

Submission to the RBI Sub-Committee of the Central Board of Directors to Study Issues and Concerns in the MFI Sector

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Micro-Credit Ratings International Limited, M-CRIL

M-CRIL is the world leader in the rating of microfinance institutions (MFIs). By December 2010, M-CRIL had undertaken around 700 financial and social ratings and assessments of around 400 institutions covering 32 countries of Asia, Africa and Europe.

M-CRIL was the pioneer in the rating of MFIs in India; it has been engaged with Indian MFIs since 1998 when the Indian microfinance sector was in its infancy. As a result M-CRIL has rated practically every Indian MFI of a significant size several times over the past few years. Resulting from this, **M-CRIL's knowledge of Indian microfinance is unparalleled by any research or assessment agency.**

Using this knowledge, M-CRIL has been publishing a periodic review of Indian microfinance regularly since 2001. The most recent review, **M-CRIL Microfinance Review 2010** was published in November 2010 and **contains a comprehensive overview of the operational and financial performance of Indian MFIs** in recent years. It undertakes both an analysis of Indian MFI performance over time and a comparison with microfinance in countries such as Bangladesh as well as with benchmarks for South Asia, all of Asia and the global industry.

M-CRIL Managing Director, Sanjay Sinha, has been a leading commentator at conferences and in newspaper columns (mainly The Economic Times and recently in a letter published in The Economist) on performance and trends in Indian microfinance. Most notably, in numerous conferences and recent writings, over the past couple of years, he has **warned of the dangers for the future of the industry resulting from uncontrolled growth shifting the focus from clients to an ethos of promoter hubris and self-enrichment.** Not surprisingly, in recent weeks commercial banks have returned to recommending M-CRIL as their preferred rater for the rigour of its analysis and its more prudential standards than others.

Submission to the Committee in relation to its Terms of Reference

1 Review the definition of Microfinance and Microfinance Institutions for the purpose of regulation of non-banking finance companies (NBFCs) undertaking microfinance by the Reserve Bank of India and make appropriate recommendation

As suggested by MFIN (below):

- Loans to individuals not exceeding Rs50,000 per borrower
- Loans to micro-enterprises, not exceeding Rs2 lakhs
- Loans to housing in line with National Housing Bank limit for EWS
- Micro-savings up to a limit of Rs50,000
- Remittance services up to an amount of Rs10,000 per transaction

- Distribution of financial products such as micro-insurance, micro-pensions, SIPs of mutual funds and so on according to definitions established by those separate regulatory authorities

2 Examine the prevalent practices of MFIs in regard to interest rates, lending and recovery practices to identify trends that impinge on borrowers' interests

The recently published M-CRIL Microfinance Review 2010 contains a detailed analysis of these issues. It makes two key points

- (i) **MFIs have failed to serve fully the interests of most microfinance borrowers since they have limited their loan sizes** to a level that is no more than 12.5% of India's GNI per capita (average outstanding loan <Rs8,000 at the end of March 2010). This compares with the average microfinance loan outstanding of Rs3,700 in March 2002, amounting to 18% of GNI per capita at that time. This means that **Indian microfinance provides a financial facility in 2010 that is one-third less useful than that provided in 2002.**

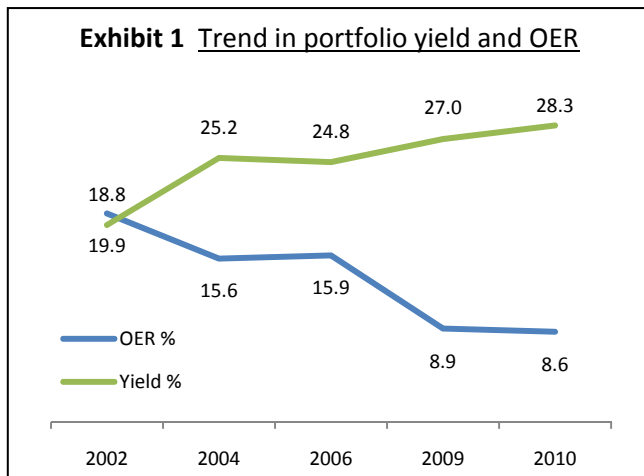
While limiting the loan size reduces risk to a given MFI from an individual borrower, by failing to meet the borrower's needs it pushes her into the arms of other MFIs at the same time, thus *promoting a culture of multiple borrowing (and multiple lending by MFIs)*. It is this multiple borrowing that can lead to **borrower over-indebtedness**.

