



Liberalisation of foreign borrowings by Indian MFIs How best to leverage this regulatory concession

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In its Circular of 19 December 2011, the Reserve Bank of India has amended the rules on External Commercial Borrowings (ECB or foreign borrowings) by Indian MFIs. In sum, India's financial sector regulator has

Allowed all MFIs – all those registered as NGOs, cooperatives and non-bank finance companies (NBFCs) and complying with the microfinance norms announced by its circular of 2 December 2011 – **to borrow from eligible foreign sources up to a limit of \$10 million (or equivalent) in a financial year.**

Until now, foreign borrowing by Indian MFIs registered as NBFCs was not allowed at all and borrowing by those registered as NGOs was only allowed up to \$5 million per year.

The **implications of the liberalization** now announced are as follows

- 1 The largest MFIs in India can now access on-lending funds from foreign sources to replace some of the funds that have been progressively withdrawn by commercial banks operating in India. Until now, just one of the 25 largest MFIs in India was registered as an NGO and permitted to borrow from foreign sources. Another, a not-for-profit company was not permitted to borrow abroad since it did not have registration under the Foreign Contribution Regulation Act (FCRA). The NGO, SKDRDP was highly favoured by Indian bankers partly on account of its link with a capital rich religious trust, so it did not need to borrow from foreign sources.
- 2 Since all the largest 25 MFIs in India have financial assets of Rs1 billion (Rs100 crore, \$20 million) and more, the new limit of \$10 million enables a more meaningful share of on-lending funds to come from foreign sources than was possible with the \$5 million limit in place until now.

In this context, there are three issues that foreign lenders to MFIs will need to bear in mind.

- 1 **Political risk:** Commercial banks operating in India have largely withdrawn from lending to MFIs due to a perception that the AP law limiting MFI activities is a manifestation of political risk. The concern is that other state governments in India could undertake similar actions jeopardizing MFI portfolios in those states in the same way that around 90% of the portfolio in AP has become delinquent and must, for now, be presumed lost.

M-CRIL's perspective on this is that the Microfinance Act proposed by the Government of India (the central/federal government) will remove ambiguity in the regulatory jurisdiction vis-à-vis MFIs. The Microfinance Bill clearly specifies that MFIs

will be regulated by the Reserve Bank of India (RBI) and, crucially, that microfinance activity undertaken by institutions regulated by the RBI cannot be classified as “money lending”. The AP Government has questioned the centre’s constitutional right to classify microfinance as not money lending. However, the matter is being addressed by the federal Law Ministry and the AP Government’s objection is likely to be overcome by defining microfinance undertaken by RBI regulated entities as a form of banking and, therefore, covered by the Banking Regulation Act which is explicitly excluded from the jurisdiction of the states.

So the timing of the passage of the Microfinance Act by Parliament is an important issue. While this is unlikely to happen in the immediate future, M-CRIL expects that the bill will be passed around the middle of 2012. However, the publication of the Microfinance Bill and the engagement of the central government with the issue has significantly reduced the likelihood of intervention by state governments other than AP, so the political risk is greatly reduced if not eliminated.

- 2 **Credit risk – MFI outreach and indebtedness amongst its clients:** Even if the political risk in an MFI’s operational area is limited, the distribution of its outreach across districts and states can be a factor in the risk profile of its portfolio. If a significant proportion of an MFI’s portfolio is in districts with high levels of MFI lending and client indebtedness it could lead to high risk in the portfolio despite political risk being low. Assessment of this risk needs good local knowledge of microfinance activity and cannot be assessed based on aggregate numbers.

While MFIs have now started to report to credit bureaus the information at the bureaus is limited to formal sector borrowing by clients. Even SHG loans are not reported to the bureaus at present and it will be many years before such reporting becomes reality. Therefore, credit risk cannot be assessed by the medium of credit bureau checks alone. To minimize credit risk, MFIs must have robust systems and processes that enable rigorous assessments of household income and indebtedness at the stages of loan renewal as well as client entry. M-CRIL believes that, for the system to work well, the rating agency should be in a position to verify that an MFI’s systems and processes meet the high standards necessary.

- 3 **Lending rate and hedging cost** – any foreign lender will need to keep in mind the effect of its lending rate on final interest rate in the context of the interest caps set by the RBI (as shown in **Table 1** below)

Table 1: Component of final interest rate	
Interest cap	26%
Loan processing fee	1%
<i>implied</i> effective cap on yield earned by the MFI on its portfolio	28%
Margin cap, 12% + loan processing fee	14%

Table 2 sets out the cost structure of a typical MFI likely to borrow from foreign sources. It shows that at the current (high) bank lending rates in India, at an interest charge of 9% on foreign funds plus the (current) 5% cost of hedging foreign exchange risk, the average borrowing cost to the MFI is likely to be around 14.25%.

At the 12% margin cap plus loan processing fee, this implies a maximum of 28.25% on the effective interest rate. However, the overall interest cap of 28% means that the MFI's effective interest rate cannot exceed that level.

