6	20.6	-2.0
Section 25	8.3	12.0	0.4	20.6	24.7	4.0
Cooperative	13.3	9.5	0.2	23.1	25.0	1.9
NBFC	12.0	11.3	10.3	33.6	22.2	-11.3
India, 2012	**12.0**	**11.1**	**9.1**	**32.2**	**22.1**	**-10.1**
– non-AP	11.7	10.2	0.8	22.7	26.8	4.1
L-10	10.9	10.9	12.2	34.0	20.8	-13.2
India, 2010	**8.6**	**9.2**	**0.8**	**18.6**	**28.3**	**9.7**
L-10	8.1	9.2	0.8	18.1	29.0	11.0
India, 2007	**20.7**	**9.1**	**5.2**	**36.0**	**19.6**	**-16.4**
L-10	11.3	9.0	2.8	23.1	22.7	-0.4
Bangladesh	13.6	7.5	4.3	25.4	25.1	-0.3
Nepal	9.2	10.1	0.7	20.0	21.9	1.9
South Asia	12.6	9.2	0.5	22.4	23.2	0.8
East Asia/Pacific*	15.0	4.1	0.6	19.7	25.8	6.1
India compared to the World	**Highly efficient**	**Very high**	**Very high (cf portfolio)**	**Moderate**	**Moderate**	**Very low**

The **effect of staff working conditions and remuneration** (as indicated by the staff turnover rate) on the operating expense ratio was apparent in **Exhibit 3.11**. Though high turnover could be related to lower expenses through a lower remuneration, it was apparent that the OER is actually higher with a high staff turnover as it imposes increased expenses on the employer due to the need for additional recruitment and training. The relationship of staff turnover to staff satisfaction could also be reflected in yield and portfolio quality resulting in a significant negative relationship between staff turnover and return on assets – presented in **Exhibit 6.4.** This shows the expected (if somewhat weak) correlation between the two parameters.

