A Covid Perspective on Nepal Microfinance

July 2020: M-CRIL Advisory Note on the liquidity of MFIs in Nepal

Lockdown dates: 23 March to 21 July 2020
Lockdown rigour: Limited, outside Kathmandu and a few major towns

Most likely scenario – assumptions	
• Client collections (January 2020-January 2021)	avge 90%
• Wholesale borrowing – expected to grow nevertheless due to high liquidity in banking system	30%
• Redemption of deposits	~5%
• Disbursements, % of normal annual disbursements	70%
• Cash buffer, % of total funds	10%

Analysis sample	8/8 large licensed MFIs + 8/12 medium MFIs
Liquidity shortfall	
• **Large MFIs*** – 6/8 have shortfalls in excess of 5% of funds 8 MFIs, active loans = 1.3 million, portfolio \$835 mn/NPR 10,000 crore	**\$5-40 million** Total: ~\$115 million) NPR 1,380 crore
• **Medium MFIs** – 4/8 shortfalls 8 MFIs, active loans = ~400,000, portfolio = \$220 mn/NPR 2,600 crore	**\$2-4 million** Total: ~\$15 million NPR 180 crore
• **Total shortfall**, largest 20 MFIs 20 MFIs, active loans = 1.9 mn, portfolio = \$1.15 bn	**~\$137 million** NPR: 1,650 crore

* known in Nepal as "laghubitta bittiya sanstha" or Class D financial institutions

This analysis is based on the understanding that

a) Covid lockdowns have posed challenges for **collections of repayment from clients** for a limited period of time but have mixed (60% medium and 40% mild) effects depending on their portfolio exposure; the service sector (hotels/restaurants, beauty parlours, hair salons) have been severely affected.
b) Because of lockdown conditions, it has been difficult for MFIs to manage their business normally; this has put a **brake on disbursements** resulting, for now, in below normal flows of fresh loans to microfinance clients. As of July 16, 2020, MFIs report a decrease in outstanding loan balances in excess of 20%. While MFIs are able to recover most of their loan instalments, their confidence both in extending repeat loans to existing clients and in issuing fresh loans to new clients has been undermined.
c) With the return of overseas migrants to Nepal, **demand for micro-loans is expected to grow**; the liquidity crisis is likely, therefore, to continue on account of the potential expansion in loan disbursements. The impact of this on liquidity is covered by the higher 80% and 90% levels of loan disbursement in our analysis.
d) The commercial banks – wholesale lenders to MFIs – have periods of substantial excess liquidity and are willing, therefore, not only to continue providing funds to MFIs but also to **grow that lending as if economic conditions were normal.**
e) There has not been, and is unlikely in the future, to be an extra-ordinary **withdrawal of deposits** from licensed MFIs. Even during the lockdown, none of the MFIs experienced significant deposit withdrawals.
f) Though the lockdown has been lifted, the Covid-19 crisis is not over. MFIs still need to maintain social distancing using personal protective equipment (jackets, masks, sanitizer, water, soap) and an increased use of digital devices. This is expected to **increase operating expenses by 10-15%**.

In undertaking this analysis we have taken into account the **maturity profile of assets and liabilities** over a **one year timeframe**.

This note parallels the analysis in the other recent Advisory Notes by M-CRIL – the details of the calculation method and other assumptions about loans without collateral and no default by trade debtors are set out in the **Annex**.

Table 1 and **Figure 1** show significant liquidity issues arising for MFIs in the following conditions

- **Most likely**: With 90% of amounts due recovered during the one year analysis period, and 70% of expected disbursements paid out, 6 of the 8 large MFIs and 4 of the 8 medium MFIs in our sample have significant liquidity shortfalls (>5% of total funds) resulting in the need for a liquidity fund amounting to $137 million (NPR 1,650 crore) for all 20 large and medium-sized MFIs to tide over the crisis.

