SECTOR OVERVIEW

A. The Economy

1. The Indian economy has grown faster than 92.0% of the world's nations since 2005,[1] with real gross domestic product (GDP) expanding at an average annual rate of 7.8% from FY2005 to FY2015, helping the country to reduce poverty from 37.2% in FY2005 to 21.9% in FY2012.[2] Declining global commodity prices, especially oil, have helped bring down inflation and allowed the Reserve Bank of India (RBI) to reduce interest rates. Since January 2015, the RBI has cut its benchmark repo rate by 175 basis points, leading to a softening of interest rates. The Indian rupee has also been relatively stable and among the better performers in emerging market currencies.

2. Stable policy, lower commodity prices, increasing government spending on infrastructure, strong fiscal performance, and a supportive monetary policy, bolstered GDP growth in FY2016 to 7.6% (up from 7.3% in FY2015). The Indian economy grew by 7.2% in the first half of FY2017, supported by robust private and government consumption.

3. The government's decision to demonetize and replace high-denomination banknotes in November 2016—temporarily erasing 86% of the value of cash in circulation—is expected to defer consumption temporarily because of the limited money supply. Small and medium-sized enterprises may also witness some disruption, along with agriculture, as these sectors have many cash transactions. Economic growth in FY2017 is therefore likely to be slow down to 7.0%. While some disruption may persist until the first quarter of FY2018, growth in FY2018 is likely to benefit as higher bank deposits should force down lending rates and boost investment. The suppression of demand in FY2017 will likely enable additional policy rate cuts, which will be positive for investment. Greater disclosure of income that has previously been unaccounted for should improve tax collection and allow the government to boost its capital spending in FY2018. The Indian economy is expected to grow by 7.8% in FY2018.[3]

4. India's return to a strong growth trajectory is possible as the long-run growth potential is also high. The dependency ratio is expected to fall from 55% of the working-age population in 2010 to 47% in 2030, allowing for higher output per capita. Savings rates are expected to rise as the share of the working-age group expands, leading to faster capital accumulation. The average education level of the population aged 25 years and above is expected to increase from 4.4 years in 2010 to 6.0 years in 2030, contributing to human capital development. Total factor productivity, which has grown by 1.4% per year over 2001–2010, is projected to increase as markets integrate further and workers shift from low- to high-productivity jobs.[4]

5. Beyond these favorable demographics, India's return to sustainable high growth rates will be predicated on continuing to address supply-side bottlenecks and structural challenges through legislative changes and policy implementation. Supported by the improvement in investor confidence and continuing focus on economic reforms, the Indian economy is expected

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[1] World Bank. 2013. *Country Partnership Strategy for India for the Period FY2013–2017*. Washington, DC.

[2] World Bank. 2014. *World Development Indicators.* Washington, DC; Reserve Bank of India (RBI). Database on Indian Economy. https://dbie.rbi.org.in/DBIE/dbie.rbi?site=home (accessed 1 March 2016).

[3] Asian Development Bank (ADB). 2016. *Asian Development Outlook 2016*. Manila.

[4] Federal Reserve Economic Data. Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org/ (accessed 10 August 2015).

to grow by an average of 7.7% from FY2017 to FY2022, with consumer price inflation expected to be 5.0%.[5]

B. Finance Sector

6. **Banking.** The Indian finance sector is still developing, with banks playing the dominant role. As of the end of FY2016, the sector comprised 216 banks, including 149 scheduled commercial banks. Notwithstanding the size of the sector, access to finance in India remains a key issue. The government has made concerted efforts to address this issue, primarily with the successful *Pradhan Mantri Jan Dhan Yojana* (Prime Minister's People Money Scheme), which had resulted in the opening of over 273 million bank accounts as of 25 January 2017. Access to credit is limited, with less than 14.0% of borrowers accessing credit through formal channels. Women are at a disadvantage, with only 11.3% of women compared with 15.8% of men having access to credit.[6]

7. After growing at an annual rate of 13.4% since 2011, credit growth in the banking sector slowed to 10.2% at the end of FY2016 because of muted investments by the private sector, rising risk aversion owing to the deteriorating asset quality of public sector banks, and alternative funds being available via the bond market, especially for top-rated corporations. Total deposits of all banks were ₹99.3 trillion and total loans outstanding were ₹77.2 trillion at the end of FY2016.[7] The high exposure of banks (especially public sector banks) to troubled sectors (e.g., power, iron, and steel) and stricter policies being advocated by the RBI to recognize problem loans, led to gross nonperforming assets for the banking sector (according to the RBI definition) worsening from 3.5% in FY2013 to 4.6% in FY2015 and 7.6% in FY2016. Loans undergoing restructuring fell during the same period from 5.5% to 3.9% because of changes in RBI guidelines that made it more difficult for banks to restructure loans. The capital adequacy ratio of the banking sector declined from 14.0% in FY2013 to 13.2% in FY2016. Profitability also fell, as evidenced by the reduction in return on assets from 0.8% to 0.4% from FY2015 to FY2016 and the decline in return on equity from 9.3% to 4.8% over the same period.

