Impact of Policies and Regulations on the Micro finance Sector

MicroSave

Market-led solutions for financial services

Partha Ghosh, Richa Valechha and Puneet Chopra

MicroSave

Market-led solutions for financial services

Impact of Policies and Regulations on the Micro finance Sector

Partha Ghosh, Richa Valechha and Puneet Chopra

Contents

List of Charts, Tables and Acronyms

Exhibits

Tables

List of Acronyms

Acronyms	Expansion
CGT	Compulsory Group Training
GRT	Group Recognition Test
IRAC	Income Recognition and Asset Classification
KYC	Know your Customer
MFI	Micro finance Institution
MPI	Micro finance Penetration Index
MPPI	Micro finance Penetration amongst Poor Index
NBFC-MFI	Non-Banking Finance Companies - Micro Finance Institution
POA	Proof of Address
POI	Proof of Identity
RBI	Reserve Bank of India
SLBC	State Level Bankers' Committee
SRO	Self-Regulatory Organisation

Acknowledgement

This report presents an analysis of the impact of the regulatory regime on the micro finance institutions and their customers. It is based on an extensive research study across the states of Assam, Bihar, Karnataka, Madhya Pradesh and Uttar Pradesh, carried out by a team of consultants from *MicroSave*.

We extend our sincere gratitude to MFIN, MIX, M-CRIL, Access Development Services and NABARD who come up with detailed sector wide reports that provided us with valuable facts and opinions. We acknowledge the cooperation and inputs provided by the management of a range of banks and micro finance institutions that enabled us gain deep insights into their operations and strategy and the impact of the regulatory regime. We thank the clients of the micro finance institutions who participated in the research and provided honest and insightful opinions on a range of areas related to micro finance. We thank our partners in the banking industry who shared their perspective on the subject matter. We thank Smt Meena Hemchandra, Principal Chief General Manager, RBI and Principal College of Agricultural Banking (RBI), Pune and Shri Manas Ranjan Mohanty, General Manager, RBI and Faculty College of Agricultural Banking (RBI), Pune for providing us an opportunity conduct this study and for the support provided to shepherd this report as a knowledge partner.

Executive Summary

0.1 The Andhra Pradesh micro finance crisis and the subsequent regulatory regime had a significant impact on the micro finance institutions and their customers. Stipulation of minimum net owned funds, introduction of the concept of "qualifying assets", strict IRAC and capital adequacy norms, cap on operational income, compliance to credit bureau checks and emphasis on corporate governance for NBFC-MFIs meant only a few who adhere to these covenants would be allowed to continue. More than the need to comply more, it was the impact on growth strategy and marginalising of profits that took the steam out of most of the small and medium scale micro finance institutions. The impact of the regulatory guidelines traversed across the customers and suppliers (banks and institutions financing the micro finance industry).

0.2 This report aims to present a qualitative assessment of the impact of the AP micro finance crisis and the consequent regulation of the sectors (NBFC-MFIs) by the RBI. The report examined RBI's current regulatory guidelines[1] for the NBFC-MFIs and the lapsed micro finance bill 2012[2]. Based on the directions/salient features of these two documents we have sought opinions of micro finance customers, management staffs of MFIs and staffs of banks (lenders to MFIs). Nine MFIs and their customers across five states were covered under the study. Three banks that are major lenders to micro finance industry for the last three years have also been included to understand the supply side perspective.

0.3 Trend in micro credit availability pre and post 2010, in states other than Andhra Pradesh - The study focused on five states, namely Assam, Bihar, Karnataka, Madhya Pradesh and Uttar Pradesh. The findings suggest that money lenders were a main source of micro credit in regions outside Andhra Pradesh prior to 2010. In Uttar Pradesh, respondents opined that they were equally dependent on money lenders as on micro finance institutions. After the 2010 micro finance crisis in Andhra Pradesh an increased focus on portfolios outside the state have resulted in higher penetration of institutional micro credit in most of these states under study. According to our study findings, micro finance institutions are now the preferred source of credit by low income households especially in the states of Assam, Uttar Pradesh, Madhya Pradesh and Bihar. This shift in trend of consumer preference for MFIs over money lenders is in conformity[3] with the Micro finance Penetration Index (MPI) and Micro finance Penetration amongst Poor Index (MPPI) published by Access Development Services. There is however an apparent non conformity of the study results from the MPI and MPPI of Karnataka and of Uttar Pradesh with regards to alternate sources of credit for the period after 2010. The reason

[1] http://rbidocs.rbi.org.in/rdocs/notification/PDFs/43BF010714FSC.pdf
[2] http://www.prsindia.org/billtrack/the-micro-finance-institutions-development-and-regulation-bill-2012-2348/
[3] Except for the state of Karnataka, where our findings differ from those of MPI and MPPI. The difference can be attributed selection of our respondents in the state. Our respondents were mainly those who were associated with institutional credit after 2010.

can be attributed to the group of respondents selected for the study. Overall, the preference for moneylenders has gone down significantly in all the states surveyed, except Uttar Pradesh, where while MFIs have gained ground, moneylenders still seem to have a reasonable hold.

0.4 Loan utilisation behaviour and its implication on regulatory guidelines - The trend amongst customers across the five states studied suggests that productive asset creation for business is the most common purpose for borrowing and utilising micro credit. Utilisation of loans for agricultural purposes and purchase of animals is also common amongst rural customers of Assam and Bihar. This trend affirms sound implementation of the regulatory guidelines by MFIs to lend primarily for income generating purposes.

0.5 Although most MFIs are adhering to the norms of lending for income generating purposes, it was observed that the repayment schedules of the loan products often do not match with the corresponding cash flows of productive activities for which loans are availed. The reason for framing the norms of lending for income generating activities was to protect poor customers from over indebtedness by assuring repayment of debt by cash generated from income. In practice, many of the income generating activities such as agriculture and animal husbandry do not generate instantaneous or continuous cash flows. The repayments in case of such loans is arranged from alternate sources of income or surplus. Moreover, the stipulated period of moratorium (a week/fortnight) although being adhered to, barely serves practical purpose, particularly in case of weekly repayment schedule. Therefore whenever financing of such activities happen through institutional micro credit, the risks or challenges, anticipated to be managed through the guidelines on sound assessment of repayment capabilities might continue to remain unaddressed. At the same time, it would be prudent to acknowledge that matching cash flows from several income generating activities with loan repayment schedules will be impractical and should not be expected of MFIs.

Recommendation 1

We recommend that the regulator stipulate higher emphasis on the quality of credit assessment based on cash flow analysis rather than adherence to minimum moratorium period criterion. This practice will eventually enhance the skills of micro finance institutions and lay the path for scaling up in future.

0.6 The provision of allowing 30% of the qualifying assets to be lent for non-income generating loans has encouraged MFIs to come up with innovative consumption loan products. Several MFIs have designed innovative loan products such as - sanitation loans, loans for purchase of solar products and loans for subscribing to the pension scheme from PFRDA.

Recommendation 2

It is also imperative that MFIs design loan products for planned household expenses. For meeting unplanned household expenses a mix of savings and micro insurance products should be developed by MFIs. Consumers, on the other hand, need to be educated about the importance of savings over micro credit in meeting unplanned household expenses. MFIs themselves, but more importantly regulators, government and multilateral institutions have a vital role in enhancing consumer financial literacy focusing on these aspects.

0.7 Impact of regulations on MFI offerings and consumer perceptions - The overall quality of offerings from MFIs is perceived as satisfactory by most customers. This can be attributed to the implementation of the regulatory guidelines. The customers are satisfied with accessibility of credit and they perceive there has been no significant decline in outreach by MFIs. Most customers also perceive that loans from MFIs have become affordable. In fact many customers are of the opinion that they find loans from MFIs more affordable than from any other source. This is partly driven by the interest rate and the operating margin cap; and partly due to changes in repayment schedules by most MFIs. Most of the small and medium sized MFIs have revised their repayment schedule from weekly to fortnightly, making it more convenient for customers to accumulate instalment amounts and repay. Regulatory emphasis on stringent consumer protection and adequate due diligence measures has led to improvement in relevance of product offered and the quality of services provided by MFIs.

0.8 Dependence of customers on alternative sources of credit and its challenges - A few customers perceive that quantum of credit from institutional sources has declined despite the fact that MFIs have increased credit concentration to existing customers. This "perceived" inadequacy is partly due to limitation in the maximum number of sources of institutional credit that were previously available and partly to the cap in maximum loan maximum household income levels. Consumers also feel that processes have become more stringent and TAT for loans processing has increased. The impact of inadequate supply of low cost institutional credit to meet the demand is evident. Some of them have to resort to costlier alternate sources of credit to meet their requirements. Most often these alternate sources tend to be money lenders.

0.9 Impact of the Andhra Pradesh micro finance crisis on fund mobilisation of MFIs outside Andhra Pradesh - It is widely known that MFIs operating outside Andhra Pradesh too were affected by heightened risk perception of lenders and investors towards this sector. Credit growth to the sector dwindled by 21% in FY11 as compared to FY10 and further by 38% in FY12 as compared to FY11. A large number of small cap MFIs could not cope up with the abrupt discontinuation of funds by banks and had to close down their business, despite no apparent problem with the quality of their portfolios. Downgraded ratings of MFIs by credit rating companies made the situation worse for the smaller MFIs. The lenders adopted more stringent credit terms such as - personal guarantees of promoters, increase in first loss default guarantees (FLDG) and higher cash margin on portfolio despite being aware that these are sub-optimal measures of risk mitigation.

0.10 Impact of paucity of funds on growth of MFIs in states other than Andhra Pradesh - Inadequacy of funds from lenders and investors resulted in immediate withholding of geographical expansion plans of most MFIs. Scarcity of funds forced MFIs to concentrate on incremental build-up of portfolios at their existing branches, with whatever funds they could mobilise. Although, after implementation of the regulatory guidelines the lost confidence has somewhat been brought back to the sector the inflow of capital is not as high as it used to be before 2010. The paucity in capital inflow coupled with restriction on maximum operating margin has constrained the risk taking capacity of most MFIs and thereby restricted expansion of services to underserved markets. Most MFIs fear this situation will eventually lead MFIs jostling for space in highly concentrated markets. A reduced focus on expanding into underserved markets will eventually hurt the broader objective of financial inclusion. Moreover, intense competition will again push some of the small and medium cap MFIs to the brink of extinction.

0.11 Reigning over windfall income: Impact of income caps on MFI operations - The covenant that puts a cap on maximum operating margin has limited institutional capacity to invest in new technology or systems to improve and enhance processes. This is especially the case for small and medium institutions. To arrest the dwindling margin, institutions have adopted several cost reduction measures. Most of them opined that any innovation or enhancements undertaken by them are meant to deliver better services to customers and inadequate funding or reserves in their balance sheets will make it difficult for the industry to innovate and upgrade. Different MFIs view the regulatory regime with respect to pricing differently. They have started devising strategies and investing in innovative systems to reduce operating costs.

Recommendation 3

There is a need to have an incentive structure for MFIs who are ready to explore underserved markets exposing them to financial risk. This could be in the form of flexibility to price services in initial three to four years of operations, by when a typical branch can attain operational self-sufficiency.

0.12 Ensuring fair lending practices: Effectiveness of the current mechanism and the way forward - Another challenge faced by the industry is the inability of the current system deployed by credit information companies (CICs) to provide accurate results about a prospective customer’s credit history. While there are multiple CICs operating in the micro finance and retail credit market, they depend on the member MFIs for credit information about borrowers. Most of the small and medium sized MFIs are concerned about frequent violation by larger MFIs of stipulations regarding credit information sharing. Moreover, it is not mandatory for banks that directly lend to micro finance customers to report credit information of their borrowers to the CICs, making it difficult for small and medium sized MFIs to ascertain the level of indebtedness of prospects. Another issue faced is the substantial time lag between credit check of a prospective customer and the disbursement of funds. It is possible for another lender to disburse loan to the prospect in this time window, thereby leading to possibility of over-indebtedness despite checks with credit bureaus/CICs. It was also observed that only few MFIs upload credit information of their borrowers “immediately” after disbursal. There is often a significant time lag between disbursal of credit and uploading of credit information into CIC databases, adding to the risk.

Recommendation 4

We recommend that the RBI take appropriate measures to ensure that MFIs irrespective of their size and nature of operations report their portfolio to CICs and adopt prudent measures to check excessive borrowings. The proposed self-regulatory organisation (SRO) should be given the responsibility of monitoring the reporting mechanism and asked to submit periodic compliance reports to the RBI. MFIs should make credit checks closer to disbursement and should share the disbursement data with CICs not later than 2 to 3 days after disbursement. It is also recommended that the CICs develop an integrated platform to avoid multiple subscription and assimilation of data from the entire universe.

0.13 Recommended future course of action to ensure sustainability of micro finance sector in India - Most MFIs concur that regulatory guidelines have brought about operational transparency in the sector. There is a tremendous improvement in the level of disclosure regarding pricing/fees, interest rates and processes. There is also an increased impetus on client protection and client education. However, concerns still remain around operating margin, threshold level of maximum permissible household income of borrowers and implementation of credit information sharing mechanisms.

0.14 A holistic solution to all these outstanding issues could have been achieved with the materialisation of the Micro Finance Institution (Development and Regulation) Bill, 2012. Nevertheless, until the bill is finalised, the newly appointed SRO, MFIN, will have to ensure transparency and level playing field for all its members.

0.15 The latest central bank guidelines on allowing non deposit taking NBFCs and NBFC-MFIs to be eligible as business correspondents is considered a positive and welcome development by the sector. Most MFIs were finding it difficult to manage separate entities formed to operate as business correspondents. They were also not able to leverage people, process, infrastructure and consumer related synergies across their micro finance and BC businesses. The amended regulation will allow eligible MFIs an opportunity of integrating their MFI and BC business for efficiency, optimisation and scale.

