A NEW PARADIGM FOR MICROFINANCE IN INDIA

Authors: V. Anantha Nageswaran, Laveesh Bhandari and Sumita Kale[1]

Abstract
The microfinance revolution that started in the late 1990s in India had a phenomenal growth trajectory until the Andhra Pradesh crisis hit in 2010. The regulations set in place after the Malegam Committee recommendations in 2010 need a relook with another crisis that occurred in Assam in 2020. In June 2021, the RBI released the Consultative Document on Regulation of Microfinance aiming to make credit available to borrowers in a transparent manner, ensure borrower protection and provide a level playing field between all institutions that make microfinance loans. This White Paper deals with the four key issues: determination of household income, interest rates charged to the borrower, transparency and disclosure to borrowers, and the involvement or interference of state governments in microfinance and sets out suggestions for each stakeholder in the microfinance ecosystem – the Reserve Bank of India, Self-Regulatory Organisations, microfinance industry participants and the Government of India.

1. Background

The Consultative Document that the Reserve Bank of India (RBI) put out in June 2021[2] presents a snapshot of

[1] Dr V. Anantha Nageswaran is Distinguished Visiting Professor, Krea University, Laveesh Bhandari and Sumita Kale are with the Indicus Centre for Financial Inclusion. We would like to thank Ammaar Mohammad at Indicus for his research and analytical support.
[2] Source: https://rbi.org.in/scripts/PublicationsView.aspx?Id=20377 (June 14, 2021)

the state of the microfinance sector in India. Microfinance loans are made in 628 districts across 37 states and union territories. The total outstanding is Rs. 2.28 lakh crores. The total number of loans outstanding is around 10.3 crores. The industry-level delinquency rate is 1.02%. These were the figures as of September 2020. On top of this, the 'Business Standard' newspaper notes that nearly 99% of the loans go to women and the mix of loans between rural and urban India is 76:24.[3] This is an impressive achievement. Clearly, the cause of financial inclusion has been served by the growth of microfinance.

Microfinance in India has had an alternating history of boom and bust. It was a boom time in the new millennium. Along with the Indian economy, the microfinance sector boomed. There were concerns about excessive lending that was taking place. Given the lack of credit information on the borrowers, multiple loans were not uncommon. Matters came to a head in Andhra Pradesh. In 2010, the sector faced its first crisis.

The Andhra Pradesh government then passed legislation writing off microfinance loans in the state. Several microfinance institutions (MFI) went down. In its wake, the Reserve Bank of India appointed a committee to suggest measures to regulate the sector. The Malegam Committee came up with elaborate prescriptions for loan amounts to be disbursed to individual borrowers, the ceiling on household income for determining eligible borrowers, elaborate calculations on interest rate margins, etc.

Many of these prescriptive rules applied mostly to Non-Banking Finance Corporation (NBFC)- MFIs. NBFC-

[3] See 'Microfinancing lessons from a mandi that govt-run Mudra seems to have lost', Business Standard, 19th May 2021 (https://www.business-standard.com/article/economy-policy/microfinancing-lessons-from-a-mandi-that-govt-run-mudra-seems-to-have-lost-121051900636_1.html)

MFIs chafed at the uneven playing field between them and Bank-MFIs. For example, the interest rate ceiling prescribed by the central bank were mostly flouted by Bank-MFIs and those ceilings were enforced strictly only for NBFC-MFIs. Given their low cost of funding compared to NBFC-MFIs, it meant that banks had a considerably better margin and profitability on microfinance loans.

Further, the maximum number of NBFC-MFI institutions that can lend to a borrower was restricted to two. There were no such restrictions on Bank-MFIs. Hence, many NBFC-MFIs were pleading with the regulator to level the playing field.

In the meantime, the sector recovered from the shock of the 2010 crisis in Andhra Pradesh. Boom conditions returned. Demonetisation of high denomination notes was another crisis for MFIs. Many reportedly had to write off nearly 10% of their loan books. Then, a few years later, it was time for another crisis. This time in Assam in 2020. Some Bank-MFIs were seen as engaging in excessive lending and creating indebtedness. The Assam government intervened ten years after the Andhra Pradesh government did in a similar situation in 2010. The share of Assam in the overall microfinance loan portfolio was only 5% whereas the share of Andhra Pradesh in microfinance loans was 25%.[4] For several MFIs, their exposure to Andhra Pradesh was more than 50% and the waiver of loans meant that they had to go out of business.

