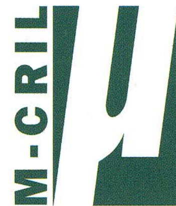

Micro-Credit Ratings International Limited

M-CRIL Microfinance Review 2014:

Risk, regulation & reward

a financial & social analysis

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A financial & social analysis

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Preface to the M-CRIL Review 2014

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
9	2014	Risk, regulation & reward

This year's review is Volume 9 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 risk and rewards from the sector in relation to its regulation as well as financial service provision in the country in general.

This 2014 Review is based on an analysis of financial data from the 51 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. The M-CRIL sample consists of 44 NBFCs, 4 NGOs, two (not-for-profit) Section 25 companies and a Local Area Bank. The review also uses outreach data and the limited social performance information provided by these MFIs and uploaded on the MIX Social Reporting platform until end-October 2014. In addition, social performance information from various M-CRIL and EDA assessments has been used to round out the still sketchy data available on this subject.

The **Table of Contents** provides a substantive flavour of the content of the review so we have not undertaken an executive summary.

The M-CRIL Microfinance Review can be downloaded from **www.m-cril.com**.

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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 2014, M-CRIL had undertaken over 1,600 financial and social ratings and assessments of nearly 1,000 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.

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 tradition of providing a wide range of assessment and microfinance support services, M-CRIL undertakes

Microfinance Institutional Ratings
along with other international microfinance rating agencies
incorporating responsible governance, management parameters and financial performance
along with client protection, transparency and mission orientation assessments
Social Ratings
Loan Portfolio Audits
SMART client protection assessments
Risk assessments and advisory
Code of conduct assessments
Truelift and PPI assessments

also ratings/assessments of

Microfinance Investment Vehicles (MIV)
(combined financial and social rating)

Low Cost Private Schools
(for children from low income families)
NGO programmes
and
Value Chain Initiatives
(to assess their impact on poverty and the efficiency and effectiveness of programmes)

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Chapter 1

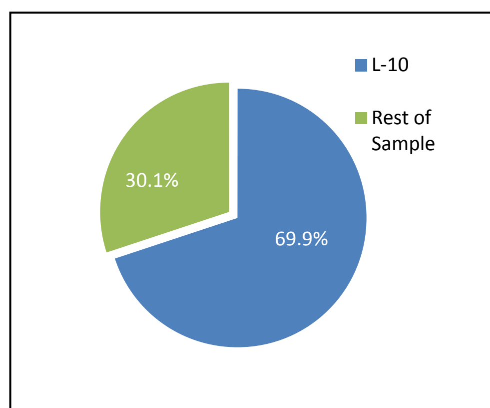
The MFI contribution to inclusion is still hobbled by the ban on deposits

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

Table 1.1

Active borrower accounts of 51 leading Indian MFIs, March 2014

Legal Type	Reported		Revised	
	Number	%	Number	%
NBFC	27,686,939	96.4%	24,495,544	95.9%
Others	1,044,983	3.6%	1,044,983	4.1%
Sample – India	**28,731,922**	**100.0%**	**25,540,527**	**100.0%**
L-10	20,842,669	72.5%	17,858,890	69.9%



As a result of the high growth rate of Indian microfinance during the late 2000s, the nominal number of clients served by MFIs grew dramatically until October 2010 as shown by earlier M-CRIL Reviews. 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.

In the context of the AP crisis, the number of credit accounts reported is, however, misleading. The AP-based MFIs adjusted their client numbers after March 2011 but only to the extent that outstanding portfolios were written off. Accounts long overdue (some by over 12 months) but not yet written off remained on their books and were reported as existing borrower accounts. M-CRIL does not regard such accounts as "active". 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 **Table 1.1** above provides a more accurate indication of the Indian microfinance sector. On this basis, the total for the sample fell below 20 million in March 2012 as a result of the AP crisis, a reduction of more than 36% compared to March 2011.

Since then the microfinance sector has grown again and reached over 25 million **active** borrower accounts at the end of March 2014. This growth is discussed in some detail later in this Review. **Figure 1.1** shows the trend in active MFI borrower accounts and **Figure 1.2** shows the extent to which the trend in the commercialisation of the microfinance sector has continued despite the microfinance crisis with over 96% of borrower accounts now with non-bank finance companies (NBFCs) compared with 73% in 2006 and a significantly smaller proportion in the years.

Figure 1.1 Trend in active MFI borrower accounts

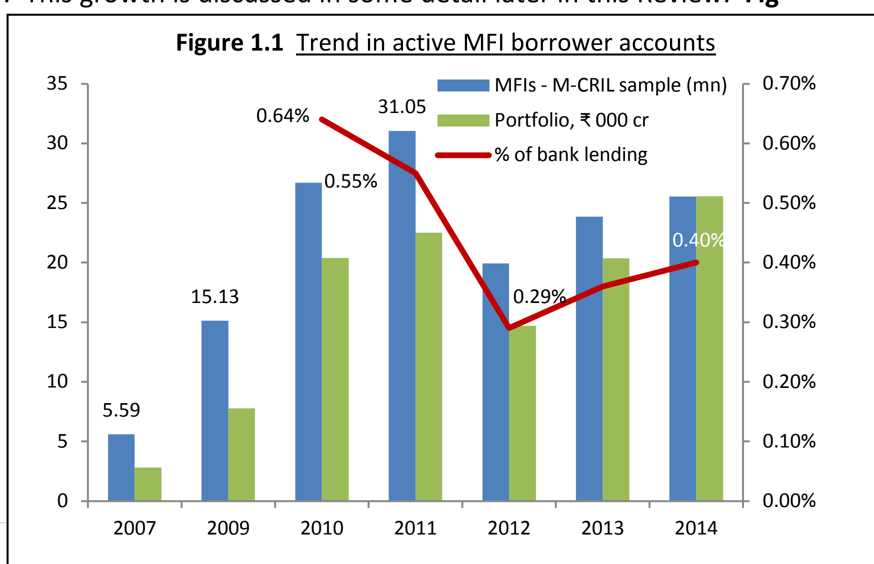
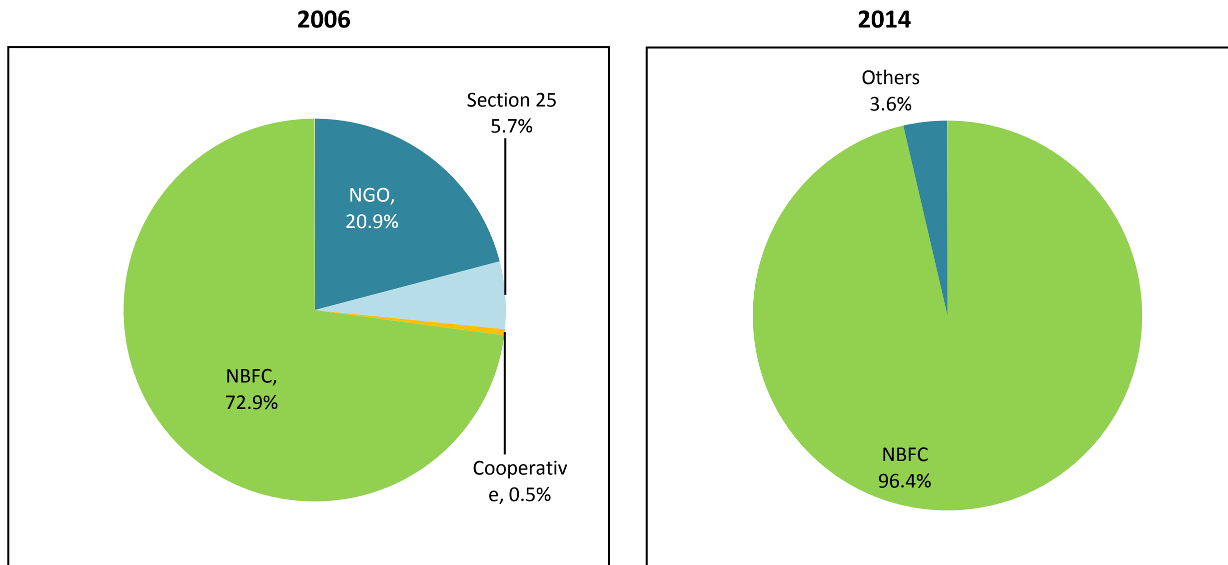
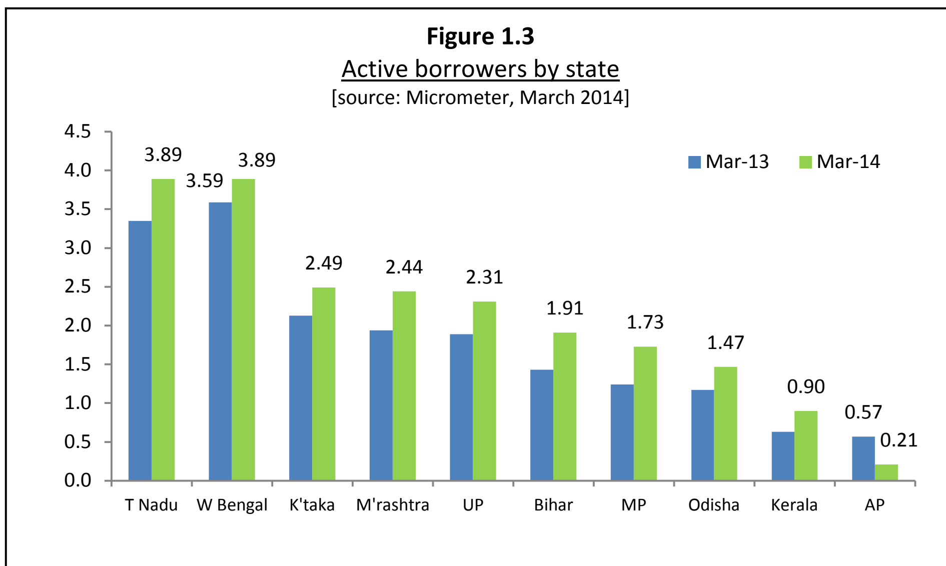


Figure 1.2
Active borrowers by legal type of MFI



The bar chart in **Figure 1.3** shows the state-wise disaggregation of borrower accounts for end-March 2013 and end-March 2014 for the leading ten states by number of MFI borrower accounts.[1] It shows the importance of the states of Tamil Nadu and West Bengal after the eclipse of Andhra Pradesh in the microfinance landscape of India. The numbers for AP have been reduced from the notionally still high number since virtually all are defaulters. It also shows the importance of Karnataka, and the relatively recent spurt of growth in Maharashtra, Uttar Pradesh, Bihar and Madhya Pradesh which are increasingly relevant in the microfinance landscape.

Figure 1.3
Active borrowers by state
[source: Micrometer, March 2014]



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 for March 2012 increased to 26.82 million for the 184 MFIs of the Sa-Dhan report. This showed that the average size of the 128 small MFIs not in the M-CRIL sample averaged just 7,400 borrowers. It is also interesting to note that the Sa-dhan report incorporated data from 266 MFIs for 2011 but had information for only 184 MFIs in 2012. Dozens of small MFIs are now too shy to report either due to shrinkage in their operations or total collapse of their microfinance portfolios.

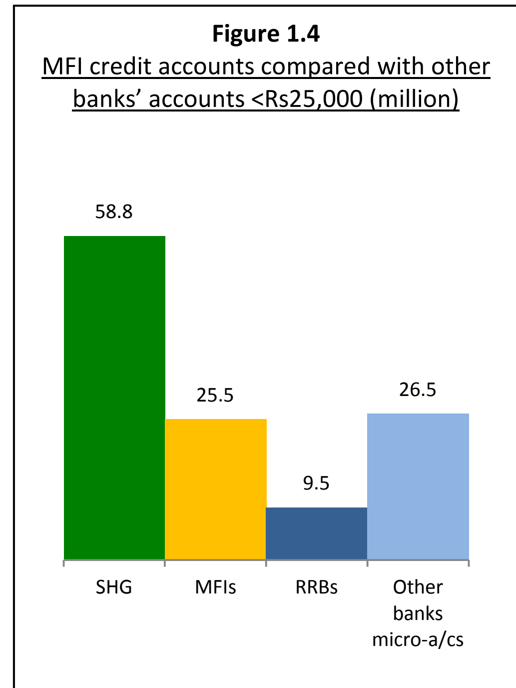
More importantly, even with 25-26 million borrower accounts the size of the microfinance sector more than matches significant parts of the Indian financial system in terms of the number of citizens affected. This number is still over **two and a half times** the number of micro-credit accounts (less

[1] As amended by MFIN, 2014. **Micrometer, March 2014**. Gurgaon: MicroFinance Institutions Network.

than Rs25,000, $500) serviced by the Regional Rural Banks (as shown by the information in **Figure 1.4**). In spite of the loss of all MFI operations in AP, MFI borrower accounts have grown again and are now over 95% 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 40%. 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 120 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.

Figure 1.4

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



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 now a 15-20% overlap of borrower accounts in the MFI sector, M-CRIL's estimate of around 20 million unique MFI borrowers means that MFIs currently serve around 7% of the total population of around 280 million families in India (and 10% of financially excluded families). The total number of MFI credit accounts (over 25 million) is substantial even in comparison with the number of **all** credit accounts (~128 million) served by all commercial banks.[2]

1.2 …and MFI portfolios are substantial relative to micro-lending by banks

The current sample of Indian MFIs reported a total **active portfolio outstanding** (owned + managed) of Rs25,556 crore ($4,400 million) on 31 March 2014. This was up by 74% on the March 2012 **active** portfolio of Rs14,702 crore ($2,883 million at the time). The largest 10 (L-10) MFIs now manage around 66% of the total portfolio of sample MFIs (while serving 70% of all active borrowers).

Table 1.2 Distribution of outstanding portfolio by legal type

Legal Type	Outstanding Portfolio			% of total
	Rs crore		US$ mn	
	Reported	Revised		
NBFC	27,601	24,655	4,105	96.5
Others	901	901	150	3.5
India	**28,502**	**25,556**	**4,255**	**100.0**
L-10	19,749	16,945	2,821	66.3
	March 2014*			Mar-10
Portfolios of…	**Rs crore**	**MFI portfolio as % of bank**		
Scheduled banks	**64,09,400**	**0.40%**		**0.64%**
– a/cs <Rs25,000	94,800	26.9%		41.2%
RRBs	160,000	16.0%		27.6%
– a/cs <Rs25,000	13,900	**184.0%**		**159.8%**
DCCBs	193,500	13.2%		19.5%

* all data for 2014 is extrapolated from RBI numbers for 2011 & earlier years and earlier years

While MFI operations remain a small proportion of the overall financial system in terms of money, it is not so in terms of clients served (as already discussed). Even in terms of money, MFI portfolios (until the onset of the current crisis) grew much faster and have done so again over the past two years. As a result, in terms of portfolio size as well as clients served it has become an increasingly significant part of the financial system. As the analysis

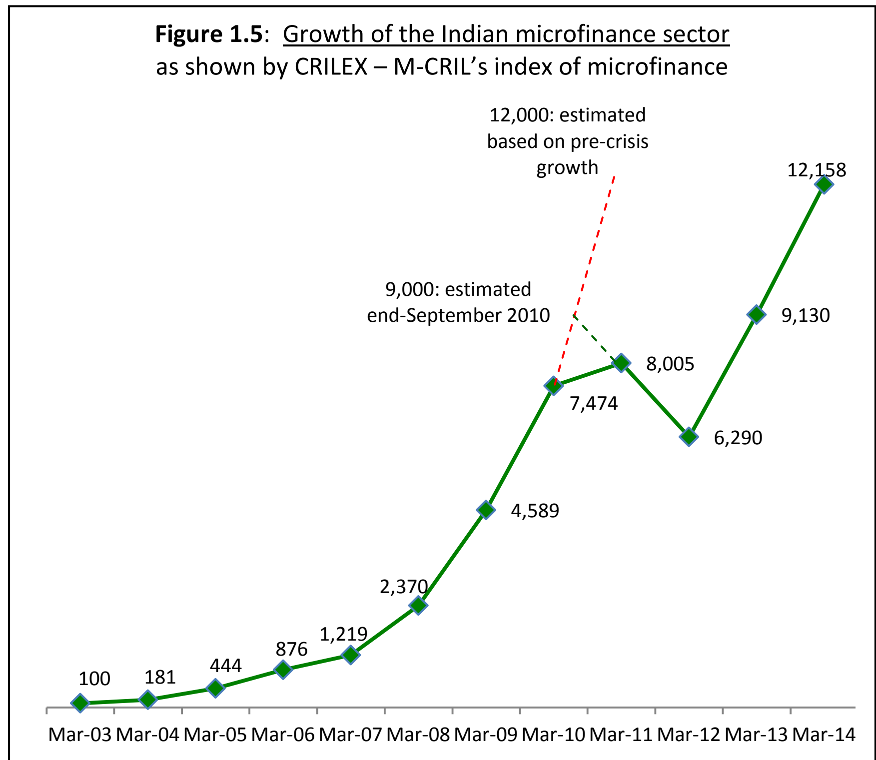
[2] All banking information used in this analysis is taken from RBI, various. **Statistical Tables Related to Banks in India.** Mumbai: Reserve Bank of India. Information for 2012 & 2013 has been extrapolated to obtain the 2014 figures (not available currently).

in **Table 1.2** shows the end-March 2014 portfolio of the MFIs accounts for just 0.40% of the total credit outstanding from the banking system, but it has grown from just 0.29% of the banking system and now accounts for over 27% of the micro-credit portfolio of the banking system (41% in 2010), still around 16% and 13% of the total credit outstanding of the RRBs and cooperative banking system respectively.[3]

Four 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]."

Figure 1.5: Growth of the Indian microfinance sector as shown by CRILEX – M-CRIL's index of microfinance



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. After two years of stagnation and decline though the growth of the MFI sector picked up again in 2012-13 and accelerated in 2013-14 as shown by CRILEX, M-CRIL's Index of Indian Microfinance in **Figure 1.5**. It is apparent from the figure that it took the MFI sector 3 years (until end-March 2014) to scale the giddy heights (expected level of 12,000) it was headed for as early as end-March 2011. Whether or not the high growth rate of the past two years is starting again to pose a risk for the sector is a moot point and is discussed in **Chapter 4** of this review.

Table 1.3 presents the portfolio size distribution of Indian MFIs. There are now 32 institutions with portfolios in excess of ₹100 crore, up from 24 in March 2012. These large NBFCS account for over 96% of the total outstanding portfolio of MFIs (and 94% of the borrower accounts).

The average portfolio of the 82 RRBs in March 2012 was Rs1,419 crore. Ten MFI portfolios exceeded Rs500 crore ($100 million), a portfolio size comparable to RRBs and their combined number of borrower accounts (23.2 million) exceeded the total for all RRBs but just 2 MFIs with active portfolios in excess of the RRB average. By March 2014, due to growth but also on account of further amalgama-

[3] All banking data from RBI, 2013 & 2014. **Statistical Tables Related to Banks in India**. Mumbai: Reserve Bank of India.

tion, the average portfolio of the 56 remaining RRBs was (estimated at) ₹2,855 crore. As **Table 1.3** shows, there were 13 MFIs with portfolios in excess of Rs500 crore. Just 7 MFI portfolios exceeded ₹1,000 crore (a level comparable with the current RRBs) and only 2 exceeded the RRB average. Nevertheless, given that their combined portfolios were nearly twice as much as the micro-credit portfolios of the RRBs (**Table 1.2**) and the number of borrower accounts over 2.5 times as many (**Figure 1.4**), **the substantial impact of the MFI sector on the availability of financial services for low income families is apparent**.

