MicroSave India Focus Note 23

The Global Financial Crisis and Indian Microfinance

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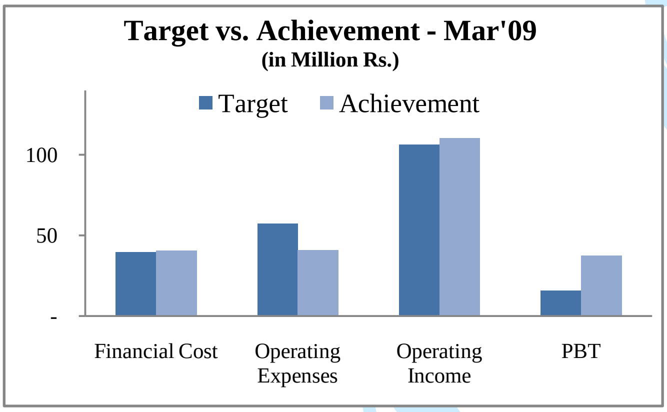
"Whereas a few years ago, we were talking about competition and 'crowding out' in the microfinance sector, now we're talking more about resilience and survival of the fittest." – Microfinance Insights Blog, May 19th 2009

Background

According to a Microfinance Insights Survey on *Microfinance and the Global Recession* published in March/April 2009, "63% MFIs have had a difficulty in raising funding during the economic crisis." *MicroSave* sought to understand more about different stakeholders' perspectives, reactions and lessons learned. This note summarises our findings from interviews with investors, MFIs, banks, and industry experts.

Impact at a Medium-Sized MFI: Sonata Microfinance

The major impact of the crisis at Sonata has been on its liquidity position as the institution could not mobilise the required funds to finance growth. Consequently, it was pushed to sell a portion of its portfolio. Shortage of funds caused delays in disbursing loans to clients and forced the organisation to revise its overall growth strategy and scale down its financial projections. Moreover, Sonata's average cost of funds increased by 3.3% to 15.7% during the year 08-09 and sanctioned debt worth Rs.30 million was pending for disbursement for more than six months. Fortunately, the organisation still managed to produce higher profits than projected by reducing its operating expenses. See Figure 1.



Source: Sonata's Performance Report, March 2009

Figure 1: Target vs. Achievement of SPFL

Sonata's Response to the Crisis[1]

Sonata used the following strategies to face the crisis:

- Reduced operating costs by 71%;
- Adjusted financial projections and modified business plan/growth strategy as market conditions changed; and
- Managed scarce on-lending resources by prioritising repeat loans to existing clients over first loans to new clients. This will contribute to long term portfolio quality and income as the assurance of repeat loans is the main driver of good repayment rates. However, this has resulted in only 81% target achievement for number of clients in March 2009, even when targets had been revised down in October 2008.

[1] Interview with Mr. Anup Singh, CEO, Sonata.

Impact on Investors

Indian microfinance investors have seen their investees affected by the crisis.[2] Dia Vikas Capital Pvt Ltd. (Dia) had to lobby with banks to provide funds for its start-up partners and leverage their capital investment. Dia also began offering subordinated debt[3] to its partners so they could further increase leverage. This enabled most of them to add 3-4 new funders and to enhance credit exposure from existing funders. Further, Dia provided short term loans to its partners, particularly start-ups, which enabled them to grow steadily and become attractive candidates for debt funding from mainstream financial institutions.

Mitigation Strategies

The microfinance sector has to prepare well in advance to reduce its vulnerability to economic shocks. Below are suggestions from various experts on how MFIs might build resilience.

Capital Structuring & Financial Management[4]

- *Diversify Debt Sources*: Due to scarce on-lending resources, many MFIs had to adapt to the stricter terms imposed by lenders (increased cash collateral, reduced repayment frequency, personal guarantee requirement, portfolio buy-outs, and increased interest rates, among others). By diversifying sources, MFIs can reduce dependency on a single source and achieve greater bargaining power to determine the terms of loans. A good mix of public and private sector banks with varying debt exposure would further reduce the risk.
- *Reduce Financial Risk by Decreasing Leverage/Increasing Equity*: As part of their diversification strategy, MFIs should focus on increasing equity. Indian microfinance is characterised by its high leverage and high off-balance sheet obligations, which means that most MFIs have acquired fixed debt obligations that must be paid irrespective of the income generated by the organisation in any year. At times of crisis (and indeed in times of significantly lower than expected revenues), debt-obligations and

[2] Interview with Mr. Saneesh Singh, Executive Director, Dia Vikas Capital Pvt. Ltd, a subsidiary of Opportunity International Australia.

[3] A subordinated loan is "debt over which senior debt takes priority. In the event of bankruptcy, subordinated debt-holders receive payment only after senior debt is paid off in full." Source: Glossary, CFA Program Curriculum Level II, 2008.