Table 2: Effect of foreign loans on the cost structure of an MFI	Cost of funds	Proportion of MFI funds	Cost to MFI
Cost of funds to the MFI			% of funds
Equity	Nominally nil	20%	0%
Bank lending rate (current)	14%	50%	7.0%
Other domestic sources	16%	10%	1.6%
Foreign lender(s) – 9% interest + 5% hedging cost	14%	20%	2.8%
<i>[Average borrowing cost]</i>	<i>14.25%</i>		
Financing cost as proportion of total funds		100%	11.4%
Portfolio as proportion of total funds		85%	
MFI cost structure		% of portfolio	
Cost of funds (as proportion of portfolio)			13.4%
Loan loss provision rate			1.0%
Operating expense ratio (~25 MFIs in 2010-11)			11.0%
Total expense ratio			25.5%
Maximum interest (APR) chargeable (based on interest cap; 28.25% with margin cap)			28.0%
Yield to APR ratio (for moderately growing MFIs)			92%
Yield			25.8%
Surplus earned by the MFI (as proportion of portfolio)			0.3%

Thus, based on the calculations in the table, the MFI can only earn a surplus if it maintains

- Tight control of its operating expenses (OER)
- Its yield to APR ratio at the (92%) level – only possible at a moderate growth rate (20-30% p.a.)
- Its loan loss provisioning requirement at the minimum 1% of portfolio required by the new RBI guidelines

These are only just possible in the current regime of enhanced emphasis on client protection, client level income assessments and repayment stress in an environment where the credit culture has been vitiated by the public debate about MFI behaviour. Thus, with the particular interest and margin caps in place, most MFIs can expect to do little more than break-even, and even that will require significant effort. In this situation, funds from foreign lenders will help to sustain and

moderately expand portfolios enabling, thereby, some reduction in operating expense ratios. To that extent the liberalisation of foreign lending to MFIs is an important step forward. Funds from foreign lenders at less than 9% interest will enable MFIs to earn a slightly higher return at a lower interest rate to clients.

However, **there is a complication**: the External Commercial Borrowing (ECB) guidelines of the RBI specify that

- 1 The **maturity period** of the ECB **should not be less than 3 years**, and
- 2 The **“all-in-cost” ceiling over 6-month LIBOR should not exceed 350 basis points** (or 3.5%) for borrowings with maturity 3-5 years and 500 basis points for borrowings with maturity in excess of 5 years. This means that, in theory, MIVs, donor agencies and international development banks can only lend to MFIs at around 4.3% (6-month LIBOR is currently around 0.8%) for a 3 year maturity.

Based on this interest rate, using the calculations in the table, the resulting average borrowing cost is 13.08%. Factoring in the margin cap (12% + 1% loan processing fee which adds 2% to yield) reduces the APR chargeable to 27.08% and increases the MFI’s potential surplus to 0.61%.

These conditions could be an issue since according to the CGAP and Symbiotics MIV surveys,

- the average maturity period for MIV loans to MFIs is **33 months** but many prefer shorter periods, and
- the **net portfolio yield** obtained by MIVs is around **8%**.

On this basis, **it is only particularly development oriented MIVs** – willing to accept high maturity periods and low yields – **that will lend to MFIs in India**. Alternatively, Indian MFIs can approach donor agencies and/or international development banks, IFC, ADB, KFW and other similar institutions to obtain foreign borrowings.

In the **exuberant microfinance environment of late-2009** (a full year before the start of the crisis in India) **M-CRIL warned of the oncoming crisis** in its publication M-CRIL Microfinance Analytics 2009,

“The concern is that some of [the] high growth may have been stimulated by the advent of investment in Indian microfinance by [investor] groups keen to maximize numbers *under any conditions* in order to boost firm size and improve share valuations. This stimulus is apparently leading to the cutting of corners in matters of consumer protection – **multiple lending, over-indebtedness and consequently coercive collection practices** – **that are likely to trigger interference by political, religious or other community groups in the practice of microfinance** (and may already have done so). Such practices result partly from the geographical concentration and rapid consumer enrolment that has occurred due to high growth.”

M-CRIL was able to foretell the oncoming crisis because of its specialised knowledge and because of its day-to-day engagement with microfinance issues at the highest management level. In the rating business, there is no substitute for the constant engagement and sensitivity towards emerging risk factors that encapsulates M-CRIL's approach to the microfinance sector in India and over 30 other countries where it works.

Foreign lenders – banks, MIVs and others – can learn more about

- Political risk
- Credit risk, and
- Social performance

of their potential MFI borrowers in India by **commissioning a**

financial rating, social rating or a responsible finance (combined) rating

– of those MFIs **from an agency that understands the special nature of microfinance as a business and is fully informed about the detail of microfinance activities in every corner of the country.** Commissioning a general credit rating from agencies that treat MFIs as yet another financial institution is unlikely to serve this purpose.