MicroSave India Focus Note 113

Small Finance Banks – Risks and Challenges of Transformation of MFIs/NBFCs

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In the first Note of this two part series on the subject, we talked about the opportunity presented by the Small Finance Bank (SFB) licence for MFIs/NBFCs, and the benefits that can accrue from transformation. In this second Note, we highlight key challenges, and the potential deal breakers.

Transformation Challenges

MFIs/NBFCs in India are based on a business model driven by credit. The loan portfolio is fuelled by bulk loans from large financial institutions and investments, including from foreign sources. Transformation to SFB entails changes in the business model, organisational structure, capital structure, product suite, IT/MIS, and others. These changes will lead to the following challenges:

1. *High costs of transformation*: MFIs/NBFCs will have to bear the incremental cost of infrastructure, human resources and organisational transformation. Key cost drivers will be: the cost of MIS and loan origination systems' upgrade to a core banking solution; establishing risk management and treasury functions: developing savings products: managing the transformation from a credit only institution to a diversified financial institution; hiring new staff; training and capacity building of existing staff; process re-engineering; and infrastructure costs such as cost of branch set up. This will add to the organisation's one-off, recurring and fixed costs and based on empirical evidence from other markets, such large scale changes and consequent investments will have a break-even time of 3-5 years (depending on the quantum of expenses and revenue).
2. *Efforts and cost of deposit mobilisation*: There are two facets to this challenge. First, SFBs will have to compete with established public sector and regional rural banks. These banks enjoy higher trust in the community, are well placed in the rural markets, and are aggressively trying to enhance their market share. Their existing infrastructure, reputation, business correspondent network, and expertise in deposit mobilisation will be a threat for SFBs – particularly after the efforts they have put in to open accounts as part of *Jan Dhan Yojana* (JDY) and the government subsidised add-ons that are part of this account, such as accident and life insurance. However, we believe that in the long run Payment Banks may well provide even fiercer competition for SFBs.

   Second, the cost of deposit mobilisation will be higher for SFBs considering the rural/underserved segment they will be catering to. In the past, such segments have had low average deposit sizes. To get a sense of how much the average savings of these segments is, the closest indicator is the quantum of deposit mobilisation in JDY. To November 2014, 71 million new customers enrolled under the scheme, of which 53 million had zero balance in their savings account. The total amount saved in the active accounts as of January 2015 was Rs.54 billion. Thus on average the net deposit balance of an active customer from the target segments is approximately Rs.3,000 (USD$50) per account. While this might be increased with recurring deposit products and broadening the client base, with this average, the cost of deposit mobilisation will be much higher than 5-6%[1] for scheduled commercial banks that have more than 50% Current-Account-Savings-Account (CASA) deposits.

   For a bank, there should be a healthy mix of current accounts and savings accounts as they are low cost funds that increase the net interest margin. In case of SFBs, considering the target segment they will cater to, it is expected that majority of the deposit mobilisation will be through savings accounts and term deposits. *MicroSave* estimates that will take at least 5-7 years for an SFB to increase number of clients and average deposit to a level where the cost of deposit mobilisation reduces to become a low-cost, sustainable source of fund for SFBs.
3. *Limited scope of using cost effective measures such as internet and phone banking*: The commercial banks target higher use of internet and phone banking by their clients to reduce the costs of branch-based services. In case of MFIs/NBFCs, their current target clientele does not yet have capacity and infrastructure to use such channels. Thus, SFBs will have to rely on traditional brick-and-mortar branches to service their customers. While SFBs may use innovative channels such as mobile money or card-based point-of-sales devices, the infrastructure set up, channel management, and investment in financial education will all pose challenges.
4. *Control dilution:* The regulation requires SFBs to ensure that a single shareholder holds a 40% stake in the organisation, and this must be reduced to 26% in 12 years. It will be a challenge for many MFIs as promoters of almost all large MFIs/NBFCs have a minority stake in the organisation. One of the leading investor groups with capacities to invest for the long term may have to don the mantle of promoter and nurture the institution. Such long term patient capital is not easy to obtain.

