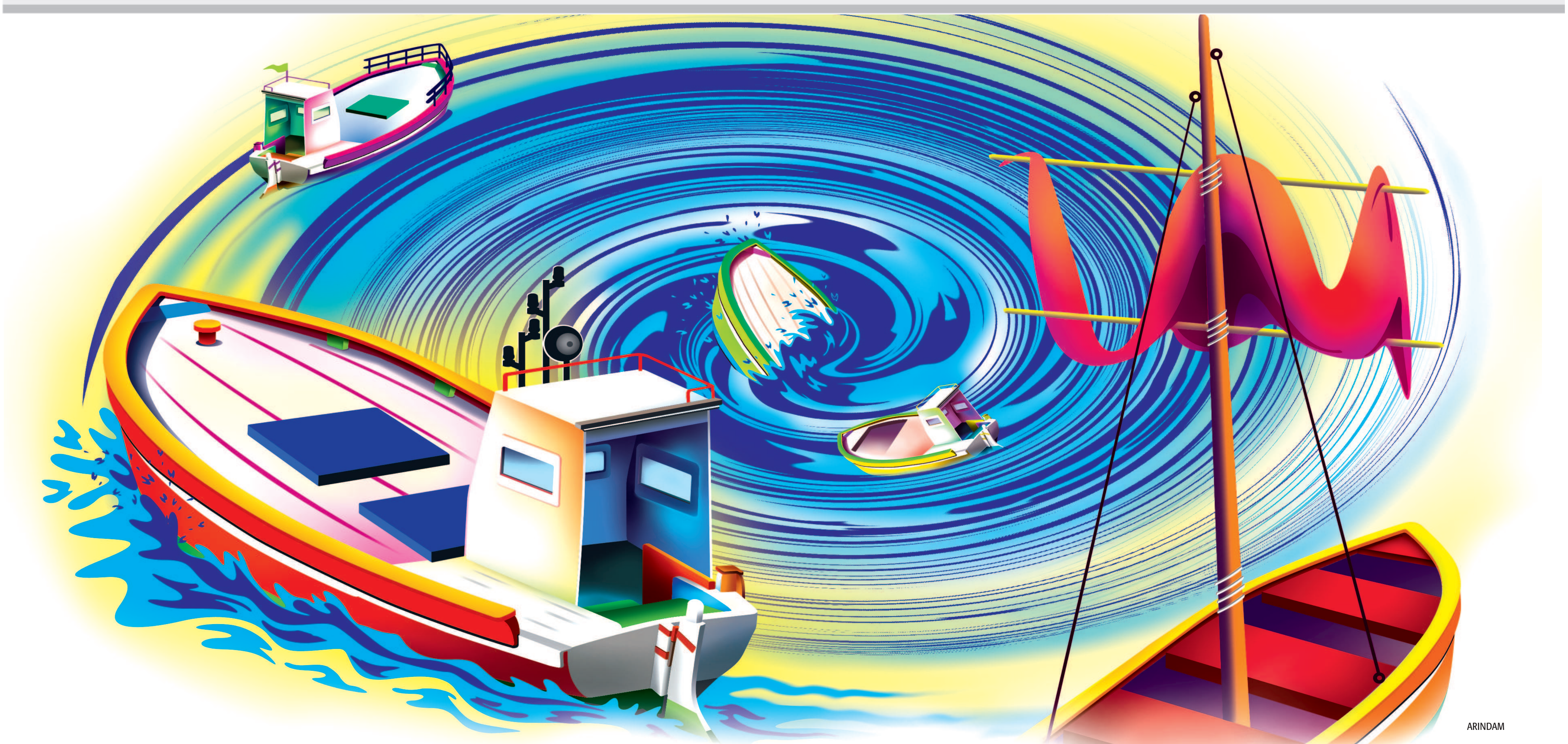
MICROFINANCE CRISIS

THE ECONOMIC TIMES NEW DELHI
THURSDAY 13 JANUARY 2011



ARINDAM

That Sinking Feeling

Microfinance institutions with a sizeable presence in Andhra Pradesh are on the brink of closure because of the crisis in the sector in the state, report **John Samuel Raja D** and **M Rajshekhar**

THIS IS IT. WE HAVE CASH TILL THE END OF February or early March. If collections do not pick up by then, we will have to shut down." This doomsday scenario is prophesied by Shiv Narain, chief financial officer of Spandana Sphoorty Financial, India's second largest microfinance institution. For each of the last eight years, Spandana reported growth in excess of 100%. Yet, today, it stands pushed to the brink, by the very state that embraced it in the first place: Andhra Pradesh.