Exhibit 6.4
Correlation between staff turnover and RoA

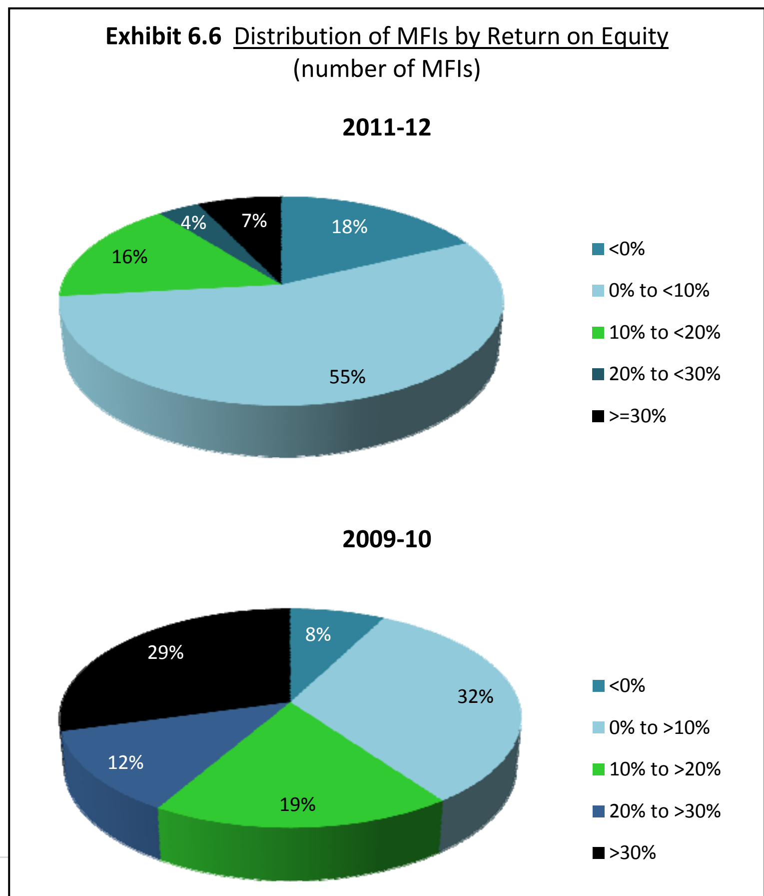


...and returns to equity have become substantially negative, as the 25.1% on a weighted average basis (**Exhibit 6.5**) for the 65 MFI sample (and over 30% for the L-10 in 2009-10) was reduced to just 9.6% and 9.8% respectively in 2010-11. On a simple average basis, the typical MFI earned a more modest 18.8% return on equity in 2009-10 which reduced to 14% in 2010-11. With the substantial write-offs of 2011-12 return on equity is now substantially negative on weighted average basis though the 12% weighted average RoE of non-AP MFIs is still respectable. As **Exhibit 6.6** shows, just 6 of the 56 MFIs in the sample earned more than a 20% return on equity while another 9 earned 10-20%. None of the others earned enough to be attractive to investors. The present situation is, of course, a disappointing result for all the investors who piled into the Indian market over the past few years with expectations of super-normal returns. However, it is precisely these expectations that created the moral hazard leading to concerns about lending quality and client protection that was responsible for the ongoing crisis.

Exhibit 6.5 Returns on equity to Indian MFIs, 2011-12, %

Legal Type	Typical MFI	Weighted average
NGO	-5.2	8.0
Section 25 company	33.4	33.4
Cooperative	13.4	10.2
NBFC	-37.0	-46.1
India, 2012	**-26.4**	**-42.5**
– non-AP	7.4	12.1
L-10	-13.1	-44.8
India, 2010	**18.8**	**25.1**
L-10	26.7	31.1

Exhibit 6.6 Distribution of MFIs by Return on Equity
(number of MFIs)



Despite the high level of write-offs this year, a substantial part of the AP portfolio – nearly 50%, amounting to Rs3,900 crore ($771 million) – remained to be written off on 31 March 2012.

The implications of the drastic intervention of the AP Government and slow progress towards a resolution of the crisis for the long term future of financial inclusion are still difficult to predict. It has already resulted in a substantial decline in capital – both debt and equity – available for microfinance and, as discussed in **Section 2**, has reversed the financial inclusion effect of MFI operations. Whether or not MFIs can continue to contribute to the process in India is now dependent on the passage of the Microfinance Bill by the Indian Parliament – a process that is currently moving very, very slowly. In the meantime, most low income families in AP have been thrown back into the not-so-benevolent arms of moneylenders with the emergence of a new informal financial sector offering 40-day loans with daily collections at interest rates of the order of 10% per loan (every 40 days). As this discussion has shown, many low income families elsewhere have also suffered collateral damage as the drying up of on-lending funds from commercial banks has caused a reduction in MFI operations throughout the country.[4]

Given the long time lag between the start of the crisis and the slow moves towards its resolution, it is apparent that the economic future of low income families has not received adequate attention; it needs to be brought immediately to the forefront of financial policy making so that the poor can receive practical support for their lives and livelihoods rather than the virtual tonic of a daily dose of soul searching rhetoric in the pronouncements of politicians.

[4] For a further, more detailed discussion of the causes of the microfinance crisis in India see Sinha, Sanjay. 2011. **Initial Public Offerings: The field's salvation or downfall?** Paper written for the Microcredit Summit 2011, September. Available on www.m-cril.com.

Chapter 7

Smart regulatory steps to promote micro-financial inclusion

At the time of writing, November 2012, the effects of the Indian microfinance crisis have taken their toll. As the discussion and analysis in this review shows, those MFIs that work extensively in Andhra Pradesh are in deep trouble. One medium-sized MFI that worked exclusively in the state has effectively been taken over by its lenders through the conversion of a significant part of their debt into equity and some of the larger MFIs have negotiated a six-year restructuring of their debt with their major lenders. Elsewhere, the shrinking portfolios some MFIs (in the absence of bank funding) have caused operational problems and led to the take-over of at least three MFI managements by investors. More acquisitions of this type are likely to occur in the near future.

