India's SFBs and the Growth Pangs of the Pandemic

August 2020: M-CRIL Advisory Note 4 on the effects of the pandemic on Small Finance Banks in India

Small Finance Banks (SFBs) in India serve some 23 million of the estimated 90 million micro borrowers in the country. Analysis of the last three years' balance sheets of the eight microlending SFBs shows that the expected delinquencies and defaults in the microfinance sector resulting from the lockdowns caused by the Covid-19 pandemic, are unlikely seriously to challenge their solvency. However, **with likely delinquencies/NPAs in excess of 10% by March 2021, a few will need to take action to maintain their capitalisation (**capital adequacy ratios of at least 15% as specified by RBI) if they are to continue to grow at the current 35% average rate. At least a couple of the SFBs will need to raise significant additional equity. **Higher levels of NPA** – possibly in excess of 15% – **will require similar efforts from two more SFBs** to maintain solvency.

The liquidity issues addressed in our previous Advisory Notes indicated the need for ₹7,000 crore ($940 million) in additional funds for SFBs. This analysis adds nuance to that calculation; **M-CRIL estimates that ₹1,300 crore ($175 mn) will need to be in the form of equity leaving ₹5,700 crore ($765 mn) to be raised as debt to ensure that SFBs not only remain solvent but also grow at the current 35% rate over 2019-20.** The additional equity requirement amounts to over 11% of the net worth of the 8 SFBs taken together and 27% of shareholder equity on 31 March 2020.

Since SFBs are the strongest set of institutions serving micro-borrowers this situation means that other parts of the sector will have more severe challenges to overcome. M-CRIL plans to publish an update as soon as 2019-20 information for the 10 largest MFIs becomes available.

To maintain the current 35% growth rate in FY 2020-21,

2 to 4 SFBs

will need to raise around

₹1,300 crore ($175 million) in equity

if the level of non-performing assets

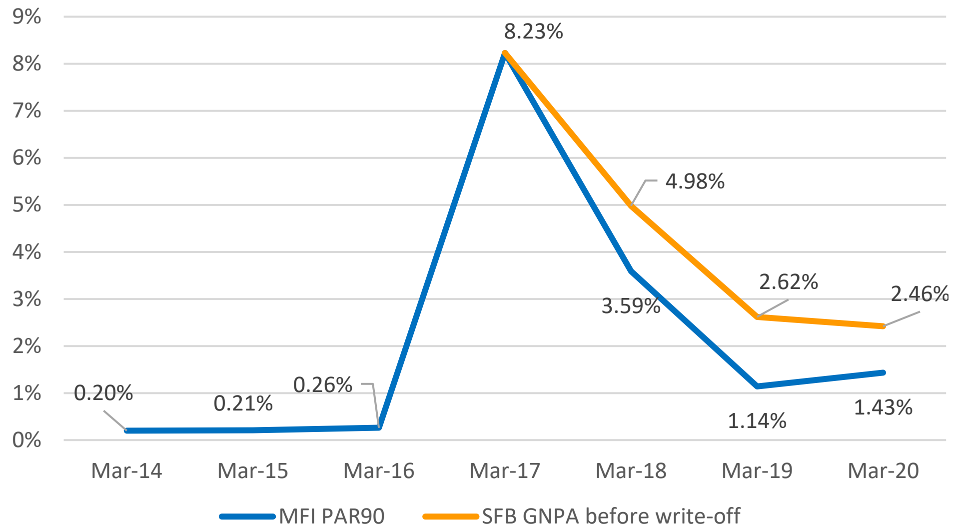
NPA rises above 12%

The remaining four SFBs do not face equity and growth challenges unless NPAs increase to levels higher than 15%

Following from the M-CRIL analysis of the liquidity of microlending Small Finance Banks (SFBs) and of MFIs in India in the context of the Covid-19 pandemic, this note takes a closer look at the expected effects of the pandemic lockdowns on the capital adequacy of Small Finance Banks. This analysis covers the growth of SFBs as providers of microfinance services and the possible need for further raising of equity capital in order to facilitate that growth.[1]

The key impact of the pandemic lockdowns is expected to be on portfolio quality. Our previous analysis, M-CRIL Advisory Note 3,[2] estimated that SFB and MFI collections on loans would average 50-60% of payments due during the period April-September 2020. The reckoning will presumably come in October 2020 when all moratorium periods are over and there is high pressure on microfinance clients to repay MFIs (as well as MFIs to repay their wholesale lenders, the commercial banks). It is only at this point that the true nature of the impact of the lockdowns on micro-lending will start to become clear.