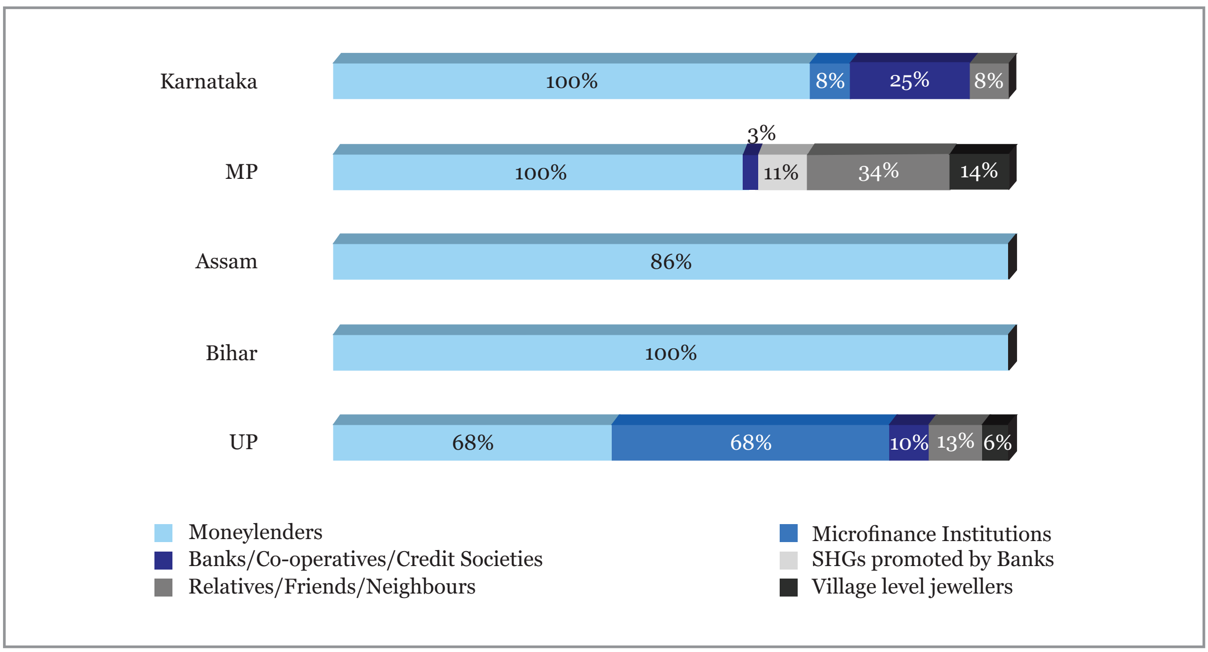
0.16 Far from static, the approach to regulating the micro finance sector in India has been one of learning and constant evolution. The approach has also been one of diversity, to enable effectively meet the residuary needs of a wide range of market participants. As highlighted through this study, a few residuary challenges and barriers remain. Addressing these will allow the already created environment of innovation, stability and growth, to be strengthened further. It will also demonstrate that regulations are alive to and evolve with the market situation and needs.

Chapter 1:

Trend in micro credit availability pre and post 2010, in states other than Andhra Pradesh

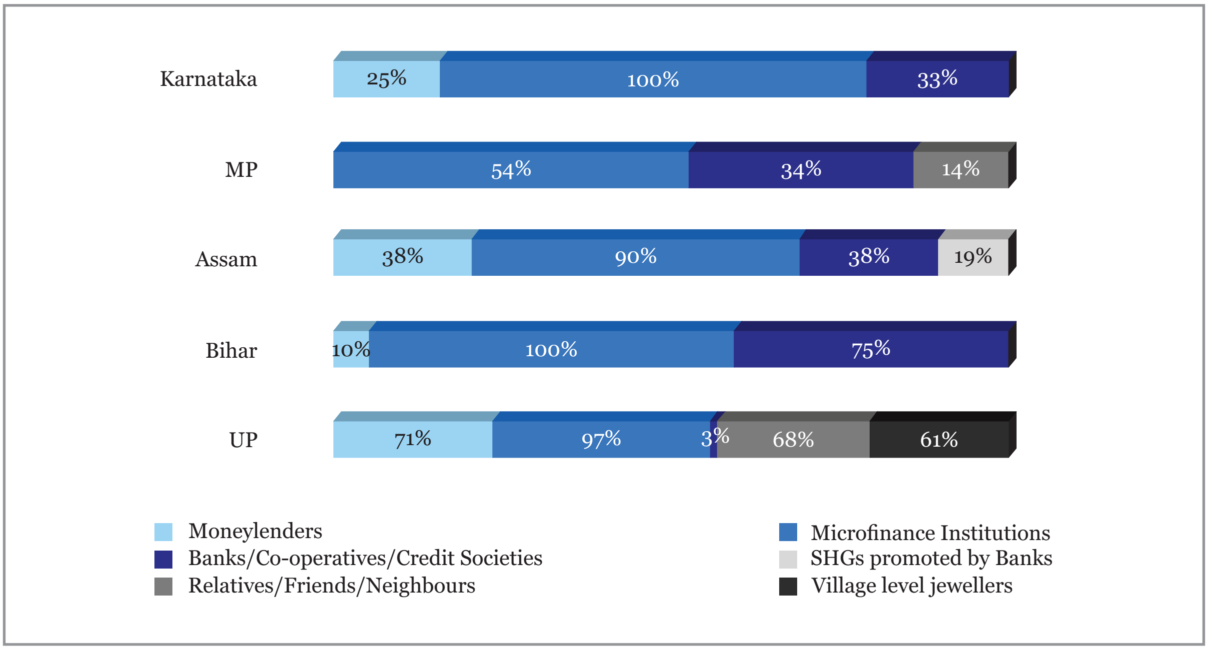
1.1 Our study elicited responses from micro credit customers across five states, on multiple aspects related to lending. One aspect was to understand their preferred sources of micro credit before and after the MFI crisis in Andhra Pradesh. A comparison of the responses is provided in Exhibit 1 and Exhibit 2. Exhibit 1 captures client preferences before November 2010 and Exhibit 2 presents their preferences after November 2010.

Exhibit 1: Sources of micro credit before year 2010



Note: the percentage figures in the exhibit indicate the relative number of times the sources of credit were mentioned by the respondents during the focus group discussions.

Exhibit 2: Sources of micro credit after year 2010



Note: the percentage figures in the exhibit indicate the relative number of times the sources of credit were mentioned by the respondents during the focus group discussions

1.2 It is interesting to note that local money lenders were a predominant source of micro credit across all these five states before 2011. In Uttar Pradesh, MFIs had a reasonable penetration, at par with moneylenders; however, in the other four states all other service providers seem to have a very low penetration. It is evident that the major source of micro credit before 2010 was local money lenders, across all the five states.

1.3 After 2010, MFIs are the preferred source of micro credit for low income groups in rural and urban areas of Assam, Bihar, UP and MP. MFIs are followed by banks and SHGs as the next common sources for small loans. With increased preference and dependence on institutional micro credit, the significance of money lenders as primary source of micro credit declined significantly. Preference for moneylenders has gone down drastically in all the states surveyed, except Uttar Pradesh, where there is still substantial dependence on money lenders.

1.4 The primary findings from our study were compared to the intensity of penetration of micro finance (MPI) and intensity of penetration of micro finance amongst poor (MPPI[4]) for the above mentioned states for the period 2008 to 2011. It can be seen that with the exception of Karnataka all the other four states studied, reported very low MPI and MPPI (1.00 or below) before 2010. Therefore, the results of the study is validated by these indices for the four of the five states under this study. The client base of MFIs in AP dipped by 28%[5] from FY11

[4] http://www.accessdev.org/downloads/state_of_the_sector_09.pdf
[5] MFIN MicroMeter, July 2012

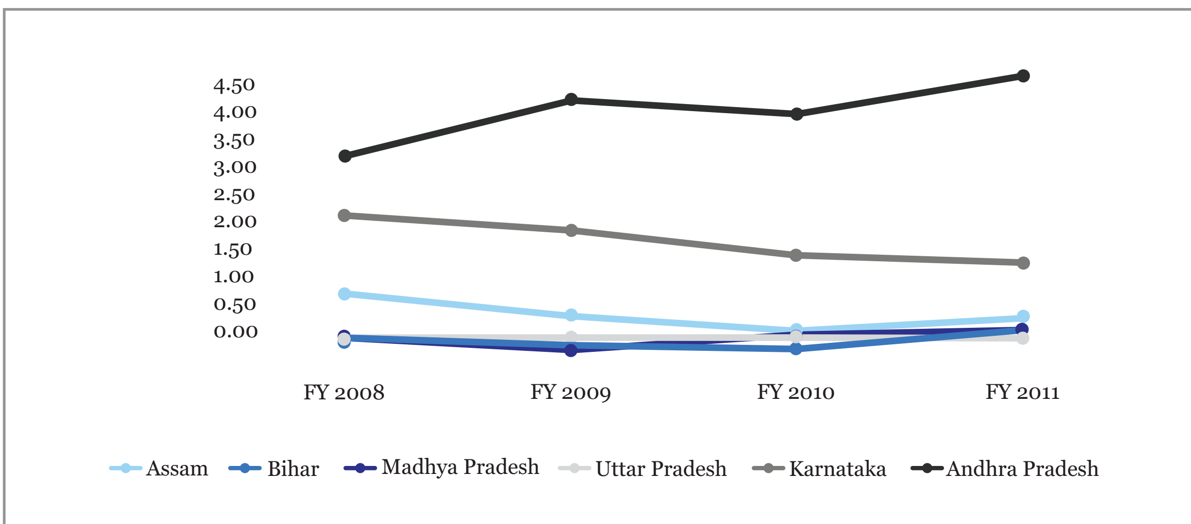
to FY12 whereas the simultaneous drop in non-AP client base was only 0.85%. This fact also substantiates the results of our findings.

The reason why the results in Karnataka does not conform to the MPI and MPPI can be attributed to the respondent sample. The customers interviewed in Karnataka were exposed to institutional micro credit only after 2010. Availability of information on these indices beyond 2011 would have helped to validate whether really there had been some tangible change in the micro finance penetration in these four states. As of now, It can only commented from this study that post AP crisis a large number of large scale MFIs have started looking into markets outside AP.

MPI and MPPI concepts introduced by Access Development Services in their micro finance state of the sector reports. These are calculated as follows:

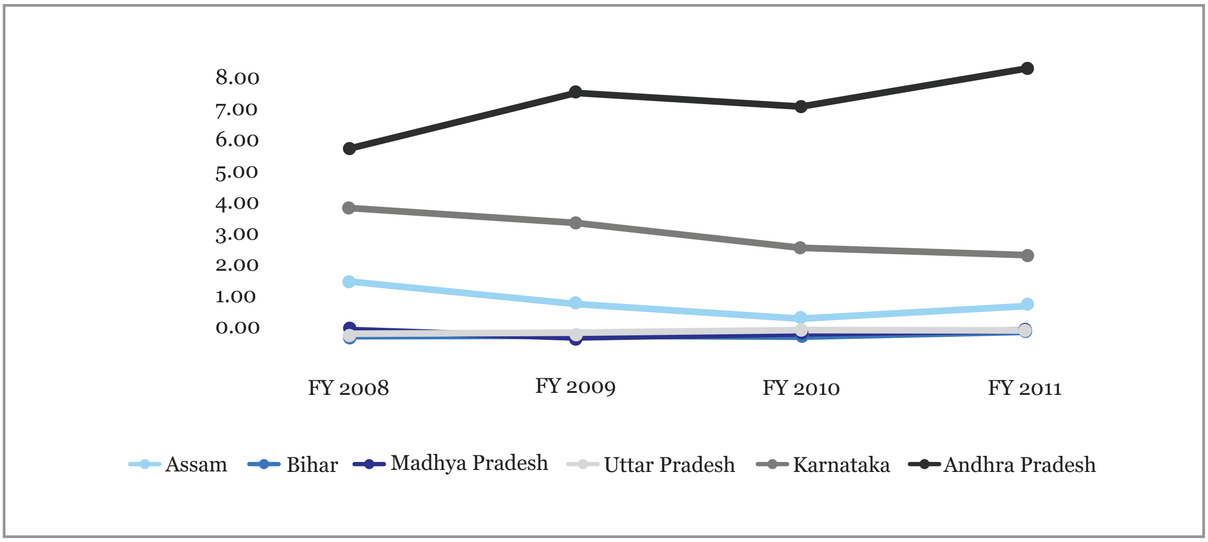
The number of credit customers of MFIs and members of SHGs with outstanding loans to banks are computed and each states share to the country's total micro finance customers is worked out. The intensity of penetration of micro finance (MPI) is computed by dividing the share of the state in micro finance customers with the share of the population. The intensity of penetration of micro finance amongst poor (MPPI) is derived by dividing the share of the state in micro finance customers by the share of the state in the population of the poor. A value of more than one indicates that customers acquired were more than proportional to the population. Higher the score is above one, better the performance. Lower the score is from one, which is the par value, poorer is the performance in the state.

Exhibit 3: Trend in intensity penetration of micro finance (MPI)



Source: Micro finance State of the Sector Reports by Access Development Services

Exhibit 4: Trend in intensity penetration of micro finance amongst poor (MPPI)



Source: Micro finance State of the Sector Reports by Access Development Services

1.5 It is evident that the prior to November 2010, the low penetration of micro finance in the states of Assam, Bihar, Madhya Pradesh (MP) and Uttar Pradesh (UP) was the major reason why micro credit loan customers resorted to money lenders for their credit requirements.

1.6 Apart from Karnataka, the change in supply trend of micro credit in the other four states is due to consumer preference for institutional micro credit over local money lenders. After the Andhra Pradesh crisis, a significant number of small MFIs closed their operations in these four (and other) states, whereas, a few (though larger) MFIs found potential and opportunities in these markets. With support from enabling regulations, these MFIs started deepening their presence and scale of operations. This in turn resulted in affordable credit at scale from MFIs and a large number of the micro credit loan customers, who previously borrowed from local money lenders, shifted to MFIs for institutional credit.

1.7 The consolidation of the sector as a result of the crisis and the subsequent regulations seem to have had a positive impact on the confidence of consumers in underserved markets (as studied in Assam, Bihar, Uttar Pradesh and Madhya Pradesh) and led to shift in preferences from informal sources to institutional credit.

