

A financial inclusion approach to microfinance regulation

Supplementary suggestions on the Recommendations of the RBI Sub-Committee of the Central Board of Directors to Study Issues and Concerns in the MFI Sector

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In the preamble to our earlier **Comments on the Recommendations of the Malegam Committee** we wrote

“The Malegam Committee was established in an environment of crisis in Indian microfinance, against the backdrop of the AP Microfinance Institutions Ordinance (now Act) instituted apparently as an emergency means of protecting microfinance clients. **Seen in the context, of the political backlash against microfinance, the recommendations of the committee are broadly appropriate.** In particular, the committee’s clear recommendation that the RBI create a specific category of NBFC MFIs and regulate them directly recognizes such institutions as an integral part of the financial system. It is, thereby, **a measure that could have a far-reaching beneficial impact in furthering financial inclusion in India.**”

However, in some of its other proposals **the committee’s focus on crisis management has perhaps diverted it from the opportunity to take a potentially broader view of financial inclusion.** In that sense this is an opportunity missed.”

The purpose of this supplementary note is to suggest some measures that the RBI can take to regulate microfinance, preventing some of the issues that have arisen in recent years while at the same time making a dynamic effort to promote financial inclusion using more sophisticated, twentyfirst century tools, than those proposed until now.

M-CRIL would like to make the following suggestions

1 Employ Basel II principles for facilitating financial inclusion – establish district wise risk weights for the purpose of determining capital adequacy

One of the critical issues that has arisen in the operations of MFIs in India in recent years is that they have attempted to grow fast in their core markets comprised of selected districts of Andhra Pradesh, Karnataka, Tamil Nadu, West Bengal and Orissa to the neglect of underserved districts in these states and also of much of the rest of the country. While the past three years have seen an expansion of microfinance operations in some of the other major states, even there the focus has been on a few key districts such as in and around Lucknow-Kanpur and Varanasi-Allahabad in UP to the exclusion of some of the more remote parts of the eastern UP region; much of Jharkhand and Chattisgarh remain underserved for the same reason. The key question in this context is **how to encourage MFIs to work in underserved areas** while discouraging them from working in already well served pockets of the country.

For this purpose, M-CRIL recommends the application of the Basel II principle of allocating risk capital according to the risk profile of the borrowing entity. Since microfinance has millions of borrowing entities (individual households) it would be impossible to do this for each borrower. It is for this reason that the RBI has categorized personal loans by commercial banks into a “regulatory retail” category and allocated a standard risk weight to the portfolio.

M-CRIL proposes that this principle be used to allocate separate risk weights to lending by NBFC MFIs in different districts of the country as shown in **Table 1** on the following page. The principle here is

- Any microfinance borrower in a particular district presents a similar risk profile to another borrower in the same district
- District-wise risk profiles can be established – from a microfinance perspective – by determining the financially excluded population of each district (Column E of **Table 1**) and relating it to the number of microfinance loan accounts in that district (Column F).
- The **risk weight** (Column G) is then the **proportion of coverage of the financially excluded** population by microfinance
- Since district-wise **financial exclusion** figures may not be available, this could be taken as **twice the poverty ratio** for that district (as determined by the national poverty line, Column C) on the basis that the national poverty ratio is around 30% while the national financial exclusion ratio is widely believed to be around 60%
- **Microfinance coverage** would be taken to be the **number of loans made by all reporting microfinance institutions** (regulated NBFCs, reporting NGOs and SHG loans as reported by banks). In the new regulatory framework, all such institutions would be required to provide district-wise microfinance lending information (number of loans and outstanding portfolio) to the regulator on a quarterly or six-monthly basis.

The capital requirement of the concerned MFI could then be calculated as shown in **Table 1**. As the illustration in the table shows, if an MFI were to re-orient its portfolio to work in districts with lower microfinance coverage relative to financial exclusion it would need ~30% less capital (in the illustration) than if it insisted on carrying on working in saturated districts.

Risk weights and the required capital could be recalculated every year in December based on the number of loan accounts on 30 September and the capital requirement would need to be met, based on these risk weights, by 31 March. Thus, **this application of the Basel II principle would incentivize MFIs to work in less well served districts and would, thereby, promote financial inclusion.**

The risk weights can be further adjusted for local conditions – such as terrorism or flood prone/scarcity prone districts – if it seems appropriate. The additional benefit of this district-wise reporting is that it would create a database of financial inclusion in the country – including identifying areas of excessive concentration and under-served areas. Accurate information of this type is not presently available. District-wise reporting can easily be undertaken by MFIs with a small adjustment in their MIS.