Half of Spandana's Rs 4,000 crore lending is to borrowers in Andhra. Over the last three months, says Narain, it has not received a penny on about Rs 1,300 crore of those loans. The freeze is the fallout of a state law that was drafted in the wake of borrower suicides, allegedly because of coercive practices of MFIs. The law was intended to check MFI excesses, but it has ended up checking all MFI activity.

Micro-loan borrowers, mostly poor women, were already distressed because of a dip in their incomes and the multiple loans they were servicing. Cushioned by the new law, provoked by local politicians and emboldened by the prevailing climate of antipathy towards MFIs, they have stopped repaying. "The industry is based on expectations," says Sanjay Sinha, whose company does credit ratings for MFIs. "When borrowers expect more loans, they will repay. But when they know they won't receive more, they will stop repaying." That's what a majority of borrowers have done in Andhra, pushing a large, profitable, cash-rich MFI like Spandana to the edge.

If that's the plight of India's second largest MFI, half of whose portfolio is locked in Andhra, how are smaller MFIs with an equal or larger exposure to the state doing? Even worse. They could tip over anytime. "Our money for repayment of bank loans will run out in January," says Kishore Kumar Puli, managing director, Trident Microfin, 70% of whose Rs 160 crore loan portfolio is in Andhra. "I foresee nothing less than the death of the small MFI," says SC Hassain, president and CEO of Star MicroFin Service Society, whose entire ₹20 crore loan portfolio is in the state.

Judgement day is two days away. January 15 will be three months since Andhra issued the contentious 10-page ordinance. In the lending business, three months is the first threshold of failure — that's when lenders have to start making provisions for bad loans, which reduces their profits. Unless normalcy returns in Andhra, for both MFIs and banks, the signs are ominous.

SO FAR, MFIS HAVE BEEN SEEING A shortfall in interest income and cash, since October. A report by credit-rating firm Crisil, released in November, said collections in Andhra had fallen below 20% of the loan amount due, from 99% just before the ordinance was issued. Some MFIs say the collection rate has fallen further.

Star MicroFin Society is a small NGO-MFI, with a loan portfolio of Rs 20 crore in Kurnool and Ananthapur districts in Andhra. It has 35,000 borrowers, 100 staff members and 11 branches. "In our 15 years, we always had 100% repayment," says Hassain. "Now, our repayment is down to zero in urban areas and 2% in rural ones."

Similarly, Trident has seen its collections in Andhra drop from Rs 22 crore in September to Rs 17 crore in October, to ₹2 crore in November, to ₹1.6 crore in December. The income and cash shortfall was the first hit for MFIs, and will show up in their results from the December quarter.

January 15 onwards, MFIs will feel the second hit: provisioning. Under the rules set by the Reserve Bank of India, the central bank, if an MFI does not receive interest income for three months, it has to provide for 10% of the loan amount. By a crude calculation, for Spandana, that works out to be about ₹133 crore - 65% of its net profit for 2009-10.

Unless collections resume, Sinha, managing director of Micro-Credit Ratings International Limited (M-Cril), says no microfinance player with operations in Andhra will report profits in the year ended March 2011 —a first for the industry. What's happening in Andhra affects virtually every MFI, in varying degrees.

Andhra leads all states in micro-loans, with a share of 35%. Now, it has an ordinance that requires MFIs to take government approval before granting a loan, bans weekly collection of dues, and stops lenders from collecting instalment from a borrower's house. Basically, it makes it almost impossible for MFIs to do business.

A private banker says MFIs have barely given 100 new loans since the ordinance came in. "On November 27, we decided to test the new process and applied for clearance for 162 loans," says MR Rao, CEO of SKS Microfinance. "We heard from the government on December 24, saying that just 29 loans had been approved."

BANKS WILL FEEL THE TRICKLE-down effect of MFI distress, as the three-month provisioning rule applies to them too. According to Nabard, as of March 2010, the banking sector had lent ₹20,000 crore to MFIs. "When the ordinance was issued, it was ₹25,000-28,000 crore," says Sinha. "Of this, about 35% is in Andhra."

On a base of Rs 25,000 crore, that is ₹8,750 crore. If only 20% of that is being serviced, as Crisil says, then Rs 7,000 crore is under stress. A 10% provisioning would mean an expenditure of Rs 700 crore by MFIs. For banks, it could be more if MFIs close down.