Chapter 2:

Loan utilisation behaviour and its implication on regulatory guidelines

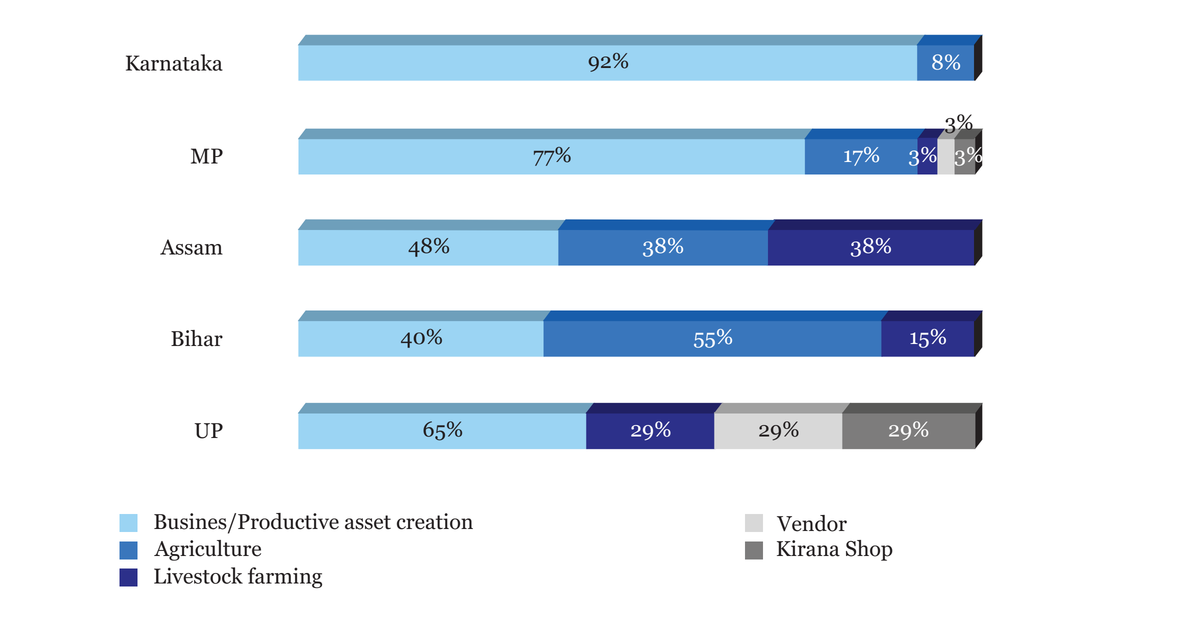
2.1 The Malegam Committee in its report[6] stated that the principal objective of micro credit should be to enable loan customers, particularly women, to work their way out of poverty by deploying the availed funds into income generating activities. Moreover, it was argued that credit used for consumption purposes might increase the financial burden of the poor. Therefore, the committee recommended that lending must be linked to strengthen consumers' sources of income. This will ensure that loans are repaid out of income generated from assets created and lead to an overall improvement in cash flows for customers or their families.

2.2 The committee also pointed out that even for loans given for income-generation, the time between grant of loan and commencement of repayment schedule is often inadequate. In the time provided, loan customers are unable to make necessary arrangements to utilise the funds appropriately and be in a position to start generating income to repay. This is particularly true for investments into agriculture or animal husbandry activities that are seasonal and cyclical. In the absence of a suitable moratorium period, it is likely that the first few instalments would be paid out of the loan itself or an existing surplus, especially when repayment schedule is weekly. This reduces the actual amount available for investment. It was therefore suggested that loan customers should be given a reasonable period of moratorium between disbursement of loans and commencement of repayments. This period should not be less than the frequency of repayments. Thus, a loan repayable weekly would have a moratorium period of not less than one week; while a loan repayable monthly would have a moratorium period of not less than one month.

2.3 The recommendations of the committee on granting moratorium have been incorporated in the regulatory guidelines by the RBI. However, there are several income generating activities or assets that might not lead to income generation within a week or even a month. Activities, such as crop production, farming and animal husbandry require a minimum gestation period till crop matures or animals become productive. Therefore whenever financing of such activities happens through institutional micro credit, the risks or challenges, anticipated to be managed through the guidelines on moratorium might continue to remain unaddressed.

[6] Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector

Exhibit 5: Pattern of productive utilisation of micro finance loans by the customers



Note: the percentage figures in the exhibit indicate the relative number of times the various purposes of credit were mentioned by the respondents during the focus group discussions

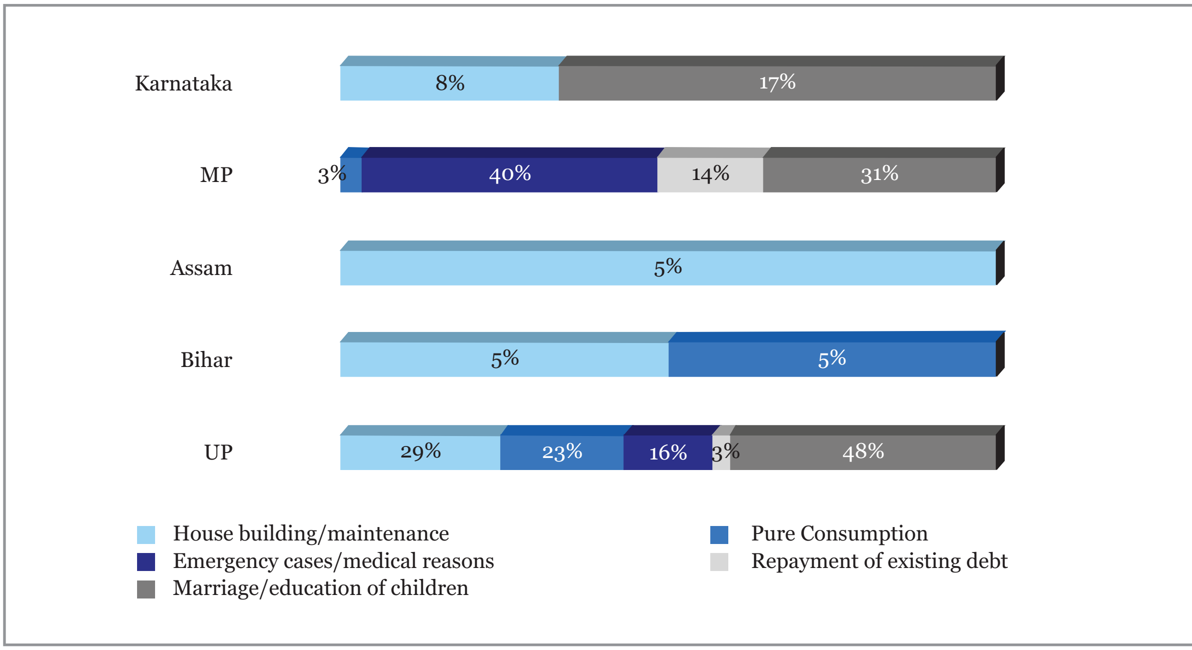
2.4 Our findings on productive utilisation of micro finance loans suggest that a substantial share of loans provided is for agricultural and allied activities. In the rural markets of Assam and Bihar the utilisation of micro credit is almost entirely towards agriculture and animal husbandry. In such cases, while a moratorium period of a week or a month will not solve the problem of cash flow mismatch, enforcing a longer moratorium period through regulations, to align with cash flows too, will not be feasible approach, as it would be unviable for the providers.

2.5 Our experience[7] shows that most customers availing loan for animal husbandry do have alternate sources of income. The repayment instalment amount is paid from these alternate sources of earning. Therefore, micro credit, even though deployed for income generating activities, might not create cash flows coinciding with the repayment cycle. However, as long as customers have adequate alternate sources of income in the family, they are likely to be able to manage the cash flows.

2.6 **It is therefore recommended that the regulator should emphasise sound credit assessment practices based on realistic cash flow analysis of micro finance customers and not merely adherence to minimum moratorium period criterion. This practice will enable skill building at the institutional level and pave the path for future scaling up.**

[7] *MicroSave* periodically conducts loan portfolio audit of MFIs across India and the opinion is based on our experiences during portfolio audits

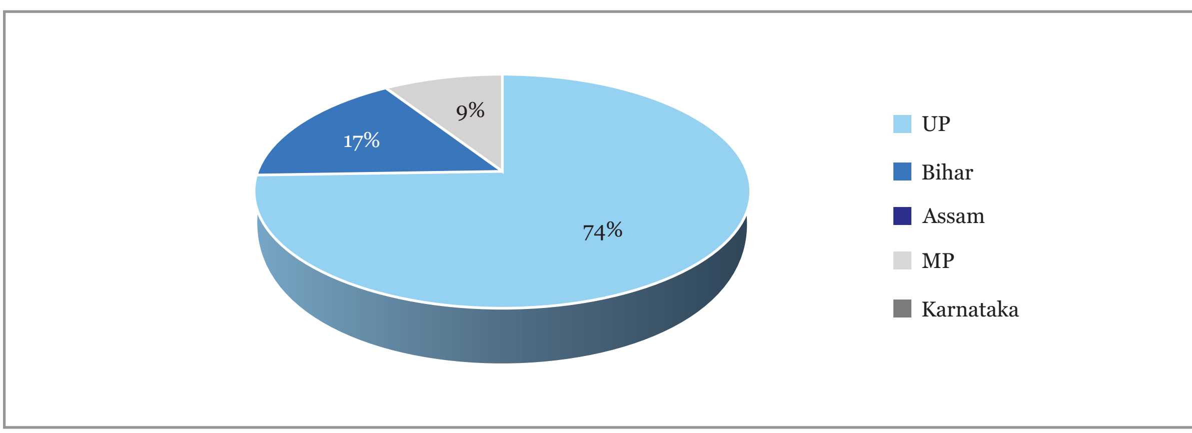
Exhibit 6: Pattern of other utilisation of micro finance loans by the customers



Note: the percentage figures in the exhibit indicate the relative number of times the various unproductive purposes of credit were mentioned by the respondents during the focus group discussions

2.7 While a majority of customers use micro credit for income generating activities, a small percentage of customers also use it for other purposes. Out of the few customers who acknowledged using the credit for other purposes, the state of Uttar Pradesh registered the highest percentage of such responses.

Exhibit 7: Utilisation pattern of micro credit for pure consumption purposes



Note: the percentage figures in the exhibit indicate the relative number of times pure consumption as purpose of utilisation were mentioned by the respondents during the focus group discussions

2.8 Our findings indicate that micro credit utilised for non-income generating activities is mostly for planned and unplanned events such as wedding, child education and medical emergency. These are, of course, not intrinsically unproductive – weddings build/maintain important social capital; child education is a long-term investment and resolving medical emergencies allow the family to return to productive working. These are aligned to the purposes for which RBI allowed MFIs to lend 30% of their qualifying assets.

2.9 Allowing 30% of the qualifying assets to be lent for non-income generating loans has encouraged MFIs to come up with innovative loan products. Several MFIs have designed innovative loan products such as - sanitation loans, loans to purchase of solar products and loans for subscribing to the pension scheme from PFRDA. **It is also imperative that MFIs design loan products for some unplanned household expenses. At the same time unplanned household expenses can be better met through an appropriate mix of savings and micro insurance products. Consumers need to be educated regarding how savings are a significantly better alternative to micro credit for unplanned expenses. MFIs themselves, but more importantly regulators, government and multilateral institutions have a vital role in enhancing consumer financial literacy focusing on these aspects.**

Chapter 3:

Impact of regulations on MFI offerings and consumer perceptions

3.1 The core philosophy of the regulatory regime for MFIs is to create a financial eco-system with a sharp focus on customer centricity. Stringent client protection measures have been stipulated to ensure that micro finance institutions refrain from adopting practices that brazenly ignore social aspects of micro finance.

3.2 Our study tried to assess the impact of this customer centric approach on the lives micro finance customers, achieved over two years of implementation of the regulatory framework. We also tried to understand perceptions of customers about offerings and services of institutional micro credit providers.

3.3 The following table presents attributes of offerings and customer perceptions about them.

Table 1: Perception of micro finance customers regarding attributes of products and services currently offered by micro finance institutions.

Product Attributes	Perception
1. Accessibility	√
2. Adequacy	×
3. Affordability	√
4. Procedural pre-requisites	×
5. Shared Liability (between group members)	√
6. Timeliness	√
7. Utility	√

Note: No weight or particular order has been assigned to the aspects (√- Like, ×-Dislike)

3.4 We found that customers perceive the overall level of offerings from MFIs as satisfactory. They are satisfied with the accessibility of credit and they perceive there has been no significant decline in the outreach of MFIs. Most customers also perceive that loans from MFIs are affordable and that they do not pay a very high interest rate. In fact many customers are of the opinion that they find loans from MFIs more affordable compared to other sources. This is partly driven by the interest rate and the operating margin cap; and partly due to the changes in repayment schedules by most MFIs. Most of the small and medium sized MFIs have revised their repayment schedule from weekly to fortnightly, making it more convenient for customers to accumulate the instalment amount and repay.

3.5 In 44% of the focus group discussion sessions during the study, customers stated that borrowing cost from MFIs has gone down. While in 27% of the sessions customers said that borrowing rates have remained constant.

Table 2: Perception of micro finance customers about cost of borrowing from MFIs

Perception about cost of borrowing from MFIs	% of sessions
Cost have decreased	44%
Cost have increased	13%
Cost have remained the same	27%
Costs should decrease further	3%
Could not differentiate between 26% per annum reducing interest rate and 12.5% per annum flat interest rate	6%

Note: the percentage figures in the table indicate the relative number of times each perception about cost of borrowing has been mentioned in the focus groups

3.6 Customers also referred to other benefits, such as sharing of responsibilities during repayment, timeliness of disbursement and utility of products and services, as some of the key positive attributes of loans from MFIs.

3.7 Although sharing of liability in the case of JLG loans is an accepted practice and is considered essential to build credit discipline, in 16% of the sessions, customers opined that they are not comfortable with the practice. They justified stating that it is very difficult to predict if someone from the group is about to default. They also added that wilful defaulters cause unwanted and unwarranted obligations to the group and some of them do not have a liking for the group format to avail loans, but are forced to do so due of lack of options for micro credit. Another challenge highlighted with the JLG/SHG approach was the lack of flexibility for a few members to renew their credit facility based on individual members' preferences. During the research it was pointed out by the customers that MFIs often discourage renewal and enhancement of the credit facility for an individual or by just a few members of the group. Whenever an individual or a few members seek renewal of their credit limits, MFIs stipulate a minimum quorum of 50% of the members to repay their loans in order to renew the facilities. While some banks and MFIs have been exploring mid-term or top-up loans to address borrower needs, a proven approach is not yet evident.