It is in this context that the Reserve Bank of India released a Consultative Document on microfinance regulation. The document is bold in its vision for it aims to sweep away all the microscopic prescriptions on

[4] See Tamal Bandyopadhyay: 'Micro loans: Assam is not Andhra Pradesh', *Business Standard*, 10th January 2021 (https://www.business-standard.com/article/opinion/micro-loans-assam-is-not-andhra-pradesh-121011000799_1.html)

NBFC-MFIs. It proposes a level playing field between all institutions that make microfinance loans.

The proposal removes the restriction on number of lenders per borrower. It does not restrict the number of loans or the lenders that can lend to a borrower. Instead, it seeks to limit the maximum loan amount to 50% of the household income.

There are no interest rate ceilings. The expectation implicit in the removal of interest rate ceilings and prescriptions is that enhanced competition between all microfinance lenders – now that the playing field has been levelled – would bring down the interest rate.

At the same time, the universe of eligible microfinance borrowers has been left untouched. Only those loans that are made to households with an annual income of Rs.1.25 lakhs in rural India and Rs. 2.0 lakhs in urban India would be considered microfinance loans. This absolute amount has remained unchanged for several years.

The key recommendations made in the Consultative Document are as follows:

- A common definition of microfinance loans for all regulated entities
- Capping the outflow on account of repayment of loan obligations of a household to a percentage of the household income.
- A Board approved policy for household income assessment.
- No pre-payment penalty; no requirement of collateral; and greater flexibility of repayment frequency for all microfinance loans.
- Alignment of pricing guidelines for NBFC-MFIs with guidelines for NBFCs.

- Introduction of a standard simplified fact sheet on pricing of microfinance loans for better transparency.
- Display of minimum, maximum, and average interest rates charged on microfinance loans on the websites of regulated entities.

The question is whether the document – brave and bold as it is – would usher in a period of sustainable growth of the sector, foster financial inclusion and contribute to the transformation of rural lives. Will the new regulatory framework arrest the knee-jerk reactions from state governments as happened in Andhra Pradesh in 2010 and in Assam in 2020?

These are the questions that this White Paper seeks to address and come up with a set of suggestions for the regulator and industry participants to consider. In what follows, this White Paper deals with the four key issues: determination of household income, interest rates charged to the borrower, transparency and disclosure to borrowers and the involvement or interference of state governments in microfinance. After a discussion of the issues involved in these four areas, the document proceeds to offer some suggestions on each of these four issues and identifies the key players in the sector responsible for implementing those suggestions.

2. The Key Issues

2.1 Determining eligible households for microfinance loans

Consider the ceiling on household income. It is not easy to calculate especially for low-income households. Their income flows are irregular and are in cash. Even the definition of a 'household' is problematic as the current standard definition is about having a shared kitchen. The definition is therefore quite amenable to be gamed.

The second issue is that income itself has been defined in absolute amounts – Rs. 1.25 lakhs in rural India and Rs. 2.0 lakhs in urban India. It is not indexed nor is it the same as is adopted in other sectors. For example, the eligibility for affordable homes under the Pradhan Mantri Awas Yojana (PMAY) is set at Rs. 3.0 lakhs per annum for Economically Weaker Sections and between Rs. 3.0 lakh and Rs. 6.0 lakhs for the low-income category. More importantly, the PMAY scheme makes no distinction between rural and urban households. Therefore, one suggestion is to adopt the definition of PMAY and make all households with annual incomes below Rs. 6.0 lakhs eligible for microfinance loans. Alternatively, it could be the case that those households whose annual income (before exemptions and eligible deductions) is below the income-tax threshold could be deemed eligible for microfinance loans.

Suggestions are also made to align the current monetary limits to disposable income rather than gross household income and to make distinctions between different cities. For example, in Mumbai, any income below Rs. 6.0 lakhs per annum might be inadequate to make ends meet and to pay for lumpy and unexpected expenditures.