Table 1.3: Portfolio size distribution of MFIs

Portfolio Size, Rs crore	Number of MFIs	Rs crore		Proportion of total	
		Portfolio	Average	Portfolio	Borrower accounts
<25	4	59	15	0.2%	1.1%
25 to <50	7	265	38	1.0%	1.8%
50 to <100	8	559	70	2.2%	2.8%
100 to <500	19	3,966	209	15.5%	14.4%
>=500	13	20,706	1,593	81.0%	79.9%
Sample	**51**	**25,556**	**501**	**100.0%**	**100.0%**

1.3 …accentuated by the disappointing results of the banks' financial inclusion efforts

This contribution of the MFI sector is brought into further focus by the disappointing results of other efforts by the RBI and the Government of India to promote financial inclusion presented in **Table 1.4**. There have been many years of effort through "zero balance accounts" now re-named Basic Savings Bank Deposit Accounts (BSBDA) and the branchless banking channel comprised of business correspondents (BCs) – a channel that is now liberally deployed through many different means (including local grocery stores and now MFIs). However, **the achievement of this effort is still insubstantial**. As the table shows, the average deposit amount in BSBDAs remains at just ₹1,285 ($21) and ₹334 ($5.57) for BC facilitated accounts. The number of transactions through such accounts remains low (at just about 3 per year over the past several years) and the amount transacted per BC account (in 2013-14) at ₹4,500 ($75) has only picked up recently due to the advent of direct benefit transfers through such accounts. It could be argued in this context that with large numbers of new accounts held by persons with little or no experience of such transactions, the number of transactions will take years to register significant growth. But this is precisely why the role of MFIs in financial inclusion cannot be denied. The well established links of MFIs with financially excluded families can play a valuable role in promoting financial inclusion. The RBI's moves since July 2014 to facilitate the establishment of small finance banks is, therefore, appropriate and welcome. Those

Table 1.4 Performance of financial inclusion initiatives through commercial banks

	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14
BSBDA through BCs (mn a/cs)	13.3	31.6	57.3	81.3	116.9
- deposit amount (₹ '000 crore)	1.07	1.82	1.05	1.82	3.90
BSBDA – total (mn a/cs)	73.5	104.8	138.5	182.1	243.0
- deposit amount (₹ '000 crore)	55.0	76.1	120.4	182.9	312.3
Average deposit amount - total	748	727	869	1,004	1,285
- through BCs	804	576	184	224	334
ICT a/cs - BC transactions, (mn)	26.5	84.2	155.9	250.5	328.6
- amount in ₹ '000 crore	0.69	5.80	9.71	23.39	52.44
Transactions per BC account	2.0	2.7	2.7	3.1	2.8
Amount transacted per a/c, ₹	519	1,834	1,694	2,877	4,486
- per transaction, ₹	260	689	623	934	1,596

Source: Table , **RBI Annual Report 2014.** Averages by M-CRIL

MFIs that are able to transform will thereby be in a position to offer deposit as well as services; an essential pre-condition to the achievement of meaningful financial inclusion.

1.4 But is multiple lending in microfinance still an issue to be addressed?

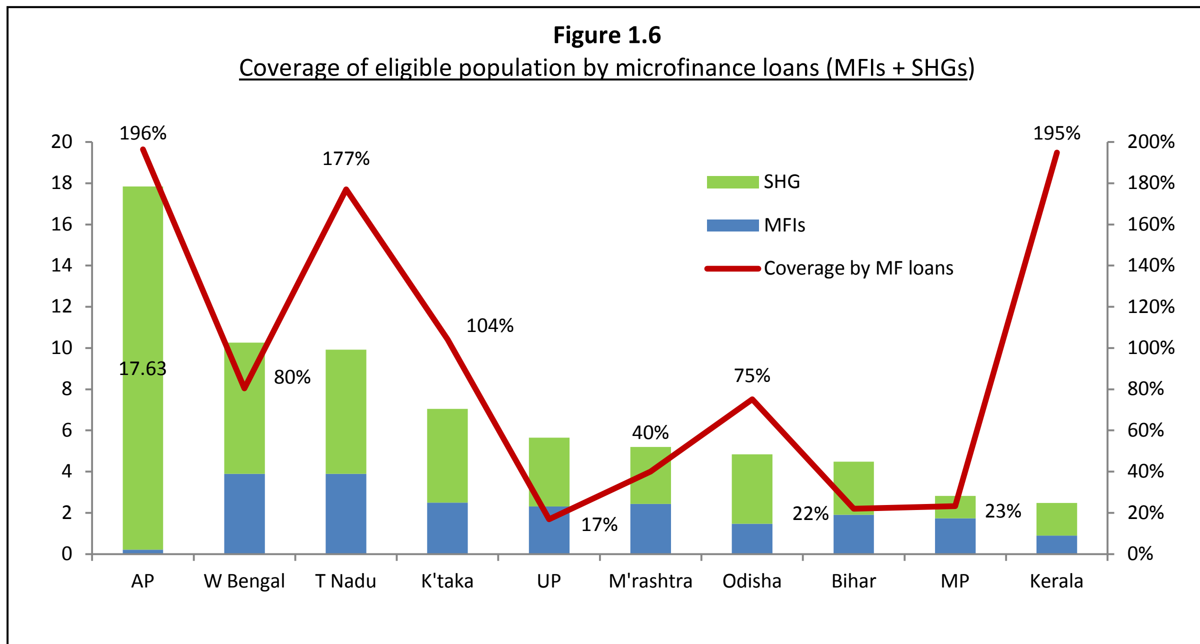
As the discussion in this section shows, the disruption in Indian microfinance caused by the AP ordinance was substantial. The apparent reasons for the ordinance were

- 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 was excessive lending in AP (and in other states of India) and who was responsible for it was assessed in the analysis **Chapter 2** of the **M-CRIL Review 2012**. The state-wise picture that emerged from that analysis showed that **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%).[4] Since distribution across districts and across families is well known not to be even, it is apparent that there was 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 were not evenly distributed this meant 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 the crisis.*

A parallel analysis of current (end-March 2014) microfinance lending is presented in **Figure 1.6**.

Figure 1.6
Coverage of eligible population by microfinance loans (MFIs + SHGs)



4 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.

The number of SHG loans is obtained from NABARD's 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 2014 and the state-wise information collated by MFIN in Micrometer. 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 (based on the World Bank's FINDEX survey of 2011) 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 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 figure shows the extent of coverage of the financially excluded population in each state by microfinance loans (whether from MFIs or SHGs).

The extent of coverage nationwide amounts to 45% of the total number of excluded families, assuming a one-to-one correspondence between the number of microfinance loans and financially excluded families. 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 35-40%. Since the amount of each loan is also inadequate for most families' needs, the scope for further expansion of microfinance in India remains substantial. This is discussed further in **Chapter 3**.

While the extent of coverage is not so high, the state-wise picture is much less sanguine. The leading 10 states have been arranged in the figure by order of the number of microfinance loans outstanding there. **Andhra Pradesh, which 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 still has amongst the highest levels of coverage despite the almost negligible number of MFI loans active there. **Due to the high SHG activity in the state**, nearly 18 million loans outstanding from SHGs to individual members**, the coverage of microfinance loans in AP is still nearly twice as much as the number of financially excluded families**. More importantly, to the extent that microfinance loans are not evenly distributed this means that there may still be a significant number of financially excluded families in AP that have as many as 3-4 loans at one time mainly from SHGs. *This raises a question about the extent to which it was SHG rather than MFI lending that was responsible for the 2010-12 crisis.*

The other main states with high proportions of microfinance loans outstanding are still the other southern states – Kerala (195%), Tamil Nadu (177%) and Karnataka (114%); West Bengal (80%) and Orissa (75%) also have high coverage ratios.[6] Since distribution across districts and across families is well known not to be even, it is apparent that there is still some multiple lending in all of these states. The extent of microfinance lending in these states needs to be watched closely both by MFIN and the regulator.

In terms of absolute numbers of microfinance loans, it is UP, Maharashtra and Bihar where the greatest absolute increases have taken place. All still have low microfinance coverage ratios (17%, 40% and 22% respectively) indicating potential for the further growth of MFIs (and SHGs) there.

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

[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.

1.5 And is the regulator on the verge of resolving the deposit-taking conundrum?

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 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 were able to get such ratings and even these could only accept deposits under highly restrictive conditions.

Most of the MFIs in the analysis (including the Section 25 companies) have not provided data on savings since such services are technically illegal under the RBI Act. Some NBFCs do collect security deposits/cash collateral (usually interest free) from their clients up to a certain (around 10%) proportion of the loan. Most 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. Only one NGO and a local area bank (licensed to take deposits) have reported on the quantum of their deposits.

Due to the lack of regulatory tolerance of deposit mobilisation, development and innovation in the provision of deposit services has been negligible. 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 lay 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 is much more likely to be wholesome, requiring a greater investment by MFIs in customer satisfaction than has been seen so far.

In July 2014, the RBI put out draft guidelines, and at the end of November, final guidelines for the establishment of Small Finance Banks. It appears from these guidelines that the regulator, under new leadership, has now accepted the idea of an institutional arrangement whereby the microcredit provider also offers micro-deposit services and facilitates other forms of financial inclusion such as micro-insurance and micro-pensions. The next few months (the first half of 2015) may well see the vision of an MFI offering deposit services come to fruition.

The following chapters discuss the effects of the extant regulation on the operations and performance of contemporary microfinance institutions. **Chapter 2** specifically covers the effects of the margin cap on the expenses and yield of MFIs.

Chapter 2

The margin cap has had the effect of limiting OERs

Price regulation in microfinance started in December 2011 with a 26% cap on the interest rate charged and an allowance of 1% for loan processing fee resulting in an effective interest rate allowed of around 28%.

In August 2012**, the pricing cap was removed** but a margin cap of 12% (above average annual borrowing cost) was introduced. Until end-March 2014 this pricing cap was applied irrespective of the size of the MFI. With effect from 1 April 2014, the margin cap may not exceed 10% for large MFIs (with portfolio exceeding ₹100 crore/$16 million) and 12% for smaller institutions. Therefore, the **interest rate cap** = average borrowing cost during the financial year (April-March) + margin cap and the Yield = borrowing cost + margin cap + 1% processing fee.

At the same time (from 1 April 2014), an **alternative calculation of the pricing cap** was also introduced as 2.75 times the average base rate of the five largest commercial banks (as calculated by the RBI) on the last working day of the previous quarter. Since then the average base rate has been static at 10.09% resulting in an interest cap of 27.75% and a yield of around 29.7%.

The **applicable cap** is the lower of the two rates calculated as above.

2.1 Compliance with the margin cap an be a challenge

Since the alternative calculation is relatively generous it is normally the first of the two conditions for the calculation of yield that has applied so far. **Table 2.1** shows that with an average annual borrowing cost of 15%, a typical MFI (with a permissible margin of 12%) could earn a 1.9% return on portfolio[1] and would have a permissible yield of 29% during 2013-14. For those MFIs with annual borrowing cost lower than 15%, this yield would be lower by the margin between the 15% borrowing cost assumed in the table and the MFI's actual average borrowing cost. Thus, if the average borrowing cost is 14.0%, the permissible yield would be 28.0%, and so on.

Table 2.1
Calculation of permissible yield on portfolio

Average cost components	% of portfolio
Annual borrowing cost	15.0%
Operating expenses (OER)	9.2%
Loan loss provision	0.9%
Return on portfolio	1.9%
Permissible margin	**12.0%**
Loan processing fee (1%)	2.0%
Permissible yield	**29.0%**

If the average borrowing cost is higher, say 16%, the yield calculated in this way would be 30%. Since this yield is higher than the RBI's alternative pricing cap of 29.7%, it is the latter cap that would apply. This would necessitate the application of economies in the OER and/or a reduction in the return on portfolio.

The level of compliance with the 12% margin cap during 2013-14 is shown in **Table 2.2**. According to this, 24 of the 45 MFIs in the M-CRIL sample were in compliance of this regulatory requirement while 21 were not. Many of those in the latter category were either marginally above the margin cap or relatively new institutions. A couple of the non-compliant NBFCs see themselves as microenterprise

[1] Return on portfolio is profit divided by average portfolio for the year. A 1.9% return on portfolio translates to an RoA of 2.5% if portfolio constitutes 75% of total assets.

lenders and have not, therefore, applied for NBFC-MFI registration. For the record, Cashpor (a Section 25 company) is also compliant with the regulation but the four NGO MFIs in this sample are non-compliant (albeit not covered by the regulation).

Table 2.2 Compliance of NBFC-MFIs with margin cap

NBFC Assets	Margin + 2% yield on LPF during 2013-14	Number of MFIs	Margin + 2% yield on LPF since April 2014	Number of MFIs
<₹100 crore	<12%	3	<12%	3
	>12%	10	>12%	10
>₹100 crore	<12%	21	<10%	11
	>12%	11	>10%	21
	Compliant	**24**	If same cost structure in 2014-15	**14**
	Non-compliant	**21**		**31**

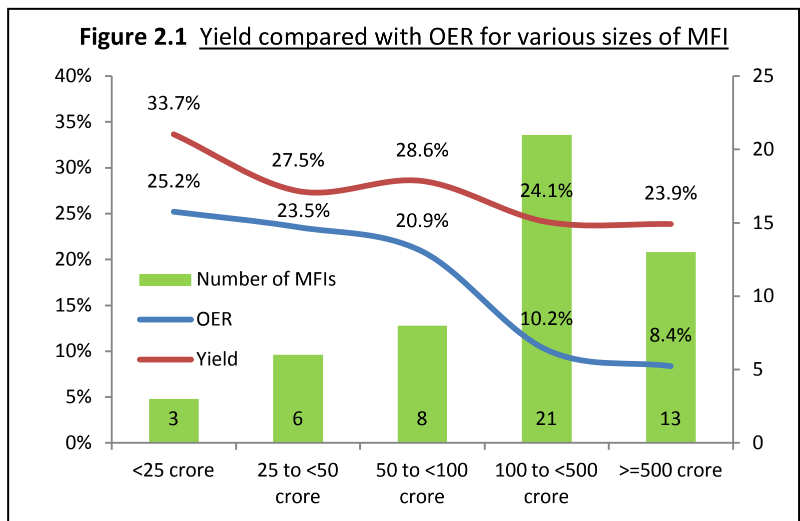
For the purpose of *stress testing*, the table also applies the 2014-15 margin cap of 10% for large MFIs with portfolios in excess of ₹100 crore. This shows that, if this condition had been applicable in 2013-14, only 11 of the 32 large MFIs would have been compliant (compared to 21 with the 12% margin cap). This suggests that the large MFIs will have to make some significant adjustments during 2014-15 to become compliant with the pricing regulation.

2.2 But the operating expense ratio is under control

As indicated above, the margin as defined by the RBI consists of the operating expense ratio (OER), the loan loss provision (LLP as a proportion of portfolio) and the profit rate (defined for this purpose as the return on portfolio).

Figure 2.1 presents the pattern of yield and OER for different sizes of MFI; large MFIs appear to show significant economies of scale compared to the small ones.[2] That a number of these are still non-compliant even with a 12% margin cap seems to indicate potentially significant stress on this account in the future. In order to cope with the more stringent regulatory requirement, many of the large MFIs in particular will need to reduce their OERs further.

Figure 2.1 Yield compared with OER for various sizes of MFI



2.2.1 There has been a significant decline in the operating expense ratio

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 discussed in previous editions of the M-CRIL Microfinance Review, 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 increased from 8.8% in 2009-10 to 11.7% in

[2] The difference between the numbers of MFIs in this figure and that in **Table 2.2** is on account of the inclusion the entire sample in the data for this figure – including two large and four small non-NBFC MFIs.

2011-12 but has, since then, declined to **9.2% in 2013-14**. It is very substantially lower than the 15.9% of the 2006-7 M-CRIL sample (**Figure 2.2**). These expense ratios are well below the MIX medians for other countries – 11.3% for Bangladesh, 14.5% for Latin America and over 20.0% for Africa (**Table 2.3**). The MIX average for India does not take into account managed portfolios, on the one hand, and defunct (but not yet fully written off) AP portfolios, on the other, and, therefore, slightly understates the OER (by taking a higher average portfolio than appropriate).

The current year's average OER represents a significant decline in the average OER over the past two years from nearly 12% in the two crisis years before.

The typical Indian MFI – as measured by the simple average across MFIs – had an OER of 15.9%. This performance represents a long term improvement in efficiency of Indian MFIs but a decline over the heydays of 2008-10. The recent reduction in OER is reflected in a greater distribution of MFIs over lower OERs compared to earlier years. It is in order to take this into account that the OER ranges in the table have been reduced with the below 12% categories having as many 33 of the 51 MFIs in the sample compared to 29 out of 56 below 15% two years earlier (in 2011-12).

Figure 2.2 Trend in portfolio yield and OER

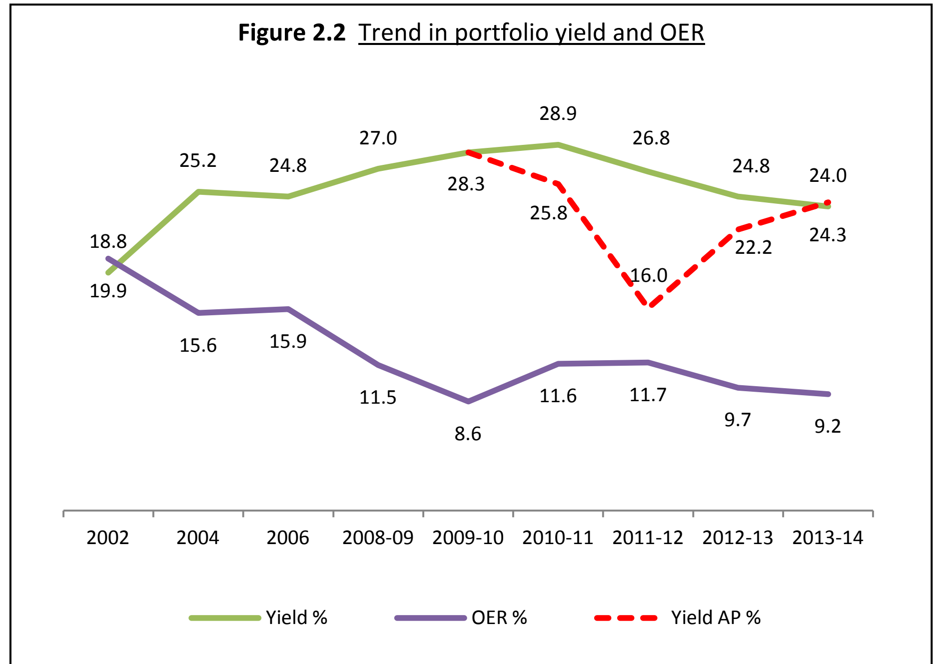


Table 2.3

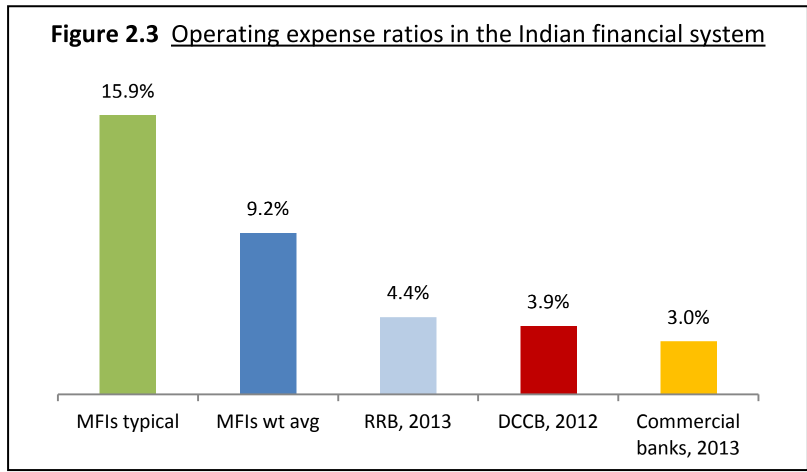
Operating expense ratios as a proportion of gross loan portfolio

Model	Weighted average (%)	Typical MFI ~median (%)	Operating Expense Ratio				Total MFIs
			<8%	8-12%	12-20%	>20%	
NBFC	9.0%	14.0%	12	19	12	2	45
Others	13.0%	30.2%	1	1	2	2	6
India 2013-14	**9.2%**	**15.9%**	**13**	**20**	**14**	**4**	**51**
			<10%	**10-15%**	**15-25%**	**>25%**	
2011-12	11.7	17.3	14	15	21	6	56
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
MIX averages, 2013	**India**	**Bangladesh**	**Nepal**	**South Asia**	**Africa**	**LAC**	
	8.6%	11.3%	9.6%	9.7%	23.6%	14.5%	

Comparing the performance of MFIs with that of the banking sector in **Figure 2.3** 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.