3.8 On the downside with institutional micro finance, customers stated that inadequacy of loans is the biggest challenge in the current environment. They explained that earlier it was possible to borrow from as many MFIs as one liked, provided one had the repayment capacity. However, with the imposition of limits on the number of lenders, the overall quantum of loans available has become inadequate. Some customer groups also complained that loan limits have been reduced by some MFIs. However considering the increasing trend of credit concentration by MFIs, the perception of inadequacy can be largely attributed to the inflationary trends and not to reduction in credit limits by individual MFIs. Inadequacy of credit adversely impacts livelihood of some of the customers. The following table presents some of the challenges faced by customers due to inadequacy of credit.

Table 3: Effect of inadequate credit on livelihood of micro finance customers

Effect of the perceived inadequate loan amount	% of sessions
Scale of business has reduced	34%
Planned expenses had to be deferred	18%
Had to borrow from other sources	11%
Has to plan conservatively for future expenditure	5%

Note: The percentage figures in the table indicate the relative number of times the effects on livelihoods were mentioned by focus groups.

3.9 Many customers also expressed their dissatisfaction or dislike for procedural hassles involved in availing and/or servicing loans from MFIs. In 34% of the sessions, customers stated that there are too many procedural prerequisites or guidelines for taking loans from MFIs. Mandatory requirements such as weekly or fortnightly meeting for repayments, often during busy hours of the day, lead to wastage of time. Some customers felt that if a family member could be allowed to attend meetings during times of emergency, it would be very helpful to them. In some of the sessions, customers expressed that they needed to undergo trainings (CGT and GRT) and submit documents every time they applied for loans, even to the same MFI. This leads to wastage of time and is a cause of inconvenience. While these procedural amendments have been made more stringent to ensure better due diligence measures by MFIs and greater client protection, at times these measures are perceived as burdensome by customers.

3.10 Another aspect probed in the study was regarding the attitude and behaviour of the field staff towards customers. It was unanimously felt by respondents (in 97% of the sessions) that the behaviour of the staff continues to be quite good and has not undergone any deterioration over the years.

3.11 Overall it can be concluded that subsequent to the implementation of stringent client protection and due diligence measures, product relevance and service quality aspects of micro finance loans has indeed improved. Cost of borrowing is also perceived to have come down and repayment schedules have become more convenient for loan customers.

3.12 The downside for the customers from the specific guidelines, issued out of concerns to prevent over indebtedness of loan customers, has been

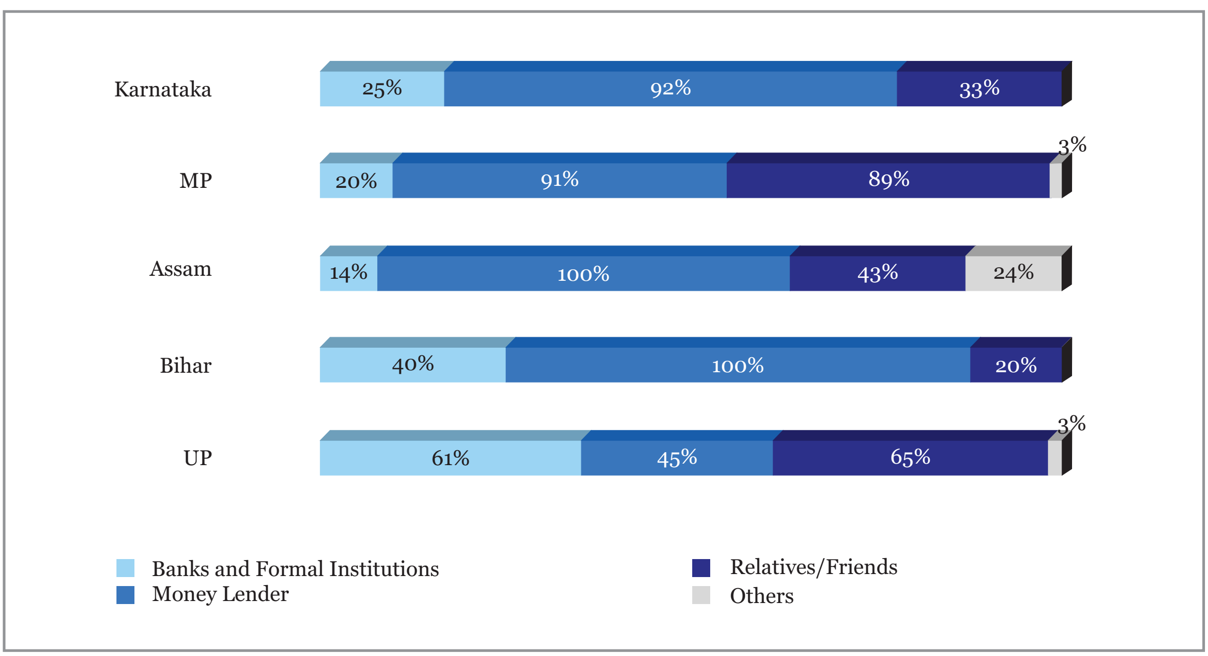
(a) Limiting the financial aspirations of a large section of the loan customers, and
(b) Making availability of micro credit more stringent and inconvenient in terms of pre-requisites and procedures.

Chapter 4:

Dependence of customers on alternative sources of credit and its challenges

4.1 In the previous section we have highlighted that customers complained about inadequacy of credit from institutional lenders. The restriction on the maximum number of MFIs that a customer can borrow from is preventing genuine borrowers, with adequate paying capacity, to meet their credit needs. Inflationary trends witnessed in recent times have widened the gap between earnings and expenditure. The low income segment is facing a situation where prices of basic necessities have gone up much higher compared to growth in their incomes. Customers are increasingly seeking higher loan amounts in order to meet their business and household needs. Therefore, "perceived" inadequacy of credit from institutional sources, such as MFIs, has compelled many customers to seek money from traditional money lenders. We probed further into the alternative sources of credit available to these customers and observed the following.

Exhibit 8: Alternative sources of credit availed by customers



Note: the percentage exhibit indicates the relative number of times each of the alternative sources of credit was mentioned within the focus groups.

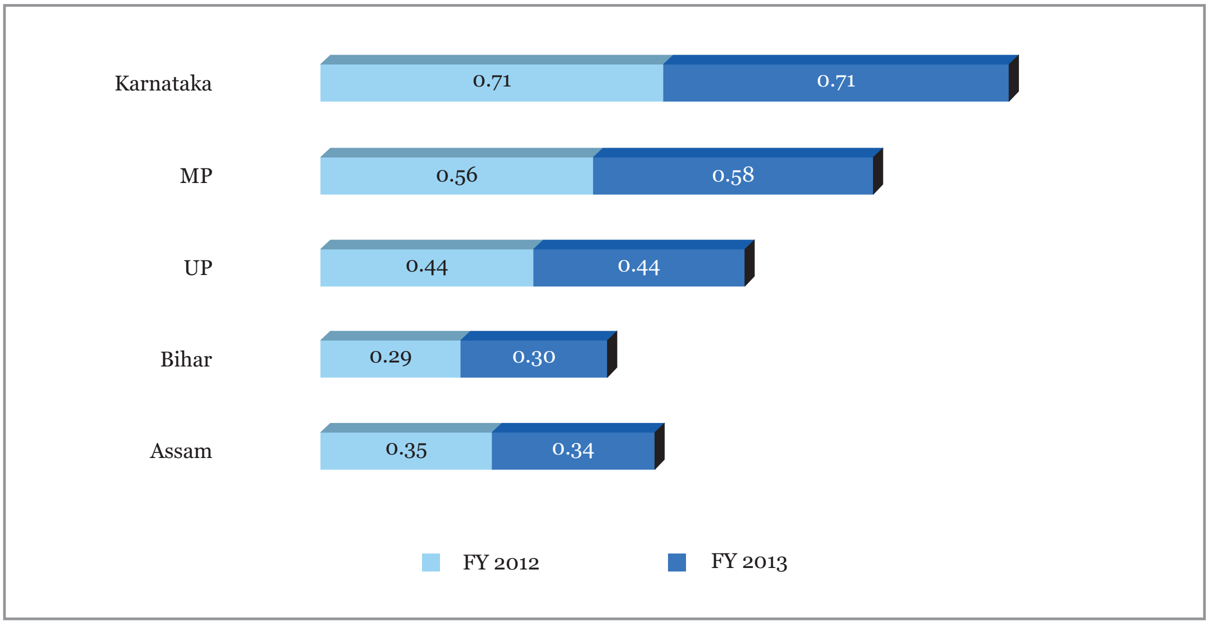
4.2 In Assam and Bihar, in almost all the sessions it came out that that money lenders continue to be the first choice amongst alternative sources of credit. Even in states such as

Madhya Pradesh and Karnataka, that have satisfactory CD (credit to deposit) ratio, customers responded in a similar manner. Only in Uttar Pradesh do a large number of customer prefer or consider banks and other formal institutions as plausible alternatives to MFIs for additional credit, although borrowing from relatives and money lenders is very common too.

Credit to Deposit Ratio (CD ratio) of a state is an important measure of availability of bank credit in that state. Although CD ratio is not a perfect measure of penetration of bank credit it provides an approximate measure of availability bank credit in the state. The reason for the ratio not being a perfect measure is because it also includes loans to corporate and commercial segments that increases the total amount of credit but has marginal effect on the number of loan customers.

4.3 These consumer insights when interpreted together with the CD ratios for these five states, provides a gloomy picture regarding the availability of micro credit from banks and formal financial institutions. It is evident that CD ratios alone are not adequately indicative of the distribution of credit across segments. Even in states with high CD ratios, we found low income groups do not have adequate access to formal credit.

Exhibit 9: Credit to Deposit ratios for the five states under study

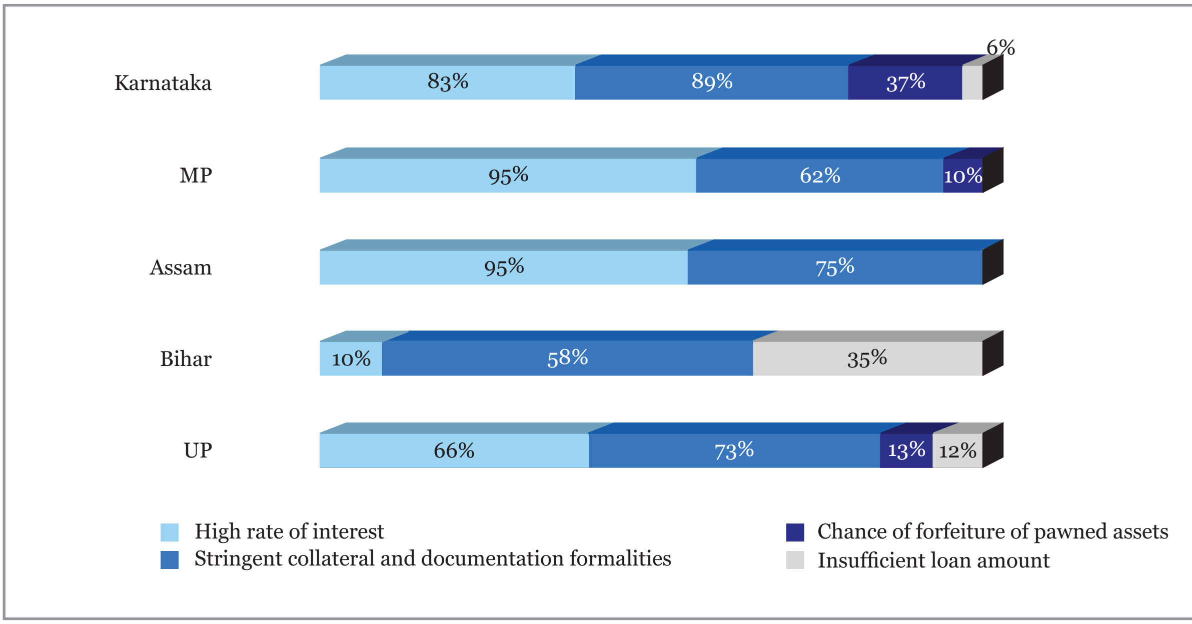


Source: Statistical tables relating to banks in India-2012-13 by RBI

4.4 However, some private sector banks are exploring their own channels or channels owned by third parties to extend micro credit directly to low income groups. However, the activity is in its nascent stage. While a few banks are confident about the third party led model, some consider it as reputation risk to extend credit using third party channels.

4.5 Nevertheless, the real issue is the challenges faced by customers in availing credit from alternative sources. These are highlighted in the following exhibit.

Exhibit 10: Challenges faced by micro finance customers in availing credit from alternate sources



Note: the percentage indicates the relative number of times the various challenges faced by customers in availing credit from alternate sources was mentioned within the focus groups.

4.6 The first major challenge is that the cost of availing loans from alternative sources is very high. The traditional money lenders usually charge exorbitant interest rates. The interest rates are dependent on factors such as loan customer's urgency, credit history and/or availability of collateral. Customers are sometimes forced to pledge valuables to the money lenders to avail loans. Moreover there is always an apprehension of forfeiture of the valuables in case of delayed payment.

4.7 Those preferring to borrow from friends or relatives felt that these funds were often not adequate to meet their needs. Many also lamented that often relationships get strained when borrowing from friends or relatives. Therefore, in the absence of adequate funds from micro finance institutions, more often than not, customers resort to money lenders despite exorbitant rates of interest.

4.8 As regards availing loans from banks, customers expressed that documentation requirements and other pre-requisites are inconvenient and unfriendly. Customers are also of the view that repayment schedule of banks is very stringent and they might be subjected to legal action, if they failed to pay bank dues on time. Discussions in some of the sessions also indicated that behaviour of bank staff is not amiable.