While the spirit behind these suggestions is laudable – expand the set of eligible borrowers so that microfinance loans make a difference to more families – they are likely to make the eligibility criteria more complicated and hence more vulnerable to abuse by both borrowers and lenders.

An unintended consequence of the current low household income threshold is that many households under-report their income to be eligible for microfinance loans and that is also one of the reasons behind the low default rates because the actual borrowers are more financially sound than borrowers with the prescribed norms. Usually, we have only had situations wherein borrowers overstate their incomes/assets to be eligible to borrow. Industry conversations reveal that, in the microfinance structure in India, the opposite happens!

What is the consequence of this? The loan amounts that are offered to these borrowers is inadequate relative to their needs. So, they either borrow from multiple lenders or from unorganised moneylenders who charge usurious rates of interest. Consequently, the underlying objective of financial inclusion – raising the standard of living of the borrowing households. – remains elusive. Indeed, keeping the income thresholds so low leaves many financially excluded.

It is far better to align the policy with reality and make available slightly larger loans. The word 'micro' in 'microfinance' should not be interpreted literally or in absolute amounts but in relation to the size of the economy, the sizes of the households and their true incomes.

In determining income, it would be consistent to adopt the same approaches that lenders, who provide subsidised loans under PMAY, use to estimate or verify household income to determine the eligible loan amount and the interest subsidy. These approaches would also include, for example, automatic exclusions for specified asset ownership and automatic inclusions for occupations like manual scavengers.

Finally, on this issue, it will be advisable to index the eligible income to the consumer price index or set a timetable for the revision of the criteria every three or five years.

2.2 Interest rate de-regulation

The next issue is one of the interest rates that microfinance lending institutions charge. The Consultative Document proposes freeing up the interest rates. The curb was a sore point with NBFC-MFIs. It is a big step forward for them. But, the all-important question, from the financial inclusion perspective, is whether it would lead to a lower cost of borrowing for poor and low-income households. Industry participants are hedging their bets. Some think that it might even initially lead to higher interest rates as some lenders test their luck by pushing the boundaries and seeing how far they could go with higher rates. Only over time will interest rates come down, provided more institutions are able to enter the fray and provided the universe of eligible borrowers is expanded based on more realistic ceilings for household income as discussed earlier.

What is interesting and telling is that industry participants do not themselves want a free rein for market participants with respect to interest rates. At the minimum, they want a range of interest rates to be prescribed by the regulator. In other words, the private sector participants are apprehensive that competitive forces would drive down interest rates beyond the ability of the incumbents to survive. Or that such unhindered competition may lead to interest rate volatility with cycles of ups and downs.

Having said this, one should note that demand for short-term funds to meet routine or unexpected expenses is so high that the borrowers are price inelastic. For example, some moneylenders charge street vendors interest rates in excess of 10% per day (Borrow 100 in the morning and return 110 in the evening)[5]. Therefore, complaints about high-interest

[5] The Karnataka Minister for Cooperation quoted in the media (Hindu, September 15, 2018, available at https://www.thehindu.com/news/national/karnataka/interest-free-loan-scheme-for-street-vendors-hawkers-soon/article24950640.ece).

rates come not from borrowers but from non-stakeholders who tend to compare the rates paid by the borrowers with the rates charged in organised and other formal credit markets for large borrowers. Note that transaction costs tend to be far lower in the organized sector and therefore the two rates are not really comparable.

Moreover, with the entry of new fintech options, better monitoring and oversight, greater operational and competition flexibility need to be given for the microfinance ecosystem to mature. A steady reduction in interventions will only leave more space for entry, and innovation in this space. The question of whether interest rate de-regulation will lead to lower rates in the long run is a matter for the future to settle. But the opportunity for greater flexibility has to be given. Otherwise, we are stuck in the regulated system where high-interest rates are a given for all times to come.

One way forward is to start with an interest rate corridor with the objective of steadily loosening it until eventually it no longer exists. And this could be done through the good offices of stronger Self-Regulatory Organizations (SRO). SROs have had an important role to play in good governance. They would need to be given more teeth for credibility and also lower the regulatory and oversight burden on the regulator.

