

Beneficial in scope but micro-measures limit impact on financial inclusion

Comments 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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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 some 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.**

Comments on the Recommendations of the Malegam Committee

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 following are some specific comments within this broad framework.

1 Definition of microfinance clients as those with annual income of less than Rs. 50,000 – will exclude large numbers of low income families

According to NSSO survey data, and allowing for inflation, this measure limits the outreach of microfinance to 50% of the population in rural areas and 20% in urban areas at 2008-09 prices. At March 2011 prices, with food inflation running at 15-20% over the past few months, this brings the proportion of population likely to be covered by the definition down to about 45% and 18% at best. Yet, we know from estimates by organisations such as the World Bank that the level of financial exclusion in India is of the order of 60%. What then, is to happen to the 20% or more of the population that is classified as non-poor but is still financially excluded? Recent research, and not just in India, has conclusively established that microfinance provides its greatest service in facilitating the lives of the financially

excluded non-poor and the upper layer of poor just below the poverty line. The poorest sections of the population are widely believed to need asset transfers and extensive hand-holding to raise their incomes closer to the poverty line.

With inflation always an uncertain factor in economic policy making, it would be far better to classify microfinance by loan size, index linked to consumer price indices. To assess the depth of outreach of MFIs, they could be required to undergo the social performance ratings that are now offered by M-CRIL and others as a product that covers (amongst other aspects of responsible finance) the Progress out of Poverty Index (PPI) to assess access by poor households and focus groups to obtain client feedback on products and services.

2 Cap of Rs. 25,000 as the maximum loan amount – *needs to be customised regionally and adjusted for inflation*

The limit of Rs25,000 on the extent of borrowing by individual households appears to be very low. If microfinance borrowers today take 3-4 loans each from different MFIs, it is because their financial needs are not fulfilled by the loan size restraints of individual MFIs. Borrowing to the extent of Rs30-40,000 found in areas like Kolar and other districts of southern Karnataka indicates that this is the level needed by many microfinance borrowers. The key is not the loan size but the loan appraisal. Routine disbursements of Rs12,000 each by 3-4 MFIs to a single client vitiate the credit environment in that there is no loan appraisal, only a loosely applied group guarantee. The same overall amount provided by a single MFI would need a proper loan appraisal resulting in a better assessment of customer needs.

A loan size cap is further complicated by the fact that client needs differ in different parts of the country; a Rs7,000 monthly income in Mumbai may well be less in real terms than a Rs4,000 monthly income in Jharkhand. The needs of microfinance borrowers in each region would also be different. In this age of computers, **it would not be so difficult to fix a loan size cap at, say, Rs25,000 in the poorest state, Bihar, while using state rural and urban per capita incomes to revise it upwards for other states** with a special dispensation for the top 15 cities in the country. These numbers could be index linked to the consumer price index for agricultural labour for rural areas and for urban manual workers for urban areas. A once a year revision would be sufficient to ensure that MFIs adequately address clients' needs.

3 Cap of only two lenders (1 MFI + 1 SHG or 2 MFIs) – *should not be necessary*

Given the need for larger loans than have been given by MFIs until now, clearly the number of lenders to an individual client needs to be limited. The ideal is for a single MFI to undertake a proper loan appraisal and give larger loans that satisfy the needs of the client. This will entail changing the business model and will need staff training (in loan appraisal) and adaptation of control systems to implement. With the establishment of credit bureaus, individual client needs will become clearer and **it is for the regulator and industry networks such as MFIN/Sa-Dhan to implement their codes of conduct** to persuade their members to change their business model and certainly to establish that they are not causing over-indebtedness. In the short term, such a low cap (Rs 25,000 proposed) will result in credit rationing and consequent loss of business for significant numbers of micro-borrowers.

4 Pricing cap (lower of mark-up of 10% / 12% and 24% interest) – *is restrictive and difficult to implement*

All over the world, pricing caps have become discredited as a means of consumer protection. India's own experience shows that such caps result in no more than credit rationing leading to increasing financial exclusion of the small customer who is more costly to serve. We know that commercial banks never lent to the poor because of pricing caps. It would be ironical if within a year of RBI removing interest rate caps on priority sector loans, the caps were to be re-introduced for MFIs. Even commercial banks, have 24-30% interest rates on small size personal loans even though they do not provide the convenience of doorstep collection and loan amounts are usually above Rs. 25,000.

