A uniform regulatory framework for microfinance sector

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***Abstract* - Microfinance is a form of financial services for poor and low-income households in form of small loans. It is an economic tool designed to promote financial inclusion which enables the economically weak section of society to come out of poverty and improve their overall way of living. The Reserve Bank of India recently issued its Consultative Document on Regulation of Micro finance sector for protecting and empowering low-income borrowers in India by encourage competition among lenders to bring down the interest rates. As per the framework, the micro loans should be controlled by a common set of guidelines regardless of who gives them.**

***Index Terms* - Microfinance, Financial inclusion, Consultative Document, Protecting and Empowering.**

INTRODUCTION

In 2001, when the demands for regulating the MFIs were made, Shri Jagdish Capoor, the then Deputy Governor, stated that "As MFIs are significantly different from commercial banks both in terms of institutional structure and product portfolio, application of the same set of regulatory and prudential guidelines to MFIs, in our view, not only runs the risk of distorting the emerging market but it may also reduce the efficiency of these institutions."
In 2005, when the demands gained momentum, the then Governor, Dr YV Reddy in 2005 stated that "Microfinance movement across the country involving common people has benefited immensely by its informality and flexibility. Hence, their organisation, structure and methods of working should be simple, and any regulation will be inconsistent with the core-spirit of the movement". Thus, RBI had extended every possible support for a financial innovation that was seen as important for furthering financial inclusion in the country.
Recently, the Reserve Bank of India issued its Consultative Document on Regulation of Micro finance sector with the motive of protecting and empowering low-income borrowers in India. With this RBI aims to lift the interest rate cap on Microfinance Institutions (MFIs). As per the framework, the micro loans should be controlled by a common set of guidelines regardless of who gives them. There will be no collateral and pre-payment penalty for all microfinance loans while all entities have to permit the borrowers to repay weekly, fortnightly or monthly instalments as per their choice. The prime objective of this move is to promote financial inclusion of the economically under privileged people and encourage competition among lenders to bring down the interest rates.
The consultative document recommends that the current ceiling on rate of interest charged by Non-Banking Financial Company (NBFC)-microfinance institutions (MFI) or regulated private microfinance companies needs to be eliminated. It recommends that the rate of interest be determined by the governing board of each agency to pull down the interest rates.
For all regulated entities, the Reserve Bank of India has proposed a common definition of microfinance loans. As per the definition, Microfinance loans should mean collateral-free loans to households with annual household income of Rs 1,25,000 for rural and Rs 2,00,000 for urban/semi urban areas. RBI has mooted capping the payment of interest and repayment of principal for all outstanding loan obligations of the household as a percentage of the household income, subject to a limit of maximum 50%. A board-approved policy will be applicable to NBFC- Micro Finance Institutions, like any other NBFC, which is based on the fair practices code, whereby disclosure and transparency can be ensured.
The current regulatory framework for NBFC-MFIs has been designed with the objective of making credit available to economically underprivileged people in a fair and transparent way. The main focus is to ensure borrower's (customer) protection from any sharp practices adopted by the lenders. Though, this framework is only applicable to just 30 per cent of the

microfinance loan portfolio. The concerns of customer protection and also the emerging dynamics in the microfinance sector call for a review of the regulations so that all the regulated entities (REs) engaged in microfinance can only focused on the goal of customer protection within a harmonized and well-calibrated set-up.

The aim of RBI was to address the issues and concerns associated with the over-indebtedness of microfinance borrowers and to control the market mechanism to pull down the interest rates in the microfinance sector while empowering the borrowers to make a fair and informed decision and also ensuring transparency in loan pricing. While introducing lender agnostic and activity-based regulations in the microfinance sector, the Reserve Bank is also mindful of the fact that certain prudential norms specific to NBFC-MFIs should not be harmonized with other REs to address the idiosyncratic risks on account of concentrated exposure of NBFC-MFIs to unsecured microfinance loans. Further, the proposed regulations shall be introduced in a non-disruptive manner and all REs shall be provided with sufficient time to comply with the guidelines post their introduction. With this step RBI can reposed faith in the maturity of the microfinance sector. Here the responsibility to fix a reasonable interest rate on transparent terms is of the institution hence is a forward-looking step.