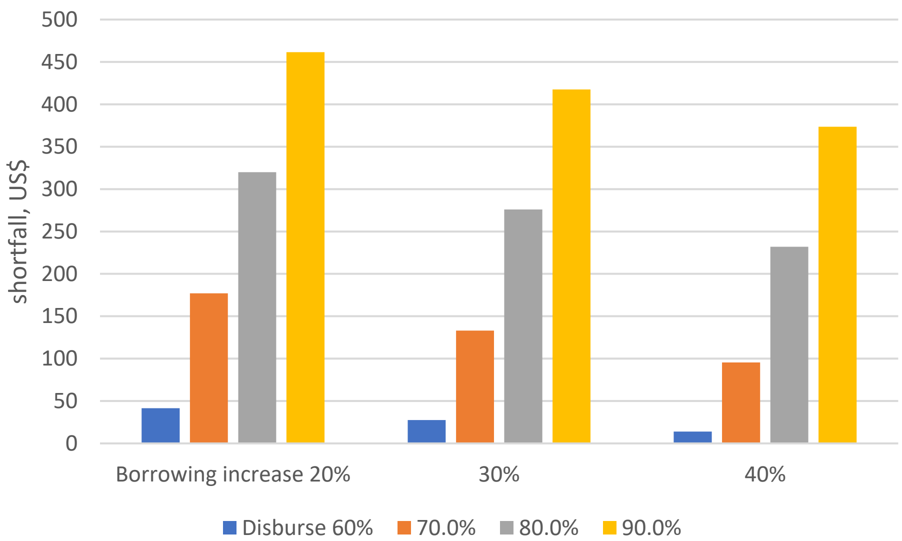
- **Maintaining disbursements at the 70%** level seems optimal since higher disbursements result in a sharp increase in the liquidity shortfall; a lower level of disbursement (even 60%) almost eliminates the liquidity shortfall but would lead to a substantial decline in operations over the next 12-18 months with drastic implications for profitability. A 70% disbursement level also affects profitability but not as drastically.

- However, with the **increase in demand for loans due to the return of overseas migrants, disbursements may need to go up to at least 90%** of the previous norm, drastically increasing the liquidity shortfall to over $400 million (up to NPR 5,000 crore).

Table 1: # MFIs in sample of 16 (of 20 largest MFIs) facing >5% liquidity shortfalls

Disbursement, % of normal	60%	70%	80%	90%
Borrowings increase by	Number of MFIs in crisis			
20%	3	15	16	16
30%	1	5	16	16
40%	1	5	14	16

Figure 1: Amount of liquidity support necessary to ensure survival of the largest 20 MFIs (extrapolated, US$ million)



The covid liquidity paradox…

Based on the above analysis, **the key pre-existing factors that enable institutions to manage Covid conditions** are as follows

- While commercial logic dictates that a high proportion of assets should be in the portfolio since that is what generates income for MFIs (and has higher interest yields than any bank deposits are likely to provide), at a time like this, a higher proportion of assets in cash (and equivalents) is beneficial for managing liquidity. However, Nepal MFIs have very high portfolio-to-asset ratios (>88%) so cash & liquid assets are very limited and this is not an important factor in this analysis.

- **A high maturity period of borrowings is also helpful** at a time like this since that reduces the pressure on liquidity of repaying wholesale lenders. On the other hand, in Nepal, the commercial banks have periods of substantial liquidity and are keen to deploy their resources in productive investments. The paradoxical result is that MFIs do not anticipate much difficulty in raising additional funds to finance their growth in spite of the pandemic. As we have calculated an additional 30% of borrowings (compared to the previous year) will provide considerable comfort to MFIs and if the addition reaches 40% it will enable better disbursements and reduce potential losses resulting from the pandemic in the current financial year (mid-July 2020 to mid-July 2021).

- However, **a substantial increase in demand for loans anticipated by the micro-lending sector** on account of the return of overseas migrants could upset this situation and create a huge liquidity shortfall limiting the availability of funds for financing both micro-enterprises and the immediate consumption needs of the families of large numbers of micro-borrowers. If this situation arises, **the Nepal Rastra Bank** (the central bank) **may need to step in to enhance liquidity** in the micro-lending value chain.

