Funding Sources and Portfolio Quality of MFIs

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ABSTRACT

The purpose of this study is to examine various funding sources of NGO-MFIs and NBFC-MFIs and see its impact on the portfolio quality of MFIs. Gross Loan portfolio is the important asset for Microfinance Institutions. NBFC-MFIs and NGO-MFIs differ from each other in regulatory structure and have different kinds of sources of fund. NGO-MFIs depend on donor funds, grants and government subsidies while NBFC-MFIs use various market-based sources of funds. Regulatory structure of NBFC-MFIs gives legal freedom to raise funds from the market or can take a loan from financial institutions. NBFC-MFIs can increase their outreach and sustainability because of having more funds for serving larger number of clients but NGO-MFIs do not have many options to raise funds from the market and banks are reluctant to give loans to these institutions because of the absence of regulatory structure. The data for this study has been taken from the MIX market, sample size for this study is 71 MFIs (25 NGO-MFIs and 46 NBFC-MFIs), independent "t" test is performed to analyse the portfolio quality of MFIs. Findings of the study show that portfolio quality of NBFC-MFIs is better than NGO-MFIs.

Keywords: Portfolio quality, Microfinance institutions, sustainability, outreach, funding sources.

1. Introduction:

Indian Micorfinance Industry is near to completing its three Decades. Microfinance in India is emerged in the late 1990 to serve the unprivileged sector of the society. In the beginning of 2000 MFIs started transformed in to NBFC-MFIs for more capital and fund (Prabhu Ghtae). Indian Microfinance Industry has faced various phases of transformation from pure NGO-MFI model to NBFC-MFIs model to small finance banks. With the growth of this industry their capital requirements have increased manifold. Microfinance industry differ from traditional financing of banks. Bank loans are backed by mortgage while MFIs loans are mortgage free. Under the World Bank millennium development goals, micro-financial services have been provided to 100 million poor people in the world by 2006 (Daley-Harris & Laegreid, 2006). MFIs lendng based on joint liability group (JLG) model where deaflut rate is very low and return on equity is high ranging from 20 to 40 percent (Kattilakoski, 2015).

In India, concept of MFIs has emerged in the form of NGOs and cooperative societies, which dependent on donor agencies and government subsidy for funding. After few years these institutions must be independent for funding as donor finding is available for few years only. It creates pressure over NGOs and they start transformation. To access more funds from the market. Major transformation has been seen in the year 2000 where most of the NGOs transformed in to NBFC s for increasing outreach and financial sustainability. Recently various NBFC-MFIs had been applied to get license of small finance banks. Bandhan MFIs was the first institution which apllied in August 2015 for license of small finance bank. The transformation from NGOs to NBFC-MFIs to small finance banks has resulted in MFIs evolving into organisations that acquire complex business structures like those of bank. To ensure profits from the business of small size loans such institutions need to increase lending rates and involve in aggressive marketing and collection mechanism..

The poor people are being charged increasing rates of interest for their small loans. Particularly, in India, borrowers have come to believe that the lenders are taking advantage of them, so in many cases, borrowers did not repay their loans. Andhra Pradesh crisis, 2009 was a great disaster which happened due to high lending rate and coercive collection policies.

Research studies indicate that financing in the form of donor funds, grants and subsidized loans may be underutilised by MFIs as a source of funding (Bogan, 2012; Hoque, Chishty, & Halloway, 2011). Indian MFIs have 70% of funding in the form of debt capital (MIX MARKET). For NGO-MFIs the major sources of funds are grants, donor funds, and loans at the subsidized rate from the Government. While for NBFC-MFIs loan from the banks and various new avenues like private equity capital, portfolio buyout, off-balance sheet and securitization. These new avenues are an attraction for NBFC-MFIs because of that various NGO-MFIs are transforming into NBFC-MFIs. NGO-MFIs do not get a variety of funds because they do not have regulatory structure and banks also show reluctant attitude for NGOs regarding debt lending.

Microfinance has been an effective and important tool for the poor and poverty reduction to reach the Millennium development goals (Morduch & Halley, 2002). In fact, it has been widely examined over the past 15 years that MFIs need to move out from subsidised operations and become commercialised to achieve efficiency and sustainability (Kapoor, 2014). Since donor funding is notsufficient to meet the financial requirements of the existing and new clients, the only way is to commercialise MFIs operations (Ledgerwood and White, 2006). As MFIs are playing a very important role in reducing the poverty and including the people in the financial system, it is very important to know their funding sources. Based on its sources of funds this study analysed its portfolio quality. Loan portfolio is the major income generating assets of MFIs. Portfolio quality of MFIs is measured with the help of various variables, which discussed in the discussion part.