7.1 The Microfinance Bill is yet to catch the fancy of parliamentarians

All microfinance stakeholders, whether within or outside Andhra Pradesh now await the passage of "The Micro Finance Institutions (Development and Regulation) Bill, 2012" tabled in the national Parliament on 29 May 2012. It is generally thought that the bill has the following positive features

1. It specifies that the central bank, Reserve Bank of India, will be the regulator of MFIs
2. It provides for MFIs regulated by RBI to accept thrift from their borrowers – thus, no public deposits but the provision of a savings service to borrowers
3. It clearly removes microfinance from the ambit of state-level money lending laws greatly reducing the risk of interference by state governments in the provision of financial services to low income families.

The **current status of the bill** is that it is under consideration of the Standing Committee on Finance of the Lok Sabha (lower house of Parliament). The Committee has invited comments from the public on the bill but has not actively discussed its provisions yet. Given the current pre-occupation of Parliament with corruption and the implications of various measures of economic reform of greater interest to the political class, the prospects for consideration of the Bill in the near future are not good.

In the meantime, the Government of Andhra Pradesh continues to challenge the constitutional validity of the bill on the grounds that in the Indian Constitution,

"List II (Item 30) mandates the State Legislature to regulate money lending and the money lenders as a part of protecting the public order. The manner of definition of money lending and the scope of regulation of money lending activities therefore falls under state jurisdiction."

It suggests that "Section 42 of the draft which proposes that MFIs shall not be treated as money lenders impinges on the legislative competence of the State and is therefore *ultra vires.*"

7.2 Summary of the revised Regulatory Framework

Norms/conditions	Revised after circular of 3 August 2012
Registration as NBFC-MFI:	Fresh applications to be submitted by 31 October 2012 [earlier this was 31 March 2012] in a revised format*
Minimum capital ("net owned funds") requirement	**Amount** (**Rs crore**) (**US$ million**) **By date** 3.0 0.6 31 March 2013 5.0 1.0 31 March 2014 NBFC-MFIs in the Northeastern states 1.0 0.2 31 March 2013 2.0 0.4 31 March 2014 New companies must have the higher level of capital immediately
Qualifying assets	All NBFC-MFIs are required to maintain at least 85% of assets that qualify as microfinance. **Assets originated after 1 January 2012 must meet all qualifying assets criteria**; any assets originated before that will be deemed to be qualifying assets but must be allowed to run off and will not be accepted as qualifying, if renewed. The qualifying asset criteria continue to be 1) **Annual household income levels** of borrowers: Rural, Rs60,000; urban/semi-urban: Rs1,20,000 2) **Total indebtedness** of borrowers: Rs35,000 for the first cycle; Rs50,000 from the second cycle; for this purpose, MFIs must be members of at least one credit information company/credit bureau + undertake checks in the community by MFI staff 3) **Loan tenure**, 12 months for amounts <Rs15,000 and 24 months for loans greater than that amount 4) **Repayment frequency** to be decided in discussion with the borrower – monthly, fortnightly, weekly 5) **Collateral** – none for microfinance loans 6) **Lending for income generation activities & restriction on multiple lending** (see next 2 points)
Lending for income generation activities	**Reduced to 70%** (from the earlier 75%); the remaining 30% can be used to lend for education, health, housing & emergencies
Multiple lending	**Only two MFIs can lend to a single borrower** whether as a member of SHG, joint liability group or as an individual. Every NBFC-MFI must be a member of at least one credit information company/credit bureau
Pricing cap/margin cap	**Pricing cap removed** but the margin cap has been retained at 10% for large NBFC MFIs (assets >Rs100 crore/$20 million) and 12% for smaller institutions. Therefore, **interest rate cap** = average borrowing cost during the financial year (April-March) + margin cap. Yield = borrowing cost + margin cap + 1% processing fee

