THE BIG PICTURE : REGULATORY FRAMEWORK FOR MICROFINANCE

Context: Recently, **RBI proposed to lift the interest rate cap on Microfinance Institutions (MFIs), and said all micro loans should be regulated by a common set of guidelines irrespective of who gives them.**

Key Proposals:

- RBI has suggested a **common definition of microfinance loans** for all regulated entities.
- Microfinance **loans should mean collateral-free loans to households with annual household income of Rs 1,25,000 and Rs 2,00,000** for rural and urban/semi urban areas, respectively.
- 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%.
- NBFC-MFIs, like any other NBFC, shall be **guided by a board-approved policy and the fair practices code**, whereby disclosure and transparency would be ensured.
- There would be **no ceiling prescribed for the interest rate**. There would be no collateral allowed for micro loans.
- There can be **no prepayment penalty**, while all entities have to permit the borrowers to repay weekly, fortnightly or monthly instalments as per their choice
- All lenders have to **spell minimum, maximum and average rates.**

What is Microfinance?

- Microfinance is a **type of banking service provided to those who have difficulty in accessing formal financial services.**
- It is targeted at the low-income and unemployed fraction of the population.
- The institutions supporting microfinance offer services such as lending, setting up bank accounts and providing micro-insurance products.
- In developing countries such as India, financial services through formal channels do not meet the demands of the rural poor, so microfinance can help small-scale businesses flourish by providing greater financial stability.
- Microfinance is a basis of financial services for entrepreneurs and small businesses deficient in contact with banking and associated services.
- The term **"microfinancing" was first used in the 1970s during the development of Grameen Bank of Bangladesh, which** was founded by the microfinance pioneer, Muhammad Yunus.
- In 1976, Yunus institutionalized the approaches of microfinance, along with the foundation of Grameen Bank in Bangladesh.

Need:

- The **leading cause of the failure of formal banking institutions while lending to the rural poor is the absence of proof of recognised employment or collateral that can be offered by the poor while applying for loans.**
- The high risk and transaction costs of small loan savings deposits create difficulty for the banks as well.
- This leaves the poor with no alternative but to borrow money from local moneylenders at high-interest rates.
- **MFIs provide easy credit and offer small loans to customers, without any collateral.**

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- It makes more money available to the poor sections of the economy, leading to increased income and employment of poor households.
- Serving the under-financed section such as poor, women, unemployed people and those with disabilities.
- It helps them become aware of the financial instruments available for their help and also helps in developing a culture of saving.

Background in India:

- In India, the **first initiative to introduce microfinance was the Self-Employed Women's Association (SEWA) in Gujarat**, which established SEWA Bank in 1974.
- Since then, this bank has been providing financial services to individuals who wish to grow their own businesses in rural areas.
- One 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 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.**

Major Business Models:

- **Joint Liability Group:** This is usually an informal group that consists of 4-10 individuals who seek loans against mutual guarantee.
- **Self Help Group:** It 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 classified as non-profit organisations.
- **Grameen Model Bank:** It was the brainchild of Nobel Laureate Prof. Muhammad Yunus in Bangladesh in the 1970s. It has inspired the creation of RRBs in India. The primary motive of this system is the end-to-end development of the rural economy. Some of the notable examples who are inspired from this model are SHARE Microfinance Limited, Activists for Social Alternatives (ASA) and CASHPOR Financial and Technical Services Limited.
- **Rural Cooperatives:** this system had complex monitoring structures and was beneficial only to the creditworthy borrowers in rural India. Hence, this system did not find the success that it sought initially.
- **Federated Self Help Groups (SHG federations):** PRADAN, Chaitanya, SEWA and Dan Foundation.
- **Rotating Savings and Credit Associations** (ROSCAS). E.g.: Chit funds
- **Microfinance companies**

Challenges:

- **Does not reach the deserving poor:** The microfinance delivery models fail to focus on people who are below the poverty level as they are deemed to be risky.
- **Limited spread in the poorer states:** The coverage of microfinance programme is low in those states where a large percentage of the population lives in poverty. States such as Orissa, Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh and Uttar Pradesh lag behind in implementing microfinance schemes.
- **High interest rates:** Borrowers are interest-sensitive, so the capacity of borrowing decreases with an increase in interest rates. Whereas the banking sector charge 9-10% annual interest rate, MFIs may charge 11-24%.

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- **Low depth of outreach:** The insufficient loan size and the short period of lending available, restrict borrowers from using the loans for productive purposes. They generally use these small loans to address liquidity issues, rather than borrowing to invest.
- **Fragmented Data:** While overall loan accounts have been increasing, the actual impact of these loans on the poverty-level of clients is not clear as data on the relative poverty-level improvement of MFI clients is fragmented.
- **Impact of Covid-19:** It has impacted the MFI sector, with collections having taken an initial hit and disbursals yet to observe any meaningful thrust.
- **Widespread Dependence on Indian Banking System:** are dependent on financial institutions such as commercial banks for stabilized funding to carry out their own lending activities.
- Inadequate Investment Validation

Way Forward:

- The focus of most of the microfinance service providers has remained on expanding the outreach of microfinance programme with **little attention to the depth, quality and viability of the financial services.**
- In addition to removing these problems, there needs to be a **proper structure to let microfinance empower rural India.**
- MFIs need to focus on creating a **sustainable and scalable microfinance model** with a **mandate that is unequivocal about both economic and social good**.
- MFIs should ensure that the **'stated purpose of the loan' that is often asked from customers at the loan-application stage is verified at the end of the tenure of the loan**.
- RBI should encourage all institutions to monitor their impact on society by means of a **'social impact scorecard'.**

https://youtu.be/euY6W9Oyh68

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