CHAPTER 1

INTRODUCTION

In the present day context, financial institutions are exposed to varied risks. The risks are classified as Credit risk, Market Risk, Operational Risks, Strategic Risk and Governance Risks (Al-Tamimi & Al-Mazrooei 2007; Raghavan 2003). Among all the types of risk, credit risk has gained much impetus followed by interest rate risk/ Market risk and technological risk. Proper management of debt and recovery mechanism shall enhance the quality of credit risk. In the recent past, the defaulting risk/ credit risk has increased due to multiple reasons like high interest rates, excessive / multiple lending, poor monitoring and recovery mechanism (Satyajit Roy 2011). Microfinance Institutions (MFIs) are those institutions which focus on providing collateral free loans to the ultra poor. Though initially it had a good take off, in recent times, they are facing huge financial crisis. Few clients of MFIs killed themselves, as they could not repay the outstanding loan which mounted beyond their repaying capacity. Similar to banks, Microfinance Institutions (MFIs) have to definitely assess credit risk in-order to reduce the default in payment by borrowers. Few studies state that Credit scoring analysis has improved the efficiency of financial institutions in developed nations (Mark Schreiner 2009).

Beyond the risk assessment, learning the Financial Sustainability becomes equally important. When the MFIs are finding it difficult to manage the risk in the present times, their credentials to survive in the future on their own without depending on donors’ support becomes a bigger challenge to
encounter. A financially sustainable MFI not only proves to be financially sound in the present day context but could survive independently in a more profitable way in the future. The growth of the MFIs’ strongly depends on their financial sustainability.

1.1 NEED FOR MICROFINANCE (MF)

Poverty is lack of human, physical and financial resources to have decent livelihood (Wright 2000). An expert panel headed by Former Reserve Bank of India (RBI) Governor C. Rangarajan demarcated that the Indian population Below the Poverty Line (BPL) was about 29.5% (363 million) during the year 2011-12, which grew from 270 million the previous year (Rangarajan 2014). The poor populace borrowed money from the local moneylenders. They charged higher interest rate to an extent of 115%. Microfinance came as a panacea to relieve them from these financial issues. Microfinance means an assortment of financial services offered to the economically deprived community of the society. It includes a bouquet of financial services like loans, savings and Insurance (Satyajit Roy 2011). Its intention was to alleviate poverty and empower borrowers, especially Women to have better lives. The MF improved the livelihood of many, over a period of time. MF targets on borrowers living below the poverty line. Policy makers have motivated the role of MF, as the formal banking alone cannot serve 450 million unbanked people inclusive of 363 million people who live BPL. More than 60 percent of credit demand is satisfied through informal sources (Vijayalakshmi Das 2006). Furthermore the functioning of banking model caters largely to credit worthy customers than bottom of the pyramid segment. MFI's bridges the gap, by attending to the needs of the poor. Understanding the fortune at the bottom of the pyramid, the number of MFIs that wanted to
cater to the needs of poor also increased. The emergence of Microfinance Institutions (MFI) is unavoidable as there is a large segment of poor untapped in Indian market. Due to intense competition, dual loans were given to borrowers. MFI also charged interest of 27 to 45 percent against 7% bank interest rate. This has created pressure on repayment of dues by the borrowers.

1.2 NEED TO STUDY CREDIT RISK OF MFIS

Credit risk means the probability of loss due to default in payment. Credit risk though unavoidable one, proper debt and recovery mechanism would help Financial Institutions to keep it under control. Knowing the customers is much essential to encounter this risk. In Indian Scenario, RBI insists all the banks to compulsorily collect details of their customers. Microfinance Industry remains as an exception in this case. It funds loans to economically deprived community who has no collateral security. Hence, much stringent policies of “Know your Customer” (KYC) norms have not been adopted by them. Referral systems have only worked in identifying a new customer. As MFIs’ commercial intention was fuelled by intense competition coupled with the urgency to capture clients, it left the KYC norms as not so important criteria. Later lack of KYC norms landed up in lot of default risk. Credit risk for MFIs matters a lot, as their sustainability and solvency depends on the recovery mechanism. Until the year 2010, the recovery was too good to an extent of 95%. However, the Andhra Pradesh (AP) Crisis (An Indian State, which was the leader in Microfinance faced a Social crisis) 2010, led to regulatory impact on coercive recovery mechanism. The recovery dipped to 15% during 2011 and again to 1% in the year 2012 (Ballem et al. 2013).
1.3 RISKS FACED BY INDIAN MICROFINANCE INSTITUTIONS

Though Indian MFIs had an upward swing before 2010, it experienced a beat in a short span of time. The issues and challenges grew up at a greater pace. Before 2010, the huge potential in microfinance industry made the banks to willingly sponsor the loans to MFIs. The banks sponsorship to 779 MFIs was Rs.10728.50 crores during 2009-10. This slipped to 471 MFIs and Rs.8448.96 crores the very next year as the banks lost confidence due to MF crisis (NABARD - Status of Micro Finance in India, 2010-2011).

