M-CRIL Brief, June 2021

RBI Consultative Document on the Regulation of Microfinance

Welcome ideas on creating a level playing field

The RBI's consultative document on the regulation of microfinance released on 14 June 2021 is a welcome initiative that gives serious consideration and takes an analytical approach to the issues affecting microfinance lending in India. In this commentary M-CRIL sets out the proposed new regulation briefly and makes an alternative suggestion.

Relying on *laissez faire* to create a level playing field…

The extant regulation requires NBFC-MFIs to follow myriad rules on loan size, interest rates and household income for lending to micro-borrowers. Commercial banks, Small Finance Banks (SFBs) and even non-microfinance NBFCs not seeking to borrow from others under the priority sector classification do not have to follow these rules. Yet, according to industry data collected by the microfinance networks, NBFC-MFIs accounted for just 31% of the portfolio at end-September 2020 compared to 41% by the commercial banks and nearly 19% by SFBs. Thus, MFIs faced an uphill playing field while other types of microfinance lenders were virtually cruising downhill with no interest rate ceilings to be determined unlike the formula based on the average base rates of the five largest commercial banks, controls on loan tenure and repayment frequencies applied to MFIs. The key point of the new regulation is that all these rules, bar one, are removed and the playing field has been levelled; it is *laissez faire*.

…but are the various types of microfinance lenders in a position to implement the remaining requirement or will it continue to be a "straw in the wind"? It is impossible to get reliable information on household income and also on the actual indebtedness of micro-borrowers

The one remaining regulation now requires all microfinance lenders (including commercial banks, presumably) to assess the borrowing household's income to ensure that the financial payment obligations of the borrower for loans from any source do not exceed 50% of that income. Interesting, since it is currently done by MFIs mostly in theory as a straw in the wind; microfinance field staff simply do not have the training or knowledge to undertake it with any degree of accuracy. What's more, due to the manner in which credit bureaus operate, it is impossible to get reliable information on the actual indebtedness of micro-borrowers. Not only is credit bureau information on micro-borrowers incomplete due to the lack of information on lending by SHGs and financial cooperatives, but the bureaus themselves have differential charges for queries about MFI borrower indebtedness and that of borrowers of other lenders (commercial banks, SFBs, non-microfinance NBFCs). The large gap between the two charges, ₹30 for a commercial lending query compared to ₹3 or less for a microfinance lending query means that MFIs go no further than enquiring about lending by other MFIs in order to satisfy the extant regulation of lending by no more than two NBFC MFIs to a single borrower.

The dense forest of niggling rules having been set aside, the rule requiring repayments not to exceed 50% of household income should be replaced by the two-lender rule for all lenders; the focus should be on consumer-friendly regulation and the promotion of proper underwriting in a knowledgeable lending environment

As a concerned specialist advisory agency for microfinance, M-CRIL has, for many years, recommended to microfinance lenders that they should undertake proper underwriting for larger loans (in excess of ₹50,000). This entails not only assessing household income in a knowledgeable way – though it will still be imprecise – it also entails understanding the economics of the enterprise or other activity for which the loan is taken. Clearly, this would be uneconomical to do for the current average microfinance loan in the ₹30,000 to ₹50,000 range. But there are few households remaining whose net borrowing is still in this range. It is well known that lending by MFIs at this level is a convenience that eliminates the need for MFI-level under-writing by limiting the risk exposure of the lender to any one household. But ultimately, this leads to a large (but indeterminate proportion, we estimate up to 80%) of borrowers having more than one loan and many having three or more loans (including lending by commercial banks, SFBs and the micro-lending SHGs and financial cooperatives) resulting in average indebtedness of micro-borrowers being more in the range of ₹80,000 to ₹1,00,000 with perhaps 20% of borrowers owing much more.

Whether MFI lending to micro-borrower households would satisfy the RBI criterion of repayments not exceeding 50% of household income is impossible to verify due to the informal nature of microeconomics. Instead, the focus should now be on consumer-friendly lending; protection through intelligent underwriting. This will entail applying the condition that the number of loans given to micro-borrowers by all lending entities (whatever their institutional form) is limited to two. Application of the two lender rule across lender types will increase average loan sizes and will, thereby, force a move to proper underwriting that has been avoided by micro-lenders until now. Increased average loan size will also help to address the plaint that proper underwriting is expensive and raises the cost of micro-lending. Implementing this will mean the RBI ensuring the equalisation of credit bureau charges for queries across types of lenders and the stricter application of credit bureau data uploading rules by MFIs and the other commercial micro-lenders referred to above. RBI will also find this easier to apply since its supervision of micro-lenders will focus on adherence to data uploading rules and the use of credit bureau queries for determining household indebtedness rather than attempting to apply a tenuous understanding of household incomes for those who borrow at the ₹30,000-50,000 level.

We believe the RBI has taken a very positive initiative to focus on the big picture of industry promotion. To take this further, **RBI should do away with the repayment limit rule along with the remaining forest of niggling regulation it now proposes to eliminate**. Simple application of the two lender rule as part of its Fair Practices Code for all lenders is more likely to protect the customer; it will go a long way in ensuring the reduction of over-indebtedness and the application of consumer-friendly micro-lending by all types of financial institutions.