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Small Finance Bank Licences: Not the End of the Road for Non-SFB MFIs

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Seventy two organisations applied for a 'Small Finance Bank' (SFB) licence. Almost all the bigger Non-Bank Finance Company - Microfinance Institutions (NBFC-MFIs) saw SFB status as a natural progression and applied for the licence. The Reserve Bank of India (RBI) granted 'in-principle' approval to 10 applicants to set up SFBs. Eight of these licensees were given to MFIs. However, there are a few that are conspicuous by their absence. Arohan Financial Services, Grameen Koota Financial Services, SKS Microfinance, Satin Credit Care, and Sonata Microfinance are among those that either missed out or did not apply for SFB licence. The focus now has understandably shifted to those who received in-principle approval from RBI; however, we believe that it may not be the end of the road for non-SFB MFIs. At least not for all of them.

Table: 1 Capital Structure of 8 SFB licensees as on 31/03/2015

Parameters	In Rs Cr.	Bn US$[2]
Total Portfolio	13,260	2.04
Total Equity	2,579	0.4
Domestic Equity	965	0.15
Foreign Equity	1,614	0.25
Requirement for further domestic equity to keep FII@49%	2,329	0.36

Our Focus Note ('Transformation of Microfinance Institutions into Small Finance Banks: Will it be a Roller Coaster?'), discussed broad challenges facing the provisional licensees. This note presents the specific challenges that face SFBs, and the opportunities that may emerge for non-SFB MFIs. The table above gives the capital structure for eight[1] prospective SFBs. All calculations have been done on the basis of these details.

Time and Space for Non-SFBs to Grow?

SFBs will face challenges while transforming, which will give both the time and space for non-SFBs MFIs to grow. Next, we present some of the challenges that SFBs will face.

Bank Borrowing: Challenges for SFBs[4]

'Priority Sector Lending' (PSL) norms (specifying the percentage of banks' lending that must be made to defined 'priority' sectors like agriculture, micro and small enterprises, etc.) has underpinned the growth of microfinance in India. The majority of even the larger MFIs' portfolios are financed under PSL. The largest 10 MFIs had portfolios of more than Rs 30,000 crore (US$4.62 billion) on 31st March 2015.[5] *MicroSave* estimates that, of this, around Rs 24,000 crore (US$ 3.69 billion) was PSL loans from banks to these MFIs. In addition, MFIs manage increasingly large portfolios of around Rs. 7,300 crore (US$ 1.12 billion) on behalf of banks, which are not reflected in the MFIs' balance sheets. However, for SFBs, these two avenues of finance will no longer be available.

Banks will still likely seek to meet much of their PSL requirement by lending to non-SFB MFIs. With five out of top 10 MFIs converting into bank/SFBs, an additional Rs 12,000 crore (US$1.8 billion) of PSL loans, previously lent to these five SFBs, will be available. Thus, while transforming, SFBs are likely to undergo a phase of contraction, and banks may be under pressure to reposition their PSL portfolio from institutions transforming from SFBs to non-SFB MFIs. This may lead, at least in the short to medium run, to a liquidity surplus that could translate into lower interest rates. This liquidity surplus will further increase if banks choose to compete with SFBs by increasing their exposure through partnership with non-SFB MFIs under the 'Business Facilitator' (BF) model.

[1] Disha, Equitas, ESAF, Janalakshmi, RGVN, Suryoday, Ujjivan, Utkarsh

[2] US$1=INR65

[3] As per the annual reports of individual organization

[4] http://www.business-standard.com/article/news-cm/ind-ra-small-bank-licenses-to-shake-up-the-micro-finance-landscape-115092100673_1.html

[5] MFIN report

Many private banks are already doing this. To meet RBI's licensing requirements, SFBs will have to rely on mobilising public deposits and bring in further (largely domestic) equity. This will be a major growth impediment for many SFBs in the short to medium term. The increase in liquidity and potential contraction of SFBs will offer significant opportunities for growth of non-SFB MFIs, provided market and credit-related risks are managed well.

Domestic Equity: Pandora's Box

Guidelines for licensing of Small Finance Banks limit aggregate foreign investment at 49% through the automatic route (i.e., without any prior approval from RBI). On the basis the existing portfolio of the SFB licensees, they will require additional domestic equity of about Rs 2,300 crore (US$ 354 million). If SFBs were to grow their asset base, this number would be even higher. The situation will, to some extent, weaken SFBs' bargaining power with domestic equity investors. Dilution at lower prices may not be acceptable to the existing foreign investors, many of whom are currently the majority shareholders and enjoy management control. This could potentially delay the transformation process. We believe that these challenges will consume the management bandwidth of SFBs over the period of next 9–12 months even as they develop strategies to counter these challenges. MFIs can use this time to penetrate and expand the market and grow their portfolio.

Non-SFB MFIs: Opportunities Abound

Non-SFB MFIs should invest this time to build upon their existing capabilities, strengthen operational processes and develop more robust risk management structures. While not all MFIs will have a competitive advantage, many will have opportunities to increase their market share. How can they do this?

1. ***Compete Through Strategic Tie-ups***

Non-SFB MFIs should scout for strategic partnerships with the payment and commercial banks[6] to offer savings and payment services. To leverage these partnerships, non-SFB MFIs will have to achieve operational excellence and higher levels of customer service through process improvements and integration with digital financial services. This will position non-SFB MFIs as preferred partners and increase the negotiation power with the partner banks. Collaborations with banks could potentially help non-SFB MFIs to enhance client satisfaction levels by providing a one-stop solution for all financial services.

2. ***Take up Segments/Geographies that SFBs may Vacate***

SFBs will face the short-term prospect of contracting portfolios, price competition from other banks (on loans as well as on savings) in an already crowded low income segment. Thus, some SFBs may move to focus on the missing middle, in an attempt to compensate for their higher operational expenses by offering larger ticket size loans. Non-SFB MFIs will have lower operating costs compared to SFBs, particularly in the medium term, given their low-cost staff and already honed lending methodology. MFIs will continue with existing low-cost staff and the prevailing low-cost operating model, and tap into surplus liquidity of PSL. However, SFBs will need to invest significantly in staff, IT systems and regulatory compliance. If SFBs do indeed go up-market, non-SFB MFIs should focus on the traditional microfinance segments/geographies and expand their reach by offering improved processes and better customer service. Non-SFB MFIs can also leverage strategic partnerships with banks and the newly created payment banks to expand their outreach.

3. ***Expanding Off Balance Sheet Portfolio***

Some of the private banks, such as Yes Bank, are aggressively expanding their reach into the low-income segment through 'Business Facilitator' (BF) model. Others will follow suit, as technology enables lower cost outreach and agents provide the necessary spokes into rural communities. Non-SFB MFIs can tap this opportunity and tie up with banks to reach the financially excluded segment.

Conclusion

Non-SFB MFIs are likely to have a short to medium term advantage over SFBs, but will need to leverage their competitive advantage by focussing on the low-income customer segment, as well as strategic partnerships with other financial institutions. Market-led products, excellent customer service, segment focus, and strategic partnerships with banks will be essential for retaining existing customers or to acquire new customers and stay competitive. Muthoot Finance, Manappuram Finance, DHFL, and Sriram Transport Finance Corporation provide examples of NBFCs that stayed competitive enough to compete with banks – even as they continued to depend, to some extent, on banks for bulk funding. There is no reason why non-SFB MFIs cannot do the same.

[6] http://www.livemint.com/Money/ltsH9yco3pH85mgKIrZaPM/SKS-Microfinance-Is-the-glass-half-full-or-half-empty.html