

MicroSave India Focus Note 112

Small Finance Banks – Is there an Opportunity for MFIs/NBFCs?

Anup Singh, Abhishek Anand and Abhay Pareek

February' 2015

Background

Approximately 35%¹ of the adult population in India has an account with a formal financial institution. This means, around 500 million people do not have access to even a basic bank account,² let alone the variety of financial products and services they need. The ambitious [Pradhan Mantri Jan Dhan Yojana \(PMJDY\)](#), with its mission to provide at least one bank account for every household in India, seems set to change the financial inclusion landscape considerably. In the last decade and more, microfinance institutions (MFIs) in India have played an important role in enhancing the reach of financial services to include low income rural communities. However, as part of rapid outreach and horizontal expansion, MFIs (including NBFC-MFIs) have largely followed a mono-product, group-based lending, approach that makes a limited contribution to the financial inclusion agenda. Realising that financial inclusion will remain a dream unless a paradigm change is introduced, the Reserve Bank of India (RBI), on 27th November 2014, released guidelines for a new class of banking entity called "[Small Finance Banks](#)". Small Finance Banks (SFBs) by definition will cater to the diverse needs for financial services amongst the low-income people.

In this first note of the two part series on the subject, we explore the opportunity presented by SFB licence to MFIs/NBFCs and the benefits they can accrue from the transformation.

Why Transform?

Sustainability of financial institutions including MFIs/NBFCs rests to a large extent on the ability to offer a full range of financial products. The risks presented by credit only institutions, dealing with low income clients, were brought to the fore during the so-called 'Andhra crisis'. Institutional formats which enable a full suite of products and services to low-income segments work for the clients, and just as well work for the long term sustainability of the institutions themselves. To this extent, the move towards SFBs will benefit NBFCs/MFIs. In addition, the transformation to SFB will allow the MFIs/NBFCs to work without constraining factors such as the margin cap and qualifying asset criteria.³ An added rationale for MFIs/NBFCs to transform into an SFB is that the rural markets in which they primarily operate are

underserved and present a business opportunity as long as client centric products can be loaded onto low cost delivery platforms.

Market potential

RBI guidelines mention that preference will be accorded to institutions that focus on the following aspects:

1. *Geography*: Underserved regions of north east, east and central regions of India
2. *Banking penetration*: Unserved and underserved populations; 25 per cent of branches must be in unbanked villages with population less than 9,999
3. *Segment*: Target segments of small businesses, unorganised sector, low income households and farmers
4. *Products*: Credit and savings

Geography and banking penetration

In terms of preferred geographies, as compared to rest of India, **Low Income States (LIS)** comprising Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh, and **North East States (NES)** comprising Assam, Arunachal Pradesh, Nagaland, Manipur, Meghalaya, Mizoram, Tripura present opportunity for expansion on account of poor banking penetration. *Table 1: Banking Penetration* below compares the key elements of banking penetration in the three geographies, namely, LIS, NES and rest of India.

Table 1: Banking penetration

Attributes	Low-Income States (LIS)	North-eastern States (NES)	Rest of India
Bank branches	36,462	2,883	70,466
Credit deposit ratio	50%	33%	86%
Average population per bank branch	14,948	15,810	8,792

Source: *MicroSave* analysis based on data extracts from RBI, Census of India and annual report of Ministry of Finance.

There is scope to expand presence in unbanked villages with a population up to 9,999. Of the 597,608 villages in India, 592,927 have population up to 9,999. Of these, 268,454 villages (with a population greater than 2,000 persons) have theoretically been covered under financial inclusion plan of the Government of India and have branches (regular or ultra-small), or business correspondents and their agents. This leaves 324,473 villages outside the formal finance landscape.

¹ The Global Findex Database (February 2013)

² *ibid.*

³ RBI Master Circular- Introduction of New Category of NBFCs - 'Non-Banking Financial Company-Micro Finance Institutions' (NBFC-MFIs) – Directions (July, 2013)

MFIs/NBFCs have significantly higher outreach in these areas than the banks.

