# *MicroSave* India Focus Note 31

## Nascent Indian MFIs and Their Fund Raising Challenges

Mukul K Singh, Neeraj Lal and Sunil Bhat

January 2010

**Introduction**

MFIs, like all companies, finance their funding needs through a combination of external debt, equity financing and internal cash generation. According to the Sousa-Shields[1] framework (2004), most MFIs start as NGOs, funding operations with grants and concessional loans from donors and development finance institutions. As the MFI matures, private debt financing becomes available, and later on, traditional equity financing becomes an option.

This Focus Note attempts to provide insights into the different sources of capital available to nascent MFIs in India; and how an MFI might improve its ability to attract such capital. Much of the data for this note is collated from *MicroSave* partners under the RBSFI/Cordaid Technical Assistance programme to train and develop "Nascent MFIs". Thirty one nascent MFIs[2] (primarily from under-served areas in north India) provided information. 80.6% of these 31 partners had been doing microfinance for 5 years or less and 90% of the MFIs were either non-profit NGOs Societies or Trusts at the time of collection of the information. In terms of size, 77.4% of the MFIs had loans outstanding of Rs.10 million or less, and 93.5% had 5,000 clients or less. The 31 MFIs had a median of 4 funding sources each, and accessed capital from 31 different organisations in total[3]. 55.1% of the capital structures from outside parties were of amounts less than Rs. 1 million. Complying with regulations, none of the MFIs in the sample collected deposits for capital.

**Grants from Donors**

For Indian MFIs, donor funds have played a strategic role in paving the way for commercial lenders and investors. However, grants have generally declined, beginning as early as 2003. Agencies like CIDA, (which indirectly supported SHG promotion through agencies such as BASIX and FWWB), and Danida, exited altogether. Agencies like SDC and USAID have also moved their focus away from large scale involvement in microfinance. Of the 99 funding transactions reported from the 31 MFIs, only 6 were pure grants.

**Equity Investments in MFIs**

Over the last few years, there has been a rapid increase in equity investment in some of the larger, established MFIs across India. This has not been reflected in the sample of nascent MFIs, most of which do not have an appropriate legal structure for equity investment. Most ownership structures are also not very clear and do not allow distributions to owners. Two additional points of weakness are governance (often with an over-reliance on one person), and weak information systems.

**Loans from Development Finance Institutions (DFIs)**

In recent years, DFIs have become the preferred choice of capital for nascent MFIs in India. The major development finance institutions in India are as follows: (i) SIDBI Foundation for Micro Credit (SFMC), (ii) Rashtriya Gramin Vikas Nidhi (RGVN), (iii) Friends of Women's World Banking (FWWB), (iv) Rashtriya Mahila Kosh (RMK), and (v) NABARD. However, only FWWB and RGVN figured prominently within the sample of 31 MFIs. SIDBI/SFMC lends largely to large and medium MFIs. NABARD provides assistance in the form of revolving funds for on-lending, but has been very limited in its outreach (little over 30 MFIs having benefited from it to date). The support provided by these institutions is not adequate to meet the needs of the large number of MFIs, especially those that are NGO-based, and has been supplemented by other, smaller DFIs not directly tied to the government, such as FWWB and RGVN.

From *MicroSave*'s sample, DFIs represented 64.3% of the total funding, with FWWB leading with a total of 16 loans. RGVN, TMN, BASIX, AGVB and CARE were also near the top of the list with between 4 and 9 loans each. SIDBI and RMK were much lower on the list with only 3 and 2 loans respectively; and NABARD was not cited as a source.

**Loan from Banks**

Indian MFIs borrow more from banks than MFIs in other parts of the world, including the rest of Asia. The median leverage ratio for the MFIs in *MicroSave*'s sample was 14 (and the median Capital Adequacy was at only 4.8%). On

[1] Sousa-Shields, de. *Financing Microfinance Institutions: The Context of Transition to Private Capital.* microREPORT #8, USAID, 2004

[2] RBS Foundation India is a part of the Royal Bank of Scotland Group. The *MicroSave* RBSFI programme has supported 37 MFIs since 2006;

[3] It is only a coincidence that 31 MFIs were funded by 31 organisations



MicroSave

the other hand, the average leverage ratio in the Philippines is about 4 and in Cambodia about 1.[4] However, this may not be sustainable as banks are becoming more risk averse due to the global financial crisis and reports of over-indebtedness of MFIs' clients. As a result, many banks are looking to concentrate their lending to fewer, larger (and perceived less risky) MFIs. This means that nascent MFIs may find it harder to raise on-lending capital.