Figure 1: End of financial year PAR_{90} collated for microfinance NBFCs & SFBs



Source: Computed using MFI PAR data for the 10 states with the largest microfinance portfolios in India for each year as shown in MFIN Micrometer for March each year. SFB GNPA as % of gross advances (since March 2018) computed from the balance sheets of all 8 microlending SFBs.

While the actual effect of the lock-downs on portfolio quality is a matter of speculation at the time of writing, for India, the demonetisation ex-perience of Nov/ Dec 2016 provides historical evidence of the impact that economic shocks of this type can have.

Figure 1 provides end of financial year average values for portfolio at risk greater than 90 days (PAR_{90}) for NBFC MFIs on an annual basis from 31 March 2014 to 31 March 2020. It also provides Gross Non-Performing Assets as a proportion of advances (effectively PAR_{90}) for SFBs from March 2017 onwards. Up to financial year 2016-17, all SFBs were still effectively MFIs so the portfolio quality averages apply to them until March 2017 as well as to those that remained MFIs after that date.

[1] Unlike the earlier analysis, this note does not cover NBFC MFIs since balance sheet data for 31 March 2020 is not consistently available yet for the largest 10 MFIs that were covered in the previous note. We will update this note when 31 March 2020 data for the largest 10 MFIs becomes fully available.

[2] **M-CRIL Advisory Note 3** on the liquidity of Small Finance Banks and of the ten largest NBFC MFIs in India. "Liquidity in lockdown – Update 2: India's SFBs & MFIs coping with the pandemic", end-June 2020. http://www.m-cril.com/pdfs/20-06-28%20[Ver3]%20Liquidity%20in%20lockdown%20-%20surviving%20the%20pandemic.pdf

Figure 1 shows the substantial spike of portfolio risk caused by the economic disruption resulting from the sudden demonetisation of Indian rupee notes of ₹500 and ₹1,000 on 8 November 2016. PAR_{90} for the microfinance sector climbed to an average of 8.3% across MFIs by 31 March 2017. The liquidity crisis resulting from demonetisation caused the collapse of a few of the weaker MFIs while many of those that survived were obliged thereafter to undertake both a costly effort at recovering overdues but also to make substantial write offs. A semblance of equilibrium in MFI portfolios took two years to restore and PAR_{90} was brought down to 1.14% by March 2019. This has again been disturbed with the beginning of the pandemic effects and lockdowns in March 2020 having already caused MFI PAR_{90} to increase to 1.46% by the end of that month.

For this analysis, the recent performance of the Gross Non-Performing Assets (GNPA) to Gross Advances ratio of SFBs – virtually equivalent to PAR_{90} for MFIs – is more directly relevant. As the figure shows, the microlending SFBs had an average GNPA to gross advances ratio of 2.46% on 31 March 2020. The ratio calculated here for SFBs **includes** NPAs written off during the year to compute the full extent of bad loans at the end of the year as this is what affects the capital of a financial institution – write offs result in a direct reduction of capital while the remaining NPAs necessitate provisioning (an allocation from margins earned to the loan loss reserve).

Table 1 shows the potential levels of GNPA by 31 March 2021 if the current average level multiplies. Thus, relative to the current level of 2.46%, GNPA could multiply by a factor of two by March 2021 and cross 5%; if it multiplies by 3 it will cross 7% and so on. In the table we have shown both the current average level and the three-year average. But for the purpose of this analysis, we have used the three year average as a better long term indicator of what GNPA might have been in March 2021 without the economic effects of the pandemic lockdown so three times the current level crosses 10% and five times is well over 16%.