As a rating agency, M-CRIL is acutely aware of the fact that attempts to introduce such caps can result in significant manipulation of loan terms and membership conditions. This situation will lead to less transparency in pricing than there is today rather than more.

The key is for there to be transparency: the RBI should establish a standard method of calculating effective interest rate (EIR) and administrative charges on other financial or non-financial services should also be fully revealed so that all MFIs are put on a comparable platform. As a rating agency, M-CRIL has been calculating EIR on an internationally acceptable formula for years and has also insisted on a transparent presentation of other charges in its rating reports. This could be standardised across MFIs.

5 Net Own Funds of Rs. 15 crores and the requirement that smaller NBFCs not undertake microfinance beyond 10% of their assets – *does not conform with the spirit of financial inclusion*

There is clearly a conflict between this provision and the Committee's intention that microfinance be undertaken by socially minded professionals. Such a large amount of start-up capital is generally not available to this class of people. This provision effectively closes the door on new entrants with a social purpose and becomes an invitation to commercially minded large companies to enter the business. The net result would be a totally commercial approach to microfinance with no social or developmental intent. The removal of smaller NBFCs from the industry would both cause a setback to microfinance in both the less well served areas of the country and would also reduce competition, strengthening the existing tendency to oligopoly. **The recommendation does not conform with the spirit of financial inclusion.**

6 Customer protection and recovery only at Centres, not at home or workplace – *unnecessarily micro-manages a business relationship*

This recommendation goes against the interests of both the MFI and the borrower. Doorstep collection is one of the key facilities that the MFI offers to a low income customer. To confine microfinance to collection centres is to negate this benefit for the customer. It will only hamper the business model and retard financial inclusion. The issue in collections is not the collection venue, it is over indebtedness; the committee has made sensible

suggestions on the implementation of codes of conduct, grievance redressal and establishment of ombudsmen. It is important for customer protection that Industry Associations and the Bankers Forum play a more proactive role to ensure that MFIs are being socially responsible. Not visiting clients at odd hours is already part of the RBI guidelines for banks and NBFCs. **Regulation and codes of conduct should focus on these consumer protection measures not micro-management of the business relationship between borrower and MFI.**

As an additional measure, MFIs could be required to conduct annual independent Customer Satisfaction Surveys through well known social / qualitative research agencies with the report to be published on their websites and submitted to the RBI.

7 Loan tenure vis a vis loan amount – *affects the business model*

This is again a case of micro-management and affects the business relationship between the lender and borrower; what if a borrower needs a four month loan? Most loans in the more developed urban microfinance market in Latin America have a four month tenure.

Regulation should focus on transparency of communication so that a conscious choice of loan size, loan tenure and other loan conditions is made by the borrower. It should not mandate the business relationship.

8 75% of loans for productive purposes

It is a simple law of economics: money is fungible, it is impossible to monitor this condition. It should, therefore, be dropped.

9 Centralized loan sanction and disbursement

No significant purpose is served by this condition. The key to good lending is to provide an adequate loan size based on good loan appraisals. The MFIs need to provide for individual lending, to train their staff to undertake good appraisals and introduce control systems that are designed to address the changed business conditions that this will result in.

10 Limitation on income from non-credit business avenues – *is unnecessary at present*

Microfinance should, first and foremost, be about financial inclusion not just credit. NBFC MFIs should ideally be allowed to collect deposits (up to strict limits and under restrictive conditions suggested by M-CRIL in its submission to the Committee). They should also be encouraged to expand the coverage of insurance services though this activity should not become a conduit for collecting substantial administrative charges. Insurance companies using MFIs as their distributors and/or agents could be required to ensure that the additional charges are not excessive but are commensurate with the service provided by the MFI for distribution. MFIs should also be encouraged to introduce other financial services such as remittances and payments to facilitate the lives of low income families.

As to non-financial services, there has been much talk of MFIs becoming distributors of large companies; some trials have been conducted but there has been little success. In practice, financial services are sufficient to keep MFI staff occupied, the scope for learning additional marketing skills is quite limited. **The limitation is unnecessary at the present time as non-financial services are unlikely to be provided by MFIs in any significant way.**