[1] Reserve Bank of India, Deregulation of Savings Bank Deposit Interest Rate: A Discussion Paper, 2010

5. *Capped foreign ownership*: The guidelines put a cap of 74% foreign ownership in SFBs. Currently, many MFIs/NBFCs have more than 75% foreign equity due to investments from foreign sources. Bringing the figure to below 74% will be a challenge for these institutions considering the dearth of domestic equity sources.
6. *Added capital pressure*: The guidelines require SFBs to ensure a capital adequacy ratio (CAR) of 15%, cash reserve ratio (CRR) of 4%, and statutory liquidity ratio (SLR) of 22%. These will be a significant burden to manage, resulting in reduced earnings until SFBs develop a substantial depositor base.
7. *Issues in human resource management*: MFI/NBFC employees are specialised in micro lending operations with limited exposure to sell and service push products such as liabilities, insurance or pension. Also, the credit teams are not well versed with banking credit assessment tools and mechanisms. This means that SFBs will have to source, hire and train talent from the banking industry. This may lead to increased compensation expectations of new incumbents and also market competition to hire the best in industry.
8. *Change management*: MFIs/NBFCs have to undergo massive organisational changes and will require comprehensive and efficient change management processes. The key organisational changes will be:
   a) Currently MFI/NBFCs have a single channel for customer acquisition for different products. However, as these MFI/NBFCs transform to SFBs, they will require different sales channels for liabilities and credit acquisition, and to focus on cross sales between these channels. Another challenge will be to establish robust operations and credit teams.
   b) The majority of the employees in MFIs/NBFCs are experienced in dealing with a mono product and group lending structure. Thus, for transformation MFIs/NBFCs would have to hire employees with banking experience. This would mean a cadre of new employees joining the team and affecting the existing organisational culture. This would require a change management so that old cadre does not feel threatened by the new additions to team and the new team adjusts to the 'culture'.
9. *Inexperience in developing and distributing liabilities products*: MFIs/NBFCs are experienced in offering generic group lending products whereas banking would require them to enhance the product suite by adding other credit products such as micro and small enterprise finance, term deposit and savings products. SFBs can also be part of clearing system either as a direct member or through the sub-member route. The inexperience of MFIs/NBFCs in offering such products will result in a period of learning before they can stabilise their product suite, its sales proposition, mix and channel.
10. *Vulnerability to failure due to limited risk exposure and inexperience in dealing with high ticket loans*: International experience shows that small banks are vulnerable to failure if they do not have a diversified credit base and are focused on relationship banking rather than centralised process-based operations. The same concern applies to SFBs in India. The quantum leap for MFIs/NBFCs from small ticket to high ticket loans of up to Rs.2.5 million is an area of concern, especially if these SFBs concentrate their primary funding in one to two sectors and particularly, the less regulated and highly vulnerable sectors.
11. *Savings to fuel the liabilities*: With inter-bank borrowing limits, SFBs will have to make rapid progress in developing their ability to attract and manage savings for their liabilities. This could be a major bottleneck for MFIs/NBFCs that are primarily known to the low-income segment as a lender. *MicroSave*'s experience in South-East Asia and East Africa shows that clients hesitate to place their savings with institutions that until recently had a credit-only positioning. SFBs will have to make major changes to their branding strategy to change this brand perception and market position. MFIs/NBFCs are not used to allocating significant funds for marketing and brand building, as their loan products are driven by "Pull strategy" rather than "Push strategy".

Some of these challenges can be deal breakers as many MFIs/NBFCs that are not in position to fulfil all these requirements. Also, some eligible MFIs/NBFCs will not want to transform to SFBs for sound strategic reasons. The reasons for such a choice include: scope for strategic tie-ups with commercial and payment banks; fear of mission drift; lack of capacity to manage banking business; and/or a desire to "wait and watch" hoping to apply for an SFB license at a later date. Other reasons could be stringent regulatory and compliance norms; strong presence in a limited geography; and lack of willingness to change organisational form.

Overall, MFIs/NBFCs are best fit to transform into SFBs given the lucrative business proposition and the potential opportunity. However, MFIs/NBFCs should conduct a thorough review of their business plans, product suite and their competence to transform and manage banking business – it is not for the faint-hearted!

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