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 <8% operating expense ratios of some of the large MFIs might be seen as “best practice” ratios for microfinance; transaction costs relative to loan sizes in microfinance 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.

Figure 2.3 Operating expense ratios in the Indian financial system



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.[3] 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”.

2.2.2 ...but the yield-OER margin has also declined substantially

Comparing OER – the cost incurred on servicing loans – with the yield (interest income earned from the portfolio outstanding for the same period) provides the yield-OER margin, before accounting for cost of funds and risk expenses. As **Figure 2.2** shows, the weighted average yield of 24.0% (compared to 28.9% at the peak at the time of the AP/microfinance crisis) 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 was reinforced by the regulatory pronouncements on margin caps discussed earlier. Most of the large MFIs (based in AP) had already reduced their interest rates drastically in response to pressure from the state government.

The increase in portfolio yield from 24.8% (around 2006 based on the 2007 Review) to 28.3% in 2009-10 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 had a substantial impact on the yield though the change appears to be small. Since then, there has been a considerable decline in yield earned by MFIs in India, now substantially lower than the Asian and global medians of 26.3% and 28% respectively. 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.

[3] Out of 92,432 primary agricultural credit societies on 31 March 2012, financial performance information was available only for 81,808 societies. Of these, 36,375 (44%) reported losses. RBI,2013, **Trend and Progress of Banking in India 2012-13**, 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.

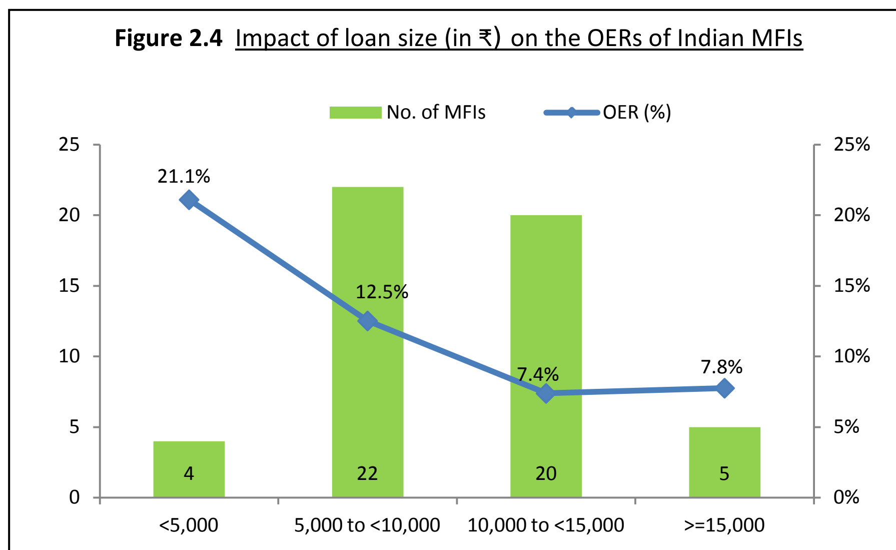
Since the weighted average (OER) declined dramatically over the years 2006 to 2010 from around 15-16% in the middle of the decade to just 8.6% in 2009-10, there was a substantial widening in the yield-OER margin available to the average MFI for covering financial expenses, loan loss provisions and surplus. Since then, this margin has declined from as much as 19.7% in 2009-10 to just 14.8% in 2013-14. As the exhibit shows, the squeeze on margins was greatest during 2011-12 but after that has been steady at around 15%.

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

A 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 (**Figure 2.4**). MFIs with the smallest size of loan (less than ₹5,000, $80) record a weighted average OER of 21.1% whereas larger categories reduce to under 8% for the above ₹10,000 ($160), 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.

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%).

Figure 2.4 Impact of loan size (in ₹) 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 ₹56,151 ($936) for an RRB account[4] contrasts with the ₹9,920 ($160) outstanding for an average MFI account at the end of March 2014. Thus, the 9.2% average OER for MFI loans compares quite favourably with the 4.4% 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 except by creating the kind of stress in the MFI-customer/borrower relationship that existed around 2009 and 2010 – leading up to the microfinance crisis. This is particularly so in the context of the additional expenses now incurred by MFIs on account of regulatory requirements such as credit bureau checks and indebtedness and income assessment of clients as well as the cost

[4] RBI, 2014. **Basic Statistical Returns of Scheduled Commercial Banks in India, Mar 2013.** Mumbai: Reserve Bank of India.

of compliance with more rigorous client protection standards than earlier. That operating expenses have been pushed down nonetheless, is largely a function of aggressive growth of both portfolios and loan sizes. The implications of these developments for the risk profile of MFIs are discussed in the following chapter along with other factors contributing to that risk.

Chapter 3

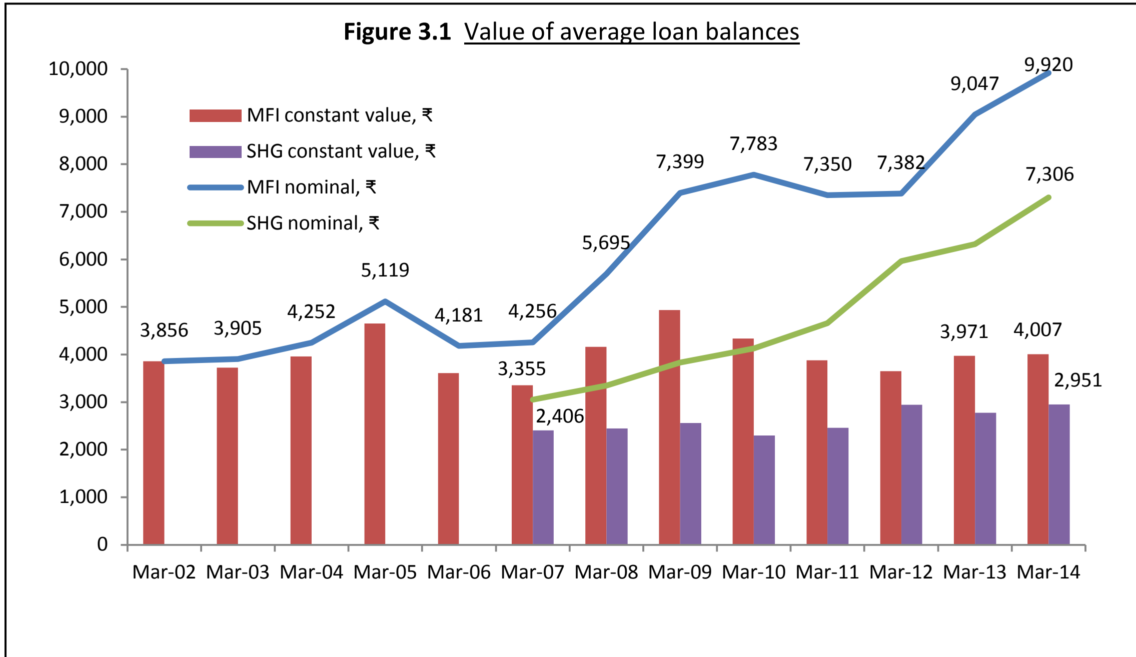
So has it conversely introduced some risks?

Based on the RBI's conditions for institutions to qualify as NBFC-MFIs and for lending to qualify as priority sector, indebtedness of individual households (with incomes less than ₹60,000 in rural areas and ₹120,000 in urban areas) must be limited to less than ₹50,000. In addition, the priority sector requirement fixes the maximum loan size at ₹35,000 for the first cycle and ₹50,000 for later cycles.

3.1 With a sudden spurt in average loan balances of MFIs

As discussed in the previous chapter, in terms of their exposure to individual clients the average MFI outstanding of ₹9,920 ($160) at the end of March 2014 is the lowest for any type of formal financial institution in India (less than 25% of the average for RRBs). Nevertheless, as **Figure 3.1** shows, even this (relatively low) amount has been reached after a substantial spurt over the past two years representing a 34.4% growth during that time. This compares with a small decline in loan size during the crisis years, 2010-2012. Since those most affected by the AP ordinance were mainly large MFIs, these 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 were somewhat smaller during 2010-12.

Figure 3.1 Value of average loan balances



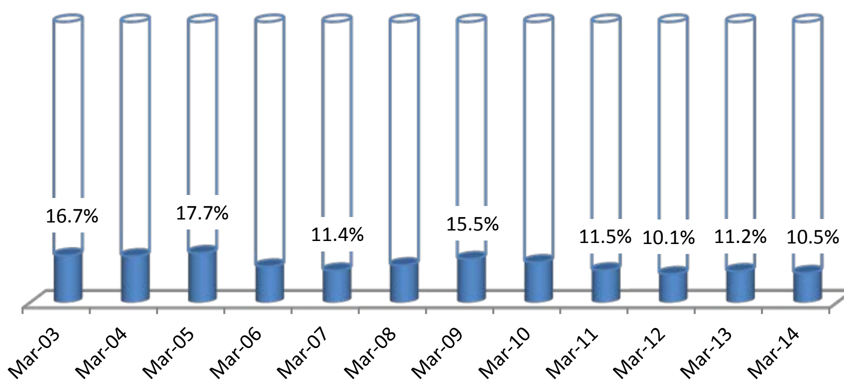
More recently, faced with the need to keep the OER in check, MFIs appear to have pushed up their loan sizes more aggressively (to spread costs over larger sums of money). It is interesting to note here that a large increase of 22.3% occurred in the loan size during 2012-13, in the immediate aftermath of the introduction of the margin cap.

From the perspective of client graduation to higher value activities, on the other hand, the most interesting aspect of loan balances is whether these increase over time in terms of real value. **Figure 3.1** also presents the real and nominal values of average loan balances of the MFIs in our sample over the period March 2002 to March 2014.

As the figure shows, the nominal value of average loan balances was more or less flat 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 2010-12 resulted in a reversal of this trend on account of the seizure suffered by microfinance in AP and shrinkage elsewhere. The return to growth in loan sizes in 2012-13 was fuelled by the renewed interest of both investors and commercial banks in providing funds to MFIs.

3.1.1 …actually being insufficient to cover the cost of productive assets

Figure 3.2 Loan balance as % of GNI per capita



The recent increase in loan size 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 from March 2004 to March 2014 there has been no increase in the real value of loan balances (**Figure 3.1**). This is during a period when India's GNP per capita increased by over 170% from less than $600 in 2004 to $1,570 in 2014. The decline in 2010-11 wiped out the 12% increase in real value there had been until then. **Figure 3.2** 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 16.7% in 2003 to just 11.4% in March 2007 before increasing to 12-14% over the next few years and then falling back again against the background of the microfinance crisis. Despite the recent spurt in the nominal value of average loan balances, **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**. Thus, in practice, MFIs have not taken advantage (individually) of the relatively liberal RBI provision of loans up to ₹35,000 in the first cycle and ₹50,000 in later cycles.

3.1.2 …creating a risk despite the credit bureau requirement of regulation

> MFIs have to be members of at least one Credit Information Company, provide "timely and accurate" data to the credit bureaus and use the data available from them to ensure compliance with microfinance conditions including levels of indebtedness and sources of borrowing.

Whether or not the reduction in real value of loan balances represents a risk for MFIs is a matter that needs to be considered. If the cost of a productive asset (such as milch buffaloes, stocks for grocery stores and supplies for tea shops) increases to 250% its previous cost in nominal terms and the loan available from an MFI increases only to 200%, it is inevitable that the borrower will either need a larger amount of her own capital or that she will approach other MFIs and/or SHGs for an-

other loan. The amounts on offer from MFIs were never adequate to cover a high proportion of the cost of a productive asset, the fact that the real value of these loans is falling further behind could be a matter of concern.

Despite the credit bureau requirement of regulation reducing the risk of multiple lending it does not (yet) eliminate it

- First, reporting to credit bureaus by MFIs is substantial but neither complete yet nor entirely "timely", resulting in significant reporting lags.
- Second, MFIs must only be members of one credit bureau; if another MFI uses data from a bureau that does not have information from a close competitor, a borrower's MFI loan record could be incomplete.
- Third, and most importantly in the medium term, data on borrowing from commercial banks is not yet part of this system while uploading records on borrowing from SHGs is a project that needs five (or more) years of effort.
- Fourth, the credit bureau record will never have access to the record of an individual from the informal market. Yet, research over the years (including by EDA) shows that informal borrowing from moneylenders and friends/relatives accounts for up to 40% of total borrowing by low income families. Further, when it comes to repayment, high cost personal debt naturally takes priority over lower cost sources resulting in MFIs being second in order of priority (with SHGs and banks following in that order).

As of now, the credit bureau requirement has only made a small dent in the risk of multiple lending. There is a long way to go before this risk is mitigated to a significant extent.

3.2 And increased pressure on staff productivity

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.

3.2.1 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 51 MFIs in this analysis have a staff strength ranging from 102 to over 13,000; with a total of 69,442 – a decline from the peak at over 90,000 in 2011. The average number of staff in the sample is now 1,335, down from 1,798 per MFI in 2011. Given the degree of concentration, it is appropriate to consider the L-10 (average 4,511 staff members compared to 7,561 in 2011) separately from the other 41 MFIs. The latter group has an average of 579 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 only a slightly smaller number (after allowing for MFIs not in our sample) than the 83,000 employed by RRBs in March 2013 and nearly a fifth of the 378,500 persons employed by the financial cooperative system (DCCBs+PACS) in 2010-11.

Figure 3.3 Staff numbers per MFI

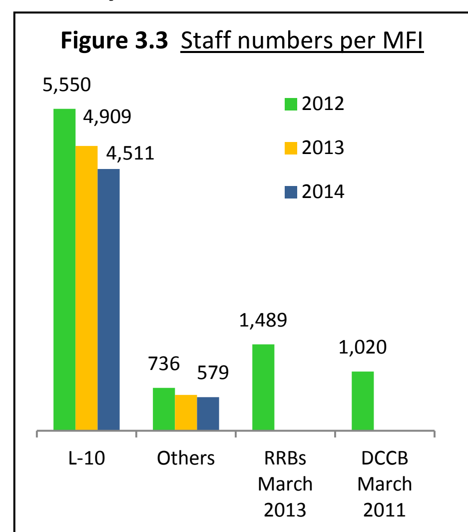


Table 3.1/Figure 3.3
Average staff employed by sample MFIs

Legal Type	Total staff	Average number of staff /institution
NBFC	65,472	1,455
Others	3,970	567
All MFIs	**69,442**	1,335
L-10	45,114	4,511
Others	24,328	579
RRBs, March 2013	83,382	1,489
DCCB + PACS, March 2010	378,468	1,020

3.2.2 …but there is a surge in MFI staff productivity

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.

Staff productivities, (averaged 223 client accounts per staff member – **Figure 3.4**) in March 2012 and were then comparable with the Asian benchmarks of the MIX (250 for South Asia and 232 for East Asia/Pacific). However, over the past two years these have surged to as many as 368 client accounts per staff member, higher than ever before. Some of the largest MFIs report 400 to >500 accounts per staff member resulting in estimated conventional loan officer/client ratios (caseloads) of the order of 600-700.

Figure 3.4 Trend in staff productivity
(client accounts per member of staff)

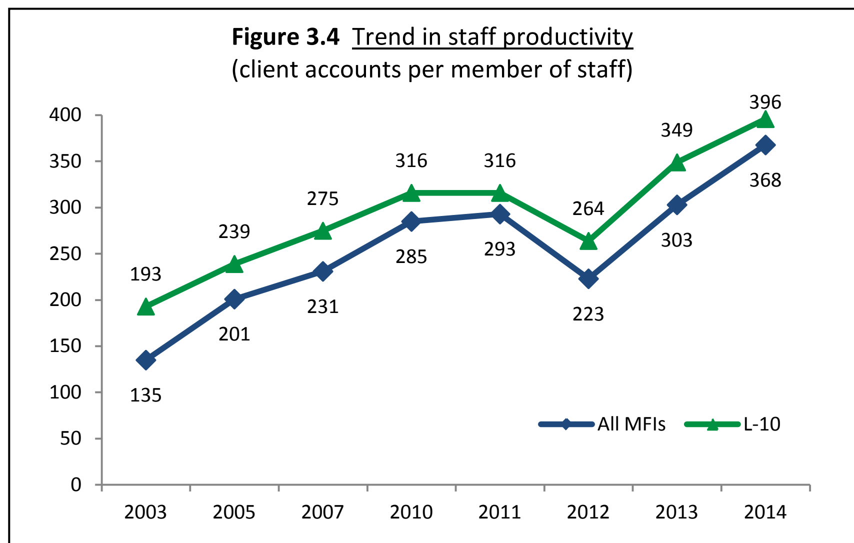


Table 3.2
Staff productivity

Legal Type	Accounts/ staff member		Portfolio serviced/staff member	
	2012	**2014**	**₹ lakh**	**$ '000**
NBFC	232	374	37.7	62.7
Others	180	263	22.7	37.8
All MFIs	**223**	**368**	**36.8**	**61.3**
L-10	264	396	37.6	62.5
RRBs	282	249	139.6	232.6
DCCBs/PACS, 2011	138		54.8	91.3

Surging caseloads have combined with significantly growing loan size. The current level of **average portfolio per staff member**, ₹36.8 lakh ($61,300) is, in rupee terms, **more than twice** the ₹16.5 lakh or nearly $33,000 **reported in March 2012**. While the 2012 level was significantly lower than 2011's ₹21 lakh ($47,000) due to substantial write-offs in AP portfolios, the large NBFCs have since forged ahead in

terms of portfolio serviced per member of staff. The portfolio serviced by average MFI staff ₹37.6 lakh ($61,300) represents a small (3.3%) increase in productivity (**in real terms**/at constant prices) over the ₹26.4 lakh per staff member in the heady days up to March 2010.

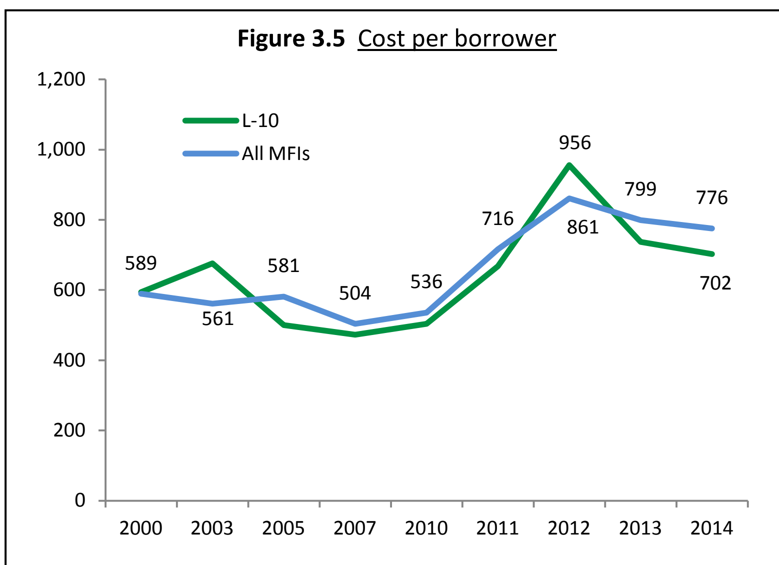
A comparison of productivity with the rural banking system shows that MFIs are again much more productive than the RRBs (average 249 credit accounts per staff member) and substantially more so than the cooperative system, though this is not an entirely appropriate comparison since bank/primary agricultural cooperative (PAC) staff also service deposit accounts.