MICROFINANCE IN INDIA

Even today, around half of the Indian population does not have a basic savings account. This section also requires financial services so that their aspirations can be fulfilled. Microfinance is basically financial service which provides small loans and other financial services to financially underserved. It is a means to promote financial inclusion among the poor and low-income households, which enables to get out of poverty and improve their living standards. It is also an economic tool to achieve national policies which targets financial inclusion, eradication of poverty, women empowerment, aid the vulnerable groups or financially under privileged, and overall improvement in way of living. Microfinance Institutions services include microloans, micro savings and micro insurance. Microfinance sector has grown rapidly over the past few decades and currently it is serving around 102 million accounts (including banks and small finance banks) of the poor population of India.

BACKGROUND IN INDIA

The Self-Employed Women’s Association (SEWA) in Gujarat, was the first initiative to introduce microfinance in India, which established SEWA Bank in 1974. Subsequently, this bank has been providing financial services to individuals who wish to grow their own businesses in rural areas. One such successful initiative is Kudumbashree, the Kerala state’s Poverty Eradication Mission that was launched in 1998. This female-led community organisation of Neighbourhood Groups (NHGs) brings women from rural and urban areas together to fight for their rights and helps empower them. Microfinance sector has full-grown rapidly over the period of time and currently it is serving more than 102 million accounts (including banks and small finance banks) of the poor population in India.

IMPORTANCE OF MICRO-FINANCE

- At present nearly 9% of microfinance is provided by NBFCs, 19% by SFBs and rest 31% alone is provided by NBFC-MFIs.
- Over a period of time, microfinance has become very important in the loan portfolio of poorer rural households.
- Micro-finance loans are of disproportionate significance to the poorest households — to poor peasants and wage workers, to persons from the Scheduled Castes and Most Backward Classes.
- In the 1990s, microcredit was given by scheduled commercial banks either directly or via non-governmental organisations to women’s self-help groups.

MAJOR MODELS OF MICROFINANCE INITIATIVES

- The Grameen Model: The Grameen model has been a case of exceptional success in Bangladesh. It was the innovation of Nobel Laureate Prof. Muhammad Yunus in Bangladesh in the 1970s. It has inspired the creation of Regional Rural Banks (RRBs) in India. The end-to-end development of the rural economy is the primary objective of this model. In India, many organisation have adopted this model with few variations. For example SHARE Microfinance Limited, Activists for Social Alternatives (ASA) and CASHPOR Financial and Technical Services Limited.

- Self Help Groups (SHGs): SHGs is a group of individuals with similar socio-economic backgrounds. These small entrepreneurs come together for a short duration and create a common fund for their business needs. These groups are further categorized as non-profit organisations. The SHG linkage program of National Bank for Agriculture and Rural Development (NABARD) is noteworthy in this regard, as several Self Help Groups are able to borrow money from banks if they are able to produce a track record of diligent repayments.
- Federated Self Help Groups (SHG federations):The Federation of SHGs brings together numerous SHGs. Compared to a single SHG; the federation of SHGs has more than 1000 members. Examples of Federated Self Help Group model in India are PRADAN, Chaitanya, SEWA and Dan Foundation.
- Joint Liability Group: This is usually an informal group that consisting of four to ten individuals who seek loans against mutual guarantee. The loans are usually taken for agricultural purposes or allied activities.
- Cooperative banks
- Rotating Savings and Credit Associations (ROSCAS). E.g.: Chit funds
- Microfinance companies.

RBI'S REGULATORY APPROACH TOWARDS MICROFINANCE

With the prime motive of incorporating the customer centric principles with the operations of NBFC-MFIs, the RBI's regulations have tried to ensure that the product design and service delivery are beneficial for the ultimate customers. With the objective of customer protection and transparency, 'fair practices code' including a proper system of grievance redressal mechanism, has also been set for NBFC-MFIs as majority of the customers of NBFC-MFIs are economically and socially vulnerable.