At the same time, behavioural change on the part of lending institutions can also be speeded up by mandating the uploading of credit information onto the credit information bureaus with penalties for non-compliance (perhaps through a more empowered SRO – discussed later). It is well-known that interest rates are a function of information asymmetry between both the borrower and the lender. The more information that lenders have about the repayment behaviour, loans taken and trends in their income, as observed and recorded by lending institutions, the overall cost of capital will come down and be differentiated according to the risk profile of the borrowers.

Indeed, in adopting this practice, MFIs may also end up setting an example for large commercial banks to make risk-based lending rather than collateral-based lending. For this to happen, credit information must be regularly updated. Right now, the updating frequency is monthly. All institutions comply with monthly updating. But very few institutions upload information on a weekly frequency, the better it is for overall loan volume growth, price of loans and for credit quality to improve. For example, NBFC-P2P intermediaries are required to upload credit information daily.

2.3 Transparency and disclosure to borrowers

The third issue with respect to interest rates is the transparency level of interest rates. The RBI Consultative Document has proposed a Fact Sheet that lenders must provide borrowers. On the face of it, the fact sheet appears simple enough. Borrowers should be able to understand it. However, the information could be made even more simple. Moreover, the Annual Percentage Rate (APR) or the relevant interest rate should be informed in boldfaced letters and the borrower should be in no doubt as to the rate and the amount of interest she pays on the loans. Further, such information must be presented in a language that the borrower understands – not just vernacular, but the common man's vernacular. The last may seem obvious, but to this today an inordinately large part of the financial domain continues to operate and inform in English. This needs to change immediately.

Again, NBFC-P2P intermediaries are required to disclose the APR to the borrowers prominently. It is interesting that the playing field has been levelled between NBFC-MFIs and Bank-MFIs in the Consultative Document issued by the Reserve Bank of India. It is now time to take a broader view of the playing field and require all participants to meet the most exacting standards on disclosure, transparency and credit information upload that are being currently insisted upon from only one set of participants, namely NBFC-P2P.

2.4 Microfinance and state governments

The fourth issue is whether the proposed regulatory framework will keep state governments from interfering whenever there are issues and disputes between borrowers and lenders, whether they are microscopic or macroscopic in nature. The prevalent view is that it would not happen and that when it comes to poor and low-income households, political considerations would always come into play.

More importantly, while Finance, including Banking, is on the Central list, moneylending is on the state list. Hence, states have a legitimate say in the affairs of moneylenders. MFIs are moneylenders, whether they are banks or NBFCs. This results in a crosswire of rules and regulations to be followed between the central bank and the state governments. Further, states that come up with regulations apply them to all institutions registered under the Companies Act. But the State Bank of India and other public sector banks do not come under the Companies Act and they will be exempt from the state-level regulations. The playing field between Bank-MFIs and NBFC-MFIs becomes even more unbalanced, consequently. This was the case with the Assam Microfinance Regulation Bill introduced and passed last year.[6]

Of course, the clear demarcation of the responsibility and authority of union and state governments is a broader topic involving larger and more important considerations related to the centre-state division of powers and constitutional checks and balances. A larger conversation is no doubt important as the

[6] See footnote 4 for citation details.

moneylending function moves away from informal localized operations to large national and even global entities. The former could have been better addressed by state or even local governments. However, the latter does require a national perspective.

In the interim, within the framework of the current constitution, a stop-gap measure is to have a focused adjudicatory or a mediation entity that mediates in that grey space between RBI and State governments.

Having dealt with the four key issues, we now propose some suggestions for the different stakeholders that arise from the foregoing discussion of the key issues that impinge on the sector's growth and viability.

3. The Way Forward

The intent and sincerity of the Consultative Document towards de-regulation are unquestionable. However, there are still chronic issues plaguing the microfinance industry that need to be sorted out. The regulator and other stakeholders will have to work together to resolve them and ensure that events like the Andhra crisis do not occur in the future, and the microfinance sector functions smoothly and serves its core purpose of providing easy and accessible finance to those in need. There is a need to finetune the responsibilities for the regulator, and by the regulator, for various stakeholder entities involved.