In comparison with the MFIs, RRBs with their much larger average loan size of Rs56,150 ($936) are at a substantial advantage servicing Rs140 lakh ($233,000) worth of loan portfolio per staff member and over Rs357 lakh worth of business (including deposits). As discussed in **Section 3.1**, however, the average MFI outstanding per account has increased by over 34% over the past two years. According to the RBI data, the average micro-credit account with the RRBs (<Rs25,000) has been constant at around ₹15,000 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 9% increase in the average value of MFI accounts over the same period substantially reducing the account size difference between MFIs and RRBs.

The DCCBs have a level of business per account that is much closer to the MFI average, the portfolio serviced per employee being just 1.5 times the average for the MFIs in this sample and not much more than the largest MFIs.

3.2.3 …and, as a result, cost per borrower has fallen again

The cost incurred by Indian MFIs in servicing loan accounts is very low in comparison with the global benchmark of $85 global average based on information in the MIX.[5] Even when compared with other Asian MFIs, the cost per borrower (₹776 for all MFIs) amounts to just 23% of the East Asian median of $57 and is similarly lower than the MIX median for low end MFIs internationally ($64). It is 10% lower than the average cost of ₹861 ($19) incurred by the MFIs during 2011-12. The trend in the average cost per borrower for the delivery of micro-loans in India is shown in **Figure 3.5**. The Indian numbers make international microfinance seem very extravagant with even Bangladesh and Nepal at slightly higher 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 5% per annum decline in the average cost for all MFIs over the past two years and it is only 5% higher in real terms than the ₹536 per borrower in 2009-10. This is attributable to the high growth strategy again being pursued by MFIs. In the first half of 2010-11 the larger MFIs 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 pay-



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

ments. 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. Again, over the past couple of years, persuading investors to take higher equity positions and bankers to lend more has become a priority resulting in higher growth and increasing staff productivity.

3.2.4 …resulting in a high level of risk

With caseloads and value productivity of MFI staff again at record levels (and costs per borrower falling), **it is likely that the productivity indicator is reaching levels that are higher than desirable**. An increasing number of clients to service could result in a decline in the quality of the relationship between MFI and clients. As happened in AP, this is likely to lead to a lack of commitment from clients to repay the MFI. With a high individual caseload for loan officers, an increasing real amount of portfolio serviced by individual staff/loan officers also increases the risk of fraud or other malpractices (such as refinancing) which the over-stretched systems of fast growing MFIs may not easily detect. **There are indications that some of the leading MFIs are again becoming unduly sanguine about their levels of growth; the situation bears watching closely**. This is discussed further in the next chapter.

Chapter 4

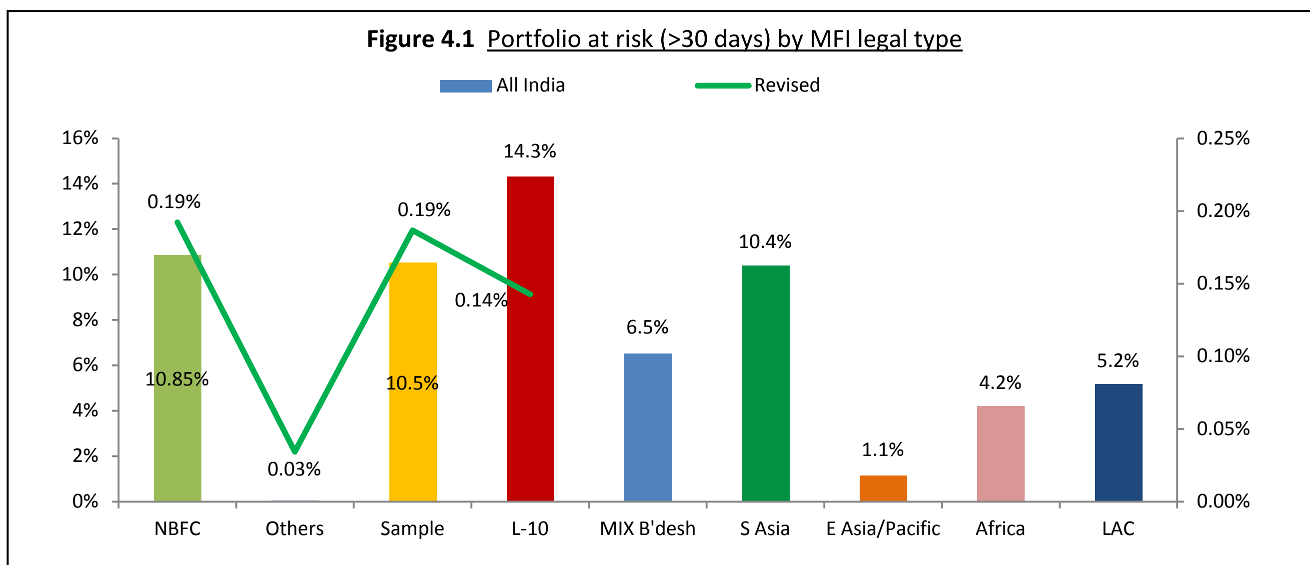
Is it safe to minimise the risk indicators in microfinance?

4.1 Since the AP crisis, PAR ratios in the rest of India have fallen to very low levels

The AP Government's ordinance on microfinance lending made it virtually impossible for MFIs 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 proclaiming that MFI borrowers no longer needed to repay their loans. Discouraging borrowers from repaying their loans is an irresponsible act since it makes clients ineligible from receiving further loans (with easy access to default information now from the credit bureaus) 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 51 MFIs (presented in **Figure 4.1**) indicates that the MFIs in India as a group continue to have amongst the worst portfolio quality ratios in the world. The sample average of PAR_{30} at 10.5% is exceeded by the L-10 group (at 14.3%) – of whom 4 had their main operations in AP. This is the case even after very substantial write-offs and 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 as a write-off as before in this review) PAR_{30} for the sample was just 0.19% on 31 March 2014. While it is clear, that there never was any contagion effect of the events in AP on microfinance clients and MFIs in other parts of India, the reduction in PAR_{30} to this extent is surprising.

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



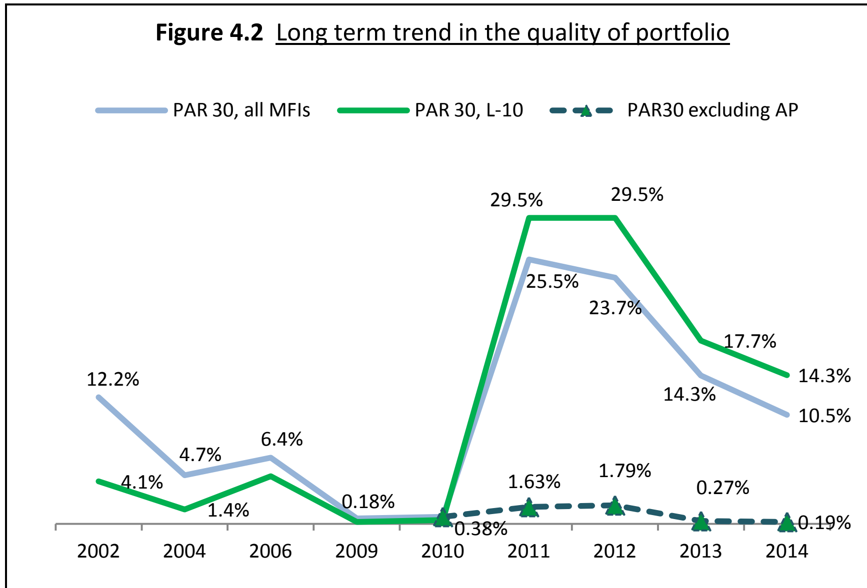
By comparison, NABARD data indicates that, even using a more liberal 90 day criterion, the non-performing assets of the banking system resulting from loans to SHGS were of the order of 6.8% at end-March 2014.[1] This is, of course, significantly below the portfolio performance of MFIs outside AP.

[1] NABARD, 2014. **Status of Microfinance in India, 2013-14**. Mumbai: National Bank for Agriculture & Rural Development.

4.2 ...but perhaps this is an occasion to frown rather than smile

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 **Figure 4.2**.

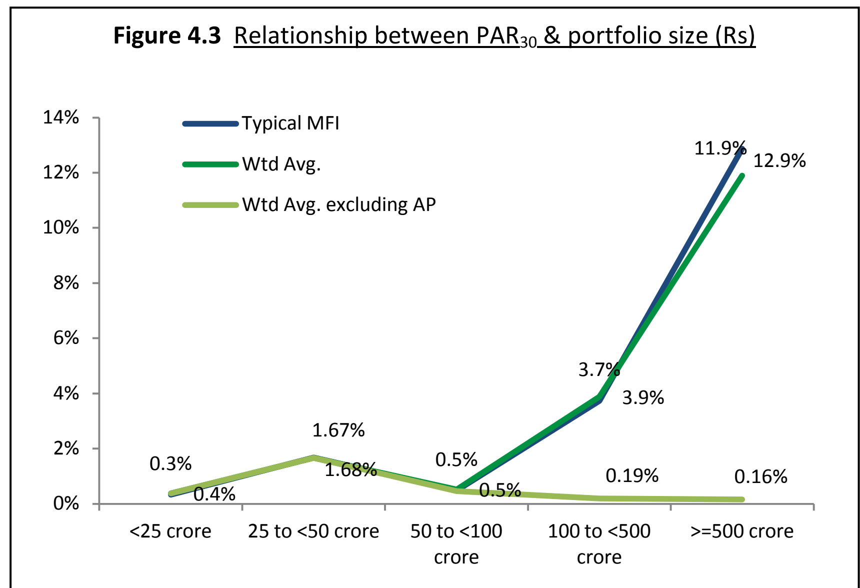
Figure 4.2 Long term trend in the quality of portfolio



Inevitably, the crisis led to a huge increase in the overall PAR ratio for Indian MFIs but, given that there was no contagion, the PAR of non-AP MFIs remained at low (but reasonable) levels of 1.63% (March 2011) and 1.79% (March 2013). Over the past couple of years, however, this ratio has fallen again to very low levels, reducing to 0.19% by end-March 2014, **roughly half the level recorded for the frenetically growing industry in 2010**.

Figure 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. In the wake of the AP crisis, the weighted average PAR of the larger organisations (most of them based in AP) became huge and continues to be very high despite substantial write-offs. Upon neutralising the effects of the crisis (portfolio excluding AP) the pattern for end-March 2014 is back to that of March 2010, the smaller organisations have PAR at a reasonable 1.7% but the largest ones (portfolios more than ₹100 crore and classified by the RBI as "systemically important") that are growing fast again have PAR below 0.2%. This figure is so low that it raises questions about the efficacy of their control systems; is this an occasion to frown about emerging risk rather than smile about good portfolio quality?

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



4.3 …because MFI growth rates are higher than is strictly prudent

It is apparent that the heavy handed October 2010 ordinance of the Government of Andhra Pradesh resulted in a delinquency crisis of huge proportions. The resolution of the 2010-12 crisis involved substantial write-offs, a major (RBI supported) rescheduling programme for bank loans to MFIs and gradual rebuilding of confidence amongst investors and bankers.

The crisis prompted introspection on issues of multiple lending, the quality of internal control systems, how to improve portfolio quality and how to manage growth. The implications of high growth rates for the issues that emerged were apparent: unbridled growth leads to poorly trained 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 growth rate – perhaps up to 40-60% per annum for smaller MFIs and 25-30% for the large ones – would be more effective in ensuring the quality of microfinance services.

As discussed in **Chapter 1**, the overall growth of the M-CRIL cohort of MFIs during 2013-14 was 45% in terms of portfolio but just 5% in terms of numbers of borrowers. As discussed before, it is the number of borrowers served (and borrower accounts created) rather than the volume of lending that poses the greater risk in microfinance since it results in weakening the relationship between MFIs (through their staff) and their borrowers. It would seem, therefore, that there is little cause for concern in this matter. However, the average belies the situation on the ground. **Table 4.1** shows that as many as 17 of the 51 MFIs (33% of the total) grew at rates beyond those that might be considered prudent.

Table 4.1 MFIs with growth rates that could pose a risk

MFI size (no. of borrowers)	Number of MFIs			Total borrowers	Borrowers, fast growing MFIs	
	Total	Growth in 2013-14			Number	% of total
upto 200,000	29	>65%	4	2,968,448	502,454	16.9%
200,000-500,000	9	>50%	8	2,604,630	1,968,359	39.4%
> 500,000	6	>30%	3	5,063,580	1,914,248	37.8%
> 1,000,000	7	>30%	2	14,903,868	3,233,825	21.7%
	51		**17**	**25,540,527**	**7,618,886**	26.1%

Since these MFIs are mainly concentrated in the southern states and Maharashtra, the appearance of instances of local problems (similar to the minor crises that occurred before the AP crisis) in these states over the past year signals the need for a more cautious approach from the microfinance sector. The fact that such MFIs serve some 26% of all microfinance borrowers emphasises the systemic risk posed by this high growth.

4.4 Though provisioning is now adequate relative to the low level of reported PAR

Asset classification and provisioning norms: Asset with no perceived default in payment of principal or interest and no apparent problem with more than normal business risk. A non-performing asset is one for which principal or interest has remained overdue for more than 90 days. The AP portfolio was allowed more liberal provisioning with assets remaining "standard" for 180 days and only loans more than 2 years overdue were classified as loss assets.

Provisioning norms:

Status of portfolio	Provisioning as % of portfolio outstanding
General provision	1%
91-180 days overdue	50%
More than 180 days overdue	100%

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. During 2008-2010, 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. In the wake of the crisis, provisioning for the AP MFIs inevitably became woefully inadequate but substantial write-offs and huge "hair cuts" (equity losses by investors) have since brought the situation under control for most of the sector.

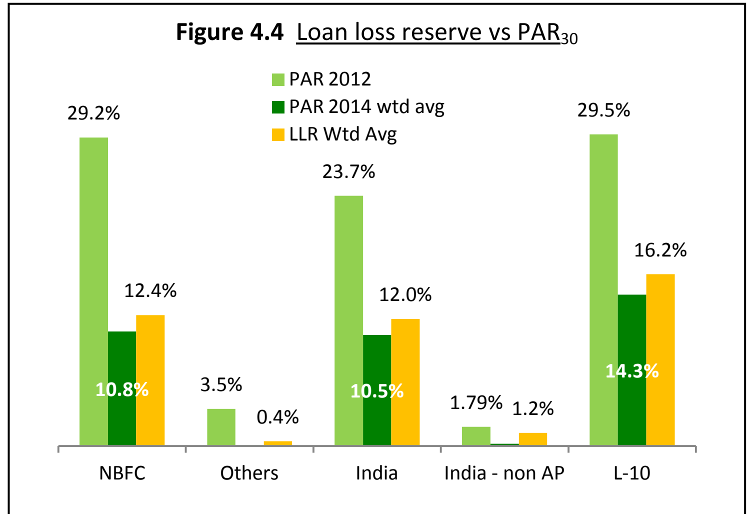
Figure 4.4 shows that NBFCs typically now have more than adequate loan loss reserves (LLR), including AP MFIs. Outside AP, with a exceptionally low reported PAR and the RBI requirement for a 1% general provision on portfolio it is not surprising that the LLR is far in excess of the apparent magnitude of risky portfolio.

Table 4.2 MFI Portfolio written off since 2009-10

as per cent of portfolio

Write-offs		All	AP MFIs
2009-10		0.5	0.8
2010-11		4.0	6.6
2011-12		20.0	34.4
2012-13			
2013-14			

Figure 4.4 Loan loss reserve vs PAR_{30}



For 2011-12, the leading MFIs operating in AP both made higher provisions and had already written off significant proportions of their portfolios (of the order of 30-40% of the total, average 34%). This was done from current income resulting in very high losses for most of them (discussed in **Chapter 5**). Their provisioning requirements were eased by the RBI's relatively liberal provisioning norms that allowed for assets up to 6 months overdue to be classified as "standard" while only loans more than two years overdue were classified as "loss" assets requiring 100% provisioning.

The aggregate write off ratio across the sector for 2011-12 was 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 in 2011-12. The amount remaining to be written off can only be estimated from the ₹3,200 loan loss reserve on the balance sheets of the AP MFIs (based on the regulatory requirement). Based on this, the total write-offs of the past four years resulting from the AP crisis (though not all in AP) amount to around Rs8,500 crore ($1.4 billion). In any case a "hair cut" for both the MFIs caught in the crisis and for their lenders is inevitable, if postponed by the RBI's corporate debt restructuring programme (CDR). It is only the closeness of the cut (the proportion of investments lost) that has been postponed by the CDR and remains to be determined.

4.5 …and the renewed optimism of investors has ensured that MFIs have sufficient capital to grow

4.5.1 …with substantial sums mobilised and effectively deployed in portfolio

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 occasionally, 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

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

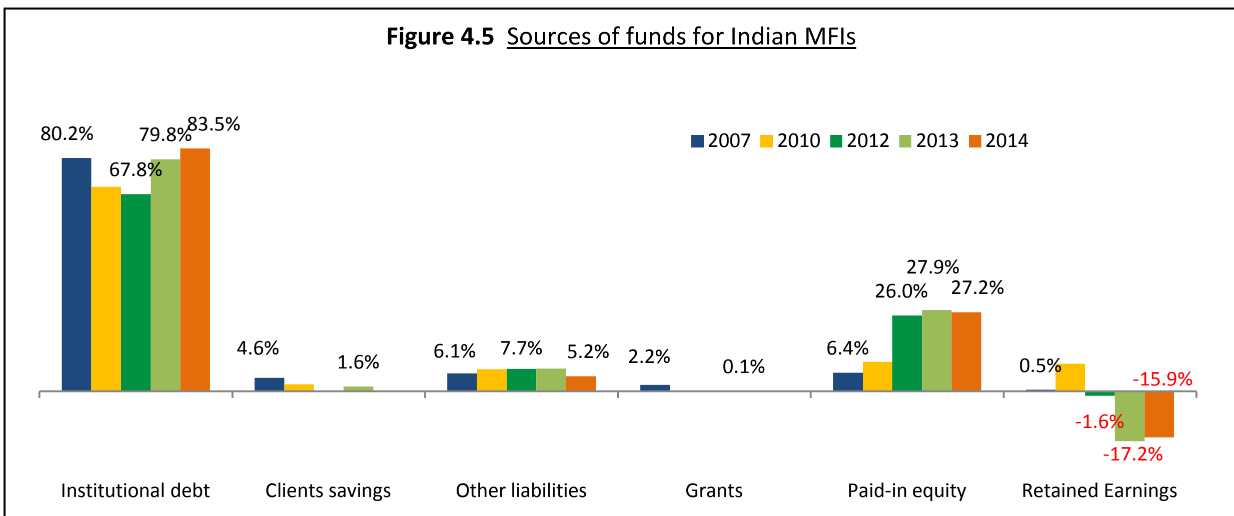
less than one year) accounting for 80.7% of the total (plus 17.5% in cash) while institutional debt alone is 83.5% of total funds (**Figures 4.5 & 4.6**). This is an area in which traditional MFI fund management is highly appropriate to their financing structure and has contributed to the relative stability of microfinance in India. This is in contrast to the asset-liability management problems of MFIs in some other Asian countries where a significant proportion of funding comes from relatively easily withdrawable client deposits.