The numbers in this analysis indicate the **additional** funds from investors or wholesale lenders (domestic banks or foreign lenders) that the MFIs will need to access **in order to thrive**. The purpose of this exercise is to facilitate decision making in relation to the Nepali micro-lending value chain; it is also to enable international understanding of the finances of MFIs in Nepal and the potential role of external lenders in supporting the eco-system of the country.

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Annex – methodology & assumptions not stated in the text above

As mentioned in the main text, this Nepal microfinance liquidity assessment is for a one year period (mid-July 2020 to mid-July 2021) on the assumption that the liquidity challenge is immediate and it is during this period that additional liquidity support may be necessary. Specifically, we have used the following (estimated for analysis period based on MFI financial statements for 15 July 2019 and applying a growth factor of 30% per annum)

Inflows over one year =
+ **opening balances** (cash + cash equivalents)
+ **portfolio** (repayment) **collections**
+ **interest income on loan portfolio** collected during the period
+ **deposits collected** (as discussed above)
+ **other income** (total for the year)

Outflows over one year =
+ **borrowings repaid** during the period (using the average maturity profile of wholesale loans as indicated by some of the MFI balance sheets; ~60% based on the available MFI data)
+ **interest paid on borrowings** over one year
+ **deposits matured** during the period (~70% based on the available data)
+ **interest paid on deposits** (total for the year)
+ **operating expenses** (annual staff salaries, establishment expenses, travel) enhanced by 5% to allow for social distancing and additional protective measures.

Since July 2020 data is not available and we have used July 2019 data for this analysis. The **assumptions** are

- The contours of the July 2019 balance sheets/financial statements remain largely unchanged in July 2020; we recognise this may not be true but the objective here is to indicate the dimensions of the liquidity problem rather than to provide accurate information. In order to make a realistic estimate of orders of magnitude a 30% average growth rate to July 2020 has been assumed (based on aggregate growth numbers available for the past two years).
- Nearly 100% of these MFI portfolios are with micro-borrowers with no collateral. Due to lockdown regulations there was very low recovery of dues in April and up to mid-May 2020. When operations picked up in the second half of May collections improved rapidly and MFIs report 95% to 99% of amounts due were collected. As June 2020 came around repayment levels grew to the normal 98-99% level with regular operations of all branches.
- There is no moratorium or any other relief to MFIs from their lenders though there may be some negotiation to delay repayments and/or obtain fresh disbursements.
- There will be no default on MFI **receivables** from debtors on non-operational transactions
- **Other income** (commissions & miscellaneous) do not decline significantly.

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See disclaimer and briefs about the authors' organisations on the following page

A disclaimer for readers…

These findings provide a guide for the managements of micro-lending institutions, for wholesale lenders to them and for investors in such institutions to understand the liquidity challenges of the lockdown. As indicated by the qualifying statement earlier in this note, the analysis here is based largely on the July 2019 balance sheets of the MFIs in the sample. This document does not purport to set out rules of operation for MFIs in normal times, it is meant mainly as an indicator for all stakeholders of the microfinance sector in Nepal of the challenges involved and the orders of magnitude of funds of additional investment or lending to be considered. ***However, actions taken by stakeholders are at their own risk and M-CRIL and CED Nepal will not be responsible for decisions based on the contents of this note***.

M-CRIL is a responsible development research and analytics firm with a concern for **inclusive microeconomics**. Along with its parent firm, EDA Rural Systems, M-CRIL has over 40 years of experience of international issues in microenterprise promotion and financial inclusion through a substantial record of analytics in this field including microfinance ratings, programme evaluations and focused management training and capacity building support for MFIs. Its work in support of smallholder farmers and with agricultural value chains in South and Southeast Asia also emphasises its commitment to supporting the lives and livelihoods of low income families.

CED Nepal is a non-government organization specialized in providing technical advice and capacity development support on banking, finance, enterprise development and livelihoods. Since inception in 2007, it has been engaged in conducting research and analysis on broad based and inclusive economic growth and has worked on project cycle management, programme evaluations and focused management training and capacity development to financial service providers to enhance the frontier of financial services and promote financial inclusion in Nepal. Its work to promote gender equity and social inclusion focuses on facilitating economic empowerment of the poor, vulnerable and indigenous families in the fight against poverty.