Rising delinquencies: Navigating MFI's Emerging Challenges

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Overview

The Microfinance Institution (MFI) segment is currently under significant stress, primarily due to increasing borrower indebtedness and the weakening of the Joint Liability Group (JLG) model. Recent data indicates a rise in delinquencies during H1 FY25, a trend that is expected to persist into the next half year, raising concerns about asset quality of underlying loans. This increase in delinquencies poses risks to the growth trajectory of NBFC-MFIs and their profitability metrics as we navigate this challenging environment.

Moreover, the RBI has recently imposed a 'cease and desist order' on some NBFC-MFIs, preventing them from sanctioning and disbursing loans. The restrictions were due to issues related to predatory pricing, insufficient transparency in disclosures, and improper evaluation of household income and fixed monthly liabilities. Additionally, concerns have been raised about lending to customers with multiple fake voter IDs, often categorised as new-to-credit (NTC) customers, which further undermines the integrity of the lending process. Furthermore, the RBI has raised concerns regarding the practice of loan netting by MFIs and has instructed certain banks and MFIs to ensure that this does not lead to 'ever-greening of delinquent loans'.

Despite these pressures, CareEdge Ratings finds some reassurance in the sector's solid capital structure and the overall support from financiers, which has been crucial in maintaining funding stability. However, it remains essential to closely monitor the evolving landscape, as the rising delinquencies may adversely affect incremental bank funding and equity investments, especially in smaller NBFC MFIs. Furthermore, the more cautious approach of MFI players amidst increasing regulatory supervision, may disrupt the funding cycle of borrowers, potentially leading to a further increase in delinquency level.

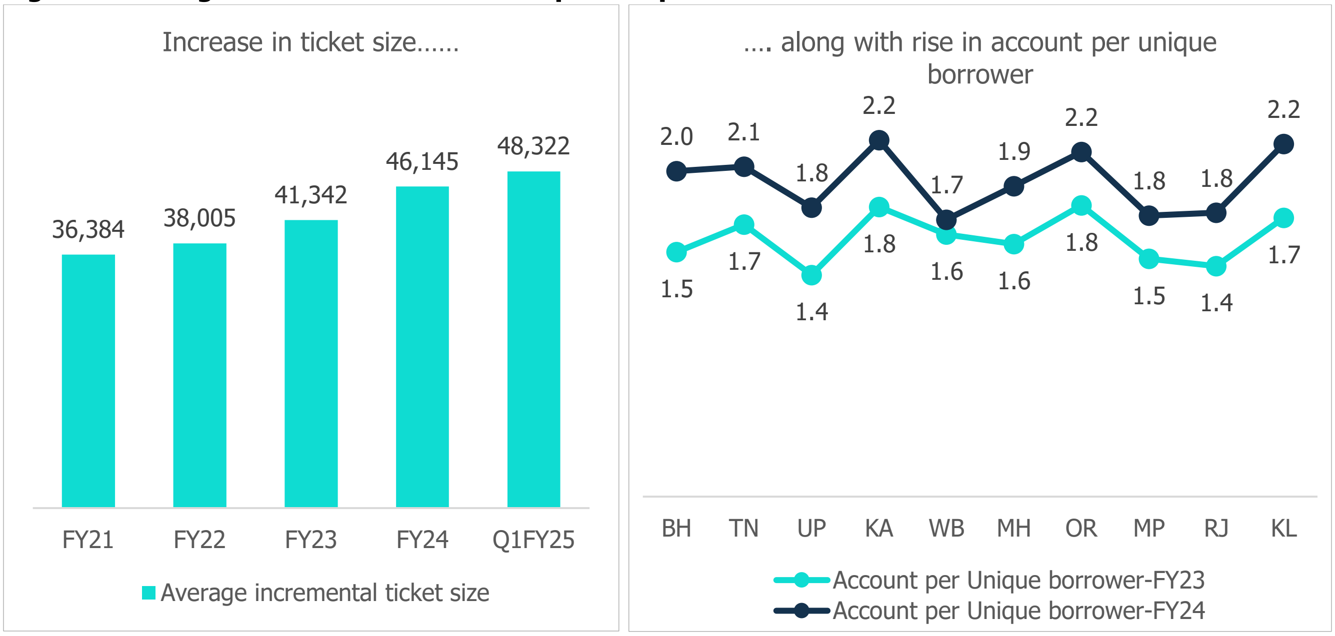
Looking ahead, CareEdge Ratings anticipates a negligible portfolio growth for the industry, projecting a rate of 4%-5% for FY25. Additionally, rising credit costs and compression in yields are expected to exert further pressure on profitability, leading to a decline in return on average assets (RoTA) to approximately 0.4% during the same period compared to 4.3% in FY24. As the sector faces these multifaceted challenges, vigilant monitoring and proactive management will be key to sustaining its viability and support for underserved communities.