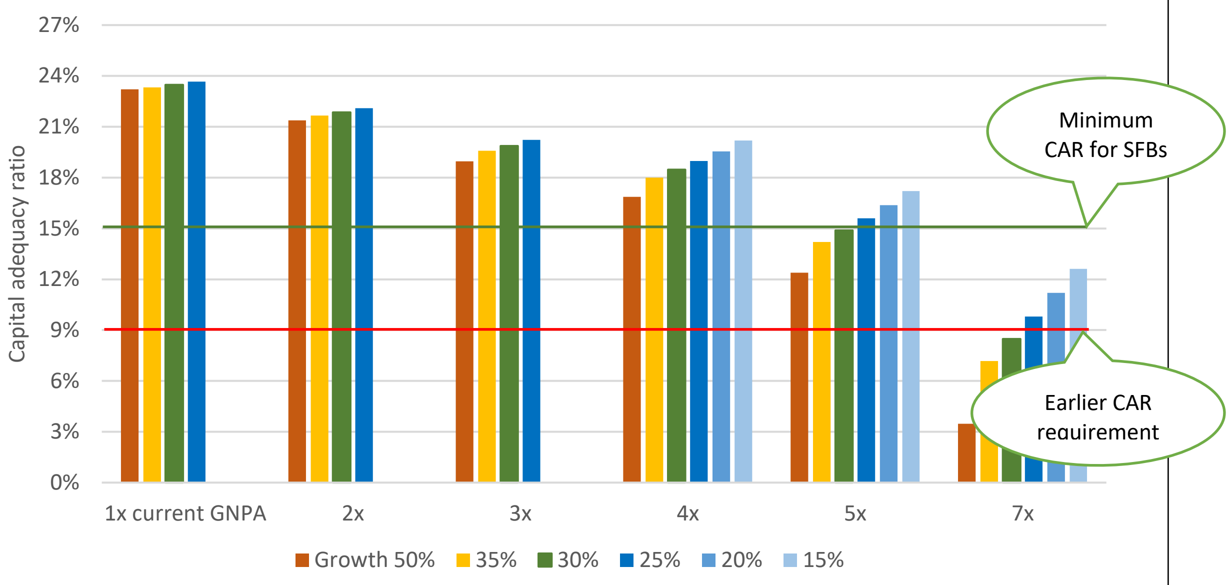
Table 1 Potential levels of GNPA by 31 March 21

GNPA multiple, Mar-21	1 = Current	2	3	4	5	7
Average GNPA ratio Mar-20	2.46%	4.92%	7.38%	9.84%	12.30%	16.22%
3 year average GNPA ratio to Mar-20	3.35%	6.71%	10.06%	13.41%	16.77%	23.47%

Comparing the potential GNPA ratios for March 2021 in **Table 1** with the effects of demonetization resulting in PAR_{90} of 8.23% in March 2017, it is apparent that a multiple in excess of 2 is a highly likely result of the pandemic and that, given the severity of the lockdown in India, a multiple around 3 is quite likely. We have also applied the effects of higher multiples, 4, 5 and 7 as a stress test in case the results of the pandemic lead to higher or even extreme levels of GNPA.

Using the GNPA levels shown in the table we have calculated the average Capital Adequacy Ratios (CARs) of the 8 microlending SFBs at various levels of growth. Average portfolio growth over the past 3 years has been 35% per annum but this figure hides a range from around 70% to 20% for individual SFBs. For this reason we have calculated average CARs for a set of growth rates from 50% down to 15% (assuming it will not be possible to sustain a growth as high as 70% in financial year 2020-21 even for the smaller SFBs). The results are shown in **Figure 2**.

Figure 2 How declining portfolio quality is likely to affect Capital Adequacy and Portfolio Growth



It is apparent from the **figure** that the average tolerance level of these SFBs vis-à-vis GNPAs is quite high. Even at **4 times** the March 2020 level of GNPA, the average SFB CAR is 18% at the normal 35% growth rate and nearly 17% at a higher 50% growth rate. This is comfortably above the **minimum CAR of 15%** required by the Reserve Bank of India though well below the current average of 25.2%. At **3 times** the March 2020 level, the 19-20% average CAR is well above the minimum threshold. It is only when the multiple goes **to 5 times** the current level that SFBs would have either to slow down their growth rates to 25% or less or raise substantial amounts of additional equity in order to comply with the minimum threshold. At **7 times** the current level (GNPA ratios of 23-25%), of course, the SFBs have substantial challenges in meeting the CAR requirement; however, GNPA ratios in India at this level are almost inconceivable based on the microfinance experience of the past two decades.

While this analysis may seem to suggest a high level of comfort for India's SFBs in the context of portfolio quality and capital adequacy, again the averages hide a less comfortable reality for a few institutions. **Figure 3** (following page) shows the range of CARs across SFBs for different multiples of GNPA and the same range of growth rates used in **Figure 2**. It is apparent from this that one SFB is challenged to maintain its CAR at three times the current level of GNPA (around 10%) and that 2 SFBs are challenged at 4 times the current level (around 13% GNPA). At 5 times, 3-4 SFBs are challenged and at 7 times all fall below the threshold even at very low growth rates (**Figure 4**).