To begin with, as explained in the earlier section, the RBI needs to have a hard look at the household income threshold. The current threshold was set more than a decade ago and also has the most obscure definition of a 'household'. A low threshold has led to a large share of financial exclusion and other unintended consequences such as households underreporting their income to get loans and, in many cases, borrowing from informal moneylenders.

The RBI could set one rule for all, in the sense that all households with annual income below the income tax threshold shall be eligible to avail loans from MFIs. This would lead to a simple and uncomplicated process and promote overall equity in the MFI ecosystem. Further, any realistic household income ceiling fixed by the regulator should be dynamic over time, linked to the Consumer Price Index such that recalibrated automatically without the need for SROs to make multiple representations to the regulator.

The regulator must think of ways of conferring some quasi-regulatory authority to the SROs such as MFIN and Sa-Dhan. The reason for this is straightforward, to have an authority that is easily approachable for all stakeholders involved, including the borrowers, and to provide RBI with the space to focus on the macro issues of the sector. It has recently been reported that the SROs have developed a Code of Conduct way back in 2006. These have been further revised in 2015 and in 2019. Therefore, a mechanism already exists, that is waiting to be further smoothened.

It is also important that MFI representatives be part of the State Level Banking Committees, this will allow for better coordination and monitoring at the district level within the states and allow for response to any evolving situation of localised over-indebtedness. Representatives from state governments can also be made observers to ensure improved free flow of information.

There is more to do to level the playing field. Just as the RBI has now made the attempt to between NBFC-MFIs and Bank-MFIs, it should examine the standards and requirements that are currently being demanded of NBFC-P2P and apply them to microfinance lending institutions. There are at least two requirements of NBFC-P2Ps that can be readily imposed on microfinance institutions too as well – both banks and non-banks. One is the prominent disclosure of Annual Percentage Rate (the interest cost borne by the borrower) and the second is the credit information updating requirement.

There is also a critical role that empowered SROs can play with respect to the interest rate corridor. As discussed earlier, even though interest rate de-regulation is expected to bring down interest rates over time, it is not likely to happen quickly for many reasons, and a steady movement towards that end could be achieved with the help of SROs who can become instruments of reducing various information asymmetries in the ecosystem. Most importantly all SROs should have a structure with equitable representation from all the stakeholder entities involved in the Microfinance ecosystem, including the customer, which shall help in maintaining an equilibrium between the SRO's authority and its responsibility. The RBI will have to be careful in delegating the level of authority to the SROs so as to prevent misuse of power, and also keep a regular check on the SRO's unbiased behaviour.

Two important informational gaps in the sector are those related to terms of lending activities and borrowers' credit quality must also be bridged. In both these respects – interest rates charged to borrowers and credit information provision - SROs can play an important role. Hence, empowering them with adequate authority would help the regulator ensure the viability and growth of the sector.

The SROs should therefore be mandated to collect and share the interest rate ranges and other terms of lending by various participants on a regular basis. The SROs can also play a key role in ensuring that credit information is uploaded with the Credit Information Bureaus regularly from all industry participants. Right now, lenders do upload credit data monthly but a 30-day gap in information sharing is too high. It needs to move in a staggered manner first to a weekly and later daily basis. This may require all-round IT upgradation among all industry players, and here again, the SRO can play a catalysing role. For more frequent uploading of credit data will, over time, lead to a better assessment of household income, assets, indebtedness and thus allow interest rates to be lowered for good-quality borrowers.

SROs have another useful role with respect to customer grievance redressal. The SROs should coordinate with industry players to evolve a standardised customer grievance redressal system for all entities to follow, which will simplify the process for customers in the space, raise trust in the industry and highlight malpractices if any as they arise. Along with grievance redressal, the SROs should also focus and promote basic financial literacy amongst the MFI customers and push the MFIs to do so. Even if they become marginally successful in spreading financial education, it will have a multiplier effect on the whole ecosystem.

