Evolving approaches to regulation of Indian Microfinance sector and Emerging need of Financial Education for the Indian Microfinance

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Evolution of regulation in the microfinance industry in India		
Prior to 2011	2011-2021	2021 onwards
Self-Regulation	Regulation by RBI	Holistic-Regulation

RBI has published a consultative paper on regulation of microfinance on June 14th, 2021. The overarching goal of the new approach contained in this paper is to harmonize the regulatory frameworks for various regulated lenders in the microfinance sector. The new approach, while applying to all the entities (unlike the previous approach that applied to only the MFIs, majorly, NBFC-MFIs), which are regulated by the Reserve Bank and which are providing the microfinance loans:

- Seeks to protect the microfinance borrowers from over-indebtedness in a well-calibrated and harmonized set-up
- Intends to benefit the microfinance borrowers, in terms of lower cost of loans availed by them, through facilitating market forces to lower the interest rates and
- Aspires to empower the borrowers to make more informed decision related to availing microfinance

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Microfinance may be defined as bouquet of financial services, broadly comprising credit, savings, insurance, leasing, remittance, pension, etc. Generally, these financial services, which are small in terms of value, short in terms of tenor and are normally made available near the place of residence/operation of the beneficiary, who are mostly from the low-income group and who have to mostly form a group before availing the financial services. The term microcredit (loan only) has evolved to microfinance to financial inclusion over the years.

In India, microcredit is delivered through a variety of institutional channels, broadly called regulated entities (REs) providing microcredit, such as:

a) Scheduled commercial banks (SCBs) (including small finance banks (SFBs) and regional rural banks (RRBs)), which lend directly as well as through business correspondents (BCs) and self-help groups (SHGs),
b) Cooperative banks,
c) Non-banking financial companies (NBFCs), and
d) Microfinance institutions (MFIs) registered as NBFCs as well as in other forms.

Globally, Indian microfinance industry is recognized as one of the strongest microfinance industries operating in any country and India has presented itself as a role model to the world, in terms of enabling financial inclusion. PMJDY (Pradhan Mantri Jan-Dhan Yojana) illustrates the remarkable progress made in the area of financial inclusion/microfinance in India, as 427 million beneficiaries got banked, who had INR 1.44 trillion in their bank balance account in July 2021!

Indian microfinance has seen huge growth in operations, especially since 1990s, in terms of volume of beneficiaries and value of financial services. As delivery of financial services was involved, with the increase in microfinance operations, there was demand for RBI to stipulate regulatory guidelines for the microfinance sector. Till the first decade of 21st century, RBI had preferred self-regulation by microfinance industry over any external regulatory guidelines, as microfinance sector was viewed to fulfill the gap between demand and supply of credit services, especially from the perspective of low-income-group section of our society.

In 2001, in a speech made by Mr Jagdish Capoor, the then Deputy Governor, RBI, view of the central bank had been stated, "*We consider it desirable and appropriate to support evolution of a self-regulatory mechanism for MFIs which would prescribe codes of conduct and ground rules. These institutions should now get together and come out with a set of proposed self-regulatory norms. Information dissemination, research, database creation and experience-*

sharing among the micro finance practitioners would be the initial step to setting out on the self-regulation path."

The rationale for not stipulating for MFIs the same set of regulation, as mandated for, for example, the commercial banks, had been also stated, *"As MFIs are significantly different from commercial banks both in terms of institutional structure and product portfolio, application of the same set of regulatory and prudential guidelines to MFIs, in our view, not only runs the risk of distorting the emerging market but it may also reduce the efficiency of these institutions.*"

Later, it was felt that even if there needed to be regulation of microfinance sector, it could be at the state-level, without there being any need for countrywide regulation by RBI. In a speech in August, 2005, Dr. Reddy, the RBI governor had stated, "*if any statute for regulation of MFIs is contemplated, it may be at the State-level with no involvement of the RBI as a banking regulator or for extending deposit-insurance.*" Again the broader idea was to leave the microfinance sector self-regulated, as stated in his speech, "*Microfinance movement across the country involving common people has benefited immensely by its informality and flexibility. Hence, their organisation, structure and methods of working should be simple and any regulation will be inconsistent with the core-spirit of the movement.*"

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As the microfinance industry grew, inadequacies of self-regulation came to light. Scaling up of operation by more aggressive MFIs led to issues like multiple lending to borrowers, which, in turn, resulted in over-indebtedness, difficulties in regular repayment and recourse to forced recovery by a few MFIs. The social and ethical angle to microfinance was getting ignored. Andhra Pradesh microfinance crisis of 2010 illustrated the negative issues related with a segment of the microfinance industry.