4.9 The major reason for the "perceived" inadequacy of micro credit despite credit concentration by MFIs is the limit on the quantum of micro finance loan amount. The maximum cap of Rs. 50,000 might address the need of people below poverty line but not of micro finance customers who use this fund to invest in their "micro" business. With rising inflation on both food and non-food items there is a need for higher sum to generate higher revenues from these "micro" businesses. With the introduction of a cap on the number of lenders and the amount individual MFIs can lend, those business people who are willing to take on greater exposure are not able to do so.

4.10 The prescribed limit on annual household income is also aggravating the situation of credit inadequacy. The present annual household income limit for micro finance loan customers is Rs.60,000 for rural areas and Rs.120,000 for urban areas. A household with income limit of Rs.60,000 per annum would not be able to service the credit limit of Rs.50,000 in two years along with interest after meeting consumption needs.

4.11 A vast majority of the MFIs interviewed during the study mentioned that both these limits (maximum loan amount and household income levels) are indeed very low and need to be raised. Most customers do have an actual household income above Rs.1,00,000 in rural areas and Rs.1,50,000 in urban areas. In order to ensure eligibility for institutional micro credit, most of them tend to under disclose their income.

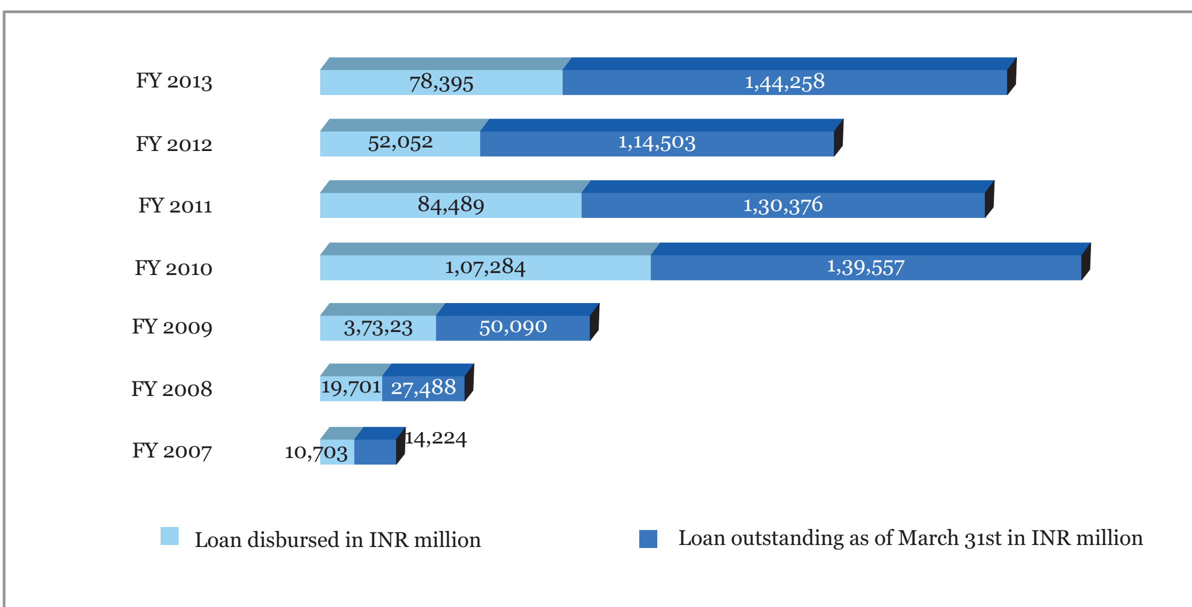
Chapter 5:

Impact of the Andhra Pradesh micro finance crisis on fund mobilisation of MFIs outside Andhra Pradesh

5.1 The most evident impact of the Andhra Pradesh micro finance crisis was on the increased perception of risk amongst lenders and investors. The surge in defaults by micro finance customers in the state increased the risk perception about the sector amongst lenders and investors. This risk perception led banks to tighten lending norms, and as a result inflow of funds to the sector started dwindling after the crisis. The country wide data on bank loans to MFIs from FY09 to FY13 shows that there was a steady growth in bank lending to MFIs till March 2010. The CAGR (from FY07 to FY10) for the amount of fresh loans disbursed by banks to MFIs was 114%. A steep growth of 187% was observed between FY09 and FY10. However, the growth in lending plummeted by 21% in FY11 and further dropped by 38% in FY12.

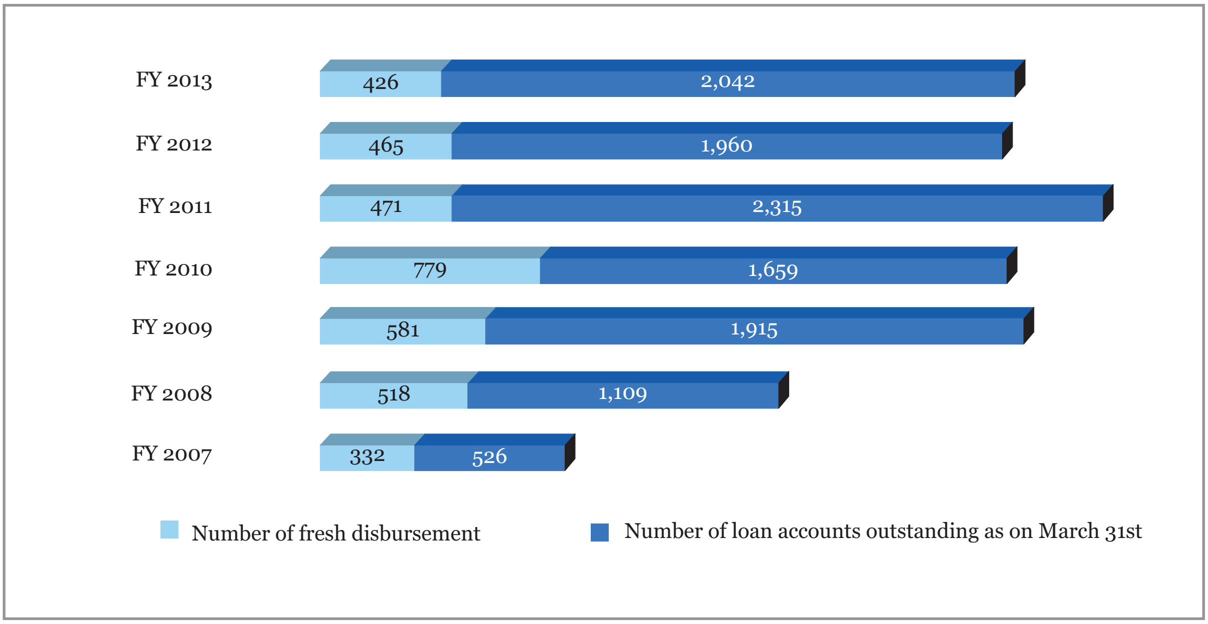
5.2 The situation started improving from FY13, and loan disbursements grew by 51% during the year. A similar trend can be observed in the number of MFI loan accounts disbursed. MFI loan accounts grew at a CAGR of 33% from FY07 to FY10 and then plummeted to a negative CAGR of 18% from FY10 to FY13.

Exhibit 11: Trend of bank loans to MFI



Source: Annual "Status of Micro finance in India" reports by NABARD

Exhibit 12: Trend of number of MFI fresh loan disbursements and loan accounts outstanding

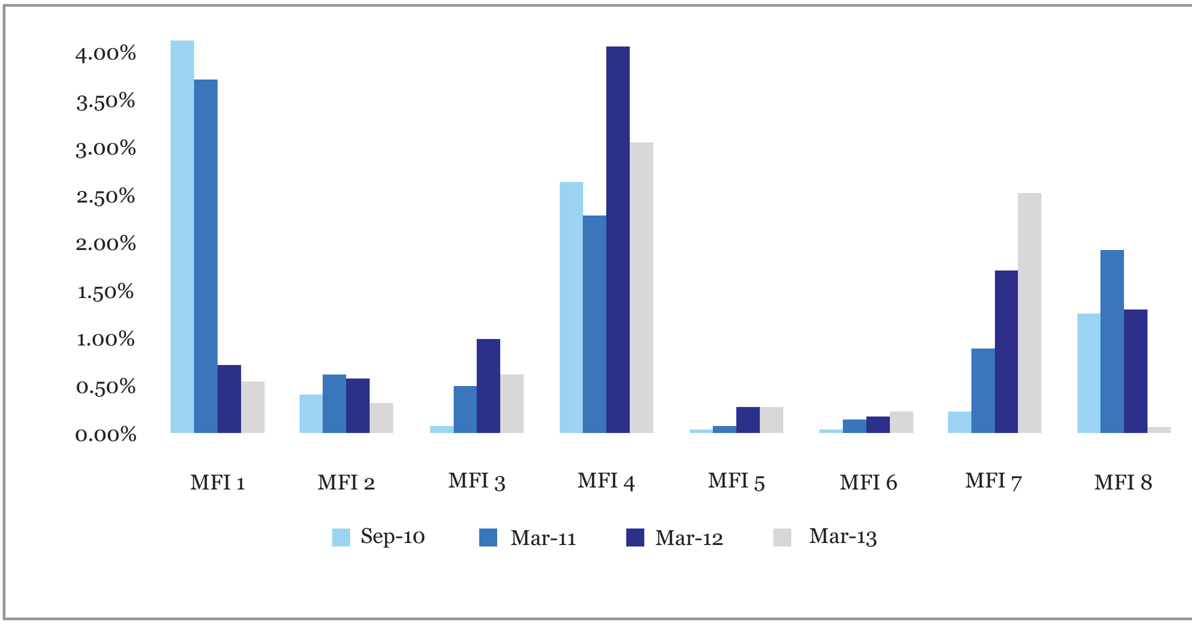


Source: Annual "Status of Micro finance in India" reports by NABARD

5.3 A large number of small cap NBFCs, NGOs and Section 25 companies could not cope with the sudden discontinuation of funds by banks and had to close down their business, despite no apparent problem with the quality of their portfolios. Key operational data collected from eight MFIs across the five states studied suggests that there has not been any significant impact of the Andhra Pradesh crisis on the quality of the micro finance portfolio of MFIs outside of the state.

5.4 The following exhibit presents the portfolio quality of these eight MFIs immediately before and after the Andhra Pradesh crisis. It is evident from the level of PAR (>30 days) that the portfolio quality of these MFIs remained largely unaffected by the crisis in the sector.

Exhibit 13: Loan portfolio quality (PAR>30 days)



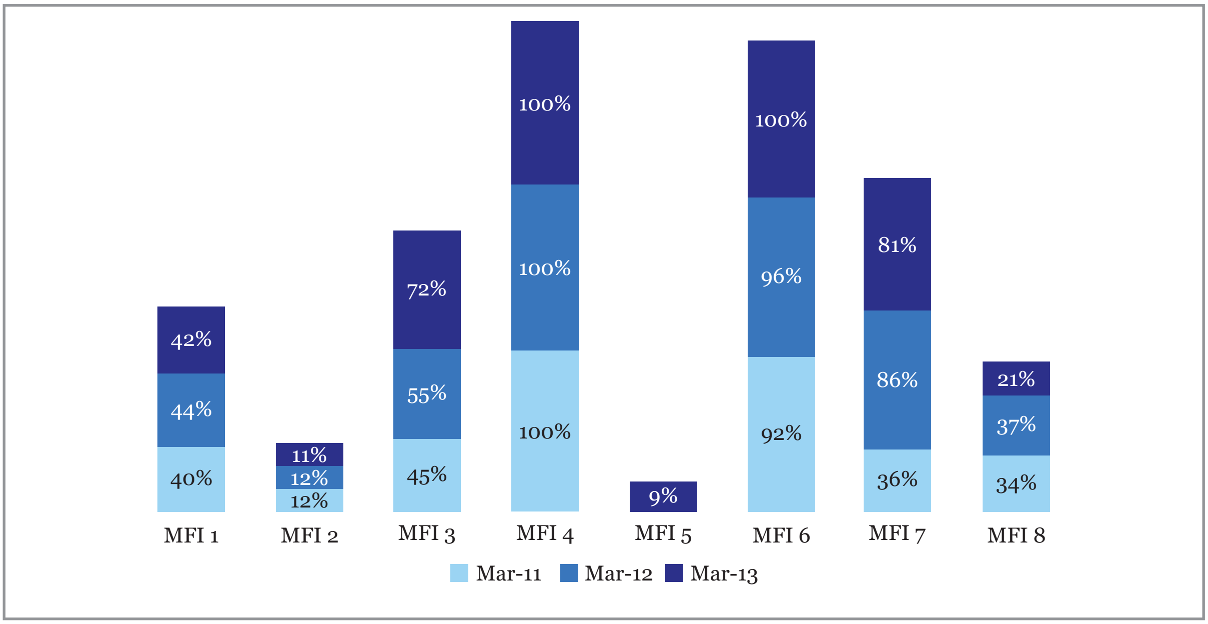
Source: Primary financial data obtained during MFI interviews.

5.5 Downgrading of ratings of MFIs by credit rating companies made the situation worse for the smaller MFIs. The management of a small cap MFI based out of Uttar Pradesh commented that after the crisis, rating agencies downgraded their rating criteria based on a negative outlook of the sector. No credit or consideration was given to the sound fundamentals and/or the portfolio quality of the well performing MFIs. Due to such mass downgrading of ratings, MFIs faced severe challenges in accessing funds from banks, who in turn had upgraded their internal benchmarks for lending.

5.6 During our study we found that some of the MFIs managed to avail funds from banks by meeting stringent lending norms imposed by the banks. Some of the severe terms laid down by banks are - personal guarantees of promoters, increase in first loss default guarantees (FLDG) and higher cash margin on portfolio loans. One of the MFIs opined that the cash margin provided to the bank barely serves any purpose. Instead, if MFIs were allowed to deposit the money with banks as unencumbered funds it could have helped them maintain capital adequacy by contributing to their tier I capital. Although banks have introduced many of these harsh measures, they themselves are not very confident about the ability or adequacy of these measures to mitigate risk. Some bankers opined that these measures are sub-optimal. They stated that personal net-worth of promoters can seldom cover the loan amount. It merely provides psychological comfort rather than any tangible protection against default.