Norms/conditions	Revised after circular of 3 August 2012
	Interest rates charged from borrowers cannot vary by more than 4% (between maximum and minimum)
Capital adequacy	All NBFC-MFIs (including those with >25% of portfolio in AP) must maintain a capital adequacy ratio (CAR) of 15% from 31 March 2013. In order to provide relief to MFIs with more than 25% of portfolio in AP, **100% of provisioning for the AP portfolio can be added back to capital for calculating CAR on 31 March 2013**. Over the next 5 years, this add-back of capital from provisioning will be reduced by 20% each year. Thus add back on **31 March 2014 will be 80%** of provisioning for AP 2015 60% 2016 40% 2017 20% 2018 and later – no add back
Regulatory compliance	**All NBFC-MFIs must be members of at least one self-regulatory organization** (SRO) **recognized by the RBI** and comply with the Code of Conduct prescribed by the SRO. Guidelines for the recognition of SROs will be notified soon. SROs will play a key role in ensuring compliance with the regulatory framework; banks lending to NBFC-MFIs will also ensure that systems, practices and lending policies of NBFC-MFIs are aligned with the regulation. Geographical exposure limits to avoid undue concentra-tion of lending in particular areas are required to be set by MFI Boards.
Non-microfinance NBFCs	NBFCs not complying with this regulatory framework must limit their lending to microfinance borrowers to 10% of their total assets. Wholesale lending to MFIs does not qualify as lending to microfinance borrowers. But this also means that **lending by banks to apex lenders of MFIs <u>does not</u> qualify as priority sector lending** (PSL).

* See http://rbi.org.in/scripts/NotificationUser.aspx?Id=7493&Mode=0#A1 for the format.

7.3 Commentary on the revised regulatory framework

The central bank's policy continues to be *restrictive* in placing margin caps and accepting income criteria that may not be practical to apply, but it has nevertheless been welcomed in the framework of the prevailing political economy of the country. Given the concerns of various state governments about the functioning of the microfinance sector, they would have expected the RBI to do no less. Still, **the role of a central bank** in the context of financial inclusion **should be to create a facilitating environment** for the financial system **and not to micro-manage the provision of financial services.** While the revisions incorporated in the circular of 3 August 2012 are welcome in removing a restrictive element of the pricing cap as well as easing the fulfillment of the CAR norm in the context of the AP crisis, **there are additional changes that could be made to improve the efficacy of the regulation from the perspective of financial inclusion**.

7.3.1 Income limits for eligible borrowers

Conditions	RBI circulars, 3 May 2011 & 2 December 2011	Suggested by EDA & M-CRIL, August 2012
Income limit for eligible borrowers from MFIs	Rural: Rs60,000 Urban: Rs1,20,000	**Rural: Rs1,00,000** Urban: Rs1,20,000

The family income limits set by the RBI assume that an urban income of Rs1,20,000 per annum is equivalent *in real terms* to a rural income Rs60,000. This is not so.

Data from the National Sample Survey for 2009-10 (NSS Round 66) presented in **Exhibit 7.1** below shows that the Rs60,000 rural income criterion for household income currently (2012-13) covers families belonging (at most) to the bottom 45% of the population. Also, this does not correspond to an income of Rs1,20,000 in urban areas. The equivalent of Rs60,000 in rural areas would be around Rs85,000 in urban areas, no more.

Exhibit 7.1

Maximum income levels by deciles of population

Income classes, deciles	Maximum annual family income, Rs NSSO 2009-10 (Round 66)	
	Rural	Urban
1	38,828	45,075
2	45,627	56,950
3	51,915	67,713
4	58,138	79,525
5	64,714	92,375
6	72,391	109,038
7	81,927	128,963
8	95,591	160,088
9	119,538	225,400

Present rural income limit, Rs60,000

Urban income limit, Rs1,20,000

*based on information from NSS, Round 66, adjusted to 2012-13 prices using appropriate Consumer Price Indexes

With the present rural household income limit then no more than 45% of the rural population is eligible to receive microfinance loans. Yet financial exclusion in rural areas is in excess of 80% of the population. On the other hand, in urban areas, the household income limit of Rs1,20,000 includes as much as 65% of the population – roughly covering all those currently excluded by the formal financial system.