This research study is focusing to analyse various kinds of funding sources for NGO-MFIs and NBFC-MFIs and based on its funding sources measure its portfolio quality. Limited studies are available in Indian context regarding funding sources and portfolio quality of MFIs. So, this study will contribute to the limited literature on MFIs. Part two provides a brief over evolution of microfinance funding and various funding sources, and Part three discusses the objective, data and methodology for the study. Part four deals with result and discussion and part five provides conclusion of the study.

Portfolio quality

The most significant and vital assets for MFIs are loan portfolio. Collaterals do not back mfis loans due to this portfolio quality is very important for MFIs. Collection policy of MFIs must be quick and , and default must be minimal; otherwise, it can quickly spin out of control (Rosenberg, 2009). Better loan collection policies show the competence of general management. Long experience with evaluating MFIs has been shown that very few successful projects have bad repayment and very few unsuccessful projects have proper repayments. Portfolio quality is an important indicator and deserves special attention to ensure meaningful and correct reporting. Therefore, this aspect of performance tends to be indirectly investigated by examining efficiency.

Loan collection policies in MFIs are complicated. MFIs have used a range of ratios that measure very different things and terminology and methods are not always consistent. Ratios can confuse the results rather than clarify performance if they are not calculated according to international standards. Numerator and denominator of the ratios must be clear to avoid any discrepency in calculation of   loan repayment, delinquency, default, or loss. MFIs self-reported collection performance often understates the extent of problems, usually because of information system weakness. Collection reporting must be verified by an independent party to make it more reliable. The most common indicator is the portfolio at risk (PAR) beyond a specified number of days. When any payment is due, the whole outstanding balance of the loan is at higher

than average risk of non-repayment. The PAR ratio should also include the exceptional value of all renegotiated loans because they have higher than average risk, especially if any payment is missed after renegotiation. Other indicators for measuring portfolio qulaity of MFIs are write off ratio, risk coverage ratio and loan loss rate.

2. Evolution of Microfinance Funding

Microfinance institutions has received significant attention from the donor community all around the world, as having potential in alleviating global poverty. MFIs charge high-interest rates (30-60%) because of lack of collateral securities (Dehejia, Montgomery, & Morduch, 2005). The loans are given for the weekly, fortnightly and monthly basis, the amount is very small, and worldwide only a few programs ask for collateral from the borrowers. Globally more than 67 million households financial needs served by Microfinance (Armendáriz de Aghion & Morduch, 2005). MFIs help poor people by reforming their conditions from poorly paid worker to small entrepreneurs and farmers. MFIs have increased the boundaries of financing and have brought the poor into the financial system. The target customers were mainly women enabling them to access credit to fight poverty (Bogan, 2011).

In spite of the success of various MFIs in developing countries, millions of low-income households are still unable to access financial services. Due to low funds and high operational costs, MFIs are unable to meet the demands of millions of households. Demand for the loans by the lower section of society is not elastic (Dehejia et al., 2005). MFIs charges high-interest rates that limit the ability of MFIs to serve larger clients. funding sources of MFIs at the initial stage are donor fund, grants, subsidies by the government. It increases the competition among MFIs and stressing the objective of social sustainability by achieving financial sustainability (Armendáriz de Aghion et al., 2004). One more difficulty, MFIs are a special type of financial institutions having the risk and return characteristics different from other traditional financial institutions. The major objective of MFIs is to increase their outreach by serving the larger number of people. But to continue with this objective, MFIs must be financially sustainable. Thus, characteristics of MFIs and funding sources have become much more critical issues in MFIs. Focusing on funding sources, this study reviews various kinds of funding sources used by MFIs. Table 1 provides information on various kinds of funding sources and how they affect MFIs' efficiency (Helms, 2006).