These factors, as also other developments related to microfinance industry, led to introduction of the first regulatory framework for NBFC-MFIs on December 02, 2011 by RBI. This regulatory framework was based on the recommendations of the Malegam Committee.

It has been a decade since the last regulatory framework was introduced and later got modified. There is a realization that the last regulatory framework needed revision, especially, as the last regulatory framework was applicable to only a third of the microfinance industry. The undermentioned data reflects the structure, volume and value of the microfinance industry at the end of March 31, 2021:

As on 31 March 2021			
Number of active loans			
Type of lenders	**No of lenders**	**No. of Active Loans** (in million)	**Lender Share** (%) –
NBFC-MFIs	87	35.9	34.92%
Banks	17	41.6	40.49%
SFBs	8	16.3	15.91%
NBFCs	58	7.8	7.60%
Non-profit MFIs	39	1.1	1.09%
Total for industry	**209**	**102.8**	**100%**
Loan outstanding (Asset of lender)			
Type of lenders	**No of lenders**	**Loan Outstanding** (₹ in billion)	**Lender share** (%)
NBFC-MFIs	87	791.15	31.92%
Banks	17	1,101.22	44.43%
SFBs	8	377.24	15.22%
NBFCs	58	187.65	8.33%
Non-profit MFIs	39	21.13	0.82%
Total for industry	**209**	**2,478.39**	**100%**
Delinquency % by value			
	Number of days		
	30+	**60+**	**90+**
NBFC-MFIs	7.21%	4.97%	3.36%
Banks	10.66%	7.14%	4.81%
SFBs	8.31%	5.68%	3.62%
NBFCs	10.57%	7.16%	5.04%
Non-profit MFIs	1.72%	1.25%	0.95%
Total for industry	9.12%	**6.18%**	**4.15%**

Source: www.sa-dhan.net/wp-content/uploads/2021/07/Q-MF-Report_Q4.pdf

More so, the review of the regulations are also called for in view of the growing concerns of customer protection as well as emerging dynamics in the microfinance sector. As per the new "Consultative document on regulation of Microfinance", RBI's plan to modify the regulatory framework can be summarized as under:

1) New definition of household and a common definition of microfinance loans for all category of regulated entities (REs)

A 'household' shall mean a group of persons normally living together and taking food from a common kitchen. More emphasis should be placed on 'normally living together' than on 'ordinarily taking food from a common kitchen'. The determination of the actual composition of a household shall be left to the judgment of the head of the household.

Microfinance loans shall mean collateral-free loans to households with annual household income of ₹1,25,000 for rural areas and ₹2,00,000 for urban/semi urban areas.

2) Other instructions applicable to microfinance loans of all REs are:

a) Provisioning of a Board approved policy, by every regulated entity, for-

i. Objective assessment of household income
ii. Setting a limit of 50% of the household income on the repayment of principal and payment of interest on all outstanding loan obligations of the household
iii. Borrowers' determined periodicity of repayments
iv. All-inclusive interest rates charged to the borrowers

b) Removal of pre-payment penalty
c) Disclosure of pricing related information in a standard simplified fact-sheet
d) Display of maximum, minimum and average interest rates charged on microfinance loans

3) Criteria for exemption of 'not for profit' microfinance companies

a) Registered under Section 8 of the Companies Act, 2013
b) Asset size of less than ₹100 crore
c) Non-acceptance of public deposits
d) Undertaking micro financing activities, indicated by

i. Offering collateral-free loans to households with annual household income of ₹1,25,000 for rural areas and ₹2,00,000 for urban/semi urban areas
ii. a limit of 50% of the household income on the repayment of principal and payment of interest on all outstanding loan obligations of the household

4) Pricing of microfinance loans provided by NBFC-MFIs would be as per the guidelines under Fair Practices Code. Pricing would entail

a) An interest rate model, taking into account relevant factors such as cost of funds, margin and risk premium, would be developed and adopted by the Board of each NBFC-MFI to determine the rate of interest to be charged for microcredit. Not only the cost of loan (rate