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 based on a consolidation of information for successive M-CRIL Reviews 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 level of debt raised by the leading MFIs peaked at over 80% in 2008. After that it declined, first on account of increased equity inflows from "social" investors excited at the prospect of super-normal profits from the accelerating growth of the MFI sector. After the crisis of 2010 the share of institutional debt declined with the discovery of caution by the banks in their lending to MFIs. With the establishment of a regulatory framework, renewed confidence in MFIs has, over the past two years, led to substantial revival in both bank lending and equity investments. As a result, (**Figure 4.5**) the proportion of institutional debt in total funds has grown to 83.5%, the highest level

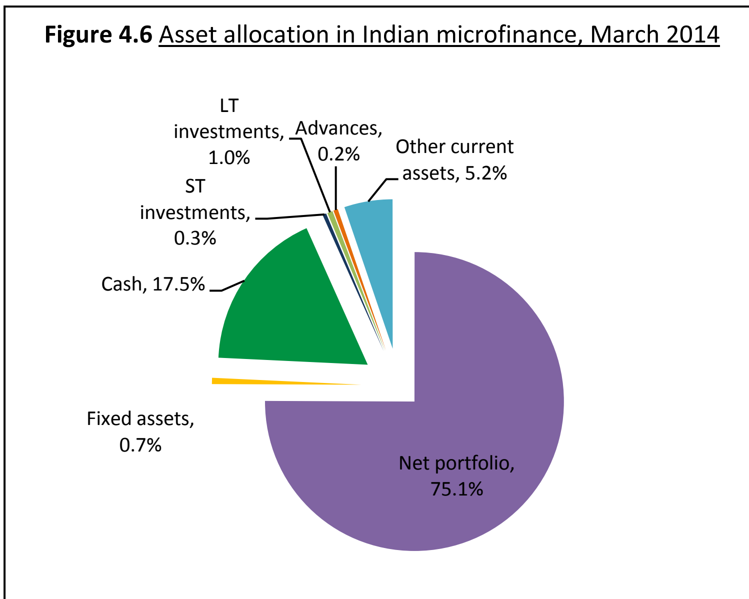
Figure 4.5 Sources of funds for Indian MFIs



yet. The quantum of funds borrowed from banks by the 51 MFIs covered here crossed ₹16,160 crore (close to $2.7 billion) while other institutional lenders like NBFCs and international lenders provided another ₹1,200 crore ($0.2 billion).

Equity investors also contributed deployed substantial additional sums taking paid up capital to nearly ₹8,000 crore ($1.3 billion) despite the retained net worth being nearly ₹4,500 crore ($750 million) in deficit as the effects of gradual write offs of the AP portfolio work their way down the balance sheets. The aggregate numbers, of course, mask the fact that the equity inflows have been to new favourites in the microfinance sector while the old stars have mostly languished or, in a few cases, virtually collapsed.

Figure 4.6 Asset allocation in Indian microfinance, March 2014



The allocation of these funds at end-March 2014, depicted in **Figure 4.6**, shows that Indian MFIs are relatively efficient at ensuring that their funds are invested in portfolio. Their cash holdings at the end of March tend to be at a higher than normal level every year due to the tendency of banks to release significant amounts of loan funds at the end of the financial year to meet their internal lending targets. It takes the MFIs a few weeks to deploy these funds in portfolio based on a planned lending schedule.

4.5.2 …enabling MFIs to grow as well as largely to fulfill prudential capital requirements

The capital adequacy ratio is required by the RBI (including Tier I and Tier II capital to be 15% of risk weighted assets with Tier II capital being less than Tier I capital at all times. There are more liberal norms for the AP portfolio lasting until end-March 2017.

Table 4.3 provides information on the capital adequacy ratios of MFIs covered by this analysis. It is apparent that capital adequacy is not a sector wide issue though some of the largest MFIs (3 amongst the largest 10, L-10, still have negative net worth due to the loss of the AP portfolio).

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

Table 4.3
Capital adequacy ratios of Indian MFIs

Models	Weighted CAR (%)	Typical MFI (%)	Banks	Weighted CAR
NBFC	21.7%	22.4%	RRBs	9.9
Others	23.6%	40.5%	DCCBs 2011	13.2
India, 2014	**21.7%**	**24.6%**	Commercial	13.0
L-10	16.5%	-6.8%	**MFI debt-equity ratios**	
India, 2012	**28.6%**	**19.1%**	**India, 2014**	**3.7**
L-10	30.5%	18.5%	**India, 2012**	**1.9**
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

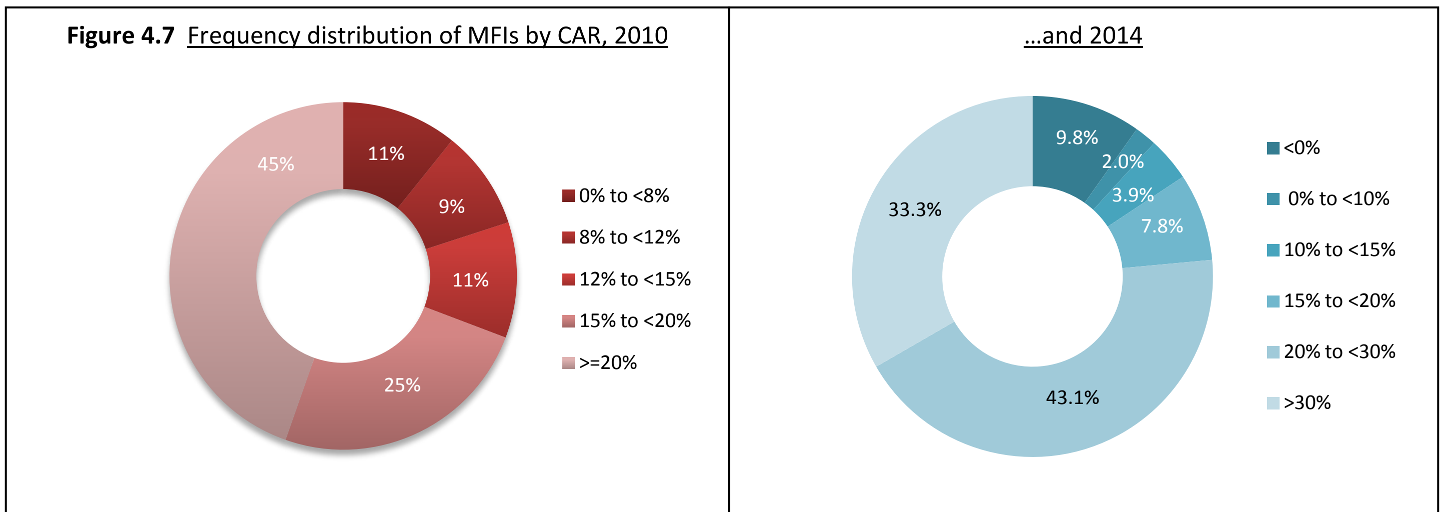
funds. From the mid-2000s, the growth aspirations of MFI managements, competition and the relative paucity of grant funds, on the one hand, and the liberal availability of commercial debt funds, on the other, took their toll. By 2007, the aggregate figures suggested that capital adequacy was an issue 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 this market.

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 were by then 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 became more cautious after October 2010, the weighted average CAR for Indian MFIs was, by March 2012, excess of 25% – well ahead of the banking sector. The slowdown and reversal of portfolio growth at this time was also responsible for the substantial increase from the 18% weighted CAR of March 2010. The current level, March 2014, of 21.7% represents a prudential level of equity deployment for a financial sector like microfinance.

This picture is reinforced by **Figure 4.7**: 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 2014, was even better from a CAR perspective; only those AP MFIs with substantial losses resulting from the high level of write-offs of the AP portfolio, now report negative net worth, while as many as 17 (33% of the cohort) have CAR in excess of 30%, reflecting the significant recent inflows of equity investment as well as an accumulation of retained profit over the past two years.

Figure 4.7 Frequency distribution of MFIs by CAR, 2010 …and 2014



4.5.3 …though the implications of securitization for prudential lending still need consideration

In the context of risk the implications of securitization (and resultant managed portfolios) for growth and related management capacity also need to be considered. 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 was 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 as low as 5%. However, for the purpose of CAR, even their 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 offers 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 re-assessed in 2012 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 M-CRIL sample to 44% in 2007, down to 20% in 2010 and 12.5% by end-March 2014 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 the context of current indications of high growth and over-heating in some regions, in M-CRIL's opinion, **the volume of securitization** (currently around ₹3,500 crore, nearly $600 million) **should be kept under observation by regulators as it challenges management capacity and dilutes the prudential effect of the CAR requirement**.

In this context, the next section undertakes a closer examination of the relationship between risk and financial return in the microfinance sector.

Chapter 5

And is the apparently low risk too good to be true?

5.1 Yields have dropped further as MFIs have reduced lending rates under pressure of 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 **Table 5.1** (and the information in **Chapter 3**, **Figure 2.2**) that, on a weighted average basis, this income grew significantly until 2010 increasing the yield steadily from 24.2% in 2007 to 28.9% in 2010 before falling back to 22.1% (for all MFIs) in 2011-12. The decline was substantially on account of the political pressure imposed on the large Andhra-based MFIs. The weighted average yield for non-AP MFIs did not decline by as much but was nevertheless lower at 26.8% as the new regulatory pressures on MFIs started to take effect. These yields compare with the MIX median yields of 25.8% for East Asia Pacific and 23.2% for South Asia in 2011. The average interest paid by Indian microfinance clients, 24.1% in 2013-14 is not exorbitant by global microfinance standards; more than 67% of MFI borrower accounts are now with MFIs that have yields less than 24% and over 88% of 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.

Table 5.1

Trends in portfolio yield, %

Models	Wt avge yield	Typical yield
NBFC	24.1%	26.6%
Others	23.3%	28.2%
India 2014	**24.1%**	**26.8%**
- non-AP 2012	25.6%	24.1%
L – 10	24.2%	27.6%
India 2010	28.3%	28.2%
L-10	29.0%	27.7%
India 2007	24.1%	26.8%
L-10	23.5%	30.6%

Frequency distribution - number of MFIs

Yield (%)	Number of MFIs				% of MFI borrowers served		
	2007	2010	2012	2014	2010	2012	2014
<24	43	21	23	23	14.7	52.1	67.7
24-30	7	18	16	19	37.6	31.5	20.9
30-36	4	17	10	7	44.1	10.3	10.2
>36		9	7	2	3.6	6.1	1.2
	54	**65**	**56**	**51**	**100.0**	**100.0**	**100.0**

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 up to 2010 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 are now in the range 22-30%. 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 was as low as 16% in 2011-12 but has recovered to over 24% as non-performing portfolios have been substantially written off.

A comparison of the weighted average and typical yield (simple average) for the different legal types of MFI in the sample is also presented in **Tables 5.1**. The frequency distribution in the exhibit indicates that compared to 50% of MFIs (including six of the L-10 MFIs) with yields in excess of 30% in 2010-11, now just 18% have yields at that level. Whereas in 2010-11 42.2% of clients were covered by such MFIs, now just 11.4% 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 26% (outside AP) represent a substantial benefit for low income MFI clients. This is significant in the context of the general perception about the apparently high rates of interest charged by MFIs.

5.2 ...and returns to investment in MFIs have recovered sharply, reaching quite high levels

The financial viability of leading microfinance institutions in India, apparent in the 2005 Review, was under threat in 2007. While this situation was dramatically reversed in 2009-10, the following crisis in Indian microfinance caused another reversal. **Table 5.2** 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 was 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).

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[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.

Table 5.2
Return on total assets of MFIs

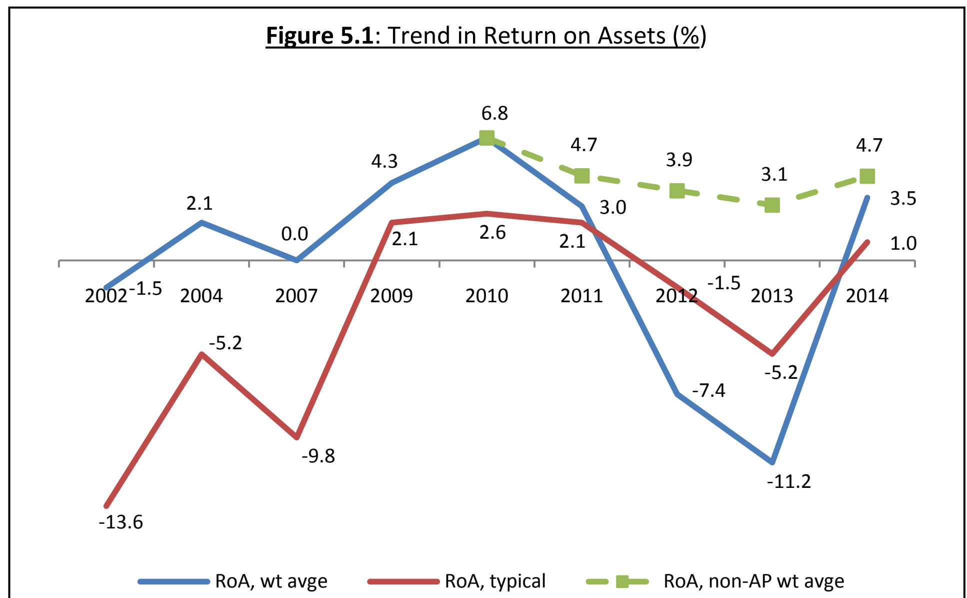
Models	Weighted average	Typical MFI	Region/country	
	%, 2013-14		Mix medians	%, 2013
NBFC	3.6	1.3	Bangladesh	
Others	0.0	-1.4	Nepal	
India 2014	**3.5**	**1.0**	S Asia	
– non AP 2014	4.7	3.0	East Asia/Pacific	
L-10 – 2014	4.2	1.7	Africa	
– non-AP 2013	3.1	1.0	Latin America	
– non-AP 2012	3.9	1.3	RRBs, 2013-14*	0.71
India – 2010	6.8	2.6	DCCBs, 2010-11*	0.35
– 2007	0.0	-9.8	Commercial banks, 2010	1.05
– 2005	2.1	-5.2	2012	1.08
– 2003	-1.5	-13.6	2014	0.81

* Source: RBI, 2014. **Financial Stability Report, 2013-14**. Mumbai: Reserve Bank of India

RoA - frequency	MFI nos. 2007	2010	2012	2014
<-2%	27		12	5
-2-0%	6	6	3	
0-1%	7	12	14	2
1-2%	5	10	5	8
2-5%	8	17	17	27
>5%		20	5	9
	53	**65**	**56**	**51**

The significant change in MFI returns by 2011-12 was 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, the substantial write-off (included partly in operating expenses and partly in loan loss provisioning) increased the total expense ratio and caused the weighted average return 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 that year. These earnings have, after a further decline in 2012-13, recovered in the current year back to the 2010-11 level of 4.7% of assets while all MFIs are also collectively back in the black.

Figure 5.1: Trend in Return on Assets (%)

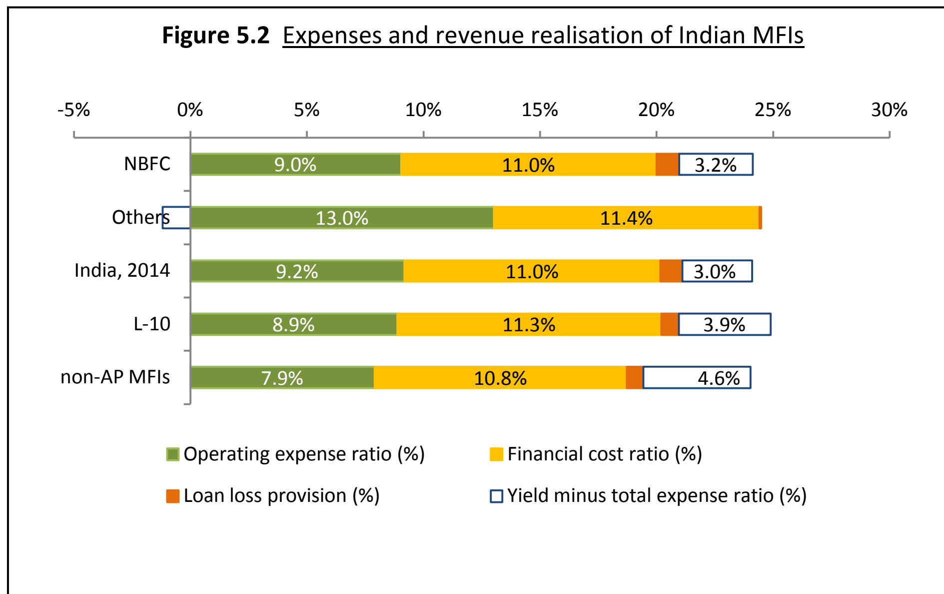


As discussed earlier, the crisis not only had the effect of bringing microfinance in AP to a halt, it also caused a sudden "rash" of prudence in commercial bank lending to MFIs (at the same time as a hardening in inflationary conditions in the country) resulting in an increase in lending rates. Thus 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 (**Figure 5.2**). With the RBI taking a strict ap-

proach to stemming inflation and prudential sentiment towards MFIs recovering relatively gradually, interest rates have continued to be high resulting in a financial expense ratio of 11% for 2013-14. These 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 is now down to less than 1% of portfolio compared to the historical high of 9.1% average for 2011-12.

The weighted average typical expenses of non-AP MFIs in India (18-22% of portfolio) are well below the global ratios of around 24-26% and subtracting total expenses from the yield results in a surplus for these MFIs of 4.6%. The unfortunate situation of AP MFIs continues to cause high losses bringing the average surplus for the sample down to 3% of portfolio. Thus, not only do Indian MFIs continue to deliver microfinance to low income clients at a reasonable operating cost by the standards of typical international MFIs, they are again quite profitable despite the risk premium inherent in their high borrowing rates (from banks) and the limitations on margin imposed by regulation.