Table 1 Funding Instruments and their Benefits and Challenges

Instruments	Benefits	Challenges
Grants	Good for start up NGOs	Institute get easily money so no focus on improving efficiency.
Equity in the form of Quasi-equity and Local equity capital	Good funding socurces for bigger and mature MFIs.	Only licensed financial institutions like NBFC-MFIs access this.
Deposits	It could be good funding source for MFIs but in INDIA mfis are not allowed to collect deposit.	Indian MFIs are not allowed to collect deposit from public because of legal issues. After transformation various MFIs converted into Small Finance Bank(SFB) and regulated by RBI and collecting deposit from public.
Debt from commercial Banks	Funding is available from banks even banks are fulfilling their priority sector lending norm by providing loans to MFIs.	If other commercial options exist, can hamper local m arkets and minimise benefits to mobilise deposits.

Source: Helms (2006)

Funding Sources of MFIs

As per MIX Market report, worldwide major sources of funds for MFIs are debt, equity and deposits. In India, deposits acceptence from public are not allowed to MFIs; these funds allow MFIs to maintain roughly five billion in assets, while Indian MFI invests 83 per cent of these funds in the loan portfolio as of 2009 (Sa-Dhan Report, 2010). In India, due to heavily dependency on debt, debt equity ratio is higher in comparison to other parts of the world, and equity only covers 10-20 percent of total assets in most MFIs. Loan portfolio is the important asset for MFIs.

(i) Savings and Deposits

Worldwide Philippines, Uganda, Pakistan, Peru and Kenya are offering various saving products as low-cost funding sources. In Indian MFIs are not allowed to accept deposit only small finance banks and other full-fledged banks are allowed. The major challenge for MFIs is that they do not have robust regulatory mechanism and government prohibited them to accept the deposit.

(ii) Social Investors and Philanthropic Funds

These investors provide funding in the form of charity or grants to a microfinance institution. Various donor agencies like Bill and Milanda gate foundation, Rang De and Indian MFIs. The primary objective of these funding is for social and economic cause like poverty reduction, education to dropouts and environmental and health issues. Financial institutions like Citibank provides charitable contributions to MFIs in Haiti to protect the country's microfinance industry which destructed in the 2010 earthquake.

(iii) Soft Loans and Grants

Subsidized loans or grants are other sources of funds from socially responsible investors. It is provided by development banks, international NGOs, non-profit corporations, charitable trusts. Various international agencies which provide funding are United States Agency for International Development, Swedish International Development Agency, Asian Development Bank, United Nations Capital Development Fund, Ford Foundation, World Bank, Bill and Melinda Gates Foundation, International Monetary Fund (IMF), ACCION and CARE.

(iv) Microfinance Investment Vehicles (MIVs)

Microfinance investment vehicles act as intermediaries between investors and MFIs. MIVs receive investments from various sources like shares, units, bonds and other financial instruments. MIV provides funds to MFIs in the form of debt, equity, and guarantees. MIVs have an international presence and make use of different currencies.

MIVs are of two types: profit-seeking and welfare oriented. Due to this diversity, it is possible for many different kinds of investors to get involved in the microfinance sector. They can conduct specialised due diligence analysis and monitor the performance of MFIs required for sound investing in this niche market. The International Association of Microfinance Investors (IAMFI) estimates that as of April 2013, there are 150 MIVs with a total of $9.1 billion in assets under management (Microfinance Investment Vehicles).

In the Indian context, the potential of MIVs has not been harnessed so far. The RBI Report (2011) suggested that for meeting the funding requirements of the sector, a 'domestic social capital fund' may be established. This fund will be specifically for 'social investors' who are willing to accept low return as 10% or 12%. This fund could also be invested in MFIs, which fulfil social performance criteria. Laid down by the fund and performance would be measured by internationally recognised measurement tools.

(v) Quasi-equity

World Bank, in collaboration with the Small Industries Development Bank of India (SIDBI) has designed a project to offer MFIs a new kind of quasi-equity product aimed at strengthening MFIs balance sheets. Similarly, NABARD is also supporting MFIs with Microfinance Development and Equity Fund (MDEF).

(vi) Bank Loan

In the Indian context, commercial banks lend to MFIs and SHGs. Commercial banks in India have to meet the mandatory requirement of lending 40% of their advances to the priority sector. Thus banks are a significant source of finance to MFIs, and their interest rate is 12-14%. Both short-term loans and long-term debt can be obtained from commercial banks. In the financial year, 2015-16 MFIs received funding of 337.06 billion from the banks against 72 billion in 2012-13.

