M-CRIL Advisory Note, 2021

Growth Pangs of the Pandemic, revisited

A stressful time for Small Finance Banks & MFIs in India, but also an opportunity

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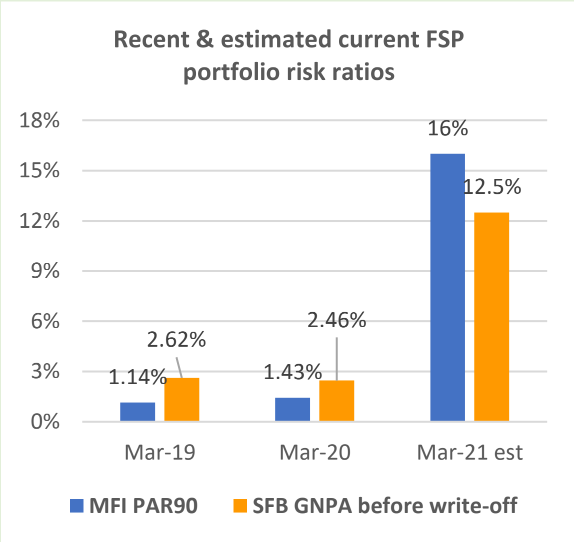
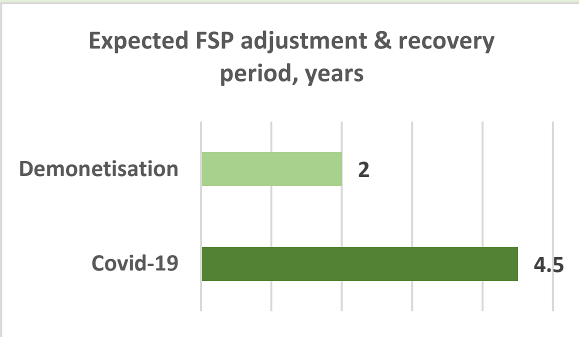
The impact of the Covid-19 pandemic on the microfinance sector, has brought forth news reports of stress faced by microfinance and other retail lenders. Undoubtedly, there is stress; the pandemic has resulted in a spurt in portfolio risk ratios (see Figure alongside) which are likely to be reported at an average of ~**16% for MFIs and at least 12.5% for Small Finance Banks** at **end-March 2021**.



Given the experience of previous crises in the microfinance sector in India, this Advisory Note sets out M-CRIL's expectation of a **four to five year adjustment and recovery period from the Covid crisis** not just the two-year setback of demonetisation.



Previous crises have demonstrated that FSPs with financial strength can withstand the significant stress caused by Covid but it will take a well-crafted strategy that helps maintain the double bottom line – long term profitability of FSPs as well as the financial welfare of their borrowers – provided the microfinance sector as a whole makes a concerted effort. For this to happen, FSPs (MFIs and SFBs) will need to deploy specialist loan restructuring skills that help to limit long term loan losses while enabling borrowers to rebuild their economic lives. ***Every crisis causes financial stress but also presents an opportunity. As with earlier crises, this too shall pass***.

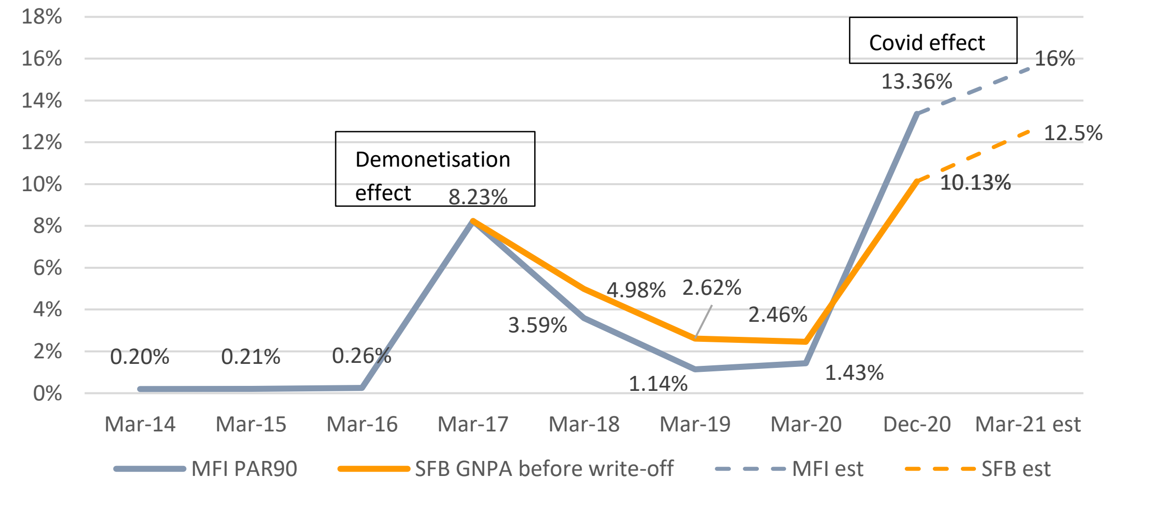
The negative impact of the Covid-19 pandemic on the microfinance sector, has brought forth news reports of stress faced by microfinance and other retail lenders.[1] Given the record of lockdowns, consequent moratoria on loan repayments, continuing ill health of large sections of the population and now a devastating second wave of the pandemic in India, such reports