Figure 5.2 Expenses and revenue realisation of Indian MFIs



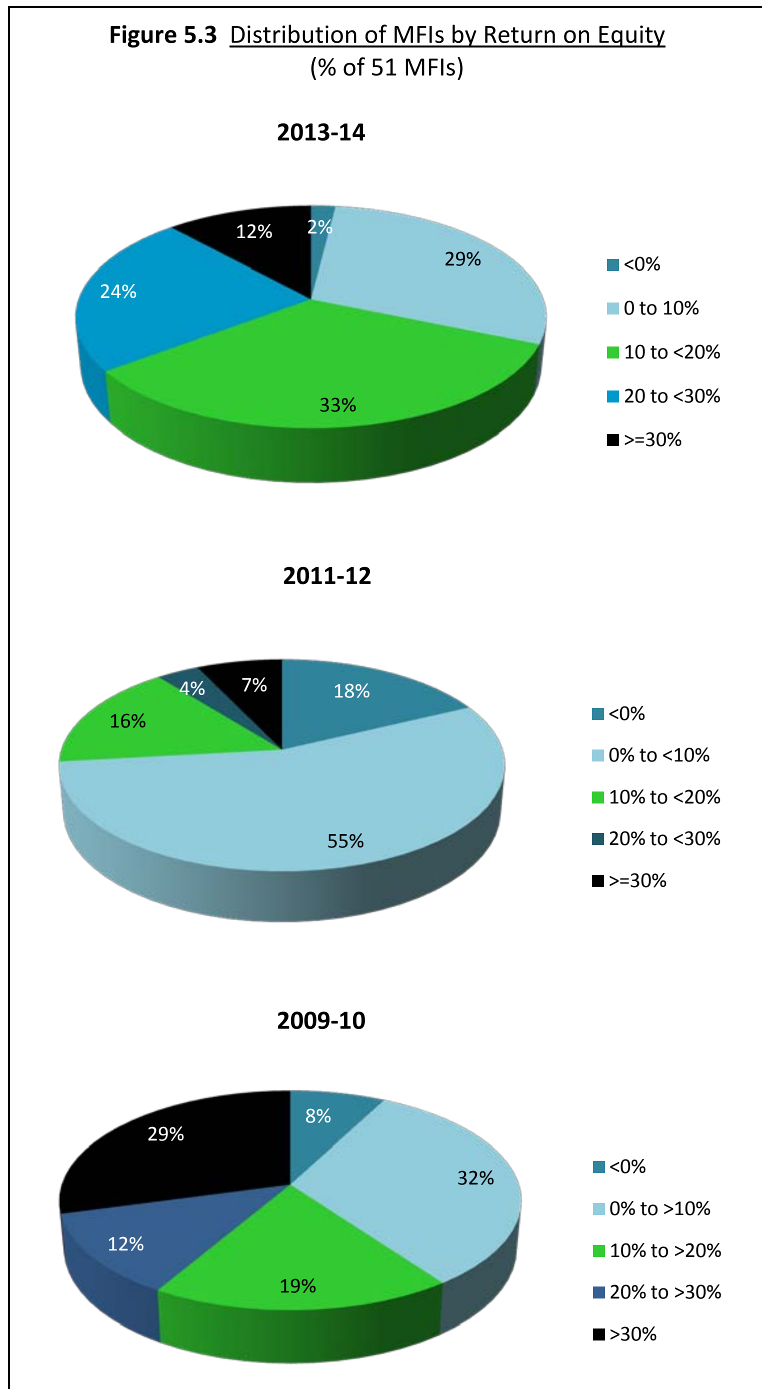
Models	Operating expense ratio (%)	Financial expense ratio (%)	Loan loss provision (%)	Total expense ratio (%)	Yield (%)	Yield minus total expense ratio (%)
NBFC	9.0	11.0	1.0	21.0	24.1	3.2
Others	13.0	11.4	0.08	24.5	23.3	-1.2
India, 2014	**9.2**	**11.0**	**0.9**	**21.1**	**24.1**	**3.0**
– non-AP	7.9	10.8	0.7	19.4	24.0	4.6
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
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
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**	**Reasonable**

...with returns on equity also having recovered substantially to quite high levels, as the 25.1% on a weighted average basis (**Table 5.3**) 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 and not much more in 2011-12 but is now well over 22.8%. With the substantial write-offs of 2011-12 return on equity was substantially negative on weighted average basis in 2011-12 though the 12% weighted average RoE of non-AP MFIs was still respectable. As **Figure 5.3** shows, just 6 of the 56 MFIs in the sample earned more than a 20% return on equity while another 9 earned 10-20% in 2011-12. This has now recovered to 18 of the 51 MFIs in 2013-14 (36%) earning more than 20% RoE. The present situation is, of course, attractive again to investors who had piled into the Indian market during 2007-10 with expectations of super-normal returns and have returned in good numbers over the past year. However, there are indications that the very high valuations (8-11 times book value) that created the moral hazard in the late 2000s have not reappeared though, in spite of that, there are now concerns about lending quality and client protection that was responsible for the earlier crisis.

Table 5.3 Returns on equity to Indian MFIs, 2013-14, %

Type	Typical MFI	Weighted average
NBFC	8.0%	22.9%
Others	53.3%	20.4%
India, 2014	**13.3%**	**22.8%**
– non-AP	16.8%	23.5%
India, 2012	**-26.4**	**-42.5**
– non-AP	7.4	12.1
India, 2010	**18.8**	**25.1**
L-10	26.7	31.1

Figure 5.3 Distribution of MFIs by Return on Equity (% of 51 MFIs)



Despite the high level of write-offs this year, a substantial part of the AP portfolio – nearly 25%, amounting to ~Rs2,000 crore ($333 million) – remained to be written off on 31 March 2014.

The drastic intervention of the AP Government may have laid low some the early leaders in the Indian microfinance sector (BASIX, SHARE Microfin, Spandana) but it is clear from this analysis that there has been gradual progress towards a resolution of the crisis through the firm intervention of the RBI (as regulator). With announcement of the final guidelines the establishment of small finance banks (at end November 2014) has effectively secured the long term future of financial inclusion in India. Though it

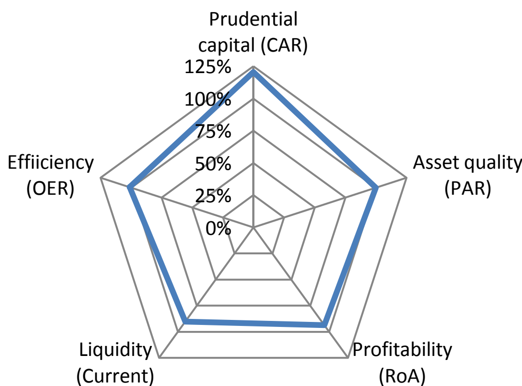
resulted in a substantial decline in capital – both debt and equity – available for microfinance , these flows have now recovered and, as discussed in **Section 2**, may even somewhat overly optimistic. The expected gradual conversion of MFIs into small finance banks may now lead to a resolution of the historical anomaly in financial inclusion in India – the relatively easy availability of credit services but great difficulty in access to deposit services for low income families. This will, in the long term, ease access to deposit services at the same time as bringing **the provision of microfinance services to low income families** closer to the mainstream as financial institutions that provide services to them (the small finance banks) **are treated more as an integral part of the financial system rather than as a minor adjunct** (until now).

It is apparent that, with this move, the RBI has taken a major step towards securing 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.

5.3 …but is it all too good to be true?

According to the foregoing analysis in this review, the non-AP MFIs, as a group, never had it so good; efficiency and profitability are high, asset quality is excellent, liquidity is more than comfortable and prudential capital exceeds even a liberal interpretation of the capital required to fulfil the RBI's requirements on the strictest criteria. The risk-return map in **Figure 5.4** (alongside) summarises this rosy scenario. Is it all too good to be true?

Figure 5.4 Risk-return map for non-AP MFIs



To some extent this scenario defies the fundamental principles of economics: there is supposed to be a trade-off between return and risk. If return is high then risk must also be high, if risk is low it must be because investors are being cautious, not taking much risk and accepting a low return. In the context of excellent portfolio quality (low risk) combined with high growth, this review has already raised the possibility of strains on MIS and internal control systems that resemble conditions in the sector in 2010, just before the AP crisis. While the present rosy conditions could endure for some more time, a cautious approach to the future outlook would seem appropriate. It is also possible that the imminent transformation of some of the leading MFIs into small finance banks will put a brake on MFI growth by limiting debt funds to the new small finance banks (who may find that borrowing on the inter-bank lending market is not as easy as NBFC MFIs obtaining priority sector funds from commercial banks). In the meantime, deposits from their low income clients are likely to build up relatively slowly. To this extent, the RBI's introduction of the small finance bank facility may be even more timely than the central bank realises.

Chapter 6

Or does good social performance mitigate the risk?

The drive for good social performance of MFIs began in the mid-2000s with an emerging concern that MFIs were, by then, focusing too much on financial returns and (some) were starting to lose touch with their original missions of meeting the needs of the poor for financial services. This developed into full blown concern about high MFI growth rates, high returns and unrealistic equity valuations in the late 2000s. It was in 2005 that the Social Performance Task Force (SPTF) was established to re-focus MFI missions and managements on value-based microfinance services as a balancing factor to financial returns. The SPTF-developed framework titled the Universal Standards for Social Performance Management (USSPM) for a balanced standard of service provision by MFIs is presented in **Figure 6.1**. The framework reflects global consensus and practical experience on the issues and practices for sustainable delivery of services that aim to balance value for clients, staff and investors whilst supporting the overall goal of financial inclusion.

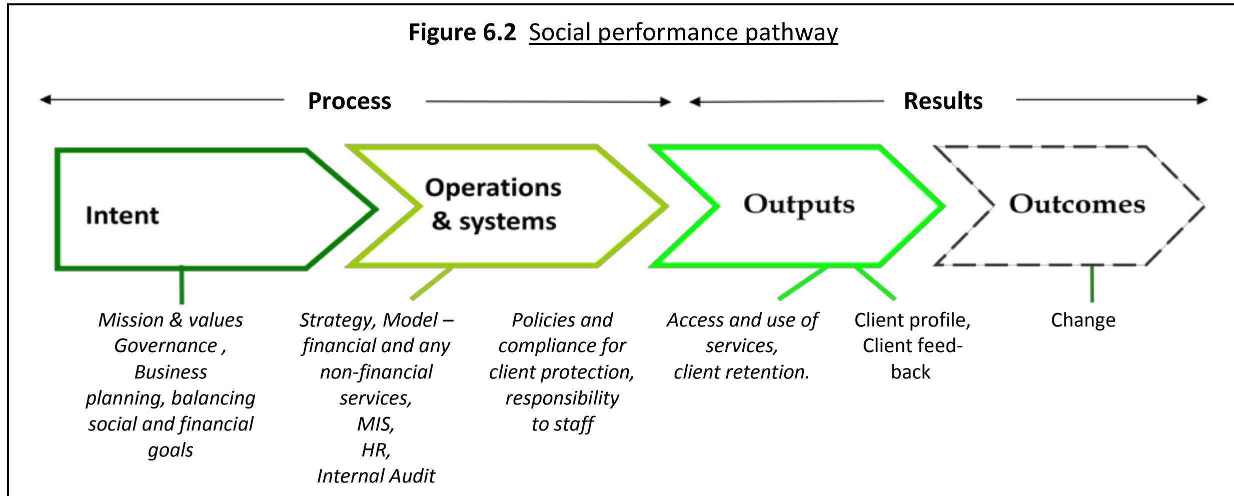
Figure 6.1 Universal Standards for Social Performance Management

The framework encourages MFIs to focus on

- Defining and monitoring social goals – mission and values on which the MFI operates
- Ensuring that the management and employees along with the Board are committed to the social goals often espoused by the MFI's stated mission and values
- Designing products and services including delivery models and channels that are geared to the clients' needs and preferences rather than, simply, geared to the convenience of the MFI
- Treating clients responsibly by ensuring transparency in pricing and other conditions for providing credit, deposit, insurance, remittances and any other service that the MFI provides
- Treating employees responsibly in terms of paying appropriate remuneration (within their local context) and having humane working conditions for people who usually lack alternative means of employment, and
- Overall, balancing their financial returns with a social orientation that ensures a positive contribution of the MFI to the social as well as economic development of its chosen operational area.

Over time, this framework has evolved from a pathway that maps the integration of social performance with governance, and organizational management as presented in **Figure 6.2**.

Figure 6.2 Social performance pathway

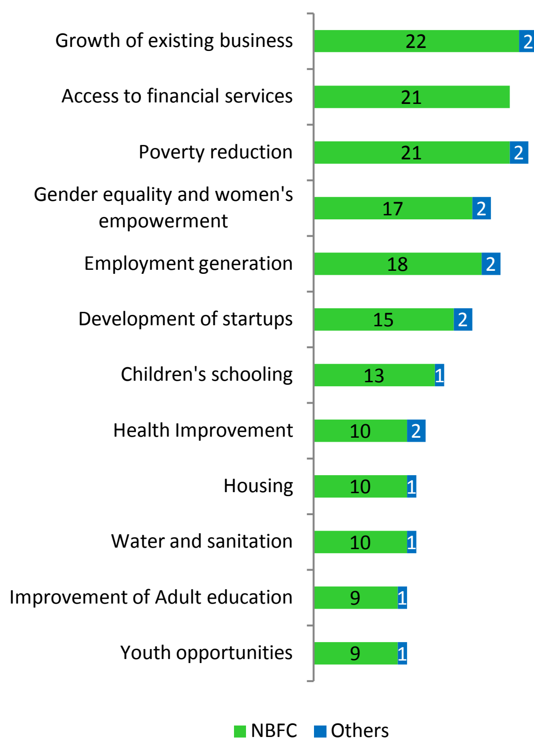


Discussion of social performance in this chapter draws on this framework and the USSPM.

6.1 Indian MFIs have the expected development objectives and outreach

RBI Guideline to MFI NBFCs: Annual household income of borrowers must not exceed ₹60,000 for rural and ₹1,20,000 for urban and semi-urban households.

Figure 6.3
Development objectives of reporting MFIs
[multiple objectives]

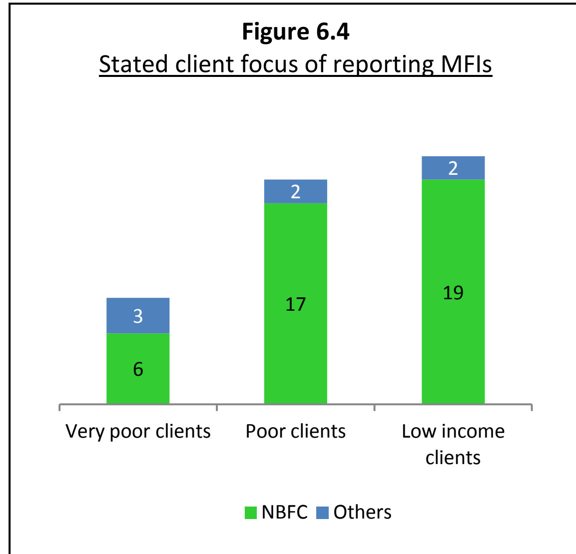


While MFIs generally subscribe to development objectives, the articulation of those objectives tends to be quite variable. **Figure 6.3** presents an analysis of the multiple objectives selected by the 26 MFIs (of 51 in the M-CRIL sample) reporting to the MIX social performance platform. As expected, nearly all MFIs include access to financial services as well as poverty reduction in their statements of objectives though in the context of the macro-economic stagnation over the past few years, the growth of the existing businesses of target clients has emerged as equally important, along with employment generation and development of start-up enterprises. It is interesting that poverty reduction remains a key objective, despite an apparent shift in perspectives to financial inclusion as an end goal *per se*, and an emerging consensus that financial services by themselves are unlikely to achieve poverty reduction – or indeed women's empowerment, another key stated objective.

Progress towards achieving financial inclusion and poverty reduction 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 broad profile of clients stated to be targeted by MFI managements is collated in **Figure 6.4**. After many years of debate on the feasibility of poverty reduction through microfinance and partly due to the consciousness created by the drive for social performance, significant numbers of MFIs have, in recent years, stated their focus to be low income (as well as "poor") clients – whose incomes may or may not be below the national or international poverty lines but who are, nevertheless, financially excluded.

Figure 6.4
Stated client focus of reporting MFIs



Of MFIs reporting a focus on the very poor – most collect data on the Progress out of Poverty Index (PPI) to measure and benchmark their outreach. A number of institutions have integrated (or are in process of integrating) poverty measurement into their MIS for regular reporting to senior management and the Board but this information is not publicly available. In terms of benchmarking, M-CRIL recognises Truelift's guidelines that 'very poor' refers to the poorest 20% of households, "poor" refers to the poorest 40%. By comparison, the RBI-mandated income limits for MFI clients cover roughly 70% of households in rural areas, 50% of households in urban areas – representing a larger number of financially excluded 'low income' households.

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. However, MFIs formed in recent years have placed emphasis on urban operations seeing this both as a service area gap, and a feasible market with lower operational costs. Though these latter institutions have been amongst the fastest growing, they have not been able to work exclusively in urban areas. Thus, 32 of the 51 MFIs reporting disaggregated outreach data work mainly in rural areas while 39 work mainly in urban areas; there are 19 MFIs that do not have significant rural operations and 12 that do not have significant operations in urban areas (**Table 6.1**). Since some of the larger MFIs are substantially rural, this aggregates to 58.2% of all MFI borrower accounts being held by rural clients (in March 2014) while urban clients held 41.8%.

Table 6.1
Rural/Urban breakdown

Mainly	MFIs	% of active borrower a/cs
Rural	32	58.2%
Urban	39	41.8%

Over time, the rural-urban ratio has declined as newly established MFIs have tended to start in easier-to-reach urban areas and these are amongst the fastest growing. Hopefully, the recent heightened concerns for social performance will see more extensive client profile information becoming available as a routine part of MFI reporting though, for now, there is a greater focus on the RBI-mandated household income limits (in the box above) . In any case, it is apparent that rural location alone is not a good proxy for poverty orientation.

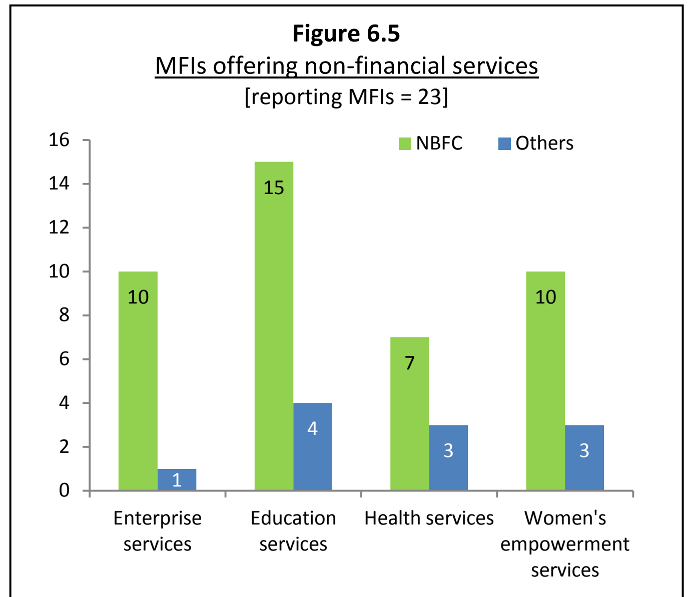
6.2 But not the best operations and systems for client centric microfinance delivery

Recognising that microfinance alone is insufficient for achieving their development objectives, some MFIs aim to offer non-financial services to their target clients. **Figure 6.5** summarises the offering of non-financial services by the 23 MFIs that have chosen to report on such services. While a few have well developed add-on services of this type, however, some 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. A particular example of this is financial education for which donor funds are now available. The extent to which financial education is effective and the extent to which it contributes to better financial planning by microfinance clients is yet to be established.

Figure 6.5

MFIs offering non-financial services

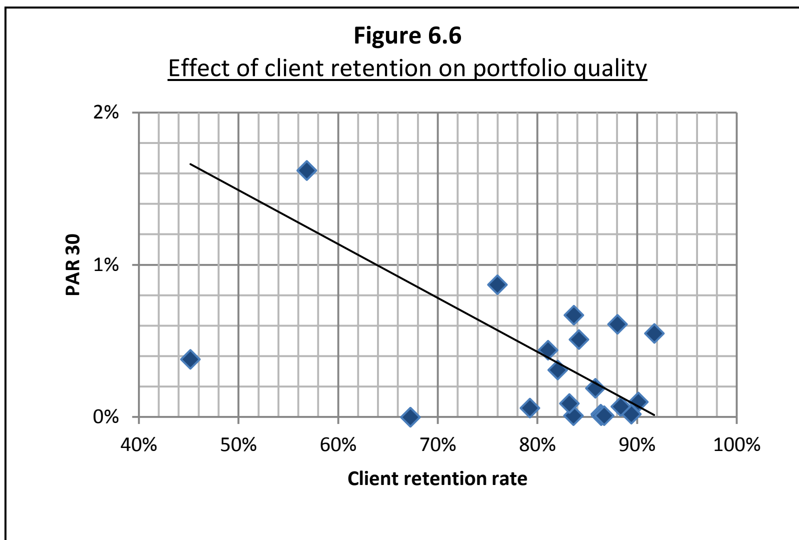
[reporting MFIs = 23]



6.3 Client satisfaction has an important effect on portfolio quality

Figure 6.6

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. **Figure 6.6** relates the client retention rates of the 26 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.