Growing Indebtedness: The Impact of Increased Ticket Sizes and Multiple Loans

The microfinance industry is currently grappling with a significant rise in customer indebtedness, as evidenced by a 27% increase in the average incremental ticket size over the past three years. This trend, along with borrowers taking on multiple loans, has elevated overall debt levels. Data shows a consistent rise in the number of accounts per unique borrower across various states, highlighting the extent of this issue within the microfinance sector. It is important to note that if other personal loan data were included (gold loan, unsecured personal loans, kisan cards, etc.), the increase in indebtedness would be even more pronounced, especially at the overall family level for the borrower families. While the growth in ticket size and multiple lending has boosted disbursements in recent years, it has also strained borrowers' repayment capacities, leading to increased stress within the sector.

In response to these challenges, the MFI Network INDIA (MFIN) has advised its members to implement specific measures, including capping the number of microfinance lenders per borrower at four and limiting total indebtedness to Rs 2 lakh, aiming to mitigate further risks and enhance financial stability.

Figure 1: Rising Ticket sizes and account per unique borrower



Source: Data from CareEdge Ratings sample of NBFC-MFIs and Micrometer

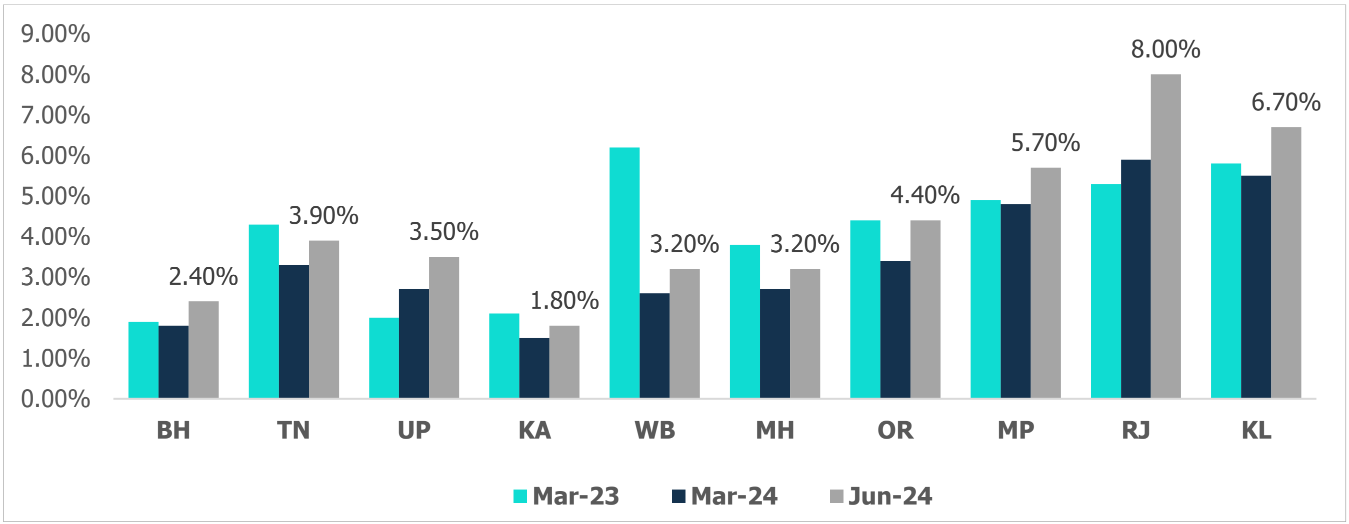
Other factors contributing to rising delinquencies among top 10 states

The increasing borrower indebtedness is compounded by various factors, such as heatwaves, general elections, and political movements like the "Karja Mukti Abhiyan." This challenge is further aggravated by the weakening of the Joint Liability Group model, characterised by a notable decrease in center attendance and diminished peer pressure and collective accountability, which have historically helped maintain low default rates.