Banks face a tough choice. If they don't restructure the loans, the MFIs could collapse, saddling banks with huge losses. If they give MFIs additional time to repay, they will have to make big provisions. Plus, unless the freeze in Andhra thaws, they can't be sure if they are throwing good money after bad. On Tuesday, the Indian Banks Association, the nodal industry grouping, asked the RBI to allow them to reschedule MFI loans without the burden of provisioning.

Corporation Bank is one of the rare banks still lending to MFIs. "We have not stopped lending. And the existing loans have not come for renewal," Says RN Pradeep, CMD of Corporation Bank. But several others have stopped. "Banks are not giving us any money at all," says Hassain of Star MicroFin. "Even in the longer term, I do not think they will give any money to smaller MFIs. They will lend only to larger MFIs, who are at the root of all this trouble, with multiple lending and client harassment."

"The fund requirement projection of a lot of MFIs is based on high growth paths," says Rakesh Rewari, deputy managing director, Sidbi. "We are asking them to moderate those growth paths." With banks refusing to lend more and collections grinding to a halt, some MFIs are using borrowed funds to repay banks. Not only is this a violation of priority-sector lending norms, sooner rather than later, this will run out.

WEEKLY ROTATION OF CASH IS critical to MFI operations — and profitability. Since they are barred from taking cash deposits, MFIs functioning as a non-banking finance company (NBFC) rely on three sources of funds: equity and grants, surplus from past operations, and loans from banks. According to M-Cril's Microfinance Review 2010, bank loans accounted for 71% of MFI funds in 2009-10.

An MFI borrows from banks at 11-14% and lends it on, mostly to poor women, at an average lending rate of 28%. Even after accounting for operating expenses, it earns a generous spread. And that's not the only source of its profits.

MFIs also profit from rotating the money. MFIs repay banks on a quarterly or half-yearly basis; however, their borrowers repay MFIs on a weekly basis. "The profit comes from the compounding effect, not just by having low distribution costs," says a chartered accountant who has been associated with the industry for 20 years.

SOUNDING **DEATH KNELL**

Since October, MFIs have been seeing a shortfall in interest income and cash. That's the first hit. January 15 onwards, MFIs will feel the second hit: provisioning for bad loans.

Say, an MFI borrows ₹1 lakh from a bank at 10%, with quarterly repayment. The MFI uses the Rs 1 lakh to give 10 micro-loans of Rs 10,000 each, for one year, at an interest rate of 24%. So, it collects ₹230 as weekly instalment from borrowers for 50 weeks — ₹200 towards principal, ₹30 towards interest.

At the end of the first week, the MFI would have collected ₹230 each from ten borrowers, or ₹2,300. But it won't repay the bank for another 11 weeks. So, the interest MFI earned in the first week is free capital, which can be lent again. Similarly in the second week, the MFI will not only earn ₹2,300 from its original borrowers, but also ₹50 from the ₹2,300 it had lent from its first week collections. With this cycle of growth disrupted, MFIs are now struggling to repay banks.

SANJAY SINHA, WHO HAS researched poor households, draws on Mughal history to contextualise the current crisis in the MFI industry. Sinha, who claims to have a limited knowledge of history, scopes in on Aurangzeb, the Mughal emperor who ruled for half a century, till his death in 1707. About 30 of those 50 years, says Sinha, Aurangzeb spent conquering Golconda, which is near Hyderabad and far away from Delhi, his kingdom's capital.

He eventually won Golconda. But while he was waging that wasteful battle, his administration in the hinterland was coming apart, with rebellions in Punjab and other places. At one point of time, his treasury money could not be moved from Delhi to Agra. "The focus on conquering the frontier kingdoms led Aurangzeb to lose the hinterland," says Sinha. "The same thing happened in the microfinance industry, with big lenders chasing growth and expanding aggressively in areas far away from their hinterland."

High growth has its shortcomings, even in a sector that services the poor. "You're bound to acquire garbage when you are driving growth," says Manmath Dalai, managing director of Krishna Bhima Samruddhi Local Area Bank. His company, which operates in two districts in Andhra, has repayment problems in just 1,000 of its 160,000 borrower accounts. Unlike most MFIs, which operate as NBFCs, Krishna Bhima operates as a bank. "The poor have respect for the bank tag," he says. "Also, we were collecting repayments on a monthly basis."

Most MFIs, though, were dealt a body blow by the ordinance, which effectively barred them from the state. MFIs did not see it coming, as they were focused on growth, with banks willing to lend and private equity (PE) investors ready to invest at generous valuations.