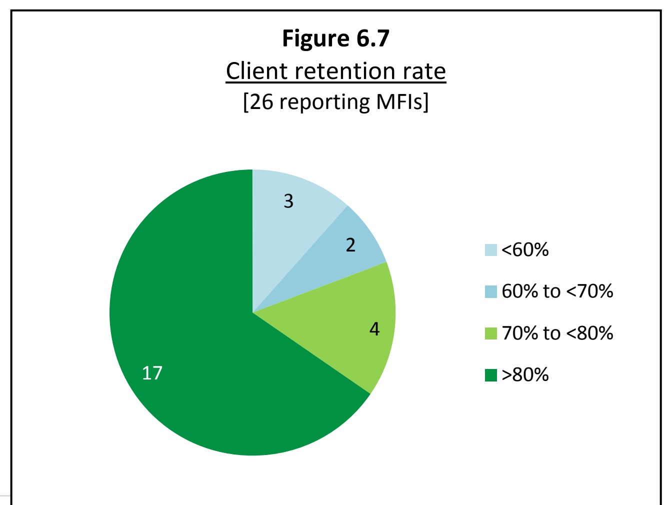
While the data set is not very large, the figure indicates a significant relationship between the two variables. Thus, it suggests that as client satisfaction increases (the retention rate goes up) the portfolio quality also improves with PAR_{30} generally falling below 0.8% as the client retention rate rises above 80% – though, as discussed in **Chapter 4**, M-CRIL has serious concerns about the quality of the PAR data.

In this context, the **average client retention rate of 79%** for 26 reporting Indian MFIs is considerably higher than the 64% rate of 2011-12 (in the aftermath of the crisis). This improvement in the client retention rate is partly on account of the growth in portfolios of the past couple of years. It is worth noting that while in 2010-11 over 40 MFIs reported

Figure 6.7

Client retention rate

[26 reporting MFIs]



on this indicator, the number reduced to 30 for 2011-12 and is even lower for 2013-14. The decline in MFI reporting on this indicator suggests a relatively low level of interest in it. Some of this decline is on account of definitional issues, what constitutes retention and dropout. Since trend information on this indicator is not systematically available it cannot be fully related to the historical performance of MFI portfolios. The distribution of the 26 reporting MFIs over various levels of the client retention rate is presented in **Figure 6.7** with a large proportion now reporting a retention rate over 80%.

6.4 …and there are a few examples of best practice in deepening financial inclusion

Social ratings now include the option of having a Truelift Assessment (earlier known as the Seal of Excellence). This is particularly relevant for MFIs with a pro-poor orientation, having a commitment to serve the poor and demonstrate results.

A Truelift Assessment recognises three principles relating to outreach to the poor, appropriate services and evidence of positive benefits over time; and for each of these principles looks at

a) organisational intent and strategy,
b) systems for measurement – client level data collection and analysis,
c) actual results, and
d) use of findings to improve performance.

In India two MFs, with strong pro-poor missions have completed a Truelift assessment: Cashpor, a Section 25 company, working in eastern UP and western Bihar, and Grameen Financial Services Private Limited (GFSPL), an NBFC working in the southern state of Karnataka. At “Leader” level, Cashpor is strategically located in a poor region of the country, with a focus on rural and *dalit* women clients, achieving significant (above average) outreach to the bottom 40% of households. At “Achiever” level, GFSPL covers rural and urban areas with poverty outreach around the national average. Both MFIs, whilst maintaining efficiency, sustainability and responsible client protection practices (see next sub-section), have diversified and adapted their products: GFSPL loans serve income generation and other diverse needs (water and toilets, festival, emergency); 5% of profits after tax go to an associated NGO to support adaptive and integrated non-financial services particularly in financial education and social awareness; Cashpor, in addition to micro-credit, acts as a Business Correspondent to a commercial bank enabling its clients to save in Bank accounts using mobile phone technology, and has strategically linked its programme to the provision of non-financial services, such as health education, as a critical area for poor women.

Both organisations have put in place quite robust monitoring systems to track outreach to the poor (using the PPI), client satisfaction, client exit, change over time and impact of non-financial services.

6.5 While the principle of responsibility in the provision of microfinance services has largely taken hold

The concern for responsible microfinance is reflected in the Codes of Conduct developed by the two networks, MFIN and Sa-Dhan, and internationally in the client protection principles developed through the SMART Campaign. M-CRIL has, included evaluation of responsibility to clients as part of Social Rating in 2005 and as part of its main rating product in 2007. During 2011, along with other specialist rating agencies, M-CRIL piloted a Responsible Finance Rating product, renamed and launched as the Microfinance Institutional Rating (MIR) in 2012. 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 under-

takes Code of Conduct Assessments (COCAs) 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 updated circulars on regulations for NBFC MFIs issued since then (and summarised in the Master Circular of July 2014.

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

Integrity: The microfinance networks expect member MFIs to adopt a Code of Conduct through formal adoption by the Board. Leading MFIs started to do in late 2010 with some also signing on to the global Client Protection Principles. There was some confusion as MFIs tried to combine features from the different documents. In 2012 the Codes of Conduct for the Indian microfinance sector were converged to produce a single code of conduct that guides the practice of responsible microfinance in the country.

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 have become institutionalised and part of the operating culture in some of the leading MFIs but remain works in progress in others. Overall, the incorporation of standards in the Codes of Conduct into operations has become common the rigour with which the mechanism for assessing compliance varies between assessment agencies empanelled by SIDBI. This has resulted in the cutting of corners by a few MFIs. However, other MFIs have made an exceptional effort to ensure that their practices conform to the codes of network and guidelines of regulators, to the extent of commissioning agencies like M-CRIL to validate the process. There are now six MFIs in India that have been certified by the Smart Campaign as following the client protection principles rigorously. These are Cashpor, Equitas, Grameen Financial Services, Swadhar, SKS, and Ujjivan.

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. Many MFI Boards have now applied these as part of their role of safeguarding stakeholder interests. However, the exposure of others to the expected standards remains variable and M-CRIL's parent organisation, EDA, is one of those working with funding from Opportunity International/Dia Vikas as well as from the Ford Foundation, NMI and others to promote this understanding. Improving understanding of governance and application of standards remains a work in progress.

Competition: Due to re-thinking emerging from the crisis in Indian microfinance, there is now a high level of 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 now being reported to MFIN and Sa-Dhan 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 have to consolidate if not cut back their operations. However, with renewed growth in the sector these guidelines have again become important and needs 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 RBI guidelines, including flexible options for repayment of loan instalments and a cap on the margin earned by MFIs for the purpose of fixing interest rates. 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. However, the provision of details of credit-life insurance along with loan information in the local language remains patchy. Information in the local language on insurance premium paid by the client, details of insurance coverage and process to claim is often not clearly provided.

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 indicated that this needed to be reinforced by follow up explanations and communication. MFIs prefer to ensure that clients know the repayment instalment, without ensuring understanding of the Effective Interest Rate (EIR) – and whether or not clients find the EIR relevant to their choice of MFI remains a moot point. Understanding of the EIR needs substantial financial education (discussed below).

MFIs have also developed 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** have, in recent years, received more systematic attention – with many MFIs including grievance cell telephone numbers on their loan cards as well as designating a person to receive and register complaints. In a few MFIs, senior management or Board members ask for regular reports with complaints categorised and action taken to address complaints. While this is a positive development, its application in practice remains variable since client understanding of the use of such mechanisms is still low and MFI grievance cells are not always pro-active. The improvement of this system remains a work in progress

MFIs have become quite active over the past 2-3 years in providing **financial education** to their clients though outreach so far is only to a fraction of their clients and there is little evidence to suggest that such programmes have more than marginal efficacy. Financial education programmes go beyond the basic details of financial products covering a wide range of issues such as financial planning, budgeting and managing debt.

6.6 …but staff working conditions also affect social performance

The social performance information on the MIX website (summarised in **Figure 6.8**) 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 platform since then].

Figure 6.8
HR policies of MFIs

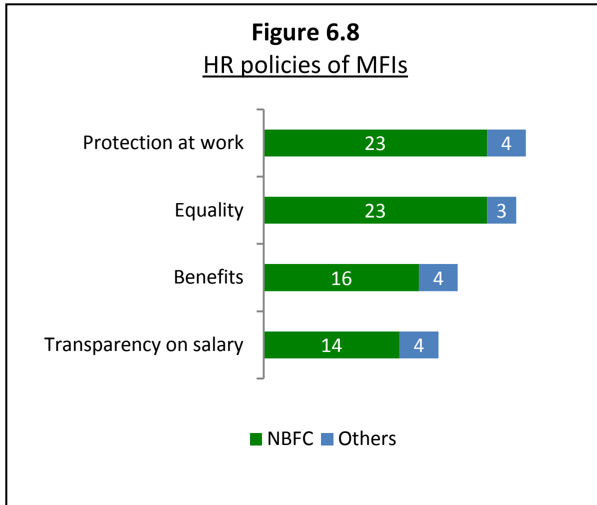
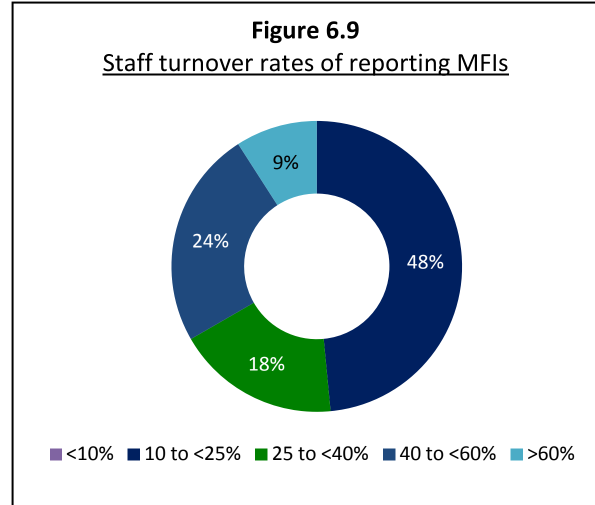


Figure 6.9
Staff turnover rates of reporting MFIs



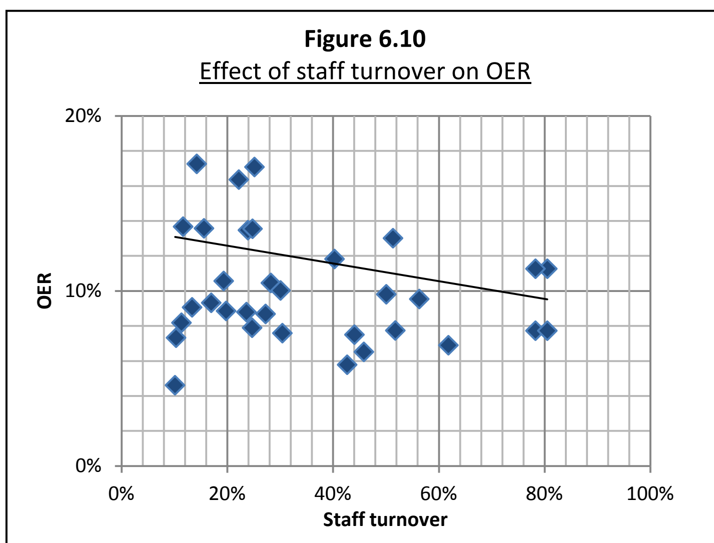
6.6.1 MFIs have a high staff turnover…

It is apparent that while some MFIs have good 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. Long working hours to cope with high loan officer caseloads, dingy and ill maintained office premises, unhygienic staff kitchens and insanitary toilet facilities for staff are some of the issues that need to be addressed.

Not surprisingly the average staff turnover rate of the reporting MFIs is high at 25%. The frequency of MFIs reporting various staff turnover rates is presented in **Figure 6.9;** as many as 11 of the 33 MFIs reporting on this indicator have staff turnover rates in excess of 40%.

6.6.2 ...so would it be better to focus on improving working conditions to reduce it?

Figure 6.10
Effect of staff turnover on OER

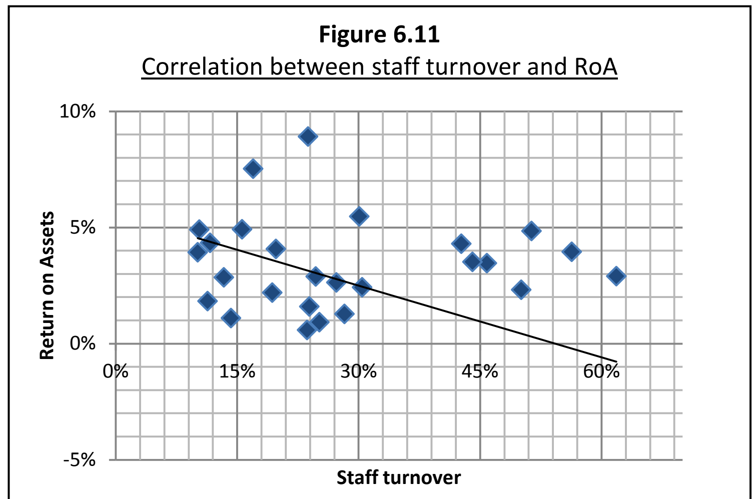


Since the labour intensity of microfinance is quite high and so is the staff turnover, it is apparent that staff working conditions have an important impact on the expense ratio. In theory, low wages and long working hours would reduce operating expenses and a few (but by no means all) of the leading 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 a caveat about the accuracy of some of the social performance information (reported by MFIs to the MIX) it appears to show, in **Figure 6.10**, that MFIs with higher staff turnover rates do not necessarily now have higher operating expense ratios; indeed the correlation is weak but negative. While high staff turnover can increase OER due to additional recruitment and training expenses of new staff it can also lower costs if new hires come in at lower salary levels.

With recently sluggish macro-economic conditions in the economy, a moderation in salaries is the most plausible explanation for this negative correlation.

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 **Figure 6.11.** This shows the expected correlation between the two parameters.

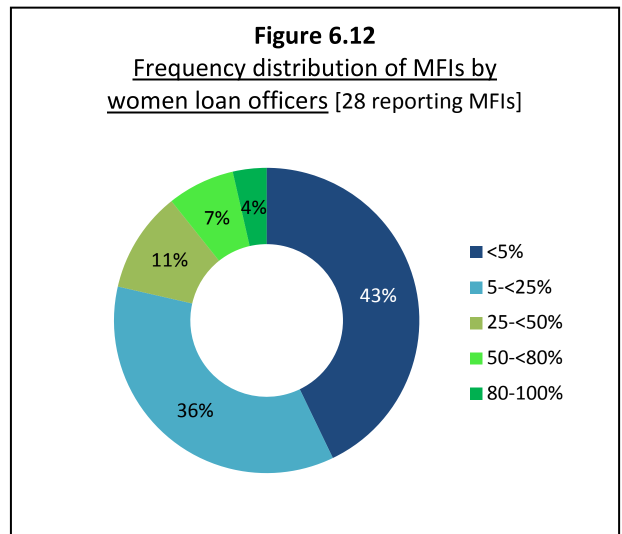
Figure 6.11
Correlation between staff turnover and RoA



6.6.3 There are relatively few women loan officers

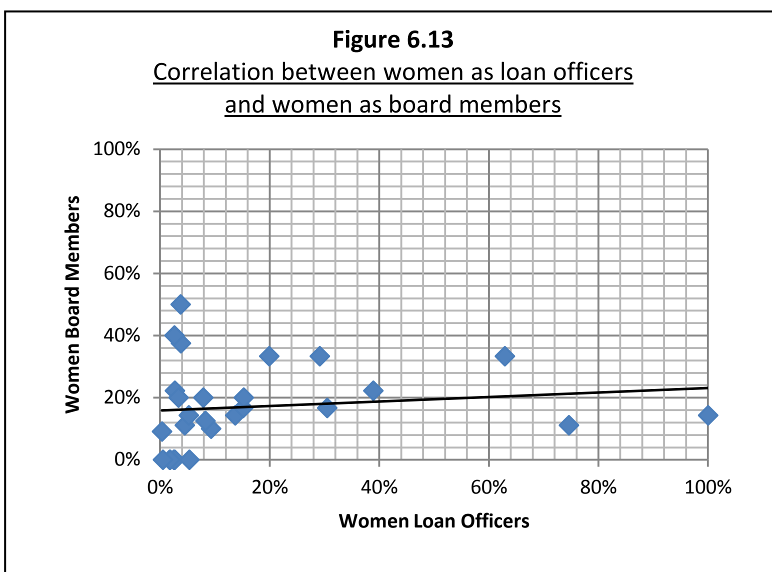
The number of loan officers employed by the 28 MFIs in the sample reporting on employees by gender is 30,353 of whom just ~3,992 or 13.2% are women. **Figure 6.12** shows that 43% of the MFIs have less than 5% women and just 3 MFIs (11% of 28) have more than 50% women loan officers. This is despite the fact that 98.5% of all clients are women (based on data from 40 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, particularly in rural areas.

Figure 6.12
Frequency distribution of MFIs by women loan officers [28 reporting MFIs]



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 very weak (**Figure 6.13**). Thus, as shown, even an MFI with 100% women loan officers has less than 20% women board members and even MFIs with 40-60% women board members have very few women as loan officers. The weak correlation is apparently related to the challenges faced by MFIs in employing women for a difficult task.

Figure 6.13
Correlation between women as loan officers and women as board members



6.6.4 Whose employment does not necessarily help to lower expenses

In theory, having a large proportion of women loan officers could have a positive effect on efficiency due to the (often) more conscientious approach of women to their work. On the other hand, it could increase expenses due to the better transport facilities and/or shorter working hours that may be necessary to facilitate women's security and enable them to fulfill family obligations.

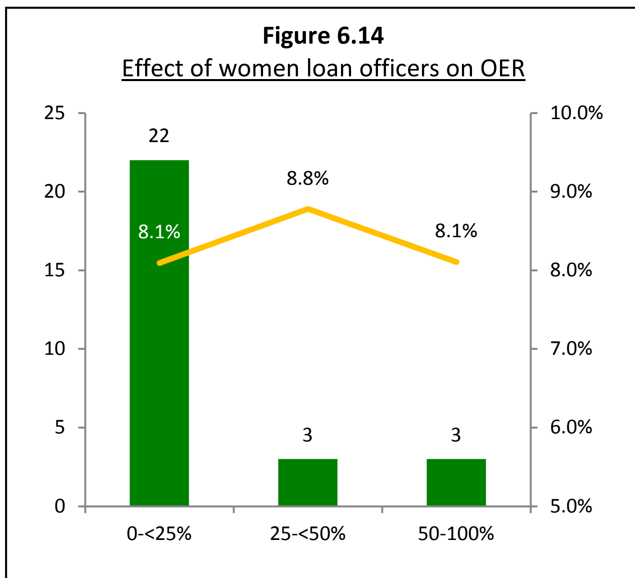


Figure 6.14
Effect of women loan officers on OER

Figure 6.14 assesses the effect of having women loan officers on MFI operating expense ratios. The numbers are not particularly high (and there are definitional issues in classifying loan officers, as mentioned in **Chapter 2**) so it is difficult to see a correlation. However, rating experience suggests that MFIs with higher proportions of women loan officers have lower operating expense ratios; here, the 3 MFIs with more than 50% women loan officers have an average OER of 8.1% while those with less than 25% women loan officers also have a combined OER of nearly 8.1%. This data does not suggest any significant difference. As suggested above, it could be that employing women loan officers cuts both ways in practice, increasing transport costs and shorter working hours negating the efficiency gains resulting from a more conscientious approach to their work.