Additionally, high attrition rates among field staff present operational hurdles, as frequent turnover disrupts client relationships and hampers loan recovery efforts.

States such as Bihar, Uttar Pradesh, Rajasthan, and Madhya Pradesh are experiencing a substantial rise in 30+ day overdues, as illustrated in the graph below in Q1FY25. CareEdge Ratings anticipates a continued increase in delinquency rates in Q2FY25 as well.

Figure 2: 30+ trend among top 10 states



Source: Data from CareEdge Ratings sample of NBFC-MFIs and Micrometer

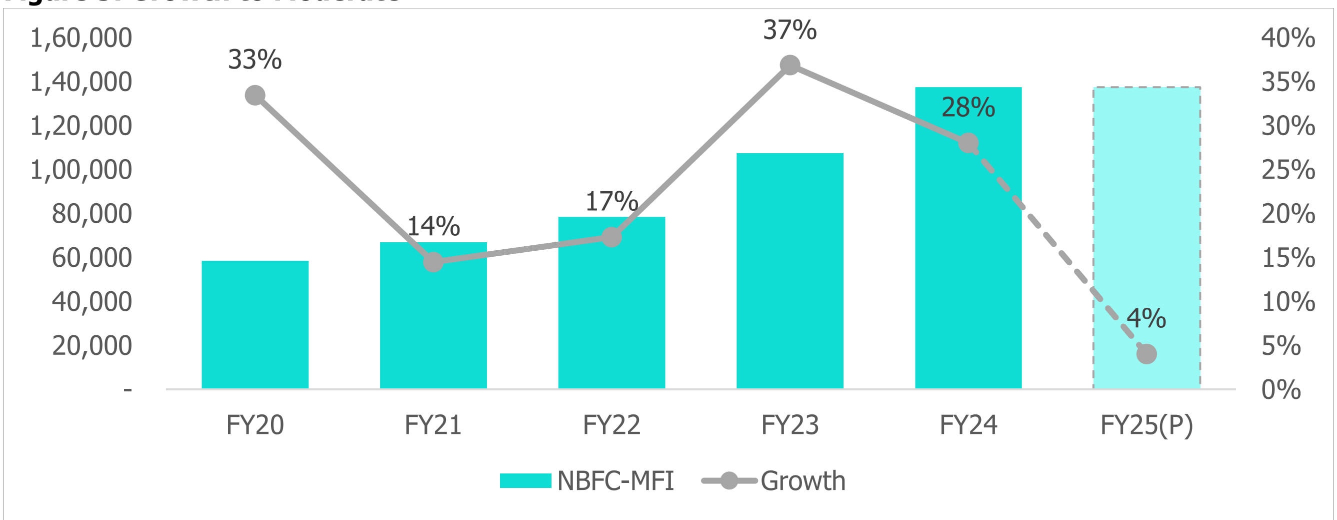
NBFC-MFIs Growth Projected to Sharply Decline

Post-COVID, NBFC MFIs have demonstrated significant growth, achieving approximately 37% year-on-year growth in FY23 and around 28% in FY24. Key states like Bihar and Uttar Pradesh have played a pivotal role in driving this expansion, with Bihar emerging as the largest microfinance market in Country.

However, the growth trajectory of NBFC-MFIs is expected to face a significant slowdown in the upcoming fiscal year, with 4% growth projected for FY 2025. According to CareEdge Ratings, this decline in growth is attributed to the rising delinquencies within the sector, which are prompting MFIs to become more cautious in their lending practices. As a result, these institutions are likely to reduce their loan disbursements in the face of increasing credit risk, leading to a stagnation in their portfolios.