When combined with a **culture of zero tolerance of delinquency**¹ (and no restructuring) prevailing in most MF NBFCs, borrower over-indebtedness leads to MFI loan officers engaging in overbearing (though not necessarily coercive) behavior at the interface with borrowers. The fact that MF borrowers are predominantly women and loan officers are mostly men, overbearing behavior is sufficient to create the perception of coercion in the microfinancial system.

Part of the solution to this problem is for microfinance to operate in a less frenetic environment in which steady growth is pursued in preference to hectic expansion. This would enable MFIs to train their staff better to understand their customers better, create relationships with clients and undertake more informed appraisals of their credit absorption capacity and broader financial needs. Naturally loan disbursements of the order of Rs40,000 need better appraisals than loan disbursements of Rs12-15,000. Larger loans would not only be better at meeting the needs of most borrowers, greater time spent in establishing relationships with borrowers would help to **alter the culture of money retailing rather than relationship building that currently prevails in the industry**.

¹ Discussed in some detail in Sanjay Sinha, 2010. **How to Calm the Charging Bull: An agenda for CGAP in the Decade of the "Teenies"**, *Microfinance Focus*, 15 June.

(ii) The portfolio yield (the effective interest rate actually recovered from borrowers) has increased significantly from 24.8% (around 2006) to 27.0% (including managed/secured portfolio) in 2008-09 and **28.3% for Financial Year 2009-10** (see Exhibit 1). This has happened largely because of changes in fees charged and sometimes on account of a change in the loan term. Nevertheless, the average yield earned by MFIs in India is still lower than the Asian and global medians of 29.1% and 31.1% respectively (see table).



When compared with moneylender rates of 30-72% in different parts of India and consumer finance rates of 24-30%

charged even by established commercial banks for much larger loans, it is apparent that Indian MFI rates of interest are not exorbitant.

Region	Yield	OER
South Asia	22.9	13.3
Asia	29.1	17.2
Global	31.1	20.0

At the same time, as Exhibit 1 shows, the average operating expense ratio (sometimes known as the administrative charge) of microfinance lending in India has declined dramatically over the past few years from around 15-16% in the middle of the decade to just 8.6% in 2009-10. As a result there has been a substantial widening in the margin available to the average MFI for covering financial expenses, loan loss provisions and surplus. While this could be seen as the achievement of economies of scale by Indian MFIs, as argued above, it has happened partly at the expense of larger numbers of clients/loan officer (average in excess of 400 per loan officer and for some MFIs as high as 700), and correspondingly weakening relationships between MFIs and their customers; a phenomenon that is largely responsible for the current crisis.

Research also shows the importance of microfinance in income smoothening for the borderline poor. Microfinance has the potential (much more so than banks) to respond more flexibly to the financial needs of poor households; it can only do this by a better understanding of clients, and through a greater willingness to diversify products than has been the case until now.

This emphasises the point made above that the relationships necessitated by a larger loan size, while taking more staff time would actually help to balance the OER more correctly since fewer customers would need to be targeted by each individual loan officer. In the long run, a larger average loan size would also help to control the cost of credit to microfinance borrowers by garnering real economies of scale at the level of the individual loan.



While interest rate controls would be counter-productive and costly to monitor, there is a case for requiring transparency about the real cost of credit. Specific suggestions in this regard are made in point 5 below.

3 Delineate the objectives and scope of regulation of NBFCs undertaking microfinance by the Reserve Bank and the Regulatory Framework needed to achieve those objectives.

Objectives and scope of regulation of NBFCs undertaking microfinance

“To promote the provision of financial services to microfinance clients (as defined under 1 above) and to facilitate the expansion of such services to all parts of the country so as to enhance the degree of financial inclusion in the country”

Regulatory Framework needed for this purpose

The **establishment of a separate category of NBFCs undertaking microfinance** (perhaps known as MF NBFCs) *to facilitate the development of specific regulatory norms for the category*

Such **specific norms** could include

- 3.1 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.
- 3.2 The establishment and rigorous application of the principle of “fit and proper” criteria to ensure socially responsible governance of MF NBFCs in a framework of steady rather than frenetic growth.
- 3.3 Special provisions for **deposit taking by MF NBFCs** 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 + A grade social rating	A+	80

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

With the provision 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 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.