6.6.5 While the composition of operating expenses indicates high labour intensity (though perhaps CEO salaries need a closer look)

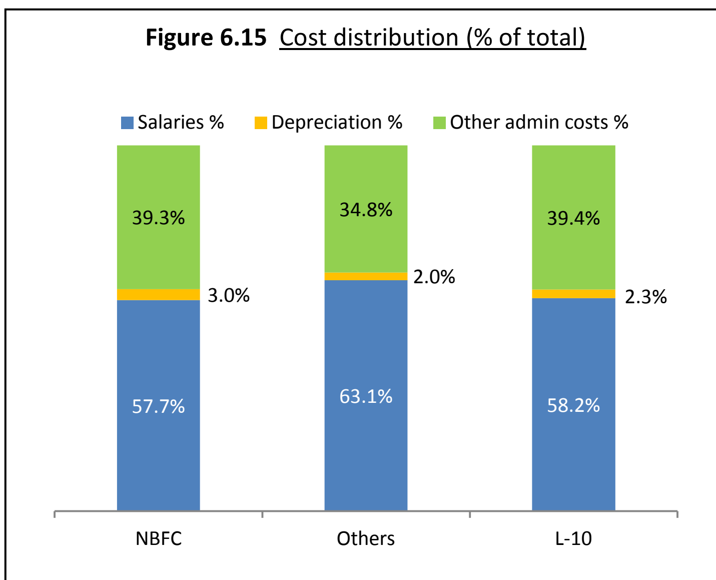


Figure 6.15 Cost distribution (% of total)

The major components of operating expense are disaggregated into the three main categories in **Figure 6.15**. The Indian MFIs' salary allocation of 40-80% (average 58%) is a little high compared to the global averages (Asia, 53.6%; global, 44.5% estimated by M-CRIL from data on the MIX). Another re-emerging issue in this context are high CEO salaries, contributing 5-20% of total personnel expenses in some Indian MFIs. These are not currently regulated but (at up to Rs3 crore, $0.5 million per annum) are quite high in comparison with international salaries in the same field. While the proportion of expenditure incurred on staff by NBFC MFIs is a little 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.

6.7 The net result of the many regulatory and social initiatives is varying social performance

The crisis of 2010 might have been expected to lead to substantial changes in Indian microfinance. In practice, **there have been significant changes in response to regulation and due to increased scrutiny both within India and internationally but the impact is variable**

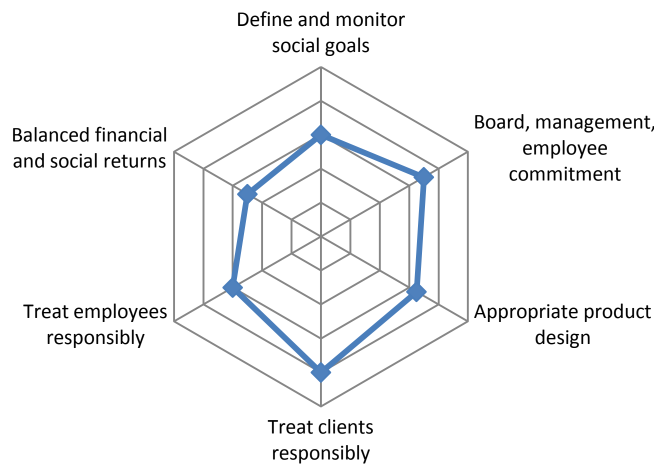
- The key effect has been in response to regulation that has addressed issues of indebtedness, pricing, staff behaviour & transparency
- The emergence of a unified code of conduct between the Indian MFI networks – MFIN and Sa-Dhan – as well as (internationally) the work of the SMART Campaign has led to increased focus on governance, human resources, privacy of information and the financial education of clients
- Ultimately, MFIs have addressed the aspects insisted upon by regulators and by funders (mostly social investors) with the mandatory areas of pricing and client protection taking precedence over aspirational aspects like (appropriate) product design and balanced social and financial returns. As discussed in **Chapter 4** there are indications that growth rates may be accelerating beyond sustainable levels and that super-normal financial returns could re-appear.

The impact of the regulatory, social performance and client protection initiatives is summarized in **Table 6.2 with reference to the Universal Standards for SPM**.

Table 6.2 Summary assessment of factors that influence social performance in Indian microfinance

1 **Define and monitor social goals**	2 **Ensure board, management and employee commitment to social goals**
Minimal change	**Good Progress**
■ Mission & Vision not SMART ■ Data limited to profile at loan cycle ■ Poverty by regulation ■ Dominated by gender/caste outreach	■ Staff Code of Conduct in place ■ Regular reporting to Board, Board composition ■ Reports focus on regulation ■ Instances of social in staff performance appraisal
3 **Appropriate product design**	4 **Treat clients responsibly**
Minimal change	**Good progress**
■ Client needs solicited ■ RBI Regulations impose restrictions ■ Other financial services also constrained ■ Repayment frequency influenced by OER	■ Transparency in pricing ■ CoC; Staff behaviour part of audit ■ 100% CB check; cash flow analysis?? ■ Rationalisation of staff incentives
5 **Treat employees responsibly**	6 **Balance social and financial returns**
Some change	**Regulation induced change**
■ Documented HR policy ■ Fair recruitment; benefits package is OK ■ Trainings – routine ■ Grievance redress – policy vs practice ■ High Impact of margin cap; high turnover	■ Back to growth? ■ No control on financing structure ■ Returns capped ■ Senior management compensation – re-emerging as an issue

Figure 6.16
Assessment of Indian MFIs' movement towards social goals



There is an overlap in content across different initiatives resulting in sometimes onerous monitoring and reporting requirements but **mostly their impact** over the past 3-4 years **has been to enhance awareness of norms for ethical practice and create a better balance between the social and financial performance of Indian MFIs**. While much progress has been made, as the radar diagram in **Figure 6.16** shows, much remains to be done in the Indian microfinance environment – investor commitment to social as opposed to financial returns remains a particular issue as do poverty targeting and employee working conditions at many if not all MFIs.

Some of the **key challenges** in obtaining full commitment to these universal standards are

- **How to move beyond mandatory to desirable changes**. It is not only (appropriate) product design and (high) growth rates, it is also issues of client centric training of staff, reasonable remuneration of managers and the overall integration of social metrics into regular operations and decision making that need to be addressed. The much neglected issue of depth of outreach also remains outstanding though the DFID-funded Poorest States Inclusive Growth project being implemented by SIDBI is in the process of facilitating some change in this direction.
- **How to accelerate the understanding of regulators so that rules and guidelines become pro-active and systemic rather than reactive and micro-managing**. Frequent changes in policy are an intrinsic characteristic of the current regime in which the knowledge and understanding of regulators is, itself, in a state of flux.

The introduction of the Small Finance Bank as an option for the provision of more comprehensive microfinance services (including deposits along with credit and insurance) has the potential to create a revolutionary new approach to microfinance delivery in India. The impact of this new institutional arrangement on financial inclusion in the country remains to be seen.

Chapter 7

Do the Small Finance Bank guidelines herald a regulatory (r)evolution?

After many years of hesitant measures to promote financial inclusion, over the past year the Reserve Bank of India has announced a series of initiatives that suggest a positive, practical approach not seen before. These initiatives include (*chronologically*)

- Issue of a letter of intent to Bandhan Financial Services for the establishment of a commercial bank. Bandhan is the largest microfinance non-bank finance company (NBFC) in India with more than 5 million client accounts focussed on the eastern and northeastern states, the regions with the largest concentration of "financially untouchable" people. Bandhan's offer of a full suite of financial services will, therefore, have a substantial immediate impact on financial inclusion.
- Permission to non-bank finance companies (NBFCs) to become business correspondents of commercial banks. This will affect mainly microfinance NBFCs (other than Bandhan) that have another 25 million client accounts. These clients can now be covered with full financial services if the microfinance NBFCs are able to establish correspondent relationships with commercial banks. The success of this measure depends on commercial banks overcoming their suspicion of mf-NBFCs as competitors.
- Appointment of the Microfinance Institutions Network (MFIN) as the self-regulation organisation (SRO) for microfinance NBFCs. There is a challenge here for MFIN but the emergence of a competent SRO for microfinance NBFCs would consolidate upon the more stable operating environment that has emerged since the traumatic Andhra Pradesh episode of 2010. Thus it would enable more and more people to receive the services provided by NBFC MFIs.

Yet, of potentially greater practical importance in the evolution of microfinance regulation in India was the announcement on 17 July 2014 of the draft Guidelines for Licensing "Small Banks" in India. If appropriately crafted the final guidelines would for the first time enable the emergence of full service institutions that

1. Welcome low income families close to or below the poverty line as clients. This is as opposed to commercial banks that are, at best, reluctant service providers to the poor rendering them "financially untouchable" (in the words of Prime Minister Modi).
2. Wholeheartedly provide outreach in districts and regions of the country where bank outlets are no more than formally present, enabling deposit services along with credit to this segment of the population. They will also be able to facilitate both microinsurance and payment services for their clients as full members of the formal financial community rather than the grudging partial acceptance accorded to microfinance NBFCs until now.

The key to ensuring the success of the small banks is, naturally, getting the licensing framework right and the RBI's publication of the draft guidelines has been a welcome move for this reason. In the hope that these guidelines represent a regulatory revolution, rather than another small evolutionary step, M-CRIL made the following suggestions before the publication of the final guidelines in November 2014

7.1 Ensuring broad financial services for low income households

The objective of the small bank as stated in the draft guidelines is the provision of “savings vehicles to underserved and unserved sections of the population” and supply of credit to small business units, small farmers, micro and small industries, and other unorganized sector entities”. Specific issues are

7.1.1 Needs to ensure that ultimate lending is to “unorganized sector entities”

The guidelines specify that “At least 50 per cent of [the small bank’s] loan portfolio should constitute loans and advances of size up to ₹25 lakh in order to extend loans primarily to micro enterprises.” This implies that the other 50% of the portfolio can be in larger loans/advances which might be seen as a welcome move to enable such banks to be viable. However, there is a major issue here

- **Cream rises to the top**: Mf-NBFCs have already shown that it is possible to operate viably with much smaller loan sizes while obtaining (wholesale) on-lending funds from banks at 10-14% interest. The average loan size (at disbursement) of the Indian microfinance sector is no more than Rs13,000-15,000 even after an increase in recent years. Having higher loan size limits will only result in the entry of entities that are not serious about lending to microenterprises who will maintain the required portfolio in loans less than ₹25 lakh without serving low income borrowers. Since cream rises to the top, they will manage their cost of operations by pushing the average loan size of this half of the portfolio as close to ₹25 lakh as possible. It may even become a temptation for microfinance NBFCs hitherto lending to micro-borrowers but now increasing loan size to capitalize on economies of scale in larger loan sizes. Meanwhile, the other half of the portfolio, in loans of larger size, is unlikely to serve microenterprises at all.

It is, therefore, important that more focused loan size limits be crafted in order to serve various segments of the population. These could be as follows

Category of loan	Loan size limit	Proportion of portfolio
Household enterprises, leasehold/marginal farmers	₹50,000	25%
Microenterprises, education, health	₹50,000 to ₹3 lakh	25%
Small enterprises	₹3 lakh to ₹25 lakh	remaining portfolio
Larger enterprises	above ₹25 lakh	no loans, clients graduate to commercial banks

Application of loan size limits at this level would also exclude the possibility of lending significant amounts to related parties.

7.1.2 Inflation indexing is necessary to maintain the efficacy of loan size limits

These loan size limits are, of course, related to today’s price levels. In order to reduce uncertainty in this matter, the loan size limits having been established for 1 April 2015, should be linked to the Consumer Price Index for Agricultural Labour (CPI_{AL}) to change automatically every year on 1 April. Use of the CPI_{AL} (rather than any other index) would be appropriate given the financial inclusion intent of the creation of small banks.

Also, presumably **all loans by small banks will be covered by the credit guarantee system** of CGTSMI.

7.1.3 …and insurance is required to facilitate the raising of deposits by Small Finance Banks

Evidence from financial diaries of low income clients in India and in other developing countries shows that savings play as important a part in the lives of low income clients as borrowing. The deposit service to be provided by small banks can, therefore, play a very valuable role in both consumption-smoothening for low income families and for facilitating the accumulation by such families of margin money needed for capital investment in microenterprises. From the small banks' perspective it will reduce their cost of funds since mf-NBFCs transforming to small banks will be able to collect deposits at lower cost than the interest paid to commercial banks for on-lending funds. This would be accomplished without making substantial additional investments because of their existing infrastructure and established client outreach.

Depositor confidence is the key: The experience of SEWA Bank in India as well as microfinance service providers like Bank Rakyat Indonesia shows that, given depositor confidence in the financial institution, small deposits can build up to substantial amounts. The amount in deposits of micro-clients with SEWA Bank has, for a number of years, been around three times its loan portfolio. However, the key to this build up of deposits and, thus, the key to the deposit service becoming useful to micro-clients is depositor confidence in the financial institution. This confidence is inevitably something that develops over time (as shown by the experience of microfinance banks in Nepal and Pakistan and of MFIs in Cambodia with deposit licences). Alternatively, confidence can be imparted via the deposit guarantee system. The **inclusion of small banks' deposits in the deposit guarantee mechanism of DICGC is essential to facilitate the use of the service by micro-clients.**

7.2 Outreach limits and prudential capital requirements should be carefully crafted to support lending to the financially excluded

The draft guidelines set the minimum paid up voting equity capital of small banks at ₹100 crore with a minimum capital adequacy ratio of 15% of risk weighted assets. Operations for such banks "will normally be restricted to contiguous districts in a homogeneous cluster of States/Union Territories so that the bank has the "local feel" and culture. However, if considered necessary, the bank will be allowed to expand its area of operations beyond contiguous districts in one or more states with reasonable geographical proximity."

This statement about limitations on operational areas seems already to address most of the concerns expressed by microfinance NBFCs about the contiguity requirement. It is important for small banks to be allowed a large enough area to limit covariant risk – from floods, drought, earthquakes, tsunami as well as from political uncertainty of the type that resulted in the near collapse of some of the largest MFIs in the country; the **minimum operational area for small banks should be 35 districts spread across at least two states**. Many microfinance NBFCs will be interested in operating in much larger areas and these requests should be considered sympathetically based on their existing areas of operation and concentrations of clients in those areas.

The concern here will be the minimum capital requirement of ₹100 crore. Using the CRAR criterion of 15%, this translates to a permitted portfolio size upto ₹666 crore at the minimum level of capital and more if the promoters are able to obtain larger amounts of paid in capital. M-CRIL data shows that excluding Bandhan there are currently 12 microfinance NBFCs and two not-for-profit MFIs that have portfolios larger than this and most of these mf-NBFCs already have the additional amounts of capital they would need to transform to small banks. However, assuming that all-India licenses will not be issued, in the initial stages, setting aside ₹100 crore capital could be a challenge for some of

them if the number of districts covered is too small (limiting the growth potential and, thereby, discouraging investors). For this reason, even an operational area of 35 districts across two states may not be enough particularly in the less developed regions of the country. To incentivize financial inclusion and the establishment of small banks in the less developed parts of the country, RBI may need to

1 **Adjust the minimum capital criterion** (but not the minimum number of districts) for small banks with their operational area in the 200 most backward districts identified by the Planning Commission for the purpose of MGNREGA. This could be done as follows

Minimum 35 districts with ₹100 crore capital results in a capital requirement of	~₹3 crore per district
Most backward district minimum capital requirement could be reduced to	₹2 crore per district
A small bank licensed to operate in an area of 30 backward districts + 5 other districts (in east UP, Bihar and/or W Bengal or the Northeast, for instance) would require a minimum capital of	30x2 = 60 + 5*3 = 15; Total: **₹75 crore**

The minimum capital criterion of ₹3 crore per district could also be applied to operations in more than 35 districts on a per district basis. Thus, small banks that were licensed to operate in 50 districts would need up to ₹150 crore capital (and less if some of those were in the most backward list).

2 **Vary the capital adequacy ratio** which could be more liberal in most backward districts provided that the portfolio quality (portfolio at risk/portfolio with days past due more than 60 days) is less than 1%, as verified by a loan portfolio audit conducted by a recognized microfinance consulting organization (panel already established by SIDBI). Thus, **CRAR for most backward districts that fulfill the portfolio quality criterion could be, say, 12%** resulting (for the above example) in permitted lending up to ₹625 crore – still less than the (₹666 crore) portfolio permitted in a region with all 35 developed districts but more than would otherwise be allowed. The relaxation of prudential norms based on low risk is a well established principle in financial regulation. It could be tried in some backward districts (to determine its impact) and then extended to all backward districts and regions.

Implementation of capital and outreach variations based on the above principles would both **incentivize operations in most backward districts** but also crucially from the perspective of investors in small banks it would **create a dynamic capitalization framework** enabling the expansion of small banks to more districts (with the prior approval of the RBI DBOD).

Other financial services: Undoubtedly, small banks will also be permitted to provide services like microinsurance and remittance/ payments since the small banks would be acting essentially as agents or facilitators for the insurance companies and payment service providers (including commercial banks).

7.3 And small finance banks may need initially relaxed regulatory norms to be financially viable

Table 7.1 (on Page 52) presents a simple model for the viability assessment of small finance banks. It assumes that

- 40% of commercial liabilities will be in the form of deposits within the next two years – which is optimistic based on the above discussion.
- The rest of the commercial liabilities come from commercial banks at a bulk (priority sector) lending rate of 11% (also lower than the present rate of borrowing by NBFC MFIs at around 13-14%).
- Loans to customers are at 22% yield (lower than the present 24% average for NBFC MFIs),
- Operating expenses are assumed to be a tight 9% (including the cost of raising deposits) while the
- Loan loss provision is 2.5% (more than NBFC MFIs but may be lower than necessary for the larger loan sizes they will now be providing).

It is only under these very **tight conditions** that the small finance bank is likely to generate a marginally reasonable return on equity, **RoE of 9.3%.**

In the initial stages some of the key conditions in the previous paragraph may not be met

- the proportion of deposits will be low (and may not even be achieved in the two year period assumed above)
- commercial bank rates for lending to them could be higher, and
- with statutory reserve requirements reducing deposit funds that can be committed to the portfolio, commercial borrowing by small banks will be higher than NBFC MFIs currently need.

The **draft guidelines present a major viability challenge for MFIs wanting to convert** to small finance banks. It is likely that such banks will need some additional effort initially to achieve viability. The composite lending rate to micro-borrowers is unlikely to come down (below 24%) until the proportion of deposits in total funds rises significantly. In order to reduce the lending rate, the guidelines may need to be relaxed in the first 2-3 years, **including a lower statutory reserve requirement**, in particular, so that the borrowing needs of small banks are minimized.

Table 7.1: Viability assessment of small finance banks

	Annual average, ₹ crore	Proportion of total	interest cost/ income	Amount spent/ earned, ₹ cr
Sources of capital				
Equity	100	13.9%		
Borrowing from commercial banks	360	50.0%	11%	39.6
Deposits from (mainly) loan clients	240	33.3%	6%	14.4
Other liabilities	20	2.8%		
Total (equity + liabilities)	**720**			**54.0**
	CAR	**16.0%**		
Uses of capital				
CRR (4% of deposits)	10	1.4%		
SLR (22% of deposits)	53	7.3%	8%	4.2
Loans to borrowers (yield includes LPF)	600	83.3%	22%	132.0
Other assets	25	3.5%		
Cash	32	4.5%		
Total assets	**720**			**136.2**
Net financial income				**82.2**
Expenses				
Operating (% of portfolio)			9%	54.0
Loan loss provision			2.5%	15.0
Total expenses				**69.0**
Surplus				13.22
Tax				3.97
Profit after tax				**9.26**
Return on equity				**9.3%**

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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