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Transformation of Microfinance Institutions into Small Finance Banks: Will it be a Roller Coaster?

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In 2013, the Reserve Bank of India constituted a committee under the chairmanship of Dr. Nachiket Mor to further the goal of financial inclusion in India. The committee recommended differential licensing in the form of two categories: i) Payments Bank, and ii) Small Finance Bank (SFB). In this Note, we focus on the effect of these recommendations on the capital structuring of Microfinance Institutions (MFIs) that plan to become SFBs.

On the basis of data from three major NBFC-MFIs that have applied for SFBs licence, we analyse the likely post-SFB set-up. The total outstanding portfolio of the three largest MFI Network (MFIN) members who have applied to become SFBs is Rs.159 billion ($2.6 billion) as on 31st March 2015. Their loan book is largely financed by bank borrowings, with debt equity ratio in the range of 3.6 to 4.5. After the RBI issues in-principle SFB licenses, these MFIs will have to phase out bank loans over the next 18 - 24 months to bring it down to a maximum limit of three times the "Net Owned Funds".[1] Eventually SFBs are expected to have their liability composition quite similar to that of traditional banks. Table 1 compares current liability structure of MFIs with those of banks to understand expected changes over time.

It is clear that with the limit on interbank borrowing in place, SFBs will have to meet their requirements with a mix of shareholders' equity, long term refinancing and interbank lending to two to three times their net owned funds and deposits mobilised from borrowers as well as non-borrowers. We will further examine all possible avenues in the next Note which will look at how MFIs can go about meeting these challenges.
In order to make the analysis realistic, we have made the projections based on assumptions.[2] These are: MFIs' current growth patterns, and the tapered growth pattern likely to emerge in future on account of the challenges of transformation and the low base effect. The numbers obtained foretell challenges in the times ahead.

Liability	MFIs			Public Sector Bank		Pvt. Bank		RRBs		Co-operative Bank	
	SKS	Ujjivan	Equitas	SBI	PNB	ICICI	HDFC	Baroda UP Grameen Bank	Uttar Bihar Grameen bank	Saraswat Bank Co-operative Bank	The Shamrao Vithal Co-op Bank Ltd.
Capital	4.33%	3.15%	11.33%	0.04%	0.07%	0.21%	0.10%	1%	4%	0.59%	0.69%
Reserves	14.06%	14.77%	6.42%	6.56%	6.46%	13.00%	8.75%	4%	2%	8.49%	8.22%
Deposits				77.80%	82.01%	59.91%	74.72%	78%	72%	84.03%	88.22%
Borrowings	68.52%	79.37%	75.09%	10.22%	8.73%	20.62%	8.02%	10%	18%	2.88%	1.67%
Other Liabilities and Provisions	13.09%	2.70%	7.16%	5.38%	2.74%	6.26%	8.41%	7%	5%	4.00%	1.20%

Table: 1 Source: Financial Statements on March 2014

Based on the assumptions[2], which we speculate are already generous in terms of savings and interbank lending that newly licensed SFBs can mobilise, these three MFIs will face a funding gap of about Rs. 5-63 billion ($0.08-1 billion) by 2018 in the most likely scenarios. We strongly reckon that other applicants will face a similar situation.

[1] RBI Circular No. 2012-13/285 DBOD.BP.No.56/21.04.098/ 2012-13[1] *MicroSave*
[2]Assumptions for calculating the loan portfolio financing requirements
- Membership of four MFIs (applied for SFB) will grow at an average rate of 30% per year.
- Loan portfolio grows with 60% in 2014-15 then falls to 40% in the year 2016-17 and then to 20% in the year 2017-18.
- 20% of the portfolio will be funded with equity. The balance is currently funded with bank borrowings. Bank's loan repayment duration for MFIs is 3 years.
- In the new scenario, MFIs will replace the bank borrowings with members' savings and interbank lending. Interbank lending will be on an average two times the net owned fund.
- Calculation of household earnings: As per World Bank, population earning below $1.25/day constitutes as BPL.
  1 USD in PPP term is equivalent to INR 15.09 as per International Comparison Programme 2011.We have increased it further to INR 20 to accommodate the impact of inflation and weakening of INR against USD. For a family of 5 (average household size in India), yearly earning for a BPL household comes around INR 45,625 (1.25*20*365*5).

