Financial Inclusion-The Case of Micro Finance: S L Rao[1]

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A policy paper on the intricacies of expanding financial inclusion

I - Introduction

Inclusive growth is about growth benefiting all the people and not a small portion. Its focus is not just on the drivers of growth (investment, trade, infrastructure etc) but also on providing affordable services to build capability through education and health services etc. Financial inclusion forms an important part of achieving inclusive growth, but it has had a populist history in India beginning with loan melas during Mrs. Indira Gandhi's regime. Bank managers were ordered to sanction loans at the behest of political leaders without worrying about the borrowers' ability to repay or the purpose of the loan. In recent years governments have indulged in writing off loans especially to farmers. These measures basically give away capital sums without building assets and at best support a failed agricultural year, doing little towards financial inclusion.

This paper considers financial inclusion to be about providing easy access to finance at reasonable costs and repayment terms to the poor, as loans for consumption, asset purchase, business, and enabling accumulation of savings, insurance, etc. The emphasis is on accessibility to credit, affordability of cost, and ability to repay for the poor. Self help groups were a grass root effort at inclusion and microfinance institutions (MFIs) developed to provide this access. This paper focuses on the evolving regulation in this sector to make the point that reliable monitoring of beneficiaries and effective regulation are crucial in ensuring a stable and effective environment for financial inclusion.

II - Types of MFIs:

The Grameen Bank in Bangladesh was the model for Indian Self-help groups. These groups were composed of low income housewives in villages who contributed a fixed sum monthly to a common pool from which loans are enabled to members, with repayments being ensured by group pressure. The loans are limited by the savings capacity of the group. Over time, banks and non-banking finance companies also lent money to such groups. Small self-help groups also receive capital sums from funding agencies to scale up operations and raise the amount of the loans to members.

Some groups receive funding from development agencies to enlarge the size of loans but function in the same way, i.e. collecting savings of members, and members repaying to the group. Funding agencies like the Marshall Foundation also finance NGOs (like the Aga Khan Foundation) to help organize such self-help groups. Self-help groups might also be formed by a group of people who want to start a business and borrow money for the purpose. The lenders to such groups are MFIs and will be subject to the Micro Finance Institutions (Development and Regulation) Bill, 2011. As MFIs grew in number and some grew in size, they began to search for larger borrowers and formed Joint Liability Groups (JLG's). These are formed primarily for business purposes. Some lend to the poor at high interest rates and use forceful collection methods. They depend on large loans from NBFCs and banks.

Irrespective of organisation and type, MFIs are essentially based around the concept of small groups of low income households/individuals collecting savings or borrowing for investment.

III - Paucity of Data

When it comes to MFI sector analysis, there is a severe problem of paucity of data. Data about self help groups in India is not only sparse, but sometimes contradictory. Whether it concerns their number, memberships, income profiles of members, lending profiles, interest charged etc., credible data is lacking here. Thus we do not know the number of individuals who are members of more than one self-help group or the usage of loans taken from the MFIs. There are varied estimates, depending on the source. For instance, according to MicroFinance Transparency, the usage of such loans is estimated for the following purposes as: 19.88% Housing, 15.66% Emergency, 8.43% Consumption,16.27% Education, 70.48% Business, Any other purpose 21.08%. However, the Malegam Committee Report gives different information – significantly higher weightage to consumption, with just around 25% for income generation. 25% for income generation.

IV - Appraisal of Recent Regulation of the MFI Sector in India:

The MicroFinance Institutions Development (and Regulation) Bill 2011) was drafted in June 2011, subsequent to the Malegam Sub-Committee Report to the RBI of January 2011, on issues and concerns in the MFI sector with reference to their loan function. This Report was called for after government intervention in Andhra Pradesh, a state that accounted for almost 40% of all microfinance in India. The Andhra government capped interest rates and put restraints on collection methods and periodicity, multiple loans etc. These measures disrupted loan repayments, attempts at collection, interest charges and many other aspects of the MFIs. The need for effective regulation of the sector as a whole translated into the MicroFinance Institutions Development(and Regulation) Bill 2011, whose draft is currently in discussion stage.