Lending to MFIs enabled banks to meet their 40% priority-sector target. Loans given by MFIs to individuals for up to ₹50,000 qualify as priority-sector lending. So, instead of subscribing to 5-6% bonds issued by Sidbi, which also carries the priority-sector tag, banks preferred lending to MFIs at 11-12%.

T Keshava Kumar, deputy general manager (credit) with State Bank of Hyderabad (SBH), says banks that lacked a strong presence in Andhra lent to MFIs. SBH's exposure to MFIs, he says, is only Rs 60 crore, that too to the two big ones, SKS and Spandana. Most of its micro-loan portfolio, estimated at around ₹500 crore, is self-managed or through local area banks, which hasn't seen an upheaval. "If I have direct access to customers and all the other business they will generate over time, why would I go through a third party?" he asks.

If banks lent to meet their priority-sector targets, PE funds invested with an over-estimation of market potential. The typical MFI business case says India has 225 million households. About 60%, or 132 million households, don't have access to banking credit. MFIs have reached 25 million households — just one-fifth of the market potential.

Sinha of M-Cril says this is an over-estimation because MFIs cannot function in many parts of India like the entire northeast, hilly areas, Maoist-affected regions, and some parts of Punjab and Gujarat. "Take those out and the market potential is 50-60 million households," he says.

By Sinha's estimation, MFIs have achieved a penetration of 40%. It doesn't merit valuing MFIs at 10 times book value, as PE investors did. "The problems would not have arisen if 35% returns were not promised to PE guys," says Dalai. "Why do you need them if you want to contain growth at the rate at which capital comes in?" Even as MFIs and investors realise this, it might be too late for a small MFI like Star MicroFin, maybe even for medium-sized and large-sized MFIs.

WITH SANGITA MEHTA

BANK **IMPACT**

Profits and Percentages

Assuming a 35% exposure to Andhra, a back-of-the-envelope calculation for the top 15 lenders shows the impact of a 10% provisioning on their 2009-10 net profit will be minimal, of up to 6%. But a 100% provisioning will erode up to 56% of their profit. The situation is especially grim for Sidbi, in both scenarios.

	Loan outstanding (₹cr)	Net profit (₹cr)	Provisioning impact (% of net profit)*	
			At 10%	At 100%
Financial institutions				
Sidbi	3,808.2	421.0	**31.7**	**316.6**
State-owned banks				
Punjab National Bank	1,069.3	3,972.6	**0.9**	**9.4**
State Bank of India	876.2	11,733.8	**0.3**	**2.6**
IDBI Bank	603.6	1,031.1	**2.0**	**20.5**
Syndicate Bank	527.9	814.3	**2.3**	**22.7**
Corporation Bank	370.9	1,181.4	**1.1**	**11.0**
Private banks				
HDFC Bank	1,324.0	3,003.7	**1.5**	**15.4**
AXIS Bank	1,207.8	2,514.5	**1.7**	**16.8**
Yes Bank	397.2	477.7	**2.9**	**29.1**
ICICI Bank	371.5	4,670.3	**0.3**	**2.8**
Tamilnad Mercantile Bank	236.1	184.5	**4.5**	**44.8**
Foreign banks				
Standard Chartered Bank	253.5	2,127.0	**0.4**	**4.2**
RBS	166.6	-104.9	**5.6**	**55.6**
BNP Paribas	164.2	180.4	**3.2**	**31.8**
Citibank	113.0	860.4	**0.5**	**4.6**

Loan figures as of March 2010; net profit for 2009-10
Since RBS posted a loss in 2009-10, the provisioning impact shows accretion to the loss
Source: Status of Microfinance in India 2009-10, Nabard; ETIG Database

MFI **IMPACT**

The Not Too Bad, The Bad, The Ugly

Large MFIs are living on survival instincts, but the medium and small ones are headed for death.

	PORTFOLIO (₹ CR)		COLLECTIONS (%)		
	In AP	Elsewhere	In AP	Elsewhere	Impact
SKS Microfinance	**1,250**	3,750	**30**	99	**"Not too bad"**
Spandana Sphoorty Financial	**2,000**	2,000	**33**	99	**Risk of closure**
Trident Microfin	**128**	32	**5**	95-99	**Bankruptcy by Jan-end**
SWAWS Credit Corporation	**75**	25	**1**	Normal	**Liquidity risk remains high**
Star Microfin	**20**	0	**2**	Not applicable	**On the verge of closure**

Portfolio of SWAWS is as of September 2010; for others, it is current
Collections are as a percentage of loans. For SWAWS, it is for November 2010; for others, it is current
Source: SWAWS information and impact is from CARE ratings press release; others is from the respective company management

TALKING **HEADS**

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