On this basis, the urban limit of Rs1,20,000 per annum per family appears to be correct. However, **the rural annual income limit should be Rs1,00,000** and not Rs60,000. With this higher income limit, some 85% of the population in rural areas (or all those currently subject to financial exclusion) would be eligible to obtain loans from MFIs.

7.3.2 Assessing family income and indebtedness

Conditions	RBI circulars, 3 May 2011 & 2 December 2011	Suggested by EDA & M-CRIL, August 2012
Assessing family income	Self-certification by borrowers; local enquiries by MFI staff	**Use PPI to estimate family income**
Assessing indebtedness	Self-certification, local enquiry by MFI staff + membership of credit information companies (CIC)	Agreed: Membership of CIC for the long term; short term, no alternative to self-certification and local enquiry but **incentivize staff to get it right**

Assessing family income and indebtedness is usually regarded as a complex, time consuming and inaccurate process. The RBI addresses this issue by

i. Asking NBFC-MFIs to obtain self-certification from the borrowers on both issues
ii. Conducting their own local enquiries
iii. Becoming members of credit bureaus for obtaining information on indebtedness.

As the circular acknowledges, credit bureaus will take a while to become fully effective. Let alone obtain **information on borrowing from informal lenders**, even covering **borrowing from SHGs** will be a major challenge for credit bureaus in the near to medium term future. As research by M-CRIL has shown, SHG lending in the leading states with microfinance – such as AP and Tamil Nadu – substantially exceeds lending by MFIs and is an important factor in the indebtedness levels of low income families (see *M-CRIL Microfinance Review 2011*). The indebtedness question cannot be addressed with much more than "self-certification" though "local enquiry", particularly a real incentive to loan/field officers to ensure good information on the issue can still be fairly effective.

On income assessment, as EDA & M-CRIL have indicated in the past, **there has emerged a relatively simple proxy method of determining family incomes**. The Progress out of Poverty Index (PPI) relates assets (items like housing quality, bicycles, cookers) and social parameters (levels of education, quality of housing, sanitary facilities and so on) for a family to its household income as reported by the most recent national surveys (such as NSS). **Using the PPI**, **MFI field officers can make a proxy assessment of a family's income based on easily verifiable indicators**. This would be a more appropriate means of estimating family income than "self certification" which only perpetuates the culture of careless declarations that have become common in the targeting of welfare programmes in India.

7.3.3 Level of Indebtedness of borrowers

Conditions	RBI circulars, 3 May 2011 & 2 December 2011	Suggested by EDA & M-CRIL, August 2012
Maximum level of indebtedness of borrowers	Rs35,000, first cycle Rs50,000 from second cycle	Same as RBI – but **based on household incomes (to determine payment capacity) + business appraisal of loans**

One of the arguments of the critics of microfinance has been that MFIs have over-burdened low income borrowers with loans and this has led to hardship through foregone meals, sale of assets, borrowing from money lenders and other forms of distress for families struggling to keep up with the

payment of regular instalments on their loans. It is important, therefore, to estimate a maximum reasonable amount of loan repayment that a family can make from its annual income.

Exhibit 7.2 presents our estimates of the ability of families in various income groups (by decile) to make loan payments. The related (maximum) size of loan that could be serviced by the loan payment is estimated in the last two columns assuming a flat interest rate of 13.5% per annum (equivalent to a declining balance rate of 24.0% on a loan with monthly payments). As the table shows, families in the lowest two deciles cannot (comfortably) service loans greater than Rs6,000 in rural areas and Rs7,500 in urban areas. The present Rs60,000 household income limit for borrowers in rural areas means that the maximum loan size in rural areas should not exceed Rs15,000. Families that have incomes near the income limits suggested by EDA & M-CRIL – Rs1,00,000 in rural areas and Rs1,20,000 in urban areas – can service loans of the order of Rs40,000 and Rs45,000 respectively. Thus, the maximum loan size of Rs50,000 covers the loan payment capabilities of all families whose incomes are below the limits suggested here.