An appraisal of the Bill reveals the following issues:

1. Both the Report and the Bill confined themselves to the MFIs and devoted little attention to the borrowers, their background and requirements. This is a lacuna that must be corrected. However, this is much easier said than done because verification of income, assets and knowledge in an illiterate/semi-literate cash economy is next to impossible at any reasonable cost.

2. Low-income borrowers from MFIs borrow for small amounts, without collateral and usually for income-generating activities, although loans are also provided for consumption, housing and other purposes. The Malegam Committee would like to see up to 25% of credit issued for non-income generating purposes (though the data above shows it is much higher). There is a basic issue here that must be appreciated, in the context of viability of these loans. The tenure of the loans is short and frequency of repayments greater than for traditional commercial loans. Many lenders started lending in efforts to help the poor. As the demand for loans grew they converted themselves to NBFCs. Many new entrants also saw a profitable business opportunity. Almost invariably small borrowers are at best literate, with little or no basic accounting knowledge, or knowledge of business practices and procedures. They have no experience in purchasing and marketing or even in organizing manufacturing. To successfully run a business, they need to learn basic management skills including using time to maximum efficiency. Further, their skills are usually quite basic and the value-add to the products they make is small, and many times not commensurate with the interest that has to be paid on borrowing. There are thus very strong chances that a business built on micro borrowing may not be viable.

3. The Bill provides for the regulation of NBFC-MFIs, defined as those that provide "Micro finance services"-i.e., one or more of the following financial services involving small amounts to individuals or groups- micro-credit provision, thrift collection, fund remittances, pension or insurance services and any other service as may be specified. A lacuna here is that there is no definition of "small amounts" and that these services are also provided by banks and moneylenders. Further, it might be desirable to differentiate MFIs lending to self-help groups and not others so that group saving and group pressure for repayment is identified. However, many MFIs follow the JLG model and not the SHG. So it is advisable that restrictions be confined only to the unsecured loan product (SHG, JLG or individual) and not to other loans with collateral. Regulation might be therefore limited to a product category rather than an institution type. That is not to say that MFIs be restricted to only unsecured loan products because that is very risky in the long run. The idea that MFIs may be required to have less than 15% of individual loans on their portfolio is too limiting. Both these recommendations make for good banking, but not for easy financial access to poor households who may not have assets to give as security.

4. The Malegam Committee had said that most MFIs consider a low-income borrower as a borrower who belongs to a household whose annual income does not exceed Rs. 50,000/-. This is a reasonable definition though impossible to ascertain. We can only rely on verbal self reports of borrowers, which are often difficult to verify.

5. The RBI has powers under the bill to prescribe the Annual Percentage Rate which shall include processing fees, interest, life insurance premium and other terms relating to financial assistance and the percentage of margin to be maintained by a MFI. Since the Bill also requires MFIs to keep aside a prescribed percentage amount as reserve fund, this percentage should also form part of the annual percentage rate.

6. RBI may stipulate norms for corporate governance. It is difficult to see why RBI should do so. After all, SEBI's clause 49 of its listing agreement does so very well; and so will the to-be-amended Indian Companies Act. In fact, there is no reason why this should wait. All MFIs should follow the corporate governance requirements of clause 49, this will take care of corporate governance norms

7. The Bill proposes a Micro Finance Development Fund for training and research purposes. This is all to the good. However all MFIs should be asked to keep a SHG Development Fund that will be supplemented from a parallel fund to be maintained by the RBI from donations, etc. Such a fund must be used to offer simple business training to self-help groups and individuals' who are applying for loans. However, training to be effective requires very different skill than what MFI may have. One MFI has spent two years developing digital training in this regard in collaboration with experts and has built a completely separate media/communication group for this purpose. Its implementation also requires a team entirely different from the MFI field force. RBI should find some way to support initiatives like these that can scale across the country rather than putting the onus on each MFI.

8. The Bill also proposes an Ombudsman for the purpose of redressal of grievances between clients and MFIs, with powers to issue directions toMFIs. Each commercial bank at present has such Ombudsmen. It is doubtful whether low income rural borrowers with little education will have the courage and the capability to use this facility. Instead, contact information of senior managers of MFIs might be publicised and a complaint line as well that can be used by members. Panchayats should not be this intermediary because of politicisation and the fact that many MFIs also fund their members for elections.