(vii) Private Equity

Private equity markets provide an essential source of funds for start-ups, private middle-market companies and firms in financial distress. The huge demand for credit among the poor has become an attractive investment avenue for private equity and venture capital investors. These investors frequently look for innovative and technology-oriented ventures where the conventional source of funding is difficult. Sequoia Capital India was the first traditional venture capital (VC) firm to invest in the space with 11.5 million USD in SKS Microfinance in 2007. International Finance Corporation (IFC), the investment arm of the World Bank has invested 300,000 USD in Utkarsh Microfinance Private Limited, a microfinance start-up providing micro-loans in northern India. The amounts raised through private equity deals are showing an increasing trend indicating that microfinance is a high return investment avenue. With India being a desirable market in this field, many private equity firms have started investing here.

3. Methodology:

The purpose of this research study is to analyse the various funding sources of MFIs and measure its portfolio quality. NBFC-MFIs and NGO-MFIs differ from each other in terms of legal compliance and have different kinds of sources of fund. NBFC-MFIs are regulated by Reserve Bank of India while NGO-MFIs are unregulated. NGO-MFIs mainly depend on donor funds, grants and government subsidies while NBFC-MFIs use various market-based sources of funds.

For MFIs the loan portfolio is the main asset as it is the primary income generating asset. Based on the accessibility of various sources of funds for NGO-MFIs and NBFC-MFIs, their portfolio quality is analysed using "t" test. Independent "t" test is used to measure the difference in the portfolio quality because the study has samples from two different populations. The data has been analysed using SPSS 20 software.

Hypothesis Formulation:

For measuring portfolio quality of MFIs four variables are used mainly portfolio at risk>30 days, write-off ratio, risk coverage ratio and loan loss rate. Based on the four indicators four hypothesis are tested to analyse portfolio quality of NBFC-MFIs and NGO-MFIs.

The hypotheses tested are:

H_1: There is no significant difference in the PAR>30 of NBFC-MFIs and NGO-MFIs.

H_2: There is no significant difference in the write-off ratio of NBFC-MFIs and NGO-MFIs.

H_3: There is no significant difference in the risk coverage ratio of NBFC-MFIs and NGO-MFIs.

H_4: There is no significant difference in the loan loss rate of NBFC-MFIs and NGO-MFIs.

4. Results and Discussion:

Table 1 provides summary statistics of portfolio quality of 46 NBFC-MFIs and 25 NGO-MFIs. The computed values indicate that values of NBFC-MFIs are lower compared to NGO-MFIs.

Table 1 Summary Statistics of Portfolio Quality

Code		N	Mean	Std. Dev.
PAR>30	NBFC	46	0.007	0.009
	NGO	25	0.056	0.129
Write Off Ratio	NBFC	46	0.003	0.004
	NGO	25	0.019	0.044
Risk coverage	NBFC	46	31.477	43.443
	NGO	25	7.160	12.094
Loan loss rate	NBFC	46	0.002	0.003
	NGO	25	0.017	0.043

Source: SPSS

Rosenberg (2009) observed that PAR>30 should be less than 10% and less than 5% is desirable situation for the company. NBFC-MFIs have a mean value of PAR>30 days less than 5% but in case of NGO-MFIs it is more than 5%. The mean value of write-off ratio in case of NBFC-MFIs is lesser than NGO-MFIs. Risk coverage ratios indicate what percent of the PAR is covered by actual loan loss reserve and gives an indication of how prepared an institution is for a worst case scenario. NBFC-MFIs have a mean value of 31.47 while NGO MFIs have 7.16. And lastly loan loss rate is higher in the case of NGO-MFIs vis-à-vis NBFC-MFIs.

Table 2 't' test for Portfolio Quality

		Levene's Test for Equality of Variances		t-test for Equality of Means						
				t	df	Sig. (2-tailed)	Mean Diff.	Std. Error Diff.	95% Confidence Interval of the Difference	
		F	Sig.						Lower	Upper
PAR>30	Equal Variances not Assumed	14.662	0	2.56	45.79	0.014	0.049	0.019	.010	0.088
Write Off Ratio	Equal Variances not Assumed	8.685	0.004	2.41	46.49	0.020	0.016	0.006	0.002	0.030
Risk Coverage Ratio	Equal Variances not Assumed	5.428	0.023	1.68	47.5	0.098	24.316	14.42	-4.69	53.32
Loan Loss Rate	Equal Variances not Assumed	8.528	0.005	2.34	45.89	0.023	0.015	0.006	0.002	0.027