After the Andhra Pradesh microfinance crisis in 2010, which was due to the irrational exuberance of some MFIs who, in willingness to grow their business, had given a go by to the conventional wisdom and fair practices such as ethical recovery practices and due diligence in lending. RBI had instituted a committee under the chairmanship of Shri Y H Malegam to study challenges and issues faced by MFI sector. Regulatory approach towards microfinance has been largely based on the recommendations of the Malegam Committee.

The key recommendations of the Malegam Committee were as follows:

- Creation of a separate category of NBFC operating in the microfinance sector to be designated as NBFC-MFI.
- Criteria for defining 'microfinance loans' classified as 'qualifying assets'.
- Prudential norms on capital adequacy and provisioning requirements.
- Prescriptions related to pricing of credit in terms of a margin cap and interest rate ceiling on individual loans.
- Transparency in interest charges as well as other terms and conditions of the loan.
- Measures to address multiple lending, over-borrowing and coercive methods of recovery.
- Establishment of a proper system of grievance redressal.

NEED FOR RBI'S CONSULTATIVE DOCUMENT ON REGULATION OF MICROFINANCE SECTOR

- Old rules and regulations: Today, Microfinance Institutions are governed and regulated by NBFC-Micro Finance Institutions (Reserve Bank) Directions, 2011. So the new regulation is very much needed to control misuse and regute Microfinance Sectors properly.
- Increasing number of banks and small finance banks: The number of banks and small finance banks started has increased in Microfinance Sector. At present, only 35% of the Microfinance sector lies with the Micro Finance Institutions, the rest are with banks and small finance banks, which has led to many complications like In 2011 RBI's directions didn't recover around 70% share

in the microfinance portfolio which further resulted into a non-level playing field among the Microfinance Sector.
- The problem of Multiple Lending and Over-indebtedness: Small borrowers are able to get multiple loans from multiple lenders, leading to their over-indebtedness. Also most of the times the loan is not used for productive work.

Thus, a new regulation is much needed, for creating a level playing field that cover all the regulated entities engaged in the microfinance sector.

SIGNIFICANCE OF RBI DOCUMENT ON REGULATION OF MICROFINANCE SECTOR

- Provides an interest rate regulatory system for Micro Finance Institutions: The fair and transparent price mechanism among competitive lenders in the microfinance sector will bring down the interest rates. The regulations provide a better market-based interest system.
- The centrality of the borrower: As per the consultative document, the borrower is at the centre of the microfinance sector. It empowers the borrowers to make wise and an informed decision.
- Deals with over-indebtedness and prepayment penalty: The document mentions that the payment of interest/loan will not exceed 50% of monthly income of the borrower. The document this way protects the microfinance borrowers from over-indebtedness. Further this also aid the borrower by providing greater flexibility in repayment of the loan.
- Helps in financial inclusion: Regulation also helps in financial inclusion as the borrower will have a wide variety of institutions to cater to his needs.
- Provides overall growth of the microfinance sector: With these guidelines, more and more small finance banks and banks can venture into the microfinance sector and provide benefits to a rural and low-income population. This will further pull down the interest rates.

CONCLUSION

The document enhances the role for the regulator as the adoption of Board-approved policies to determine the norms of household indebtedness and to fix a transparent rate of interest by each institution and their implementation need a rigorous supervisory oversight. Further, self-regulatory organisations (SROs) will have to reframe the existing code of conduct in tune with the new guidelines and ensure adherence to these norms. Therefore, finding cost-effective yet accurate ways of capturing this information becomes crucial. Technology service providers could play a crucial role in this exercise and create customised digital architecture for FSPs depending on their specific needs. Eventually, an accurate assessment of household-level incomes would avoid instances of over-indebtedness and ensure long-term stability of the ecosystem.

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