As of October 2010, in AP, more than 54 clients committed suicide in a short span due to coercive practices adopted by MFIs in lending and recovery (Society for Elimination of Rural Poverty Report (SERP), 2011). The compulsion to sponsor multiple loans to individuals due to the rival competition between MFIs resulted in the extreme commercialization of Microfinance which led to the worrying suicides.

Malegam committee was set up to provide recommendations to encounter the emergency situation and regulate Microfinance industry (Sub Committee- Central Board of Directors, RBI report 2011). It suggested differential interest rates for MFIs with more than Rs.100 crores and for the smaller MFIs. It opined pricing rate of 26 percent for smaller MFIs is highly challenging as their economies of scale may not support their cost. As well, it recommended loans upto Rs.25000 for individuals whose income is less than Rs.50000. However, banks offered loans at much cheaper rate comparatively. In Andhra Pradesh, banks offered loans at 12% per annum (1996) which was slashed as part of declared manifesto during state election period. The interest rate was slashed to 9 percent (1999) and later to 3% (2004) (SERP, 2012-13,
budget line report). The cost of funds was brought down to zero percent during 2011.

Though MFIs charged high interest rates, it had not been self-sufficient for the MFIs, as they are not self-sponsored like banks. The decision on interest rates by those MFIs have to cover the varied risks associated with the funding process. Their operating cost worked to be about 45 percent. On the other hand, the Indian Government planned to offer loans to Self-Help groups across the nation at a very cheaper interest rate. It also proposed to commence Microfinance bank in Andhra Pradesh which would provide loans at 12-14 percent for these Self-Help groups against 26 percent offered by MFIs (Naga Sridhar, 2011). This would be a great threat for the MFIs’ sustainability, as they charged between 27 to 45 percent, inclusive of insurance.

The Microfinance Schism means the inability to repay loans due to high interest rate, which sets in the problem of credit risk in large number of cases (Morduch Jonathan (1999). Higher interest rates, Double loans had been the resultant factor for defaults. During 2011, the top 26 MFIs in the country spared multiple loans to Individual poor clients with no collaterals to an extent of $174, which made them debtors and the number of active borrowers slashed down from 25.14 million (2010) to 20.22 million (2011) (Chandrakekhar Jayati Ghosh 2012). As a part of legal regulatory measure the MFIs were instructed to reduce their interest rates. It affected the operational efficiency of the MFIs and crept into losses as well led them to high credit risk and greater solvency problems. The survival of most of MFIs became a challenge.
1.4 STATEMENT OF THE PROBLEM

The core intentions for the MFIs’ are to provide funds to the economically deprived community. The microfinance helped in poverty alleviation and women empowerment.

Women Empowerment had been the strong goal of MF. This also led the mediocre women to exercise decision making upon purchases of the female oriented durable goods (Nava Ashraf et al. 2006). As the lending is done to economically deprived people, the funding is done with no collaterals. Hence the risks pertaining to such funding seem to be very high and more specifically the risk of default seems to be very high in such lending types.

The credit risks arise due to multiple reasons viz., lack of adequate information about borrowers, excessive lending without analysing the debt repayment capacity, multiple lending, poor monitoring and recovery to name a few. The credit risk is found to be more in larger companies as they operate at large levels and the operating cost also seems to be too huge.

In India, microfinance industry had not been under regulatory radar until the crisis stroked at Andhra Pradesh state MFIs during October 2010. It created a shock wave to the entire Microfinance Industry as a whole. Multiple loans, higher interest rates, Coercive recovery practices lead to self killing by MFI clients. This gained the attention of the Andhra Pradesh government, which enacted an ordinance bill. This chained the hands of MFIs by introducing changes in collection policy. The Act brought the operations of MFIs to standstill.

To tackle the issue, the Government came out with regulatory norms to monitor and govern the industry. A committee formed with Malegam as head, prescribed the norms on fixing interest rates based on the
scale of operations. Apart from credit risk, the attrition rate of employees was another major problem faced by this industry.

In this regard the researcher had an intention to learn about the performance of such institutions in-order to assess the credit risk faced by the top five microfinance institutions in India. The problem taken for the study meant to focus on the credit risks encountered by the microfinance institutions.

The sustainability of MFIs purely depends on its financial sustainability. It is the capability of the MFIs to cover all the costs on its own without donors support (Thapa et al. 1992). It means MFIs are financially bountiful and could continue their existence without the sponsorship from the donors. Indian MFI industry faced credit crunch, which seeds a doubt of continued existence. Thereby in addition, there exists a need to explore the financial sustainability and solvency position of the Indian MFIs.

This research will also focus on the performance of the institutions in terms of risks, solvency position, financial sustainability, survival of MFIs and pre and post effect of MF ordinance bill on the operational self sufficiency.

1.5 OBJECTIVES OF THE STUDY

1. To study the credit risk position of top five Microfinance institutions in India listed in MFIN using the Morgan Stanley method.