5.7 In effect, these stringent lending terms have only served the purpose of making credit unaffordable to MFIs. The following exhibit shows the proportion of bank loans to total amount of debt capital availed. Our findings suggest that most of the large cap MFIs were able to generate adequate funds from banks owing to their capital base and relationships with their banks. However, small and medium cap MFIs have found it very difficult to borrow from banks. In the following exhibit MFI7 and MFI8 are small cap MFIs who reported lower contribution of bank borrowing to their total debt. These MFIs opined that their small size coupled with their inability to arrange for large equity capital is the reason why lenders are less willing to increase their credit limits.

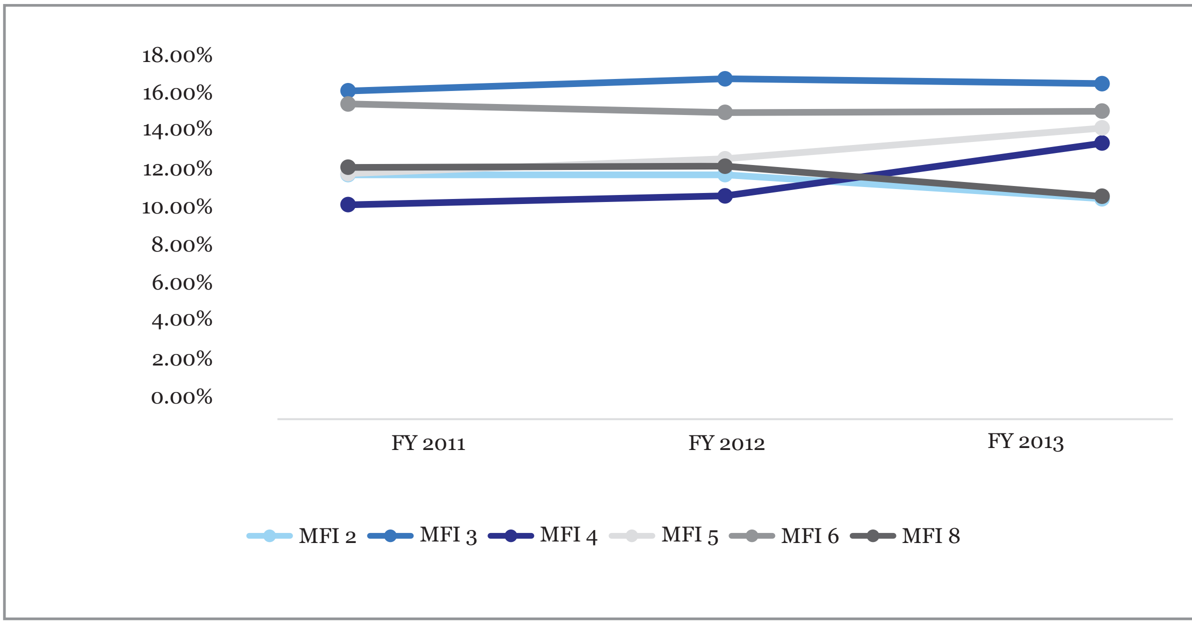
Exhibit 14: Proportion of bank borrowing to the total amount of debt availed



Source: Primary financial data obtained during MFI interviews.

5.8 The deficit in debt funding was largely met by NBFCs. A few large cap MFIs also borrowed directly from market using non-convertible debentures. Most of the MFIs interviewed by us mentioned that their average cost of borrowing from bank in the last three years (presented in the following table) was comparatively lower than that from NBFCs.

Exhibit 15: Average annual cost of bank loans during last three years



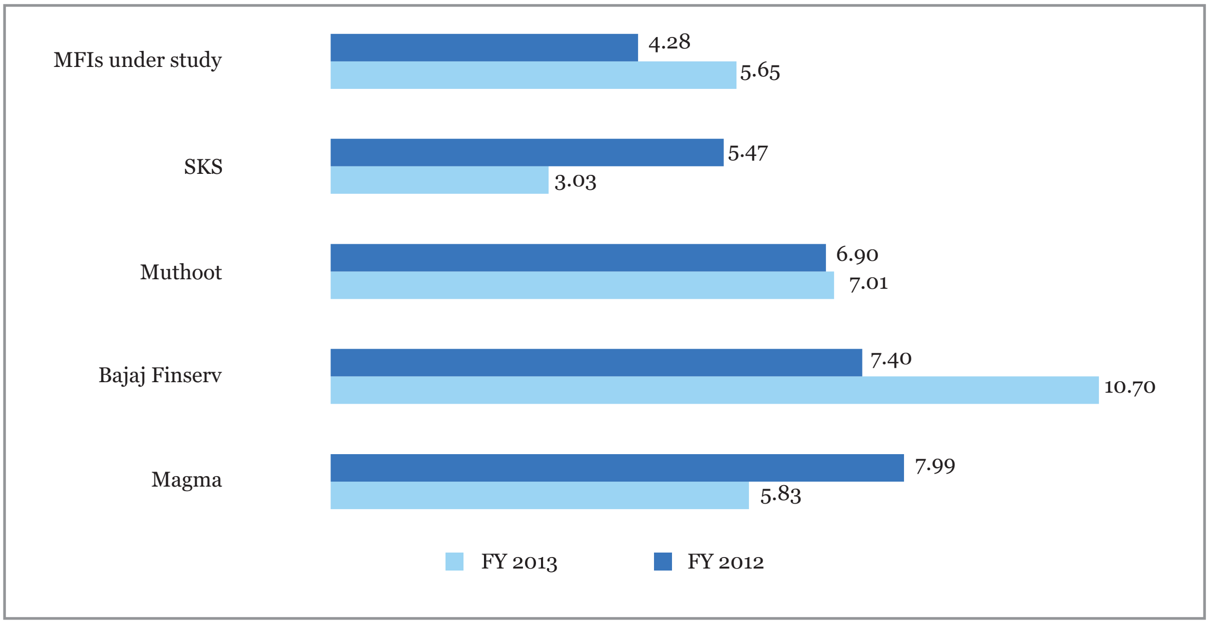
Source: Primary financial data obtained during MFI interviews.

5.9 Despite all the negativities about declining bank credit to the sector, there was one positive takeaway from the crisis. It apparently made MFIs realise the importance of being well capitalised in the lending business. Fortunately some of the successful MFIs outside of Andhra Pradesh were leveraged optimally. This allowed them to continue their operations profitably even during the period of muted growth. The capital gearing ratios of most of these MFIs are lower in comparison to large NBFCs (non MFI). A comparison of the capital gearing ratio (highest amongst the eight) of MFIs under study with that of some large NBFCs indicate that most MFIs are under leveraged.

Capital gearing ratio (Total Outside Liability/Tangible Net Worth) was adopted as the measure of financial leverage since debt equity ratio does not provide comprehensive picture of the amount of financial leverage enjoyed by business entities. For calculating TNW intangible assets and investment in subsidiaries/ group companies were deducted from total net worth.

5.10 As evident from the following exhibit the capital gearing ratio (highest amongst of the eight) of the MFIs under study for the financial year 2012 and 2013 is lower than most of the large NBFCs.

Exhibit 16: Comparison of capital gearing ratio of MFIs under study and large NBFCs



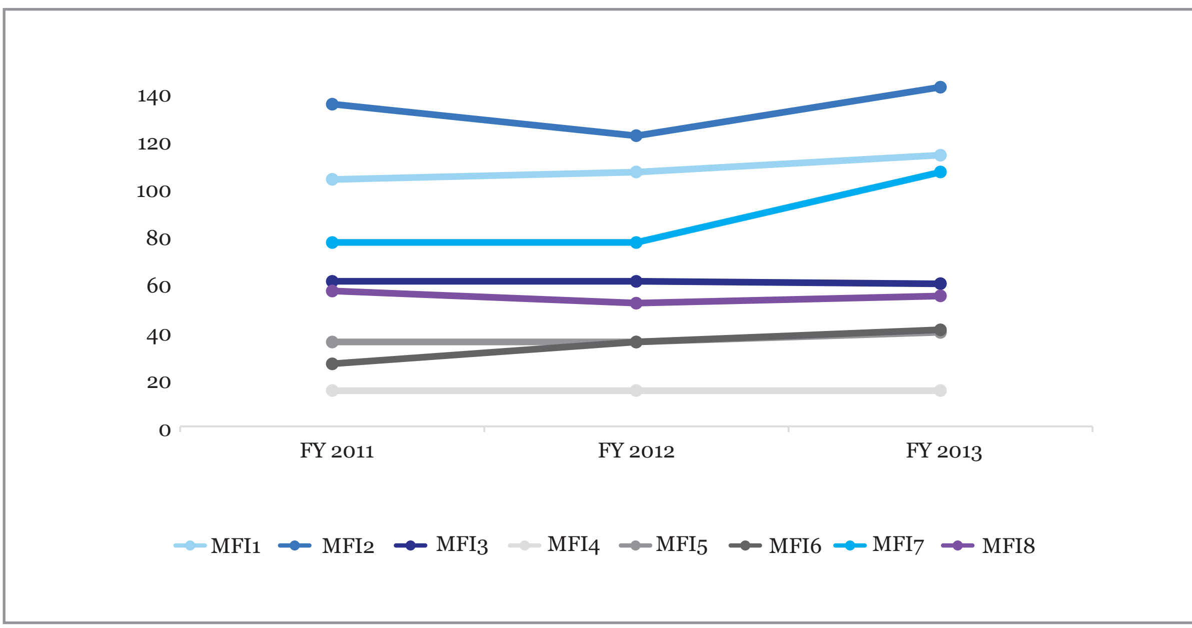
Source: Primary financial data obtained during MFI interviews.

Chapter 6:

Impact of paucity of funds on growth of MFIs in states other than Andhra Pradesh

6.1 As mentioned in the previous section, the immediate impact of the Andhra Pradesh crisis was on inflow of funds to the sector. A few MFIs who survived and continued to grow during the period had to redirect their business strategies to a large extent. It came out quite strongly in our study that the reaction of most of MFIs towards the crisis was similar. The inadequacy of funds translated into immediate rationalisation of horizontal growth plans. All the MFIs interviewed by us reported slow, stagnated or negative growth in the number of branches. The MFIs opined that funds from lenders and investors provide the necessary capital to undertake the risk of exploring new and underserved markets. Therefore during the phase of acute scarcity of these funds, some of them completely shelved their expansion plans, while others closed down branches to optimise the utilisation of resources. The following table represents the state of active branches of eight MFIs situated outside of Andhra Pradesh between FY11 to FY13.

Exhibit 17: Trend in the number of active branches



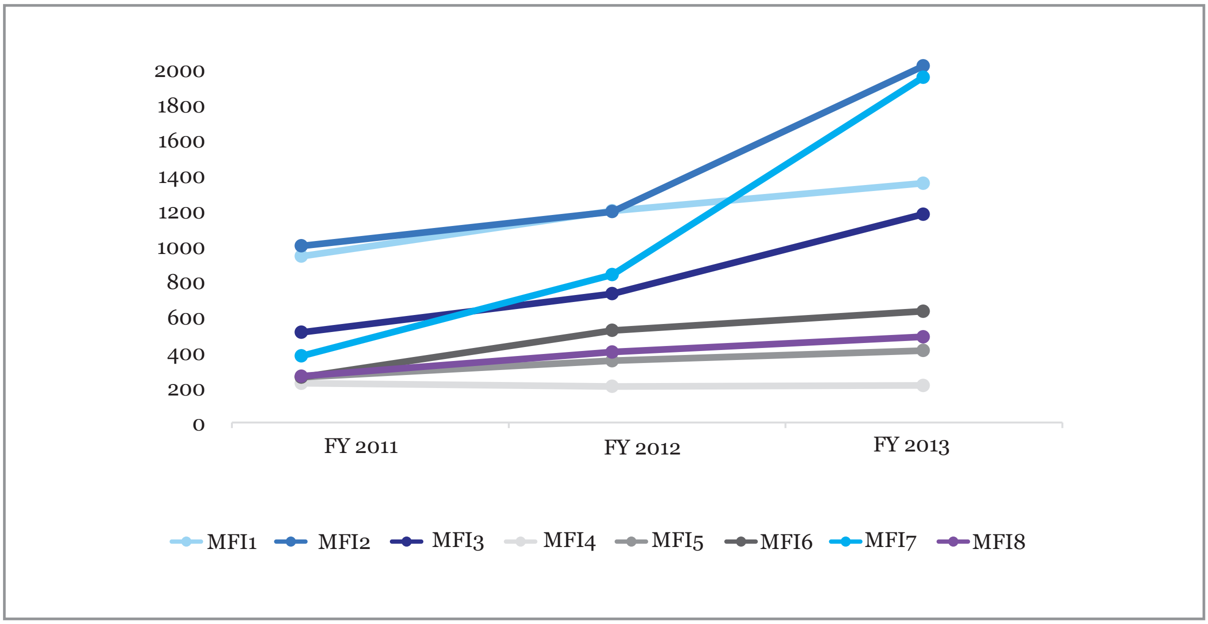
Source: Primary operational data obtained during MFI interviews.

6.2 An MFI based out of Delhi had initial plans to grow its branch strength from 50 (as on March 2011) to 150 by March 2012. However their expansion plans were stalled and even by the end of March 2013 they could not add even a single branch. Another MFI, based out of

Karnataka had to suspend their expansion plans for a complete financial year. Throughout FY11 this MFI kept bearing the cost of salaries of the staffs hired for the planned branches that could not be opened due to paucity of funds.

6.3 Under the circumstances, some MFIs concentrated on building up the portfolios of their existing branches with whatever funds they could muster from investors and lenders. The portfolio growth of existing branches was ensured by increasing the number of members in JLGs and the quantum of loans to customers to the extent possible. According to most of the MFIs interviewed this was the only strategy that ensured continued growth without risking "valuable" capital in unserved/new geographies. This vertical growth strategy resulted to satisfactory portfolio growth of the MFIs as presented in the following exhibit.