8. **Nonbanking financial companies.** At the end of FY2016, 11,682 nonbanking financial companies (NBFCs) were registered with the RBI, with total loans outstanding amounting to an estimated ₹13.0 trillion. Like commercial banks, gross nonperforming assets for NBFCs increased from 3.6% at the end of FY2013 to 4.6% at the end of FY2016 because of a slowdown in certain areas such as commercial vehicles, power, and other infrastructures. The capital adequacy ratio for NBFCs was 24.3% at the end of FY2016 against 27.3% at the end of FY2015. The profitability of the NBFC sector has remained stable over the last year, with a return on assets of 2.2% and return on equity of 10.6% for FY2016.[8]

9. Access to debt funding for small and medium-sized NBFCs is severely constrained, especially for medium- and long-term finance. Debt capital markets are also closed for lower rated companies and smaller and midsized financial institutions. Over 50% of the bonds raised by all financial firms in 2015 were for short-term paper (less than 1 year), while short-term paper accounted for over 75% of the total bonds raised by private sector firms. The situation is compounded for NBFCs that focus on financial inclusion, as these institutions tend to be smaller and often have limited operating history.

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5 RBI. 2016. *Results of the Survey of Professional Forecasters on Macroeconomic Indicators– Round 43*. Delhi.
6 World Bank. Global Financial Inclusion Database. http://datatopics.worldbank.org/financialinclusion/ (accessed 27 June 2016).
7 RBI. Database on Indian Economy. https://dbie.rbi.org.in/DBIE/dbie.rbi?site=home (accessed 27 June 2016).
8 RBI. 2016. *Fiscal Stability Report – June 2016*. Delhi.

10. **Small finance bank licenses**. As part of the government's initiative to promote financial inclusion and access to credit, the RBI awarded in-principle small finance bank (SFB) licenses to 10 applicants in September 2015, of which eight were microfinance institutions (MFIs). Awardees have 18 months to comply with requirements and start banking operations. SFBs will function like a standard commercial bank, with the ability to raise deposits, and will be subject to the regulatory requirements of banks, such as maintaining a required cash reserve and statutory liquidity ratios. However, SFBs will also have a higher priority sector requirement (75% of the loan portfolio against 40% for a universal bank) and need to focus on smaller loans (50% of their loan portfolio should comprise loans of less than $37,000). Further, SFBs will not have category 1 authorized dealer licenses, restricting their ability to undertake derivatives or offer such products to their clients.

C. Microfinance

11. **Overview.** Microfinance was established to provide financial inclusion to significantly unserved and underserved population segments. Access to institutional credit has been problematic for the poor, leading to them relying on alternative and often costly channels such as borrowing from friends and family or informal moneylenders for their credit needs. MFIs were initially established as not-for-profit entities, but they lacked the ability to expand their operations and become economically sustainable given their inability to use leverage. Recognizing this problem, the RBI began allowing MFIs to be registered as NBFC-MFIs in 2011. With this structure and under the purview of RBI regulations, NBFC-MFIs could adopt sustainable and scalable business models. The regulatory supervision of the RBI also allowed microfinance to overcome the challenges that arose from the Andhra Pradesh crisis of 2010, enabling it to emerge stronger than before.[9]

12. **Performance.** At the end of FY2016, microfinance in India had provided micro credit to 33.2 million customers through 9,781 branches across the country, disbursing 34.7 million loans amounting to ₹670 billion. Disbursements grew by 78.2% over FY2015, while the aggregate gross loan portfolio increased by 91.0% during the same period.[10] Since FY2013, the sector has seen a compound annual growth rate of 88.6% in disbursements and a 93.7% compound annual growth rate in the gross loan portfolio.[11]

13. **Demonetization.** On 8 November 2016, the Government of India demonetized or banned all existing ₹500 and ₹1,000 notes, the two highest denominations in circulation at that point (accounting for 86% by value of currency in circulation) to reduce the role of the black economy, increase tax collections, and push the economy toward digital payments. The government also introduced new currency notes (of ₹500 and ₹2,000) but imposed certain withdrawal limits on both individuals and corporates, limiting the amount of cash that MFIs could

[9] Andhra Pradesh was the largest market for MFI loans in 2010, with the microfinance industry having grown at a rapid pace since 2006, and the Andhra Pradesh MFIs emerged as the largest in the country. The state government tried to curb the rapid growth of the sector, which it felt was exploiting the poor. It promulgated the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Bill in October 2010, which significantly affected the collection of existing loans by MFIs and the processing of additional loans in the state. The new law severely affected the operations of all major players in the state. The Andhra Pradesh crisis led to several regulatory reforms and operational improvements, including the formation of a self-regulatory organization by the NBFC-MFIs and the RBI's involvement in microfinance.