Of the sample of *MicroSave*'s partners, banks provided 29.6% of the capital funding. HDFC, SBI, AGVB, Indian Bank and ICICI Bank were the most commonly reported, with 4 to 6 loans each. Surprisingly, only a minority of the 29 loans from banks to these MFIs were provided at market interest rates of 12% or above. The majority of loans had interest rates of between 8-12%.

**The Way Forward**

With the limited availability of grant funds and concessional loans, nascent Indian MFIs are dependent on borrowed funds from commercial sources. MFIs may therefore want to consider the following measures that can be taken to improve access to funding:

***Maintain High Quality Portfolios:*** The biggest strength of microfinance has been high repayment rates and good portfolio quality. A high quality portfolio also indicates presence of robust systems and processes and hence instils confidence in the funders.

***Prepare A Robust Yet Realistic Business Plan:*** Financiers value the ability of an MFI to plan for its financial needs, especially during periods of high demand. They will, rightly, consider an MFI that cannot plan and manage the evolution and growth of its business as a risky client.

***Build A Strong Board and Robust Systems:*** The makeup of an MFI's board is a main factor on which its reputation is built. Hence, care should be taken in selecting board members to ensure both their credibility and an appropriate mix of skills. Similarly, strong systems like operations, human resources, finance, MIS and internal audit underpin good organisational performance.

***Provide Full Transparency in Business Operations and Performance:*** Specifically, an MFI should be transparent about its social and financial performance, interest rates, board decisions, and other important matters. Commercial funders are sceptical of MFIs that appear to hide even the slightest bit of information.

***Build Relationships With More Than One Bank:*** Doing so increases the chances of ultimately securing loans from a willing lender and could even result in having a choice of lenders. In such a position, an MFI's managers can compare loan terms and choose the best lender.

***Consider Changing Legal Status:*** The NBFC status can give MFIs better access to funders, bankers and equity investors. However, this is a challenge for nascent MFIs as it demands a capital base of about Rs.2 crores, high fees, and much of the senior management's time. Some MFIs have preferred to choose the Section 25 Company route, which increases (but also limits) the types of capital sources, has lighter resource requirements and allows an NGO to keep its social mission intact.

***Sell Portfolios to Banks:*** MFIs that find it difficult to raise capital can think of lightening their balance sheets by selling off their loans to banks. Banks tend to buy these loans as they fall into their priority sector lending norms. The MFIs can sell loans at a discount in transactions that are typically termed as "securitisation". Through these transactions, MFIs have the opportunity to share the risk of the loan portfolio with other investors, while maintaining their profits and improving liquidity to keep generating loans[5].

***Pursue Unconventional Options:*** Finally, two less conventional options can improve an MFI's access to capital. The first, loan guarantees, can provide comfort to lenders that if the MFI defaults, the larger and stronger guarantor will step in. The second option, subordinated debt, entails having a subordinated lender (usually a patient equity fund) that is willing to take a higher risk of losing its money so that the borrower MFI can access additional debt capital. Both of these options are often provided by DFIs.

**Conclusion**

Microfinance is a very capital intensive business, and fund infusion at regular intervals is invariably necessary. As there is a large demand-supply gap, the MFI sector (including nascent MFIs) will grow at rates that are much higher than other industries in the long-term. As such, capital sources have been, and will likely continue to be, more than willing to invest in the Indian microfinance sector (despite the recent slow-down). However, there is a concomitant risk of 'mission drift' in any fund-raising and growth drive, as is faced by SKS with its pending IPO. Nascent MFIs will have to guard against such a risk.

[4] Microfinance India, State of the Sector Report, 2008

[5] See *MicroSave* India Focus Note 30 "Alternative Financing for Indian MFIs"



MicroSave