2. To analyse the solvency position, identify the major determinants of the solvency position, Return on Assets and predict the future of Select MFIs.
To identify the factors affecting the sustainability and build financial sustainability index for the MFIs.

To identify the relationship between the performance indicators ie, Sustainability, Outreach, Operating Efficiency and Bad Debts.

To understand before and after effect of the AP crisis ordinance bill on the Operational Self-Sufficiency of the MFIs.

1.6. SCOPE OF THE STUDY

This study focuses on understanding the credit risk levels of top five Indian Microfinance Institutions. Morgan Stanley’s credit risk assessment methodology is adopted for the purpose of analysis. A Morgan Stanley standard considers factors like Loan Portfolio; Sustainability, Profitability, Operating Efficiency; Assets and Liability Management; Management; Strategy; Internal & Operational Controls and Growth Potentials. In addition, the solvency position of the MFI’s is also tested using the Altman’s Multi Discriminant Analysis pertaining to financial institutions and the survival position is tested through survival analysis. This study covers the top five companies listed in the MFIN micrometer (March 31, 2013) based on a gross loan portfolio for the financial year 2012-13.

1.7 NEED FOR THE STUDY

In India, the situation is too critical for microfinance institutions and they need more attention in terms of credit risk assessment. This research will help the microfinance institutions to understand the credit levels and adjust or redraft their policy to ensure better sustainability and operational efficiency. This will in turn help the company to come with new products.
suitable for the deprived people. In addition, it will enhance the standards of livelihood of poor through generation of self employment.

1.8 RESEARCH MOTIVATION AND GAP

Analysing the credit risk of MFI is the need of the hour. The good credit rating system followed by Indian banking led them to be strong even during the global crisis. However with regard to MFIs, much impetus was not given to Credit risk assessment methods, as the things fell in line in the initial course. MFIs started facing huge financial crisis when the social activity took the form of commercialization. The strategic myopia took roots which created a hustle and urge to grow faster amongst the players.

Not much research on credit risk of Indian MFIs has been done, and this has motivated the researcher to do credit risk assessment for MFIs. Many of the Indian MFIs suffer credit risk. Many lost the ground as they followed the credit methods which measures only quantitative factors. The already existing models which are much suitable for Banks, gives priority to quantitative factors only. As stated in the introduction, in reality qualitative factors like Technology, Growth Potential, Management & Operations also have much impact on Credit risk. Ignoring them will not provide the real picture. Credit Risk Assessment based on Morgan Stanley method, measures the risk using 3 quantitative factors and 4 qualitative factors. It is designed exclusively to measure credit risk of MFIs. In addition the researcher intends to analyse the profitability, solvency and survival of MFIs.

RESEARCH GAP

Number of studies had been done on the modus operandi of the Indian MFIs. Not much of research is done on the areas of credit risk and sustainability of Indian MFIs. Such research is found in western countries and
has not been carried out extensively in the Indian context. However the research on Credit risk & Sustainability gains prominence in the context of turmoils’ encountered by Indian MF Industry in the recent times.

In this context the present research study will enable to identify variables to be concentrated inorder to maintain profitability, solvency, sustainability and survival of the MFIs in long run.

1.9 HYPOTHESES

- There are no significant discriminating factors determining solvency position of firms.
- There is no significant difference between the survival positions of companies over a period of time.
- There is no significant relationship between the predictor variables of Financial Sustainability and Operating Self-Sufficiency.
- There exists no significant relationship between the performance indicators ie, Sustainability, Outreach, Operating Efficiency and Bad Debts.
- There is no significant difference between before and after effect of AP Crisis ordinance bill on Operational Self-Sufficiency of the MFIs.

1.10 LIMITATIONS OF THE STUDY:

- The study utilizes secondary data, and hence all limitations pertaining secondary data holds good for this study too.
Secondary data are past data, not necessarily the same trend need to prevail in the future.

- The primary data was collected from MFI officials and internet sources. Their opinion may influence a lot.

1.11 CHAPTER SCHEME

Chapter One includes the need and importance of the study in the current Scenario. This includes the Need for Microfinance, risks faced by Indian MFIs, Statement of the problem, objectives of the study, Research Motivation, Hypotheses and chapter scheme.

Chapter Two includes the extensive review of literature on Credit Risk, Solvency, Sustainability and Profitability and Survival analysis to analyse and predict the credit risk and sustainability of MFIs. It also covers the theoretical underpinnings of MF and types of risk.

Chapter Three narrates the Microfinance industry at national and global level. It covers the profile of MFIs selected for the study purpose.

Chapter Four explains the methodology adopted for the research, explaining the data, sources of data and tools employed in the study. It emphasises the utility of tools used in analysing the Credit Risk, Solvency, Sustainability and Profitability.

Chapter Five focuses on data analysis. The result of the Morgan Stanley Credit Risk Assessment method, Survival Analysis, Altman revised Z score model and Financial Sustainability index are discussed in detail.

Chapter Six provides the summary of findings, recommendations, conclusions and future scope of research of the study.