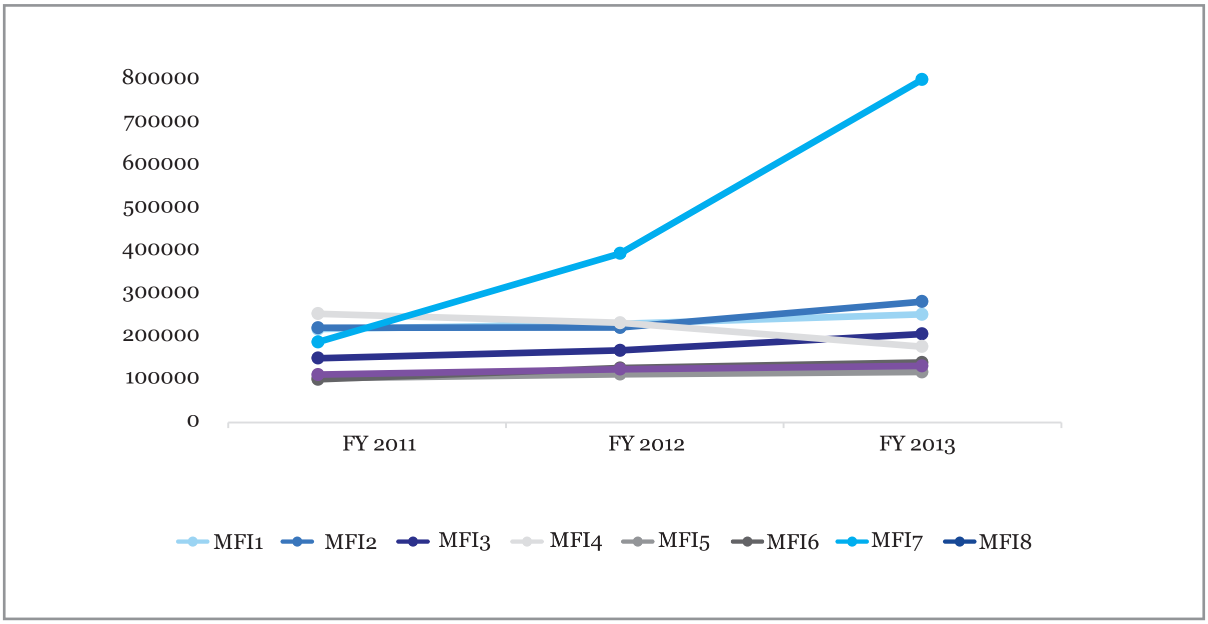
Exhibit 18: Trend in portfolio growth of MFIs



Note: figures are in million INR
Source: Primary financial data obtained during MFI interviews.

6.4 As mentioned earlier portfolio growth was largely achieved by increasing loan size for existing loan customers instead of growth in new customer acquisition. The uneven disbursement of loans during the financial year by banks is also a major reason why small and medium MFIs could not grow their new customer base after the Andhra Pradesh crisis. An MFI based out of Madhya Pradesh explained that, since FY 2011-12, their lenders have been disbursing sanctioned loans largely during the last quarter. This pattern of funding has restricted the ability of the MFI to acquire new customers throughout the year at an even pace. Moreover, uncertainties around the availability of funds has prevented them from planning rollout of new branches to achieve horizontal growth. The following exhibit represents the growth in customer base of the MFIs interviewed during the study.

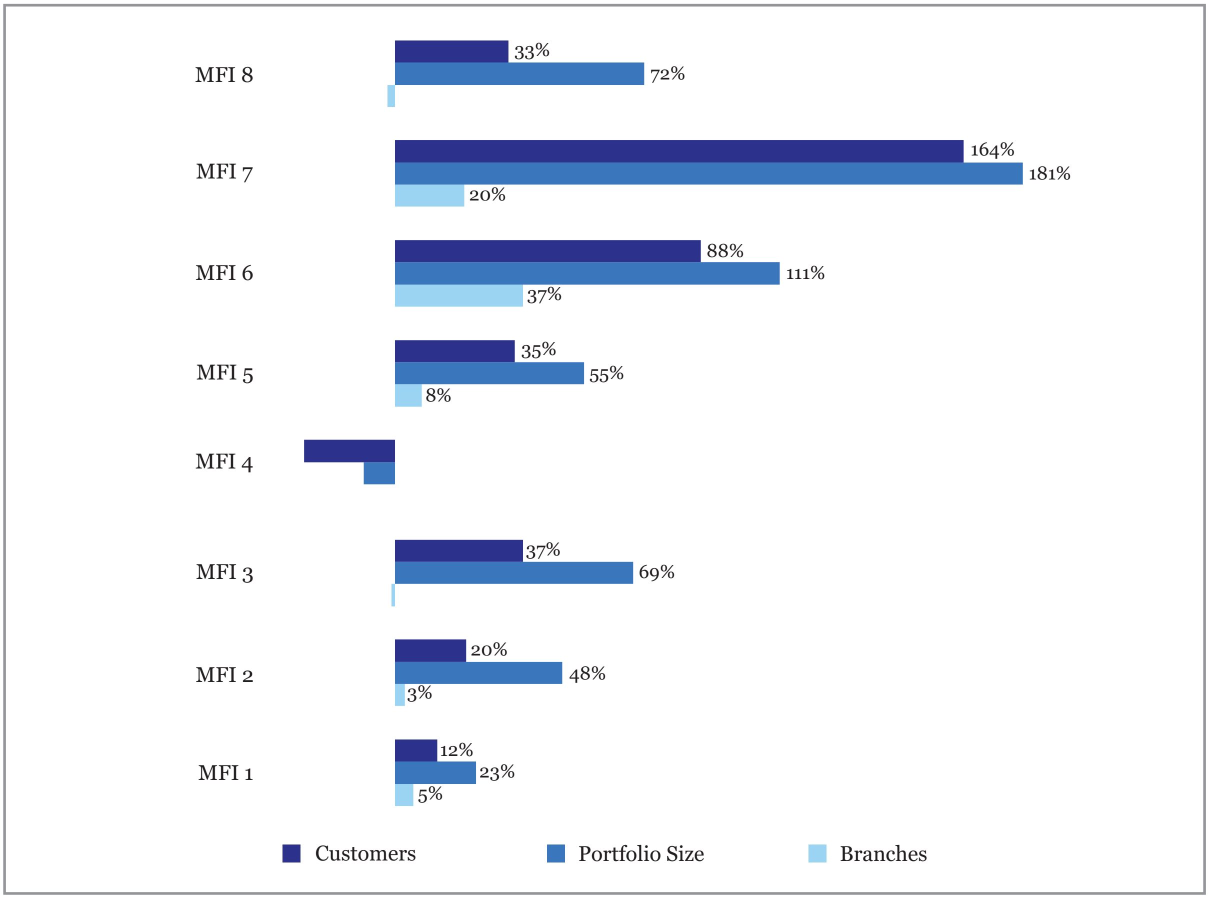
Exhibit 19: Trend in growth of customer base of MFIs interviewed



Note: the axis on the left hand side indicates number of customers
Source: Primary financial data obtained during MFI interviews.

6.5 It seems from the above exhibit that most of the MFIs have registered some positive growth in terms of customer base. However, a comparison of the growth rates (CAGR) of number of branches, number of customers and portfolio size indicates that whatever portfolio growth happened was actually achieved by adopting vertical growth strategy that is increasing the customer base and loan quantum and restricting the number of new branches.

Exhibit 20: Comparison of growth rate of number of branches, customers and portfolio size



Note: the percentage figures represent the cumulative annual growth rate of the three indicators from FY11 to FY13
Source: Primary financial data obtained during MFI interviews.

6.6 As evident the growth rate of portfolio size over a three year period from FY11 to FY13 is significantly higher than the growth rate of number of branches and customers. This phenomenon is not an indication of an inclusive approach to cater to underserved markets. It was therefore, imperative for the RBI to step in with regulatory guidelines for the sector that has brought back some confidence. Nevertheless, that confidence has not translated into investment in the sector at the level of 2010 and before.

Chapter 7:

Reigning over windfall income: Impact of income caps on MFI operations

7.1 The Malegam committee, set up to study the issues and concerns in the micro finance sector acknowledged that although it is necessary to ensure sustainability of MFIs, this should not be at the cost of poor consumers. The recommendations of the committee to rationalise the interest rate and the operating profit margin of the MFIs were based on insights drawn from studies of financial statements (of FY09 and FY10) of nine major MFIs. The committee concluded that the total cost incurred on servicing a micro finance loan account is independent of the number of accounts, but the cost of overheads gradually reduces with increase in the portfolio size. It also mentioned that MFIs factor in the cost of branch development into the operational cost and recovers this cost from customers by way of interests and other fees. The committee found this practice unacceptable, considering the section of the society the customers belong to. Therefore, the committee proposed a uniform interest rate cap for individual loans and also proposed a cap on operating profits.

7.2 In its November 2012 study on the cost of micro finance operations, M-CRIL reported that the cost incurred by Indian MFIs in servicing a loan account is considerably low at $21 when compared with the global benchmark of $85. Even when compared with other Asian MFIs, the cost per loan customer (at $21) is just 34% of the East Asian median of $61, and is also substantially lower than the median for low end MFIs internationally. This is very relevant to appreciate the perspective of the Malegam committee in proposing rationalisation of pricing structure of micro credit in India.

7.3 Subsequently, the RBI incorporated the recommendations of the committee with regards to interest rate and operating margin cap along with uniform loan processing fee and insurance premium into its regulatory guidelines. Initially the interest rate on an individual loan was capped at 26% (calculated on average monthly outstanding balance) and the operating margin was capped at 12%. However, through subsequent amendments in the regulatory guideline the maximum interest rate cap was withdrawn. In April 2014, the RBI allowed MFIs to choose between a lower of 2.75 times the average base rate of five large commercial banks (by asset size) or their cost of funds, plus a margin of 10.0% (for MFIs with portfolio more than Rs. 1,000 million) or 12.0%, whichever is applicable. This measure was adopted to protect MFIs from volatility in their cost of borrowing.

7.4 The perspectives on this topic of the MFIs covered were diverse. The MFIs who welcome the move of regulated pricing of micro credit believe that micro finance sector is a social enterprise and they need to display sensitivity towards the vulnerable section of the society. They should desist from viewing micro finance as an attractive and high returns business proposition. These MFIs argued that 10.0% to 12.0% is a reasonable operating margin for ventures and firms operating in social sectors. Moreover, internal inefficiency should not be an excuse to levy high rates on to the customers.

7.5 These MFIs have undertaken internal measures to manage the expectations of their staffs and investors. They have positioned themselves as social enterprises to their internal and external stakeholders. Their opinion is that current regulations would encourage socially committed institutions to stay and continue, while weeding out the avaricious ones.

7.6 On the other hand, the institutions who believe that the industry would do better without hard restrictions on operating margins and interest rates put forth another set of arguments. They argue that restrictions in operating margin will also restrict growth of reserves and will have impact on balance sheets. They are apprehensive that it will be very difficult to undertake risk with shallow balance sheet reserves. This issue coupled with unavailability of funds is already starting to get reflected in dwindling rate of branch expansion in underserved markets. They foresee this trend will eventually lead MFIs jostling for space in highly concentrated markets, putting aside the broader objective of financial inclusion. This intense competition will impact small and medium sized MFIs more than the larger ones.

7.7 Another argument put forth by some MFIs was that the interest rate regime has limited the capacity of institutions to invest in new technology or systems to improve and enhance processes. Although the recommendation of Malegam committee emphasises that burden of capital expenditure should not be enforced on poor customers in reality medium and small size MFIs has no source other than revenue to make capital investment. For example, one of the industry champions stated that they have issued biometric cards to their customers to enhance customer service. They have also hosted the client data on a core banking system (CBS) involving substantial investment. While this has enhanced the quality of service to customers, and improved their ability to report better to credit bureaus and enhance compliance on multiple lending, there is no way they can recover these costs from their customers.

7.8 To offset reduction in profitability level triggered by operating margin cap, some of the MFIs focussed on cutting down redundant and material costs. For example, the costs incurred due to weekly repayment schedule were cut back by decreasing the frequency to fortnightly/ monthly collections. Some of the MFIs have also adopted paperless operations in an attempt to cut costs. Nevertheless, they are not sure about the impact of such technology initiatives in the short run.

7.9 Innovative strategies such as reducing the operating radii of branches were also adopted by some MFIs. Explaining the strategy, an MFI operating in three states in north India disclosed that earlier they had allocated a radius of about 25 kilometres for each field officer to operate, for which they were remunerated commensurately. However, while developing strategies for cost optimisation, they found that a radius of 25 kilometres is barely catered to by any field officer and most of the business is actually conducted within a distance of 7 to 10 kilometres from the branches. The MFI thus reduced the area of operation for the field staff and also lowered the remuneration accordingly. Some MFIs said that they are now targeting customers with higher value of loans. As per RBI guidelines the loan customer shall be allowed a minimum tenure of 24 months to serve loans that are more than Rs.15,000. This was seen as an opportunity by some MFIs. Not only a higher amount of loan provides opportunity to earn more but it also eliminates the cost of "re-acquiring" the customer, as is the case for loans with annual tenor.

7.10 Therefore, it can be concluded that different MFIs view the regulatory regime with respect to pricing differently. They have started devising strategies and investing in innovative systems to reduce operating costs. However need is felt to have an incentive structure for MFIs who are ready to explore underserved markets. This could be in the form of flexibility to price services in initial three to four years of operations, by when a typical branch can attain operational self-sufficiency.

7.11 The recent decision of the RBI to allow MFIs to fix their interest rate cap based on their cost of funds is certainly viewed as a welcome step by the industry. An industry expert commented that there was some degree of inconsistency in the earlier RBI circulars on this matter. Now, the pricing has been made dynamic by linking it to the actual cost of funds. Some experts also opined that it will help small and medium sized MFIs whose cost of funds is usually higher than the bigger players in the industry. Hopefully this dynamic pricing regime, effective from April 1st 2014, will serve as an incentive for the small and medium sized MFIs to open up additional services in underserved markets and help them avoid competing with large MFIs in intensely crowded and saturated markets. In turn, that should also gradually lead to a reduction is concentration risk.

Chapter 8:

Ensuring fair lending practices: Effectiveness of the current mechanism and the way forward

8.1 The Malegam committee has recommended that MFIs should be required to adopt a customer protection code. There are certain core principles of the proposed customer protection code. Avoidance of multiple lending is one of the core principles. The committee, in its report, has established a strong correlation between multiple borrowing and over indebtedness of customers. The committee therefore recommended to the RBI to mandate every MFI to be a member of a credit bureau, also referred to as credit information companies (CICs). Consequently the RBI, under its regulatory guidelines, instructed all NBFC-MFIs to register with at least one of the CICs that abide by the CIC Regulation Act 2005. Most of the micro finance institutions interviewed during our study opined that compliance to this system will encourage fair lending practices and ensure healthy competition in the market.