Though 4x may be thought to be an unreasonable level it is quite possible for SFBs operating in some states of India, while 3x is quite likely for SFBs with portfolios concentrated there. **Figure 5** (page 6) presents the PAR_{90} levels of NBFC MFIs in various states of India resulting from the demonetisation debacle. It shows that Karnataka (KA), Maharashtra (MH), UP, Madhya Pradesh (MP) and Gujarat (GJ) are the states where SFBs with significant proportions of portfolio will particularly need to watch their capitalisation relative to their GNPA levels.

Figure 3 Range of estimated CARs at various levels of GNPA and growth

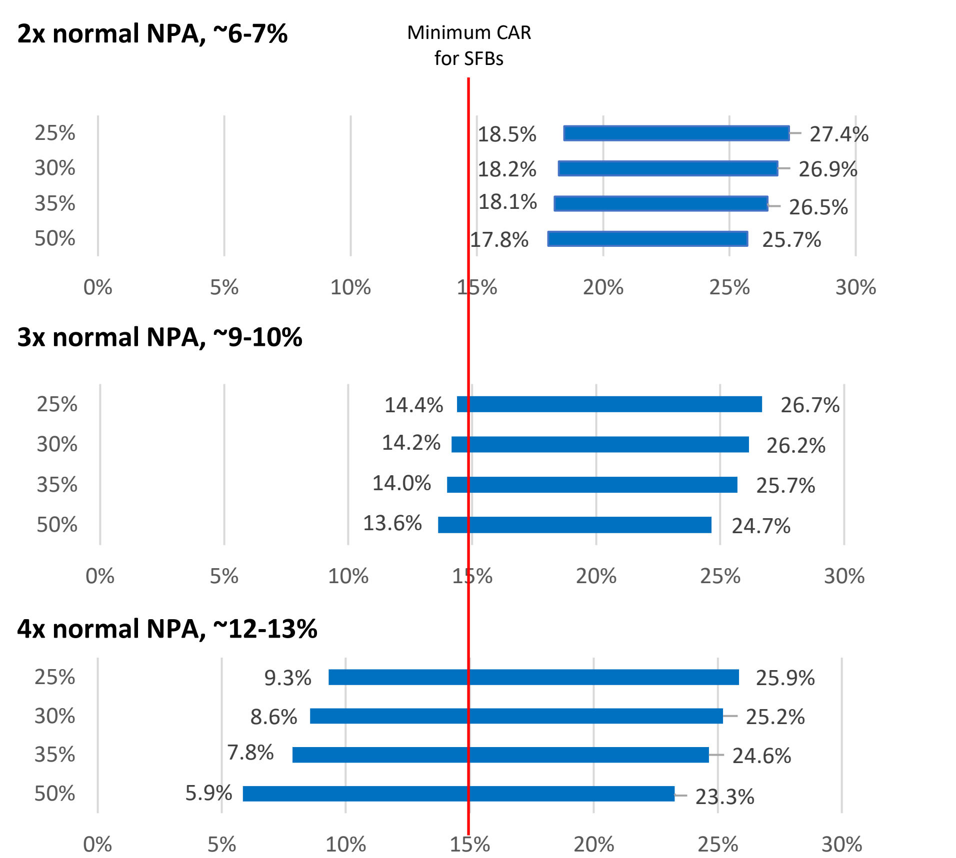


Figure 4 Number of microlending SFBs challenged by various multiples of GNPA

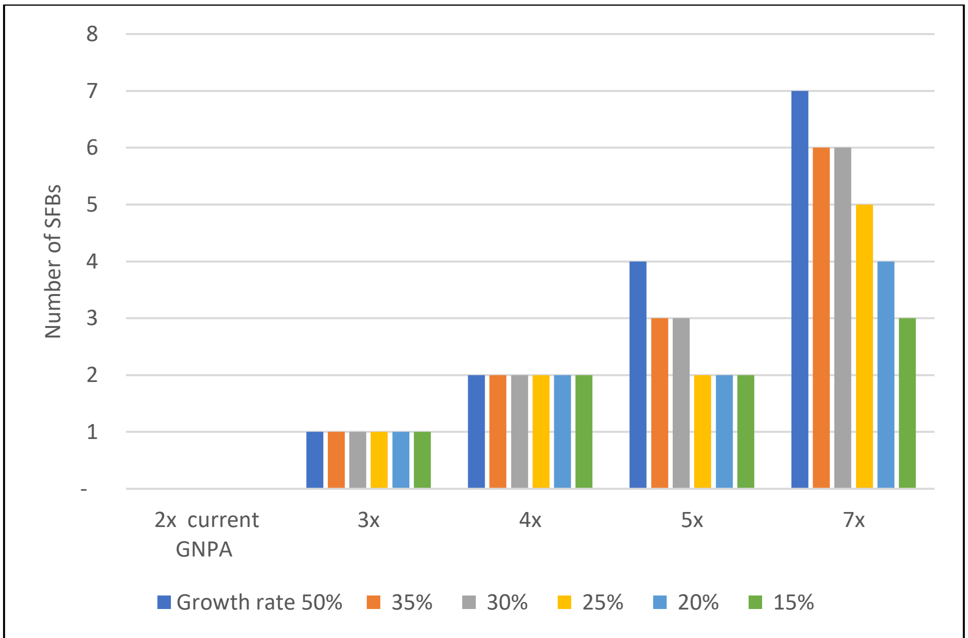
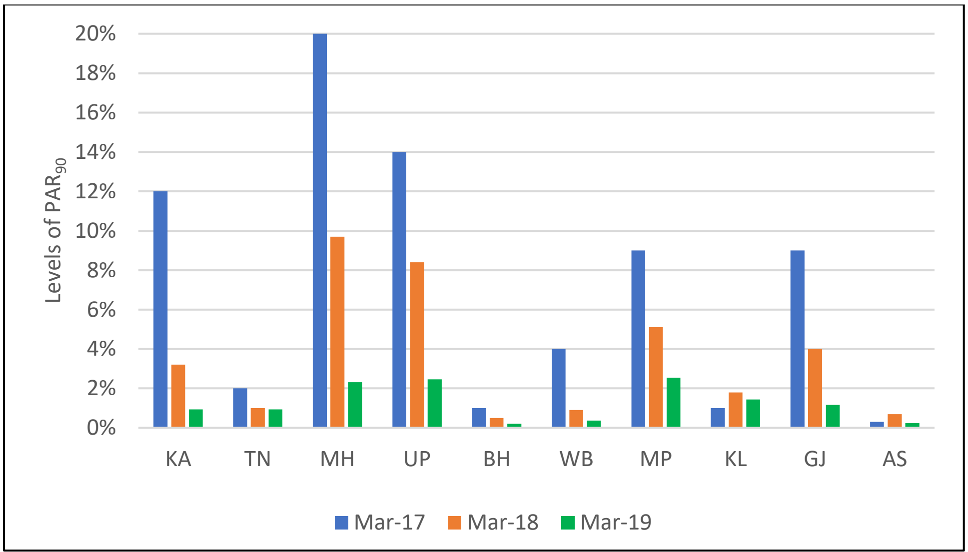


Figure 5 Effect of demonetisation on the MFI PAR_{90} levels in key states of India



To conclude, at least a couple of SFBs will need to raise significant additional equity to survive the pandemic. Higher levels of NPA – possibly in excess of 15% – will require similar efforts from two more SFBs to maintain solvency. The liquidity issues addressed in our previous Advisory Notes indicated the need for ₹7,000 crore ($940 million) in additional funds for SFBs. This analysis adds nuance to that calculation; M-CRIL estimates that ₹1,300 crore ($175 mn) will need to be in the form of equity leaving ₹5,700 crore ($765 mn) to be raised as debt.

Since SFBs are the strongest set of institutions serving micro-borrowers this situation means that other parts of the sector will have more severe challenges to overcome. M-CRIL plans to publish an update as soon as information from large MFIs comes through.

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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 in the text, this note is based on March 2020 financial statements of SFBs; as the March 2020 financial information for MFIs becomes available, the coverage of this advisory will be expanded. This document does not purport to set out rules of operation for SFBs or other micro-lenders in normal times, it is meant mainly as an indicator for all stakeholders in the micro-lending sector 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 will not be responsible for decisions based on the contents of this note***.

Sanjay Sinha, Managing Director

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 emphasises its commitment to supporting the lives and livelihoods of low income families.