This cautious approach to lending, combined with the growing challenges in maintaining loan recovery rates, is expected to curb the expansion potential for NBFC-MFIs, marking a sharp contrast to the robust growth seen in previous years.

Figure 3: Growth to Moderate



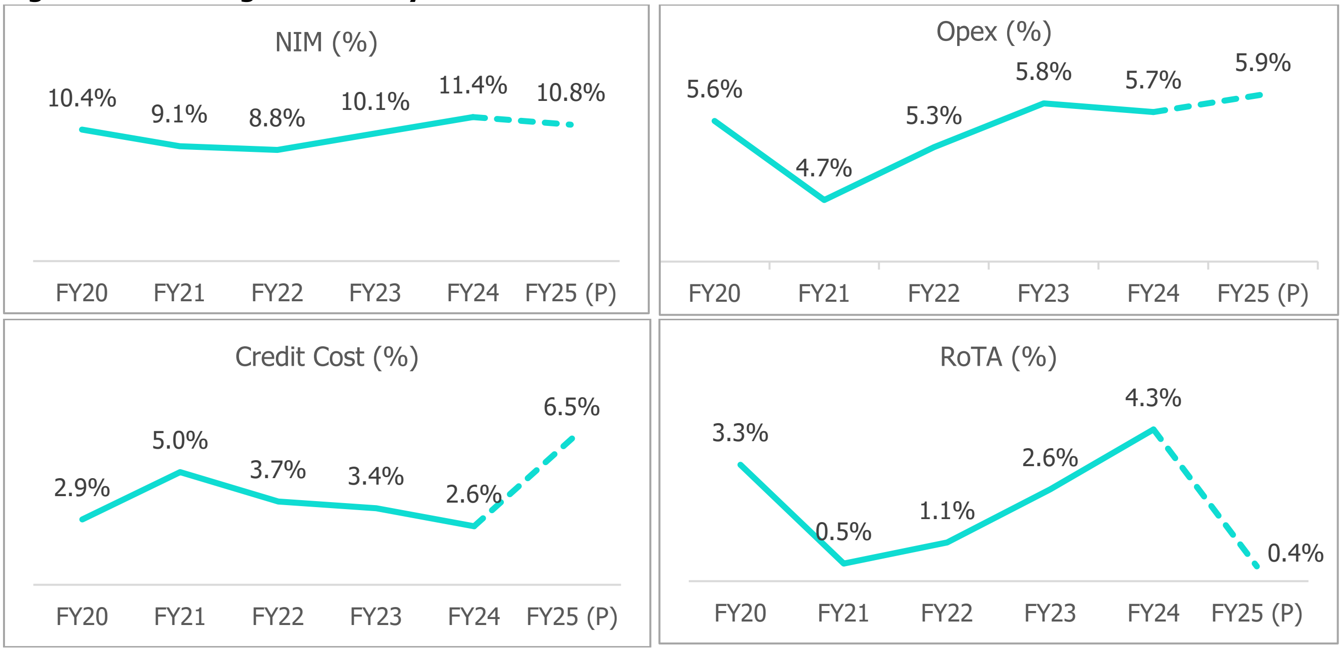
Source: Data from CareEdge Ratings sample of NBFC-MFIs

Profitability Indicators declined due to an increase in credit costs

The microfinance industry has seen notable improvements in profitability over the past two years, due to the RBI’s removal of the lending rate cap, better asset quality, and reduced leverage. Additionally, operating expenses saw a slight decline in FY24, benefiting from economies of scale driven by rapid branch expansion.

For the current fiscal year, Net Interest Margins (NIMs) are anticipated to shrink due to rising delinquencies and reduced yields among several MFI players. Additionally, credit costs are expected to rise notably, with CareEdge Ratings predicting a jump to 6% for FY25, which could lead to a decline in Return on Total Assets (RoTA) to 0.42%. Operating expenses are also projected to increase modestly to 5.9%, driven by the impact of a smaller denominator.