Source: SPSS

The result of the independent 't' test for portfolio quality is presented in Table 2. In the parametric test it is assumed that the variance in groups are roughly equal. For testing variance Levene's test of equality of variance is performed. The null hypothesis states that equal variance assumed in both the groups. But here Leven's test is found significant and hypothesis of equality of variance is violated. For first hypothesis (H1), the p-value is less than 5%, there is evidence towards alternative hypothesis and there is a significant difference in the PAR>30 of NBFC-MFIs and NGO-MFIs, this ratio is lower in NBFC-MFIs and higher in NGO-MFIs. For the second hypothesis, p-value is less than 5% and found evidence against H2 and there is significant difference in the write-off ratio of NBFC-MFIs and NGO-MFIs. Write-off ratio is dependent on portfolio at risk ratio, MFIs with higher PAR will have a higher write-off ratio. In the second hypothesis write-off ratio of NBFC-MFIs are lower than NGO-MFIs.

For third hypothesis, p-value is less than 10%, found evidence against H3, and there is a significant difference in the risk coverage ratio of NBFC-MFIs and NGO-MFIs. Risk coverage ratio shows the percentage of PAR is covered by actual loan loss reserve. Risk coverage ratio of NBFC-MFIs are better than NGO-MFIs.

For the fourth hypothesis, the p-value is less than 5%, evidence found against H4, and there is a significant difference in the loan loss rate of NBFC-MFIs and NGO-MFIs. The loan loss rate is a parameter to measure the unrecovered loans. It is calculated by dividing total write-off by active portfolio. It should be lower. As per the analysis significant difference is found in the loan loss rate of NBFC and NGO-MFIs. Loan loss rate is lower in NBFC-MFIs

Thus, portfolio quality of NBFC-MFIs is better than NGO-MFIs as NBFC-MFIs can access market-based sources of funds like private equity, non-convertible debentures and via securitization. NBFC-MFIs are

regulated institution and they can easily get loans from commercial banks compared to NGO-MFIs. It can be seen from the results that the portfolio quality of NBFC-MFIs is better and this is because they are subject to more regulations and therefore ensure that norms are being followed. The study strongly recommended that a proper regulatory structure must be provided to NGO-MFIs so that they can also increase their accessibility of funds. Microfinance Industry is susceptible and crucial for India, as about 38 million people are dependent on MFIs for essential financial services (as per Sa-Dhan 2017). The government must show its concern for this sector.

5.Conclusion:

Microfinance Institutions are unique kind of institutions in providing financial services to financially excluded population without any mortgage. Loan portfolio is the important assets and its quality is very crucial for the MFIs. To maintain high quality of its portfolio is the prime objective of Microfinance Institutions. For measuring the portfolio quality, technical guide on performance indicators of Microfinance Institutions is used. In India majorly two kind of MFIs are prevalent-NBFC-MFIs and NGO-MFIs. Both MFIs differ in term of accessing various kind of funding sources and regulatory structure. Objective of this study is to analyse the portfolio quality of both kind of MFIs. With the help of independent "t" test, the study concludes that portfolio quality of NBFC-MFIs is better than NGO-MFIs as they can access market-based sources of the fund like private equity, via securitization and other market-based sources of instruments. NBFC-MFIs are regulated institutions, and they can easily get loans from commercial banks compare to NGO-MFIs. And the institutions which are having continuous sources of funds for their operations, they can easily achieve efficiency regarding outreach by serving the larger number of peoples and financially. While NGO-MFIs are unable to raise funds from the market because of lack of ownership structure and donor funds and grants are not sufficient to meet its operational expenses that is why NGO-MFIs are unable to increase its outreach and become financially unsustainable.

As per sa-dhan report (2016), 40 million people in India served by NBFC-MFIs, and 90% of the market is captured by NBFC-MFIs. NGO-MFIs serve 5-6% financially excluded population of India. Besides this there is an urgent need to provide a strong regulatory system for microfinance institutions in India. Microfinance bill discussed two times in the parliament in 2007 and 2012 but no final decision has come. As these Institutions are serving larger population of India, so I recommended, Government must pay attention to regulate NGO-MFIs and provide a strong conducive environment for the flourishment of MFIs.

At present it's a need of NGO-MFIs that it should get converted into regulated institutions so that they can easily access market-based sources of funds and use banks facility to increase its outreach and financial sustainability.

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