It must however be noted that the ultimate objective is to enable healthy and greater competition between all lenders. SROs therefore cannot be allowed to become a means of cartelization and therefore, need to be designed and mandated with very specific tasks and limits on their operations.

Once the RBI Consultative Document becomes policy, the industry will likely have a more level playing field between all types of microfinance lending institutions. A more flexible, less intrusive, and less prescriptive regulatory regime imposes greater challenges on industry participants, but of a different kind. Participants with a short-sighted perspective may end up over-exploiting their freedoms, and if others follow, this could very well lead to a downward spiral, harming all concerned.

Firstly, it is up to the lenders to show that they can operate under a less intrusive and less prescriptive regulatory regime. In other words, their governance must keep evolving and improving such that systemic crises do not arise. When they do, the political and regulatory response is mostly detrimental to their own business growth. Even if they are not altruistic, self-interest driven behaviour should result in better governance.

Second, they must use technology and artificial intelligence-driven credit scoring and data analysis to enhance their understanding of their borrowers' credit risk. Such enhanced understanding must be used to drive down the cost of borrowing for India's poorer households even as such technology deployment helps keep their margins up.

Third, they must continue to engage in the financial literacy and education of borrowers. It is again in their self-interest. It is not a charitable activity. Over-indebtedness results from the combination of the dire situation that most households with irregular cashflows and income find themselves in and the avarice of lenders. But the consequence of it is regulatory overzealousness which renders microlending an unviable business. Therefore, financial education for borrowers serves the lenders. Importantly, in the long term, it enables lenders to cross-sell other financial products.

Finally, the SRO is one mechanism for the industry to be more cooperative while competing with each other. But there can be other mechanisms as well. Industry leaders need to play a leading role in this area as well.

Then we come to the role and responsibilities of refinancers. The Micro Units Development and Refinancing Agency (MUDRA) was set up as a subsidiary of the Small Industries Development Bank of India (SIDBI) in 2016. Its most recent income statement (for the year ending March 2020) shows that nearly 50% of its income is derived from investing in government debt securities. It should do more to refinance MFIs and report this on a regular basis.

Further, like MFIs, it should also invest in and deploy technology to assess the credit risk of the MFIs and find ways to refinance them according to their credit standards and profile. That would lower the cost of capital for good-quality MFIs and enable them to lend at lower rates. This is possible if a special R&D group on financial technology and analytics with an emphasis on micro-finance is set up within SIDBI.

In fact, If SIDBI can refinance MFIs at interest rates that are based on a risk assessment of MFIs, and if MFIs realise that their refinancing rates would drop if they got their act together on their own risk metrics, then it would surely provide an incentive for them to get their act together on risk management practices in lending. This would galvanise MFIs to up their game with respect to their lending practices, risk management and credit assessment practices.

Finally, we turn to the uncertainty created by the division of regulatory responsibilities between the Centre and State governments. Moneylending is a state subject whereas banking and finance is central subject. Since microfinance has become part of the staple of products/solutions offered by banks and non-banks, it will be useful for the union government to engage with state governments and move microfinance off moneylending. That would reduce the scope for politically motivated intervention to meddle with the regulatory framework. Uncertainty for the financial institutions will also thus be correspondingly lower.

In the interim, the Central Government must introduce a mechanism for mediation between state governments, MFIs, and RBI on specifically these matters.

4. Conclusion

This White Paper has looked at the regulatory framework of India's microfinance sector, in the light of the Consultative Document by the RBI. The questions to address were whether the brave and bold proposals in the document would bring in a period of sustainable growth of the sector, foster financial inclusion and contribute to the transformation of rural lives. Four key issues were taken up in-depth - determination of household income, interest rates charged to the borrower, transparency and disclosure to borrowers and the involvement or interference of state governments in microfinance.

The proposals set out by the RBI were finetuned and small gaps were filled in through recommendations made for each stakeholder in the ecosystem – the RBI, the SRO, Refinancers, industry participants and the Central Government. The onus lies on the industry, just as much as the regulators. To conclude, if the supply side of the microfinance ecosystem can get their act together, the need and demand for informal moneylenders will automatically be hugely diminished. This would be the end-state for meaningful financial inclusion in India.

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