8.2 The CICs provide information about loan customers' credit history to the member MFIs. The credit information about a prospective customer helps the member MFIs determine their level of indebtedness. The credit information from CICs has emerged as a powerful tool for MFIs to ensure that customers do not resort to excessive borrowing and get caught into a debt trap. It is also a good tool to assess the level of competition in a given market geography. Our study revealed that even NGO-MFIs and Section 25 companies have subscribed to the CICs and availing credit information about prospective or existing loan customers. The system is working well for most MFIs as it has helped reduce credit concentration.

8.3 However not all the CICs have a very robust system to provide high quality information or have limitations of coverage. Even the RBI, in its guidelines has mentioned that until the system of CICs become robust the NBFC-MFIs may rely upon self-certification from customers and their own local enquiries on level of borrowing and household income of customers and prospects. While there are multiple CICs operating in the micro finance and retail credit market, each depends on the member MFIs for credit information about loan customers. Therefore it is vital that MFIs share their own information in a transparent and holistic manner to enable the entire industry to gain the benefits in the long term. However certain challenges still remain. For example, while the quality of data with ration card or voters' identity card is perceived to be accurate, UIDAI Aadhaar linked data is perceived to be incomplete and hence the preference is to avoid taking Aadhaar as a reference document for POA and/or POI.

8.4 A few MFIs have started integrating their internal platform with the database of the CICs. These kinds of integrated MIS systems will be very effective as they would reduce some of the data discrepancy and under reporting challenges that exist currently. They might also enable online or rapid decision making capabilities. The decision to accept or reject an application based on a prospects' credit history can be built into these integrated platforms. MFIs' operations staff might also be able to query the database of the CICs and get immediate responses. These integrations will also help MFIs reduce processing times considerably.

8.5 Most MFIs are keen to use credit bureaus and are hopeful that this system will bring transparency into the micro finance sector and will help rationalise credit decisions. Nevertheless, there are certain concerns about the way the system is being implemented in the sector. According to most MFIs the principal issue is a lack of monitoring of the implementation of the bureaus.

8.6 Mid-sized and small MFIs are also concerned about the frequent violation of the mandate by larger MFIs. It was revealed during the study that a few very large MFIs were not disclosing all their customer details to CICs. As a result, a considerable part of their portfolio is not reflected in the database of CICs. This incidentally gets discovered during CGTs, when some customers agree to having availed loans from these MFIs. Moreover, it is not mandatory for banks that directly lend to micro finance customers to report credit information of their loan customers to the CICs making it difficult for majority of small and medium sized MFIs to ascertain the level of indebtedness of the prospects. Although there is a provision to ascertain the level of borrowing of prospective customers through field due diligence, it is not a cost-effective solution. Many cases were observed where a bank might be the third lender and a fourth MFI approaching these customers would not know of this, in case the customers choose to hide this information. This would naturally lead to over lending.

8.7 Another challenge is with regards to the manner in which customer information is shared with the CICs. In our study it came out that often there is a substantial time lag between credit check of a prospective customer and the disbursement of funds. It has been our experience that usually the credit check on a prospective customer is undertaken before the compulsory group training (CGT). Disbursal generally happens after the process of sanctioning and the group recognition test (GRT). It also depends upon the availability of funds. Therefore, it is possible for another player (MFI or bank) to also disburse funds to these prospective customers in this time window, in case the customers choose not to disclose concurrent processing. This "additional" loan would be revealed only during a credit check undertaken at the time of the next loan cycle. By then it will be too late to act to prevent excessive borrowing.

8.8 Apart from this issue, it has also been observed that only a few MFIs upload credit information of their loan customers "immediately" after disbursal. There is often a time lag between disbursal of credit and uploading credit information into the CIC database.

8.9 Another concern is about the cost of downloading reports from multiple CICs. Smaller MFIs with leaner operating margin are of the opinion that subscribing to multiple CICs is a significant financial burden for them. It was observed that as it is mandatory for an MFI to upload credit history of their customers to only one CIC, it will be difficult to get a comprehensive report on customers from a single CIC. This deficiency makes it essential for MFIs to subscribe to two or more CICs to ensure a better view to the credit history of consumers. One of the MFIs mentioned that although they think that the present business volume in the industry justifies the need for at least two CICs it should be made compulsory for MFIs to share their data will all the CICs. This will not only ensure wider coverage of the market but will also be financially less burdensome for smaller MFIs to access comprehensive information from a single CIC. The MFI also opined that if they have to obtain declaration from prospective customers themselves about their borrowing level, then CICs are not serving their purpose.

8.10 These challenges and gaps compromise the effectiveness of credit bureaus and need to be addressed to prevent multiple lending and to protect customers from over indebtedness.

8.11 A way forward to address some of these challenges is to ensure close coordination between the regulatory authorities; representatives from the micro finance industry and credit information companies. The regulations for avoidance of multiple lending are path-breaking, nevertheless their success will depend upon the rigour of implementation, monitoring and coordination.

8.12 We recommend that the RBI undertake the following measures to ensure that this vital regulation is effectively implemented.

8.12.1. The mandate of subscribing to and reporting credit information to CICs should be inclusive. Not only NBFC-MFIs but any financial institution or bank that caters to micro finance customers should be brought under the purview of this regulatory guideline.

8.12.2. The proposed self-regulatory organisation (SRO) should be given the responsibility of monitoring the reporting mechanism and asked to submit periodic compliance reports to the RBI. A mechanism of penalties should be instituted and levied upon the defaulters.

8.12.3. Credit checks for loan customers should be done closer to disbursement (timelines can be agreed in consultation with the market participants). The disbursement data should be provided to CICs at the earliest and not later than 2 or 3 days after disbursement.

8.12.4. There should be an integrated platform that allows access to shared information across all the CICs. This will eliminate the need to subscribe to multiple CICs for comprehensive information, which is expensive and operationally cumbersome, and therefore not followed in practice.

Chapter 9:

Recommended future course of action to ensure sustainability of micro finance sector in India

9.1 The MFIs interviewed during our study opined that the regulatory guidelines issued by the RBI have set the right course for future developments in the micro finance sector. They believe that regulatory guidelines have brought about operational transparency in the sector. There is an increased level of disclosure about pricing and processes. There is also an increased impetus on client protection and client education. MFIs are investing more time and resources to enhance operational efficiency and minimise redundant costs. Nevertheless, there are a few areas MFIs would like the RBI to re-consider. These concerns are mainly around (a) capping of operating margin, (b) uniform and higher maximum household income level for eligibility of customers and (c) superior implementation of credit information sharing mechanisms.

9.2 A holistic solution to all these outstanding issues could have been achieved with the materialisation of the Micro Finance Institution (Development and Regulation) Bill, 2012. In our opinion the bill will be beneficial for most micro finance institutions, irrespective of their constitutions. The bill can bring a radical progressive change in the way micro finance is conceptualised and executed in our country. A summary of our analysis of the bill follows.

9.3 Formation of Micro Finance Development Council: The proposed council would be constituted of nominated members from central government ministries, the RBI, SIDBI, NABARD and NHB would provide policy advisory services to the central government. The committee would formulate, advice on, and help implement policies with regards to introduction of innovative technology, client protection measures, credit information sharing and financial inclusion in the micro finance sector. Currently in the absence of any such committee, the RBI has to depend on ad hoc committees to review the sector and provide policy advisory services. The current approach is reactive rather than proactive. Formation of this committee as prescribed in the bill will be a very good measure to develop proactive policies for the micro finance sector.

9.4 Formation of State Micro Finance Councils and District Micro Finance Committees: The proposed state committees would be represented by members of state governments and representatives from the SLBC convener bank, state representative of MFIs nominated by the central government and a senior member of RBI looking after micro finance sector. The role of this committee would be to monitor, ensure compliance of RBI guidelines and coordinate with central government in matters related to operations of MFIs in states and districts. These councils and committees will ensure that at least one additional body is monitoring MFIs apart from the RBI. This will improve monitoring and compliance and prevent future occurrence of events such as those in Andhra Pradesh.

9.5 The RBI as the sole regulator of the entire sector: The RBI was provided a larger authority to regulate the sector under the provisions of the bill. The bill proposes that any MFI operating in India must register with the RBI. The RBI was proposed to be responsible to formulate of regulatory guidelines and to issue directives to entities in the sector. Matters ranging from interest rate to winding up of an institution would be governed by the central bank. There is also a provision for establishment of an entity similar to ombudsmen to implement complaint redressing mechanism for customers of the MFIs. It is mentioned in the bill that the RBI will be given the powers to impose penalties on the institutions violating the directives and its orders could not be challenged in civil courts. The implication of this legislation would have been far reaching. It would have provided the micro finance sector a mature and progressive regulatory environment enjoyed by the banking sector in India. It would have helped build robust systems, encourage innovation in technology, enable the sector manage risks better manner and so forth.

9.6 Creation of Micro Finance Development Fund: The bill had proposed creation of a fund with contributions from government, institutions, and donors and other entities and public for the purpose of the proposed Act. The fund would have been used to provide loans, refinance, grants and seed capital to micro finance institutions. The fund could also have been used for training and capacity building of member MFIs, investing in equity of these MFIs, meet expenses towards monitoring, governance and policy formulation for the sector. Adoption of the bill and creation of this fund would have allowed MFIs to become more resilient and reduce dependence on private investment in the sector.

9.7 It is important that till such time the Micro finance Bill is approved in its current or revised form, MFIN the newly appointed self-regulatory organisation, and/or any other such industry body should ensure transparency and level playing field for its members.

9.8 The latest guideline from the central bank allows non deposit taking NBFCs and NBFC-MFIs to operate as BC for banks. It is another positive development in the sector since most MFIs interviewed during this study operating BC business for commercial banks were finding it difficult to do so under different entities. The cost of operating through multiple entities was high compared to the return from the business. Moreover synergies across field infrastructure, staff, processes and consumers also could not be realised effectively. Nevertheless, many of the mid and small size MFIs adopted this business model for want of a better alternative.

9.9 A similar study[8] conducted by MFIN reported that 84% of the 70 MFIs interviewed by them stated that BC operations is a strategic fit for them. They also opined that a single operating entity would help them reduce operational cost and underutilisation of BC staff. The regulation should enable them to operate more efficiently and synergistically across the micro finance and BC business.

9.10 The micro finance industry is at a very crucial juncture and witnessing very interesting developments. From easing of the interest rate cap to an in principle approval to Bandhan to set up a bank are positive and important developments. The concept of a micro finance bank is new to India and it will be very interesting to observe Bandhan's evolution into a full scale commercial bank. The draft guidelines issued on Payments Bank and Small Banks are in the direction of setting up specialised horizontally and vertically differentiated banks in India.

9.11 It is evident that regulating such an important industry was long due. **Now that the industry (or at least the major portion of it) is under the ambit of regulations, it must be ensured that it achieves sustainability and growth. Policies and regulations need to be balanced. They need to drive consumer centric behaviour on the part of the MFIs and at the same time encourage innovation, growth and sustainability.** It is very reassuring that the Reserve Bank of India is adopting a range of strategies for the sector. Apart from the direct regulations for the micro finance sector (and subsequent enabling amendments), allowing NBFCs to become business correspondents; banking license for a large players like *Bandhan*; draft guidelines on Payments Bank and Small Bank, are very welcome steps taken in the right direction. They demonstrate a diversified regulatory approach that addresses the needs of a range of MFIs – from small to very large ones. **More can be done to meet the outstanding needs of the sector and to overcome the barriers that remain, as highlighted through this study. Policies and regulations need to evolve continuously linked to the market context, situation and demands.** It is very encouraging to find Indian regulators believe in and follow this approach.

[8] Online survey of MFIs as Business Correspondent: An MFIN-GIZ Assessment dated 18th February 2014

Annexure:

Approach and methodology adopted for the study

Approach

A.1 This study was conducted to understand the perspective of the MFI customers and management staffs of MFIs about the impact of regulatory guidelines on them. Views of some of the banks' lending to MFIs or directly to micro finance customers were also sought to understand their risk perspective of the sector and challenges of lending to the sector.

Methodology

A.2 Qualitative interviews of each these group of respondents were conducted over a period of two months. Major/ minor changes in the regulatory guidelines were covered in the report by conducting follow up interviews.

A.3 Focus group discussions (FGDs) were conducted with customers. The sampling or identification of respondents were done based on convenience of the MFIs and availability of MFI staff to assist the researchers. Each aspect, on which the opinion of the participating customers was sought, was discussed in the group to reach a consensus. The frequency of an aspect on which a consensus was reached was noted. Later, based on the number of times (per 100 FGD) the aspect was referred to by customers tally tables were generated.

A.4 Some of these individual aspects was clubbed into an attribute (especially in the case of likes and dislikes about the micro finance facilities). For example; high interest and high processing fee was clubbed and termed "unaffordability". Subsequently, the frequency of this attribute was tabulated and the response of the customer (like or dislike) was noted against it.

Limitation

A.5 Each and every fact/ data presented in the report is either based on secondary research or qualitative primary research. *MicroSave* does not assume responsibility of facts and data obtained from secondary sources. On the other hand primary facts/ data are qualitative nature and may be more representative of MFI customers and MFIs operating in India.

edgecommunication@gmail.com

MicroSave

Market-led solutions for financial services

India - Head Office

B-52, Kapoorthala Crossing,
Mahanagar Extension,
Mahanagar,
Lucknow-226006, UP, India.
Tel: +91-522-2335734
Fax: +91-522-4063773

India - Delhi Office

S-10, Second Floor,
Green Park Extension,
New Delhi-110016,
India.
Phone: +91-11-410 55537

India - Hyderabad Office

H No: 12-2-823/A/30, Santosh
Nagar Colony, Mehdipatnam,
Hyderabad -500028,
Telengana, India.
Phone: +91-040-23516140

E-Mail: Info@*MicroSave*.net | Website: www.*MicroSave*.org