[1] https://m.economictimes.com/industry/banking/finance/banking/millions-of-defaults-threaten-microfinances-future-in-india/amp_articleshow/80682643.cms; https://economictimes.indiatimes.com/markets/stocks/news/nbfc-retail-loans-showing-stress-signs/articleshow/82264035.cms?from=mdr

are inevitable. While crises of this type certainly result in stress for financial institutions, it is important to take a calculated look at the degree of such stress, its likely impact on the survival and growth of microfinance institutions before making dire predictions about the future of the sector. After all, neither the impulsive and cynical decisions of politicians (demonetisation, loan waivers) nor the temerity of monetarist economic advisers advocating caution about a fiscal stimulus have brought down the sector so far. So what lies ahead? This paper takes a look at the current status and prospects for the microlending sector over the next few years.

Undoubtedly, there is stress; the pandemic has resulted in a spurt in portfolio risk ratios as shown in the **Figure** below. According to industry data,[2] the average 90-day portfolio at risk ratio (PAR_{90}) rose to as much as 13.4% for NBFC MFIs at end-December 2020 and M-CRIL estimates it will rise further to around 16% by the end of March. Similarly, for Small Finance Banks (SFBs) this ratio rose to 10.1% in December and is expected to reach 12.5% by 31 March 2021.

Figure Portfolio quality ratios of SFBs & MFIs



Source: PAR_{90} ratios as reported in MFIN's Micrometer covering data for end-March of each year. Projections for Mar-21 are by M-CRIL since data from the institutions will take several more weeks to become available.

In a paper by the author published by the Boulder Institute of Microfinance in August 2020, M-CRIL estimated the likely effect of the decline in portfolio quality on the growth and capitalisation levels of the SFBs. This showed that if the gross non-performing assets (GNPA, 90 days) of SFBs rose to an average level that was four times the normal (3.35%) NPA level of March 2020 (**Table** below), two of the eight SFBs would be challenged maintaining the regulator, RBI's minimum required capitalisation level of 15% even at a low 25% growth rate (compared to average SFB growth rates of the order of 38% per annum). In the event, the latest information (for December 2020 reported by MFIN) indicates that the average growth of SFBs was less than 5% over the past year. The high capital adequacy ratios (25-35% in March 2020) of the largest 10 NBFC MFIs means that while none of these was immediately threatened by Covid level portfolio risk ratios, their average growth rate during 2020-21 had fallen from 31% to a defensive 9%.

[2] MFIN, Micrometer, No.36, Q3 2020.

Table: SFB portfolio quality ratios in March 2020 and projected multiples for March 2021

projected GNPA multiple, Mar-21	Current Mar-20	projected March-21				
		2	3	4	5	7
GNPA ratio Mar-20 & projected to Mar-21	2.46%	4.92%	7.38%	9.84%	12.30%	17.22%
Normal = 3 year average GNPA ratio to Mar-20	3.35%	6.71%	10.06%	13.41%	16.77%	23.47%

Managing Portfolio Risk

So what are the implications of the spike in portfolio risk caused by the pandemic? M-CRIL's assessment is that stress in such a situation can only be expected. But, while a few of the smaller MFIs are already reported to have defaulted on their payment obligations to wholesale lenders, it **does not constitute a major threat to the sector as a whole**.

There are lessons available from the recent history of the sector. The **Figure** (above) 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. The **average PAR_{90}** for the Indian microfinance sector climbed to 8.3% by 31 March 2017 from just 0.26% a year earlier. The repayment and liquidity crisis resulting from demonetisation caused the collapse of a few of the weaker MFIs (that registered above average PAR values of 15-20% in the aftermath of this policy shock), while many of those that survived were obliged thereafter to undertake both a large and 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 equilibrium 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 the month and, as shown in the **Figure**, to as much as 10-13% by end-December 2020 and expected to increase to 12-16%. Clearly, the challenge of managing portfolio risk will be far greater this time than that posed by demonetisation.