3.4 Recognition of qualified rating agencies for microfinance: 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 either by SEBI or 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) **that need to be understood.**

One of the reasons for the current impasse 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.

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

- non-adherence by MFIs to some 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 the social aspects with a more conventional financial rating analysis.**

The net result of the conventional 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.**

4 Examine and make appropriate recommendations in regard to money lending legislation of the States and other relevant laws to NBFCs/MFIs

As RBI-regulated entities operating on a pan-India basis, MF NBFCs should be exempted from the state level Money Lending Acts. We agree with the submission of MFIN in this matter

- The state level money lending laws are designed to protect undiscerning borrowers from abusive lending and collection practices by unregulated lenders. NBFCs, by contrast, have to follow the strict prudential, disclosure and governance norms specified by the RBI; there is little purpose in introducing a duality of regulation in the matter leading to multiple reporting, poor information sharing and turf battles amongst regulators.
- MFIs as financial institutions, as opposed to informal lenders, need sophisticated regulatory norms and experienced regulators/supervisors with an understanding of their operations. A varied and changing legal regime across states and populism in governance at the local level would have a destabilizing effect on the sector.
- Since microfinance affects a large proportion of the population and can play a crucial role in their economic lives, in most countries it is the central bank that regulates microfinance. In India, microfinance has a real and/or potential role in the lives of more than 60% of the population. Even today, **the outreach of microfinance exceeds that of all Regional Rural Banks together** and constitutes a substantial proportion (40%) of all formal loans of value less than Rs25,000. **Microfinance is, thus, an increasingly important part of the financial system and should be given due importance as part of the national mainstream,** deserving regulation by the country’s central bank.



5 Examine the role that associations and bodies of MFIs could play in enhancing transparency disclosure and best practices

As the two main associations of MFIs, both MFIN and Sa-Dhan have put in place transparency and disclosure processes and have also introduced Codes of Conduct for their members. MFIN has also instituted an Enforcement Committee for its Code of Conduct. The efficacy of these measures is yet to be seen.

A helpful measure could be to require all regulated MFIs to **report full pricing details** of their products to one of the above two associations who would, in turn, be required to publish the information on the following format

Name of MFI	Product (s)	Interest rate charged	Loan term and period of payment	Other linked charges	Effective interest rate EIR*

*on the basis of declining balances

The **expertise necessary for calculating EIR in a standardized manner is not commonly available**. Either the associations employ trained staff specifically for this purpose or, since this could not be a full time activity, an agency such as M-CRIL specializing in microfinance analysis could be outsourced the work of monitoring the EIR for the associations to publish on their websites. Please note that the impetus for this to happen systematically will need to come from the regulator.

Some supervisory roles could also be delegated by the RBI to selected industry bodies. As a highly respected agency with an *international reputation* for integrity and technical competence, M-CRIL would be happy to perform some delegated supervisory functions. Through its understanding of sector-specific issues, M-CRIL is in a position to support the RBI in discharging its regulatory responsibilities.

6 Recommend a grievance redressal machinery that could be put in place for ensuring adherence to the regulations recommended at 3 above

The MFIN recommendations for setting up multilingual helplines for customers in each state and a Lok Adalat type body seem most appropriate.

7 Examine the conditions under which loans to MFIs can be classified as priority sector lending and make appropriate recommendations

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 MF NBFCs 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 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**

8 Consider any other item that is relevant to the Terms of Reference

We are in agreement with the MFIN suggestion that based on the experience in AP in 2010 (and in the Kolar area of Karnataka in 2009), the committee could consider recommending amendments to the RBI Act which specifically prohibit and penalize persons engaging in actions that are tantamount to encouraging credit indiscipline and lead to mass default.

It would also be pertinent to point out that **a more balanced microfinance product offering that combines deposits with loans** and is linked with insurance services, **reduces the risk of mass default.** Having customer money (partly) financing loans would result in microfinance clients being more prudent in their approach to participation in populist calls for mass default.