9. The Bill places no ceiling on loan amounts. The Malegam Committee found that loans ranged between Rs 10,000/ and Rs. 25,000/ and suggested an overall ceiling of Rs 25,000 counting all loans. For the present it is a reasonable ceiling and might be reviewed after the first loan cycle and lifted for clients with a good credit history. The goal of microfinance to self help groups of small borrowers must be for the borrower to grow, not stay the same size.

10. The Bill recommends repayment over 12 months if the loan is up to Rs 15000/ and up to 24 months if it is up to the Rs 25000/. Given that we are dealing with small and poor borrowers, the repayment should not extend over a long period and 24 months is an upper limit. This is therefore a reasonable recommendation.

11. After a study of costs of large and small MFIs , the Malegam Committee found wide variation in margins after allowing for the cost of capital. This was found to be on account of development costs (new branches, staff, etc) being taken into current costs, overheads other than staff costs, provision for loan losses. The Committee recommended "that there should be a "margin cap" of 10% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of `100 crores and a "margin cap" of 12% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding `100 crores. There should also be a cap of 24% on individual loans." This recommendation is good but one-sided since it does not cap bank lending rates to MFIs. The cap on loans becomes the signal for bank lending rates which must therefore also be capped. Banks raised these lending rates after the Malegam report came out..

12. Development costs are not to be taken as part of current costs to be paid by the borrower. Since the percentage costs of servicing small loans are high, the percentage return is also kept higher than on large loans. The Malegam recommendations appear reasonable and will push MFIs towards more efficiency and cost control. However viability of any livelihood built on small loans earning that level of return is unlikely.

13. The Malegam Committee rightly recommends that additional charges to interest have a processing fee not exceeding 1% of the gross loan amount, interest charge and actual insurance premium (in case of the premature death of the borrower). Every MFI should provide to the borrower a loan card in a standard format to be given by RBI showing and explaining any deviations, the effective rate of interest, the other terms and conditions attached to the loan, information to adequately identify the borrower and acknowledgements of payments of instalments received and the final discharge.

14. The Malegam Committee makes many other practical recommendations relating to exempting MFIs from the Moneylenders Act, allowing only two MFIs to lend to the same borrower, providing a moratorium equal to the instalment payment period (e.g. one week moratorium if the instalment payment is to be made every week) etc.

V - Conclusion

The focus so far of the regulatory move has been on the lenders and their regulation. This is important to ensure that poor borrowers are not exploited. However, it is even more important to know the borrowers and help them use loans effectively. We have seen that data on borrowers is sparse. This must be quickly corrected, with periodic universal surveys. One important recommendation that is not made in the Malegam Report is the need for accurate and universal data about recipients. This is not merely about MFIs but about the loan recipients who are the self-help groups that help financial inclusion.

For long term sustainability of the MFI sector, it is crucial that the nature of assets built through such borrowing and their viability are identified. There is considerable need for simple business training to borrowers and very few lenders arrange for appropriate training. For this, separate and specialized institutions are necessary. Madurai Micro Finance in Chennai has developed an 18 hour module that is easily delivered (for a fee) over some weeks and exposes the trainees to simple book-keeping, purchasing, understanding consumer needs, sourcing new markets beyond a particular village and the importance of cutting out middle-men. This type of simple business training to poor borrowers is essential and might be financed by the development funds.

To conclude, this paper suggests that MFIs have not been very useful for livelihood enhancement of the poor in India, have done more to promote small enterprises (some allegedly also lend to moneylenders), and that separate focus on SHGs is essential for improving financial inclusion of the poor. In the end, the purpose behind micro-credit is to enhance the earning capacity of poor households. The MFI sector, in its own interest must never lose sight of this paramount purpose and it must create a conducive environment to achieve this goal.

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[1] *S L Rao, former Director-General of NCAER, is a noted economist and columnist with vast experience in regulation.*
[2] *January 2011, Micro Finance Transparency, www.mftransparency.org*
[3] *Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector-2011*