With such high portfolio risk ratios and an intensified pandemic, the solutions this time will, however, need to go much further than the challenge of 2017-2019. These include not just the recovery of overdues and writing off of unrecoverable loans but also a knowledgeable and sympathetic effort at restructuring and (if necessary) refinancing micro-loans. To look at each of these measures individually

- **Write off of overdues** is the simplest task since it involves identifying loans considered unrecoverable by the intermediation teams jointly at branch and head office levels followed by appropriate entries in the FSP's books of accounts. However, it is usually the last option to be exercised since it puts pressure on the balance sheet (by reducing reserves) and on profitability if reserves prove to be inadequate in the middle of or after a crisis.
- **Recovery of overdues** can rarely be successful during a crisis since it will only add to the stress already faced by the borrower. Recovery after a crisis requires a sustained effort

by loan officers, branch managers and/or specialised recovery teams. This is an expensive task and the pressure thereby exercised on borrowers can lead to complaints of harassment and create the potential for political intervention either from the local or higher (district or state) levels.

- **Restructuring of loan repayment schedules** is, in theory, the most humane way of addressing problems faced by borrowers in times of crisis. But the process is challenging for the FSP since there is a series of concerns
  - ✦ Regulators routinely require restructured loans to be accounted for separately and for **provisions to be made at the same levels as for overdue loans**; when overdues are abnormally high, this places pressure on the margins of the FSP and depresses profitability with implications for the FSP's ability to raise debt (by depressing the capital adequacy ratio) and to mobilise additional capital.
  - ✦ Many FSPs restructure whole sets of loans with overdues (**bulk restructuring**) without engaging in individual oversight; this assumes that the number of wilful defaulters is a small proportion (at most 10%) of the overall number of defaulters. In practice, this may not always be true and could, therefore, result in long term contamination of the repayment culture that the FSP must cope with.
  - ✦ The process of restructuring ideally requires **detailed intermediation** (individual oversight): the separation of borrowers with genuine repayment issues on account of the crisis from wilful defaulters, those who might take advantage of the situation to withhold loan repayments to the FSP. This separation can be a challenging task requiring supervisory staff (or recovery teams) to spend time with each borrower to understand their situation. Most FSPs shy away from this level of borrower engagement because of its incremental effect on operating cost.

Bulk restructuring leads to higher provisioning requirements and (in the long run) could lead to higher write off needs depressing the overall capitalisation of the FSP. It also misses the key aspect that an economic crisis creates a number of defaulters who lose their capital due to temporary lack of business; enabling them to restart and rebuild their economic lives needs the provision of more capital not the addition of their names to write off or defaulter lists. For this, judicious refinancing may be necessary which can only be undertaken on the basis of detailed intermediation. **FSPs must inevitably balance the cost of detailed intermediation against the write offs that will be needed as a result of bulk restructuring.**

Detailed intermediation has never been favoured by FSP managements because of the cost involved but, in a long term crisis like that caused by the Covid-19 pandemic, there may be no alternative. Indeed, M-CRIL has always argued that even at the best of times FSPs need to have specialised **loan resolution teams** that can undertake this type of intermediation. The catch is that loan officers accustomed to rolling out loans to micro-borrowers based on routine group guarantees cannot do this; **it must be done by specialised credit analysts with higher levels of education and training than is typical of the average loan officer**. Having such teams in normal times enables an FSP to gather experience of the process; expanding and deploying that experience in times of crisis can enable the FSP to minimise its long term loan loss as well as to make a real contribution to economic revival through refinancing where necessary. As of now though, the number of FSPs that have such teams is very small indeed.

Given the experience of managing previous crises – the AP crisis of 2010, demonetisation of 2016 and, in recent years, a rash of politically mandated loan waivers in multiple states – it is apparent that FSPs with financial strength, whether SFBs or MFIs, will withstand this crisis as well. But it will take 4-5 years of persistent crisis management not just the two year setback of demonetisation. A well-crafted strategy of the type laid out above can still service the FSPs' double bottom line – maintaining long term profitability while serving the needs of the community – provided FSPs as a group make a concerted effort to undertake detailed intermediation.

The next few years are going to be a period of slow growth for FSPs (perhaps no growth for a few) but it can be a period of consolidation for them along with revival for micro-borrower livelihoods. It is an opportunity not to be missed.

Every crisis causes financial stress but it also presents an opportunity. As with earlier crises, this too shall pass.

Postscript: This Advisory Note was researched and written in April 2021 before the full impact of the second Covid wave had become apparent. The second wave and associated lockdowns are reported to have caused further stress to microfinance clients with related effects on FSP portfolio quality. M-CRIL will monitor information emerging on FSP portfolio quality and a second version of this note may be published when appropriate. For now this document covers the period up to end-March 2021, and no further.