Exhibit 7.2

Estimated ability to set aside incomes for loan payments

Income classes, deciles	Maximum annual family income, Rs NSSO 2009-10 (Round 66)		Estimated % of income that could be set aside for loan payments		Disposable income available for family expenses		Loan size implications	
	Rural	Urban	Rural	Urban	Rural	Urban	Rural	Urban
1	38,828	45,075	10%	10%	34,945	40,568	3,421	3,971
2	45,627	56,950	15%	15%	38,783	48,408	6,030	7,526
3	51,915	67,713	20%	20%	41,532	54,170	9,148	11,932
4	58,138	79,525	25%	25%	43,604	59,644	12,806	17,517
5	64,714	92,375	30%	30%	45,300	64,663	17,105	24,416
6	72,391	109,038	35%	35%	47,054	70,875	22,323	33,624
7	81,927	128,963	40%	40%	49,156	77,378	28,873	45,450
8	95,591	160,088	45%		52,575	160,088	37,900	
9	119,538	225,400	50%		59,769	225,400	52,660	

* Inflated to 2012-13 rupees using the Consumer Price Index (CPI) for Agricultural Labour (Rural) and CPI for Industrial Workers (Urban).

Ultimately the key to good lending is knowledge of the borrowing family's income level (which can be broadly established via the PPI as discussed above) **and a good appraisal of its business capabilities** (in the case of loans for productive purposes). Some of the problems in microfinance until 2010 arose from the failure to adhere to these principles.

7.3.4 Implications of the margin cap – *"smart" regulation can make a difference*

Conditions	RBI circulars, 3 August 2012	Suggested by EDA & M-CRIL, August 2012
Margin cap + loan processing fee	10% for large MFIs; 12% for small MFIs; both allowed 1% loan processing fee	Definition of margin should exclude cost of loan loss provisioning

The removal of the interest cap is a welcome acceptance by the RBI of the reality of variations over time (and between MFIs) in the cost of funds. In the present high interest rate regime, when commercial banks have been lending to MFIs at over 14% and quite often at 16% the interest cap of 26% would have made it impossible for small MFIs to charge a 12% margin (since it would take the interest rate beyond 26%).

As argued by us in the past, **the difficulty in MFIs achieving viability was not so much from the interest cap as from the margin cap** (which remains in place). A 10% margin plus the 1% (of disbursement allowed as loan processing fee) for large MFIs must cover both loan loss provisioning as well as operating expenses. Since 1% of disbursement translates roughly to a 2% yield over the term of a loan, this means the maximum OER for viable operations of large MFIs is 10.5% (10% margin + 2% processing fee minus 1.5% for loan provisioning) and for small MFIs is 12.5% (on the same basis). The table in **Exhibit 7.3** shows that only 10 of the 24 large MFIs (portfolio>Rs100 crore as defined by RBI) in our sample would have been viable in 2011-12 if the rules were already applicable. Even if the definition is stretched to allow a 12% OER, it covers only 11 MFIs serving about 50% of the total number of clients.

Exhibit 7.3

MFI's currently operating within the margin cap

OER	Large MFIs	
	No.	% borrowers
<10.5%	10	48.5%
<12% large	1	1.6%
All large MFIs	24	89.3%
	Small MFIs	
<12.5% small	9	4.2%
<14% small	2	0.7%
All small MFIs	32	10.7%

In the case of small MFIs, only 9 of the 32 in our sample would have been viable (below 12.5% OER) and 11 of the 32 if the margin is stretched to 14%, reaching less than 5% of clients. Thus, overall, just 19 of the 56 MFIs in our sample (serving 52.7% of the total number of MFI clients) would have been viable in 2011-12 under the RBI's new rules.

EDA & M-CRIL's paper (July 2011) also showed that very few MFIs are able to restrict their OER to this level.[5] Those that did before the AP crisis were only able to do so by reducing their relationship with borrowers to a minimal level. It was this minimal relationship that lay behind the multiple lending, over-indebtedness and client coercion issues that resulted in the crisis.