Table 1

Calculation of capital requirement for alternative distributions of portfolio based on the financial exclusion levels of districts
 (all numbers below are illustrative)

State	District	Population 2010	Families	Poverty rate	Fin excl, proxy	Excl families	No. of loan a/cs	Risk weight	MFI's portfolio	% of portfolio	CAR @15%
			5.3 persons per hh	National Poverty Line	2x				Rs lakhs		
		A	B	C	D	E	F	G	H	I	J
Basic scenario where the MFI works extensively in financially over-served districts – it needs 30% more capital to operate there											
Haryana	Gurgaon	2,500,000	471,698	20%	40%	188,679	125,000	66%	300	22.5%	29.81
AP	Guntur	1,200,000	226,415	30%	60%	135,849	275,000	202%	500	37.5%	151.82
Karnataka	Kolar	1,000,000	188,679	40%	80%	150,943	230,000	152%	300	22.5%	68.57
UP	Gorakhpur	2,100,000	396,226	40%	80%	316,981	120,000	38%	160	12.0%	9.09
Jharkhand	Godda	900,000	169,811	45%	90%	152,830	30,000	20%	73	5.5%	2.15
									1,333	100.0%	261.44
					Capital at standard 100% risk weight				200		
Alternative scenario where the MFI has the same portfolio without needing to increase capital – leading to greater financial inclusion											
Haryana	Gurgaon								510	38.3%	50.68
AP	Guntur								290	21.8%	88.06
Karnataka	Kolar								200	15.0%	45.71
UP	Gorakhpur								210	15.8%	11.93
Jharkhand	Godda								123	9.2%	3.62
									1,333	100.0%	200.00

2 The Malegam Committee has recommended the establishment of a separate category of NBFCs undertaking microfinance (to be called NBFC MFIs) *to facilitate the development of specific regulatory norms for the category.*

Such **specific regulatory norms** could include

2.1 MF NBFCs to be defined as NBFCs with 65% of their assets in micro-loans (<Rs50,000) and at least 50% of their income derived from direct microfinance activities – as suggested by MFIN.

2.2 The establishment and rigorous application of the principle of “fit and proper” criteria for both board directors and senior managers to ensure socially responsible governance of MF NBFCs in a framework of steady rather than frenetic growth. This could be supplemented by specific guidelines for reporting by MFI managements to the board.

3 Deposit taking by microfinance NBFCs

In the context of events in the mid-1990s, the RBI’s concerns about deposit taking by NBFCs are well grounded. However, microfinance NBFCs work with a completely different set of clients from those served by the likes of the erstwhile CRB Caps. Since the practice of microfinance is undertaken as a credit-only activity both MFI staff and clients see the MFIs as benefactors and clients as recipients. This uni-dimensional relationship is one of the factors that has vitiated the relationship between MFIs and their clients. The provision of licences for limited deposit taking would benefit

- a The MFI-client interaction by creating a two way interaction where the MFI is also partly dependent on its relationship with clients to generate funds for intermediation.
- b Client families by providing them with an option to undertake some savings in a more reliable way than stuffing money in mattresses or earthen pots, subject to the vagaries of thieves and the weather.

This would entail special provisions for **deposit taking by NBFC MFIs** classified above investment grade by qualified **microfinance rating agencies** (see below). The extent of deposit taking allowed could be as follows

Rating grade from qualified microfinance rating agencies	Rating grade	Limit of customer deposits as % of microfinance loan portfolio
Any form of “B” grade rating	B, B+	No deposits
Lowest A grade financial rating – with minus suffix + at least a social rating undertaken	A–	50
A grade financial rating – without minus & at least A– social rating	A	70
A rating – with plus suffix & an A grade social rating	A+	80

* the purpose of the social rating is to ensure transparency and client protection

With the provisions that

- **Deposit taking would be only from borrowing customers** and not from the general public
- **No individual's deposit should exceed twice the size of the maximum loan** disbursed to her/him from the MFI within the past 3 years and repaid in the normal course (in not less than 70% of the normal loan period)
- The interest rate on passbook deposits should not exceed the commercial bank passbook rate by more than 1.5% and on contractual (fixed) deposits should not exceed the MFI's average commercial bank borrowing rate minus 5%.
- And the MFI should refund the deposits (with interest) of any individual whose savings account registers no activity (no deposit and no withdrawal) for over 12 months after repaying the final instalment of the previous loan.