[4] See *MicroSave*'s Basic Financial Management and Ratio Analysis and Institutional and Product Risk Analysis Toolkits.

dependence on lenders can hamper growth, achievement of mission/vision, and even can threaten the existence of the MFI. By increasing equity, the MFI obtains a cushion to fund its operations during the bad times and to absorb possible losses; the MFI reduces dependence on external sources and risk of default, and most importantly, it increases chances of survival.

- *Reduce Refinancing Risk by Increasing the Term of Debt*: Refinancing risk is the possibility that an MFI will not be able to obtain new sources of funds as the old ones mature, or that the sources obtained will come at a higher cost, adversely affecting net income. Increasing the term of the loans is one way to reduce this risk, as there are fewer chances that the loan will mature at the time of a crisis. However, the strategy also has a cost: when market rates go down, the MFI may find itself with higher cost of funds than its competitors.
- *Improve Asset-Liability Management:* MFIs should engage in better Asset Liability Management practices by looking at their liquidity maturity buckets to find gaps between cash inflows and outflows at different points in time. Accordingly, the organisation can structure its debt loans to be received on dates with negative cash-flows. MFIs need to stress the importance of on-time negotiation with bankers to ensure adequate funding availability. Bandhan uses at least one quarter advanced planning for obtaining funds[5].

SIDBI's Initiatives to Aid the Sector[6]

SIDBI has a mandate to increase the liquidity in the microfinance sector. For this purpose, it has invested in MFIs through three investment vehicles[7]. Starting in the financial year 2008-2009, SIDBI has begun syndicating loans for MFIs. This means that, in addition to its own lending, SIDBI arranges funds from different institutions to its investees for a fee ranging from 0.5% to 1%. So far, SIDBI has entered one syndication agreement with SKS to obtain Rs. 1,000 crore. The syndicated loan should result in reduced cost of funding for the MFI[8] and ease access to variety of funding sources.

Measure Growth

"*MFIs should not take for granted that money will come... growth may be finite.*"[9] Organisations should emphasise sustainability and measured growth, and should carefully consider the cost of their expansion strategies. Saturation of existing operational areas before large-scale horizontal expansion may be a better growth strategy, reducing cost and increasing efficiency in caseload and overall management.

Strengthen Governance

All rating agencies and investors pay great attention to the quality of governance of MFIs. Below are key indicators of sound governance which may ease fundraising efforts:

- Presence of experienced microfinance practitioners and bankers in the Board of Directors,
- Involvement and efficiency,
- Quality and track record of senior management, and
- Issues of transparency, disclosure and audit.

Reduce Operating Costs through Efficient Systems or Technology Leverage[10]

In the era of intensifying competition, most MFIs have focused on rapid growth as their core strategy. But too often limited attention is given to quality of operations and products, which are the core of any MFI. Sound and efficient operations and strengthened systems have three effects. First, they reduce operating costs; second, they boost the confidence of funding institutions as they see better security of their investments; and third, they help in maintaining better portfolio quality, thus increasing revenues. Optimising processes (and where appropriate, leveraging technology) can help in reducing operating costs and bringing efficiency. In addition, reduced operating costs can set off some losses arising due to increased financial cost.

Enhance Value Proposition[11]

In times of crises, with increasing cost of capital and narrowing margins, only the fittest may survive. This means that MFIs must re-consider their value proposition in light of client's needs. An MFI which serves the needs of its target market will see continued revenue flow by retaining clients. MFIs should revise their strategic business plans and develop a strategy to attain sustainable competitive advantage.[12]

Conclusion

In the Indian context, the financial crisis has challenged the assumption of unlimited fund availability that has sustained growth higher than 70 per year in the last 3 years.[13] It is now time for MFIs to emphasise on issues of quality (and to focus less on quantity): quality of products, quality of management, and quality of governance. Hopefully, Indian MFIs will take advantage of this low period to strengthen their systems and plan for future market-led growth.

[5] Interview with Finance Team, Bandhan.
[6] Interview with SIDBI officials at SIDBI's Lucknow office.
[7] In FY 08-09, SIDBI has subscribed Rs.32crore in MFI's equity/ quasi equity through three types of investment vehicles: pure equity for well performing NBFCs, convertible term loan, and transformation loan.
[8] Loan Market Guide, S&P, October 2008.
[9] Interview with Mr. Manoj Sharma, Director, *MicroSave.*

[10] See *MicroSave*'s Toolkits on Process Mapping and MIS for MFIs.
[11] See *MicroSave*'s Market Research for MicroFinance Toolkit.
[12] See *MicroSave*'s Strategic Business Planning Toolkit.
[13] Bharat Microfinance Reports - Quick Data (2008 and 2009).