Exhibit 7.4 below provides an "a priori" analysis of the effect of the margin cap on the viability of MFIs. **The cost of compliance** with the renewed emphasis on group promotion processes, more intensive relationships with low income clients and client protection **needs to be taken into account in determining the margin cap.** An achievable OER for large MFIs is 10.5%; for small MFIs it is more like 15%.

The analysis in the table shows that large MFIs can only adhere to the margin cap if they work very frugally and *forego the surplus required to service equity and enable accruals for moderate expansion*. The average small MFI cannot even cover its expenses within the margin cap. To **continue to limit MFIs to such low expense levels while also emphasizing group promotion processes and client protection issues is to make it impossible for MFIs to be viable**. With this margin cap, the MFI sector will continue to shrink as it has over the past 2 years. In order to provide microfinance in a reasonable environment that addresses borrower interests, RBI will need to consider some increase in the margin.

[5] M-CRIL, July 2011. **Of interest rates, margin caps and poverty lending: How the RBI policy will affect access to microcredit by low income clients.** Gurgaon: Micro-Credit Ratings International Limited (*www.m-cril.com*).

Exhibit 7.4

Effect of the margin cap on the viability of MFIs

% of portfolio

Component of MFI expense		Small MFIs	Large MFIs
Financial expenses [FE]		**16.0**	**15.0**
Components of Margin	Operating expenses	15.0	10.5
	Loan loss provision expense	1.5	1.5
	Surplus for equity enhancement	1.5	1.0
Margin required for viability (2012-13)		**18.0**	**13.0**
Yield to MFI/Cost to MFI client (to enable viable lending)		34.0	28.0
With margin cap		12.0	10.0
Loan processing fee (as % of outstanding portfolio) [LPF]		2.0	2.0
Yield/Cost to client (with margin cap) = FE + margin + LPF		30.0	27.0
Viability gap on account of margin cap		**-4.0**	**-1.0**

EDA & M-CRIL suggest that this matter can be addressed by **excluding loan loss provisioning expenses from the calculation of the margin**. This will introduce an element of "smart" regulation by allowing **MFIs to charge loan loss provisioning expenses in addition to the margin** in accordance with the performance of the portfolio in a geographical area. Thus, in those areas where portfolio quality is poor, borrowers will pay more due to the higher expected provisioning expenses while borrowers in geographical areas with good portfolio quality will automatically pay less due to a lower provisioning charge. This will reward borrowers in areas with good portfolio quality while penalizing those with poor portfolio quality, thereby introducing an incentive for improving the credit culture.

7.3.5 Capital Adequacy Ratio – *use "smartly" to promote financial inclusion*

The relief provided by the RBI in the calculation of the capital adequacy criterion is welcome. The role of the action by the AP government in the woes of MFIs operating there cannot be denied. However, as argued by us before there are longer term implications of the use of the CAR for promoting financial inclusion.[6] In this era of electronic data processing systems, it is quite possible to calculate CAR on a district-wise basis and to set it at levels that are proportional to the level of financial inclusion in the district – lower for those districts with lower levels of inclusion, thereby encouraging MFIs to operate there. This is another element of "smart" regulation that could promote development objectives to supplement the prudential effect of the CAR criterion.

7.3.6 Other issues – *restrictions on loan tenure/repayment frequency and loan purpose can unnecessarily affect the business relationship between the borrower and her lender*

In its circulars of 3 May 2011 and 2 December 2011, the RBI sensibly stipulated that **repayment frequency** (weekly, fortnightly, monthly) should be negotiated between lender (MFI) and borrower. This is an appropriate recognition of the business relationship between the two parties. Yet, the loan tenure continues to be rigidly specified as 12 months for loans less than Rs15,000 and two years for larger loans up to the Rs50,000 limit. Experience over the past 15 months, as indicated by feedback from microfinance borrowers, shows that such **borrowers are generally more comfortable with 12 month repayment cycles from a cash management perspective**. This reinforces our belief that these restrictions on loan tenure are an unnecessary interference in the business relationship between borrower and MFI. While it could be argued that less educated borrowers need protection

[6] See **A financial inclusion approach to microfinance regulation**: Supplementary suggestions on the recommendations of the Malegam Committee, 10 February 2011 (*www.m-cril.com*).

from excessive pricing, not much purpose is served by forcing such borrowers to manage their funds over a longer period than they would like.