Figure 4: Declining Profitability



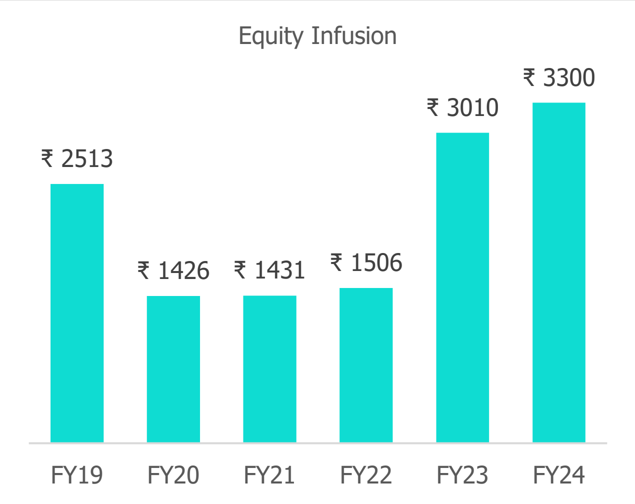
Source: Data from CareEdge Ratings sample of NBFC-MFIs

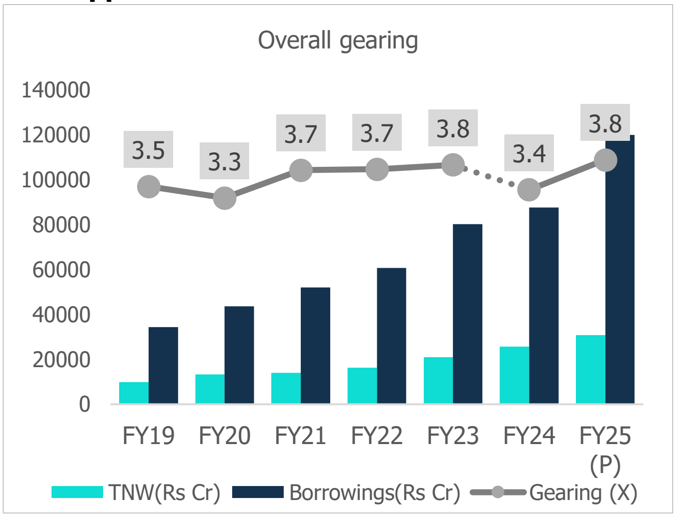
Capital Structure continue to remain Stable

Investors have demonstrated significant interest in the microfinance industry in recent years, as evidenced by substantial capital infusions. During FY23 and FY24, the NBFC-MFI sector raised ₹3,010 crore and ₹3,300 crore, respectively, resulting in improved gearing levels of 3.8x and 3.4x despite considerable disbursements. This enhancement can be attributed to two main factors: robust internal accruals and continued investor support.

However, with the microfinance sector facing ongoing challenges and increasing regulatory scrutiny, investor caution and selectivity are expected to rise in the coming periods. From a broader perspective, CareEdge Ratings anticipate that the microfinance sector's gearing levels will stabilize within a moderate range of 3.8x to 4x over the next 12 months. It is important to note that any significant increase in gearing beyond the 4x threshold will require careful oversight, given the inherent characteristics of this asset class.