It is going to be an enormous challenge for MFIs meagre capacity in terms of products or systems, to mobilise savings to raise such large amounts. Furthermore, MFIs' lack of a 'trusted' brand for savings will also be an obstacle for SFBs in their quest to mobilise deposits. SFBs will have to offer at least competitive interests on deposits to counterbalance this inherent drawback. Furthermore, the cost of mobilising these deposits will be high because of the relatively lower ticket size. In such a scenario there are two probable outcomes.

Combined Data of the three NBFC who have applied for SFB	Year 0	Year 1	Year 2	Year 3
Members (in millions)	8.73	11.25	14.99	18.90
Loan Portfolio (Rs. billion)	159	255	357	428
Net Owned Funds (Rs. billion)	31	51	71	85
Inter Bank Lending (Rs. billion)	128	102	144	173
Gap=Loan Portfolio-(Equity+ Borrowings) (Rs. billion)	0	120	245	343
Savings Mobilised (Rs. Billion) @Rs. 10,037/annum				
if 100% of customers save	N/A	115	163	230
if 50% of customers save	N/A	56	81	115
if 25% of customers save	N/A	29	41	57
Resultant Gap (Rs. bn.)				
Gap if 100% of customers save (Optimistic scenario)	N/A	5	-43	-110
Gap if 50% of customers save (Probable scenario)	N/A	64	39	5
Gap if 25% of customers save (Possible scenario)	N/A	91	79	63

The first and most likely scenario is down-scaling of the lending portfolios of MFIs. The second outcome could be intense competition among MFIs to chase the same set of depositors leading to a war based on interest rates, which will be unviable in long run.

MFIs will first try to leverage their relationships with existing borrowers before trying to acquire deposits from non-clients. However, relying only on borrowers may delay efforts to mobilise savings needed to restructure MFI-SFB's balance sheets.

Compounding the challenge will be low interest of private equity (PE). PE players have come to expect exponential growth in MFIs' lending. Faced with the probability of low growth, their interest in investing will decrease – and thus they are less likely to contribute positively to the restructuring of SFBs' balance sheets.

Related developments may make it even more challenging

Competition from public sector banks that have opened PMJDY accounts for under-banked segments, will be another challenge. These banks will try to spur transaction activity in newly opened PMJDY accounts. They are likely to go after the potential savings of this segment, which of course is the very segment that newly set-up SFBs will target. And without doubt, public sector banks enjoy better credibility when it comes to safety of deposits.

The recent in-principle approval of RBI to set-up payments banks will create another challenge. Incumbent payments banks belong to large conglomerates and thus have robust financial muscle. RBI's intended objective to allow such banks is to enhance financial inclusion in otherwise unbanked regions. SFBs will face competition from payments banks to mobilise deposits as their target segments will overlap.

We believe that the restructuring of MFIs' balance sheets will be quite challenging. However, on the basis of our experience with similar MFI to bank transformations across the world, it is feasible. There are precedents that SFBs can follow. In the following IFN "Transformation of Microfinance Institutions to Small Finance Banks: Differentiating Men from the Boys!", we will talk about the ground work necessary to enable the relatively smooth transformation from a credit juggernaut into a trusted and well-rounded banking institution.

Assumptions continued …
- Average savings per household are Rs. 10,037 ($152) per year which is 22% of their household income Rs. 45,625 ($691) per annum of as per the estimates given by NCAER in the report. (45,625 ($691) per annum for a BPL family.
- Only one of the member from each household has taken loan from the MFI.
- In different scenarios, different proportions of members are making saving deposits with the MFI.
- Savings/person grows by 10% per annum commensurate with GDP growth of India.