of interest) but also the approach for gradations of risk as well as the rationale for charging different rate of interest to different categories of borrowers need to be disclosed to the borrower in the application form. All the parameters need to be communicated explicitly to the borrower in the sanction letter.
b) The cost of loan (rate of interest) and the approach for gradations of risk be also made available and regularly updated on the web-site of the companies or published in the relevant newspapers.
c) For the sake of clarity and facilitating comparison, the annualized rate of interest must be indicated so that the borrower is aware of the exact rates that would be charged to the account.
d) Boards of NBFC-MFIs should lay out appropriate internal principles and procedures for determining interest rates and processing and other charges to ensure that the total cost on loan are not excessive, as such cost would be neither sustainable nor conforming to normal financial practice. Though interest rates would not be regulated by the Reserve Bank, MFIs needful to be mindful of the burden of cost of microcredit on borrowers.
e) Any notice or information, related to the terms and conditions of microcredit, such as, rate of interest, disbursement schedule, service charges, prepayment charges, etc. should be provided to borrower in a language commonly understood by the borrower. As per general practice of credit, changes in interest rates and charges should be effected only prospectively and a proper condition be incorporated in the loan agreement.
f) Any penal interest, charged for late repayment, should be mentioned in bold in the loan agreement.

5) Withdrawal of following guidelines presently applicable to only NBFC-MFIs

a) Cap of two-lender norm for lending by NBFC-MFIs
b) All pricing related instructions applicable to NBFC-MFIs
c) Specific stipulations related to
   i. sub-limits on loan amount (₹75,000 in first cycle, exclusion of loans towards education and medical expenses from overall limit),
   ii. tenure (minimum tenure of 24 months for loans above ₹30,000) and
   iii. purpose (minimum 50 per cent of loans for income generation activities)

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The proposed modification in regulatory framework is expected to not only harmonize the microfinance industry but also benefit the borrowers and the MFIs.

The potential benefits to borrowers can be summarized as under:

a) Tendency for over-indebtedness would get checked, as borrowing gets linked to household income

b) Loans from REs/lenders, other than NBFC-MFIs, may become less costly

c) As the limit to borrowing is 50% of the household income, in principle, household will always have at least 50% of the income to meet the basic financial needs of the household members

d) Increased transparency on loan, as the full and detailed cost of loans would be available, that too in the local/vernacular language

e) Waiver of pre-payment clause for borrowers would be empowering borrowers in making decisions. For example, when borrowers get the proceeds from selling their crops, they can settle the loan, without any penalty, and save on the cost of the loan.

f) Removal of two-lenders rule mean that, within the 50% limit of household income, borrowers can shop around for more efficient loan from different lenders.

g) Exclusion of collateral against the loan would enhance access to finance for more needy persons

h) Overall, borrowers can expect to have improved supply of microcredit and better access to financial services

The potential benefits accruing to MFIs can be summarized as under:

a) Could remove the unduly restrictive cap on the rate of interest to be charged on the loans purveyed by MFIs,

b) Could provide a boost to the microfinance lending by NBFC-MFIs

c) Could improve the asset quality of MFIs. Provision of penal interest would inject discipline in borrowers for making timely repayment, thus lowering the NPA/PAR for MFIs. Better quality of asset would lead to better financial sustainability of MFIs

Though these are the numerous benefits accruing to borrowers as well as to lender MFIs, there could also be new set of challenges depicted by:

a) Missing-middle conundrum - what happens to those microfinance borrowers, whose income exceeds the limit proposed under this regulation, but who are unable to get finance from non-MFI financial institutions, for a variety of reasons

b) As the cap on interest would get removed, in the underserved locations, where MFIs are fewer, such MFIs could charge enhanced rate of interest on the loan to borrowers

Moving forward, once the new framework of regulation comes into force, the next steps to consider could be related to:

1) More conscientious self-regulation by the microfinance industry in an auto mode.

   As the new proposal plans to do away with external regulation, for example, regulation related to loan size or interest rate, and monitoring by RBI, there is greater need for self-regulation by the microfinance industry and related stakeholders. The 2019 Code for Responsible Lending was a great initiative. The code needs to evolve with newer developments in the industry.

2) Implementing apposite programmes of financial education for borrowers as well as for loan officers. Properly designed programmes of financial education could be helpful, especially for borrowers, as financial education would help in the aspects of

   a) Improving financial knowledge related to risk and returns, impact of inflation on the cost of living, diversification of risk, compounding of returns, etc.

   b) Acquiring and cultivating appropriate financial attitude related to spending, saving and making financial plans for future

   c) Promoting positive and desirable financial behaviour related to budgeting and planning, making payment of dues on time, evaluating options/alternatives before spending, keeping a close watch on financial affairs, etc. A few of these behavioural traits would be helpful to borrowers in evaluating and making sound decisions related to
      a. income (household income) and expenditure and
      b. asset and liability (arising due to microcredit and related loan repayment)

A properly designed programme of financial education, aimed at meeting the specific requirements of borrowers in enhancing their financial knowledge, developing appropriate financial attitude and restraining inapt and risky financial behaviour would be helpful for ensuring long-term financial well-being of the microcredit borrowers and their family.

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