Figure 5: NBFC-MFIs Continue to Receive Significant Support from Investors





Source: Data from CareEdge Ratings sample of NBFC-MFIs

Banks support critical for the MFI industry

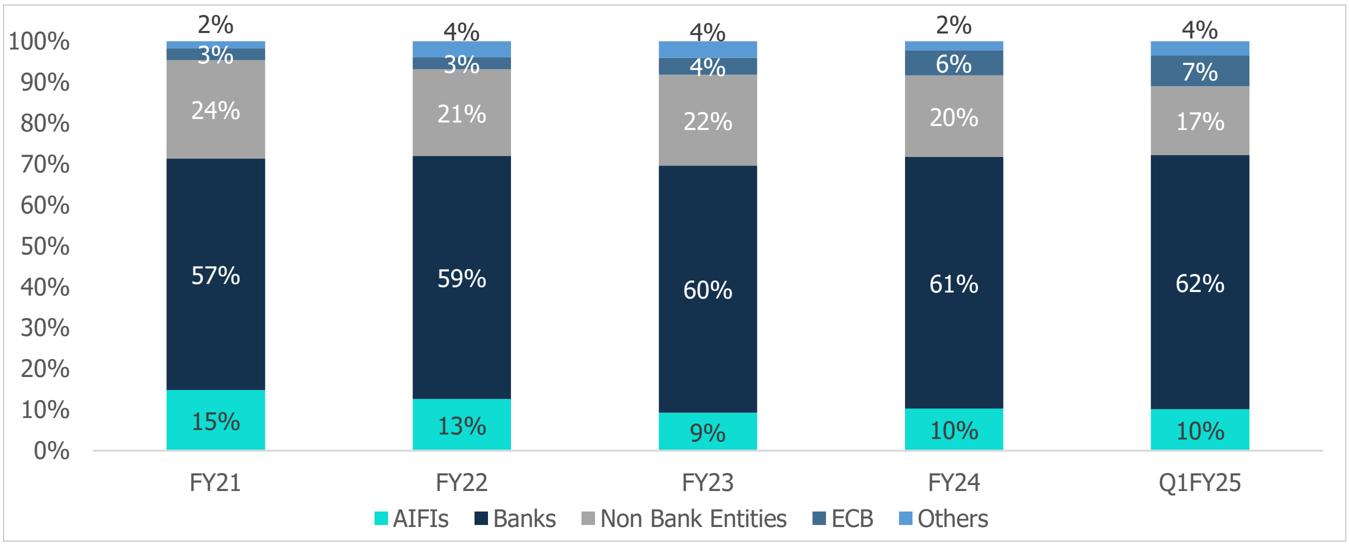
Banks have consistently demonstrated their support for NBFC-MFIs, with their share of on-book funding remaining between 59% and 62% over the past four years. It is noteworthy that, in addition to direct lending, banks also provide support to NBFCs through direct assignments and co-lending arrangements.

Refinancing institutions, such as SIDBI, play a vital role as funding partners, contributing approximately 10% to the overall funding mix.

In accordance with the Priority Sector Lending (PSL) guidelines, banks are required to allocate a specified percentage of their lending to sectors that foster financial inclusion. NBFC-MFIs, which focus on underserved segments, are well-aligned with the PSL objectives established by banks.

However, with delinquencies on the rise within the sector, the ongoing support from banks, particularly to smaller NBFC-MFIs, is under closer scrutiny. Banks are becoming increasingly cautious in their lending decisions, as the sector grapples with growing challenges, including the effects of predatory lending practices, a lack of transparency, and heightened regulatory oversight.

Figure 6: Lender wise breakup of on-book borrowing



Source: Data from CareEdge Ratings sample of NBFC-MFIs and Micrometer

CareEdge View

The NBFC-MFI sector is projected to see only a modest 4% growth in fiscal 2025, indicating a phase of stagnation due to a range of challenging factors. A major concern is the sharp increase in credit costs, which is expected to severely affect profitability, potentially bringing the return on average assets (RoTA) down to an estimated 0.4%.

Several key risk factors warrant close attention. The increasing indebtedness of borrowers is a significant challenge, as larger ticket sizes and multiple loans taken by low-income individuals have led to over-leverage and difficulties in repayment. Compounding this issue is the weakening of the Joint Liability Group (JLG) model, traditionally a cornerstone of MFI operations. Declining centre attendance has weakened the peer pressure and collective responsibility that once helped maintain low default rates. Further, regulators getting more stricter about the predatory pricing will further impact the profitability of the industry.

In addition to this, the industry faces significant challenges beyond financial and operational risks, including high staff turnover and rising fraud, both of which disrupt client relationships and loan recovery. These issues, coupled with vulnerabilities to socio-political risks and natural disasters, further complicate the already difficult operating environment for NBFC-MFIs, making 2025 a challenging year ahead.

However, despite operating in a vulnerable segment, the NBFC-MFI sector has consistently shown resilience, overcoming challenges like COVID-19 and demonetization. Its ability to recover and adapt has earned continued investor support, highlighting the sector's strength and its critical role in financial inclusion. CareEdge Ratings expect that the sector will also navigate through the current stress and continue playing a vital role in serving underserved communities.

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