[10] This pertains to NBFC-MFIs, which constitute over 90% of the total microfinance industry business in the country on an aggregate basis. The data exclude Bandhan, which was the largest MFI and converted to a full-fledged bank in August 2015.

[11] Microfinance Institutions Network. 2016. *Micrometer.* Issue 17. Delhi. This excludes the portfolio of Bandhan and the microfinance portfolio in Andhra Pradesh.

withdraw for fresh disbursements. This severely affected the microfinance industry, as most MFI operations (both collections and disbursements) are carried out in cash. According to CARE Ratings, collection efficiency for the microfinance industry fell to 86% in the week ending 11 December 2016 compared with 99% before demonetization. The fall was largely due to lack of availability of cash rather than intentional defaults by the borrowers. Demonetization has dampened the industry's growth prospects in FY2017 as it has affected fresh disbursements. Disbursement rates have fallen because of the imposition of withdrawal limits, with disbursement as a percentage of collection falling to 34% in the week ending 11 December 2016 compared with 80% the week before demonetization.[12] However, the impact is likely to be temporary, and growth rates are expected to recover fully in FY2018. The larger and better run MFIs are expected to benefit from demonetization, as it will drive the industry toward the cashless mode and is expected to weed out some of the small, less operationally sound players.

14. Banks also provide micro loans through the business correspondent model, where MFIs originate the loans but the loans reside on the balance sheet of the banks as they provide the funding. Banks also provide such micro loans through the self-help group linkage program, administered by the National Bank for Agriculture and Rural Development, a Government of India owned development financial institution. ICRA, a rating agency, estimates the total size of the microfinance market—including self-help groups, business correspondent loans, and loans extended by Bandhan—to be ₹1.4 trillion in terms of gross portfolio, increasing by 40% during FY2016. This growth has mainly been driven by the MFIs and the business correspondent model. ICRA projects this market will grow by 30%–35% from FY2017 to FY2020 (without considering the impact of demonetization).[13]

15. Problem loans among MFIs have seen a steadily decreasing trend, falling from 0.5% in FY2013 to 0.3% in FY2016 for 30 days past due. For 90 days past due, the ratio fell from 0.4% to 0.2% during the same period (footnote 11). CRISIL Research expects the profitability of MFIs to fall marginally against earlier years following the introduction of caps on lending rates.[14] Gross spreads are expected to fall from 10.9% in FY2014 to 10.0% in FY2017, while the net profit margin for the microfinance sector is expected to decline from 3.6% to 3.3% during the same period.[15]

16. ICRA estimates the overall penetration levels of the micro-loan segment to be 50%–55%, with mature markets such as Karnataka, Tamil Nadu, and West Bengal having higher penetration (footnote 13). Five states account for over 60% of total MFI assets under management at the end of FY2016: Tamil Nadu (16%), Karnataka (13%), Maharashtra (12%), Uttar Pradesh (11%), and Madhya Pradesh (8%).[16] The leading institutions (excluding Bandhan) in terms of assets under management at the end of FY2016 were Janalakshmi Financial Services Limited (with a 19.1% market share), Bharat Financial Inclusion Limited[17] (14.6%),

[12] CARE Ratings. 2017. *Impact of Demonetization on Microfinance Sector.* Mumbai.

[13] ICRA. 2016. *Indian Micro Finance: Penetration levels increasing; Borrower-Lender discipline holds the key for sustainable growth – Review for the year ended March 31, 2016 and Industry Outlook*. Delhi.

[14] The RBI has imposed a margin cap of 10% on the cost of funds for MFIs with loan portfolios exceeding ₹1 billion. Smaller MFIs have a margin cap of 12%. The RBI introduced these caps in February 2014 and replaced the previous overall interest rate cap of 26%. SFBs do not need to adhere to these margin caps.

[15] CRISIL Research. 2014. *Rural Banking: Stronger business case.* Mumbai.

[16] These data exclude the loans extended by Bandhan, which is a dominant microfinance lender in West Bengal, and accounted for about 25% of the industry assets under management before its conversion to a bank in August 2015. Hence, West Bengal does not appear in the list of top five states.

[17] Previously known as SKS Microfinance.

Ujjivan Financial Services (9.7%), Satin Creditcare Network Limited (6.0%), and Equitas Holdings Limited (5.5%) (footnote 11).