Finally, we have argued before that, on account of the fungibility of money, **the restrictions on loan purpose** (70% of loans to be given for productive purposes only) **are effectively redundant**. What is there to stop a microfinance borrower running down the stocks in her *kirana* (grocery) store in order to accumulate cash for her daughter's wedding and then show the premises, devoid of stocks, to an MFI as evidence of her need for a "productive" microfinance loan? Such a restriction – like the one requiring self-certification of income – does no more than result in a casual approach to the collection and use of information. Inaccurate information results in inappropriate management decision making causing efficiency losses to the economy as a whole. As a society, India would do well not to continue to promote this culture of economy in truth-telling; it is inimical rather than beneficial to the welfare of the poor.

Conclusion: A "smart" approach to regulation could create a dynamic environment for micro-financial inclusion

The RBI has been studied and cautious in its response to the microfinance crisis. **EDA** & **M-CRIL hope that the RBI will also be dynamic in its approach to the needs of low income families for financial services.** The suggestions made in this chapter for a degree of "smart" regulation could provide some food for thought.

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Glossary of terms

Annual percentage rate (APR)	Expected earnings from a loan portfolio based on the stated terms of the financial institution's loan products
Capital Adequacy Ratio (CAR)	Ratio of net worth to risk weighted assets (Risk weights: 100% for all assets except fixed assets & interest bearing deposits: 50%; cash 0%).
Client retention rate	Rate as reported to MIX by MFIs – defined by MIX as active borrowers at the end of the period to (active borrowers at the beginning of the period + new borrowers during the period)
CRILEX	M-CRIL's index of growth of the microfinance sub-sector
DCCB	District cooperative central bank
Financial spread	Portfolio yield minus financial costs (interest paid on borrowings, interest paid on deposits and loan loss provision expenses)
Financial cost ratio (FCR)	Total interest expense for the year divided by the average portfolio
Financial inclusion ratio	Extent of coverage of the population of a region by financial services provided by formal financial institutions
GNI per capita	Gross national income per capita – ratio of the dollar value of a country's final income in a year divided by the population
Loan loss provisioning ratio	Total loan loss provision expense for the year divided by the average portfolio
Loan loss reserve ratio	Ending Loan loss reserve divided by ending gross loan portfolio.
Managed portfolio	Portfolio sold to other financial institutions/banks or securitised but still managed in the field by the MFI. For calculating OER, Yield, FCR, TER, LLP, LLR (excluding RoA) managed portfolio has been included in the loan portfolio figure where applicable.
Cost per borrower	Ratio of operating expenses to number of borrowers
Coverage ratio/MF penetration	Ratio of number of loans outstanding to estimated number of financially excluded families
Operating expense ratio (OER)	Sum of staff, travel, administration costs, other overheads and depreciation charges of the MFI divided by average loan portfolio.
Operational Self-Sufficiency (OSS)	Ratio of total income to total expenses for the year

Portfolio at risk (>=30 days) (PAR30)	Ratio of the principal balance outstanding on all loans with overdues greater than or equal to 30 days to the total loans outstanding on a given date
Return on assets (ROA)	Ratio of operational income/loss to average total assets
Return on Equity (ROE)	Ratio of operational income/loss to average total equity
RRB	Regional rural bank
Staff turnover rate	Rate as reported to MIX by MFIs – defined by MIX as number of exit during the period to average (number of employees at the end of the period + staff employed for one year or more)
Total expense ratio (TER)	Ratio of total financing expenses, loan loss expenses and operating expenses to the average loan portfolio
Yield on portfolio	Interest and fee income from loans to clients divided by the average loan portfolio for the year
Write off ratio	Ratio of write off amount to average gross loan portfolio

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