Product and segments

As highlighted in *Table 2: Market Potential*, micro and small enterprises as well as low-income households (comprising agriculture-dependent households, small and marginal farmers, and agricultural labourers) face severe challenges in terms of access to finance. These two primary segments present significant demand for credit and savings.

Table 2: Market Potential

	Low-Income States (LIS)	North-eastern States (NES)	Rest of India
Numbers (in Million)			
Micro and small enterprises	10.5	1.3	20.1
Agricultural households	27.8	22.2	13.2
Low income households (other than agri)	33.2	2.5	18.2
Unfulfilled credit needs (in INR Trillion)			
Micro and small enterprises	20.6	1.2	16.9
Agricultural and low income households	12.1	6.2	3.9
Unfulfilled savings needs (in INR Trillion)			
Micro and small enterprises	5.2	0.7	10.0
Agricultural and low income households	19.9	1.5	10.9

Source: *MicroSave* analysis based on data extracts from RBI, Census of India and annual report of Ministry of Finance and Ministry of MSME.

LIS and NES are not considered potential markets by banks, which is why banks invest less in infrastructure there and have lower penetration. However, collectively, LIS and NES have a total of 85.7 million low-income households. These households have an unfulfilled credit demand of INR18.3 trillion (US\$295 billion) and the potential to save INR21.4 trillion (US\$345 billion).

In addition, there are about 11.8 million micro and small enterprises in LIS and NES that have a collective debt demand (for working capital and assets financing of around INR 21.8 trillion (US\$351 billion) and savings potential of INR5.9 trillion (US\$95 billion)).

Together, these two segments present a considerable opportunity for formal financial institutions to tap.

Benefits from Transformation

Apart from the sizeable market opportunity, the additional benefits for MFIs/NBFCs to transform to SFB include:

- **Diversification:** Diversification of the range of products to create a holistic product suite comprising primarily savings and credit, as well as distribution of insurance, pension, mutual funds, payment/remittance facilities and access to ATMs. SFBs can be a part of the payment and settlement system as a direct member or a sub-member of a sponsor bank. A holistic product suite is likely to lead to both improved customer loyalty and reduced delinquency as customers will not want to

compromise their access to high quality, secure savings services.

- **Leverage low cost structures:** MFIs/NBFCs have significantly lower operational expenses than that of banks because of their low cost infrastructure and high productivity/low salary structure of their staff. Thus, MFIs/NBFCs can use their low cost structures to rapidly achieve profitability.
- **Branding:** Microfinance is a burgeoning industry with a plethora of financial service providers in overcrowded markets. Individual microfinance institutions struggle to gain the desired mind space of, or real loyalty from, customers. An SFB licence allows MFIs to create differentiated brands and leverage these to create long-term client relationships.⁴
- **Diversified funding base:** Currently, MFIs are entirely dependent on debt and equity sources. While initially mobilising savings may not be cost effective, in the long run and with customer-centric offerings, the SFB may mobilise savings at costs lower than debt – particularly if they address the unmet demand for illiquid and programmed/recurring savings deposits.
- **Political risk management:** A holistic product offering and a banking framework reduces the possibility of political interference, a risk experienced by MFIs.
- **Deepening rather than widening:** SFBs, by definition, will cater to the low-income segment and can offer a comprehensive product suite. Thus, SFBs will have an opportunity for vertical penetration with an expanded range of products, unlike the MFIs/NBFCs that expand horizontally with limited number of products. This will also allow SFBs to create a judicious mix of high and low value customers, thus strengthening the business case.
- **Impact on customers' financial well-being:** A range of products gives poor people the tools they need to manage the fluctuations in their income and expenses better, protect themselves against risk and to seize opportunities as they arise. This is not only important from a development perspective, but also from a business perspective in that customers with growing wealth are, of course, more valuable to (and profitable for) the financial institution.

While there is significant market potential and opportunities for MFIs/NBFCs, they have to be cognisant of the costs associated with the transformation, and the challenges and risks that it presents. [In the second Note](#) of this two part series, we analyse the fit of MFIs/NBFCs for transformation, key risks and challenges, and the potential deal breakers.

⁴ http://www.microsave.net/resource/how_can_bc_mfis_tap_household_savings#.VIG21DGUEs0