These provisions will guard against the establishment of pyramid schemes by MFIs and the payment of excessive rates of interest on deposits in order to maximize deposit collection. This will also ensure that MF NBFCs have a healthy mix of deposits and borrowings in their funding base, whilst deepening financial inclusion through deposit services. It will also, incidentally, reduce the cost of funds for MFIs enabling the resulting savings to be passed on to microfinance customers.

The requirement of equity will continue to be ensured via the risk-weighted capital adequacy norms normally fixed by the RBI – currently requiring NBFCs to reach 15% CRAR by end-March 2011.

4 Certification of qualified rating agencies for microfinance

Rating agencies with analysts who have at least 5 years' knowledge and experience of working with or undertaking extensive research of the operational, social and financial performance of microfinance institutions (MFIs) should be certified as "qualified" rating agencies for microfinance.

To be classified as a microfinance rating agency at all, the organization would need to be recognized for the purpose by a well respected **international microfinance rating fund** that understands issues related to the competence of agencies engaged with microfinance – such as the erstwhile rating fund of CGAP (World Bank affiliate) or currently of ADA (Luxembourg). The microfinance analysts should have knowledge of and empathy with the objectives and working systems of MFIs and the lives and livelihoods of microfinance clients. **Mere knowledge and application of the general principles of rating in a corporate context cannot be sufficient for rating MFIs since there are microfinance-specific factors** (such as the issue of multiple lending and the diversity of client markets) **that need to be understood.**

One of the reasons for the current crisis is that **SEBI-recognized raters** accredited by RBI (for Basel II purposes) but **with little specialist knowledge of microfinance have given good ratings to institutions with inappropriate operational strategies from a microfinance perspective.** They have done this on the basis of the satisfactory historical performance of

MFIs rather than on an understanding of the MFIs' relationships (or lack of these) with their clients. Thus, all manner of commercial papers are currently being rated highly *without any reference to the underlying microfinance portfolio*. It is well known that it was the rating of CDOs in this manner by international rating agencies (without reference to the quality of the underlying portfolio) that was partly the cause of the global financial crisis. The rating of MFIs needs a deeper understanding of the quality of governance and management of such institutions than corporate rating agencies are normally in a position to develop. It is only specialist rating agencies that can do this.

Key issues that are often missed by (corporate) rating agencies that do not fully appreciate the nuances of microfinance are

- failure of MFIs to adhere to basic client protection principles,
- the need to focus on the quality of governance of MFIs, and
- the most basic concern about multiple lending and over-indebtedness.

These are issues that cannot be addressed via mere desk based analysis of financial statements. **M-CRIL** covers such issues via its social rating and **is currently working with a global initiative to develop an enhanced credit rating that combines core social values with a more conventional financial rating analysis.**

The net result of the conventional corporate rating approach has been more and more bank funding pouring into MFIs that have been expanding on the basis of staff “poaching”, client “poaching” and multiple lending rather than through widening the market base and serving the objective of financial inclusion by reaching new low income clients. Thus, **a separate accreditation system is required for the rating of MFIs taking into account the rating agency's knowledge of microfinance.**

5 Classification of loans to MFIs as “priority sector lending”

The basic objective of Priority Sector Lending (PSL) norms is to ensure the flow of credit to important sectors of the economy which would otherwise either be denied credit or would not receive an adequate quantity of credit. Going by this principle, lending by banks to MFIs has a good reason to qualify as PSL since it serves low income women (in particular) with small loans that could not and would not otherwise be provided by the banking sector. Clearly, **direct loans by banks to NBFC MFIs should qualify as PSL.**

However, a feature that has contributed to the turmoil in the sector is the practice of **sale or securitization of microfinance portfolios by MFIs to banks.** In this situation, the microfinance portfolio sold continues to be managed by the MF NBFC in return for a service charge while being held, for accounting purposes, as an asset on the balance sheet of the bank.

This latter transaction usually happens in the last quarter of the financial year when commercial banks want to increase the proportion of their portfolios qualifying for PSL. MFIs are happy to sell a part of their portfolios in this way because it enables them to increase the size of their operations without having to raise additional capital to satisfy the

prudential capital to risk weighted assets ratio (CRAR) set by the RBI. ***This is a form of regulatory arbitrage at both ends of the transaction;*** the commercial bank has done little to augment financial inclusion while the MFI has been freed from the restraints on growth imposed by the CRAR requirement. It is apparent that **such transactions should not qualify as PSL**

Conclusion: M-CRIL believes that the RBI has the expertise and commitment to financial sector development that is the essential pre-requisite to ensuring orderly growth and enhancing real financial inclusion. To the extent that staff understanding of specific microfinance conditions needs to be augmented, M-CRIL would be happy to apply its experience and knowledge to provide any support that is useful.