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INDIAN MICROFINANCE INDUSTRY

RBI's proposed regulatory changes to create level playing field and provide more flexibility to NBFC-MFIs

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RBI’s CONSULTATION PAPER ON MICROFINANCE

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RBI proposes lender-agnostic regulatory framework providing more flexibility to NBFC-MFIs

Focus shifts to overall repayment capacity of borrowers from earlier defined borrowing caps by NBFC-MFIs

Proposed framework to harmonise microfinance regulations across lenders and provide more flexibility to NBFC-MFIs while protecting borrowers’ interests

Lenders in the microfinance finance industry in India comprise not only non-banking financial company - microfinance institutions (NBFC-MFIs), but also NBFC - investment and credit companies (NBFC-ICC), scheduled commercial banks (SCBs), small finance banks (SFBs) and others. However, the Reserve Bank of India’s (RBI) regulations for microfinance lending activities are applicable only to NBFC-MFIs while the other lenders are governed by the different regulatory frameworks applicable to them. As the composition of the industry is tilted towards SCBs and SFBs, which have a majority share (~60%) of microfinance (excluding the self-help groups bank linkage programme) in the country while NBFC-MFIs have a share of ~30%, there is a need for a harmonised regulatory framework.

Accordingly, the RBI has issued a consultation paper on regulation of microfinance on June 14, 2021. The said paper proposes changes in the regulations to make them lender agnostic and hence applicable to all RBI regulated entities (REs) involved in microfinancing activities including SCBs, SFBs and NBFC-ICCs. The proposed regulations aim to provide a level playing field to all the players involved in microfinancing activities and is targeted towards addressing some of the issues faced by the industry such as:

1. **Over-leveraging –** As per the current regulatory framework for NBFC-MFIs, they must adhere to a cap on the lending amount and with respect to the number of lenders who can provide loans to a microfinance borrower. This is done to avoid over-leveraging at the borrower level. However, since the said regulation does not apply to other lenders, the borrower may borrow more from a lender other than an NBFC-MFI, thereby defeating the purpose. The proposed set of rules applicable for all lenders and with the focus on borrowers’ repayment obligations in relation to the total household income are expected to help mitigate this issue and prevent over-leveraging at the borrower level.

2. **Interest rates –** The current regulatory framework for NBFC-MFIs has guidelines, which cap the rate of interest charged by NBFC-MFIs while other borrowers are not required to adhere to the same. The proposal to remove such caps is expected to provide more flexibility to NBFC-MFIs and create a level playing field for all the REs. Moreover, the interest rate ceiling had been working as a de facto interest rate in the industry for all the players and the removal of the same is expected to make the players compete on the pricing of loans, thus benefiting the borrowers in the long-term. However, given the low interest rate elasticity in the sector and given the moderation in the profitability because of the Covid-19 induced stress, there might not be interest rate reduction in the near-term.

Though NBFC-MFIs will enjoy more flexibility, they will have to put in place board-approved policies on household income assessment, loan pricing regulations and related aspects. In addition, increased data gathering and enhanced disclosure requirements may slightly increase the operating expenses.

EXHIBIT 1: Comparison of Existing Framework for NBFC-MFIs with Proposed Regulations for all Lenders in the Sector and its Impact on the Sector

	Existing Framework for NBFC–MFIs	Proposed Regulations for all REs	Impact on the Sector
Definition of microfinance loans ***{As per extant guidelines, each NBFC-MFI is required to maintain not less than 85 per cent of its net assets (assets other than cash, bank balances and money market instruments) as 'qualifying assets'}***	I. To be classified as a 'qualifying asset' i.e. a microfinance loan, a loan should satisfy the following conditions: a) Loan to a borrower with a rural household annual income not exceeding Rs. 1,25,000 or urban and semi-urban household income not exceeding Rs. 2,00,000 b) Loan amount does not exceed Rs. 75,000 in the first cycle and Rs. 1,25,000 in subsequent cycles c) Total indebtedness of the borrower does not exceed Rs. 1,25,000 (excluding loans availed towards meeting education and medical expenses) d) Minimum tenure of 24 months for loan amount greater than Rs. 30,000 with prepayment without penalty e) Loan to be extended without collateral f) Aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs g) Loan is repayable in weekly, fortnightly, or monthly instalments at the choice of the borrower II. Not more than two NBFC-MFIs can lend to the same borrower	I. Microfinance loans shall 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 'Household' means a group of persons normally living together and taking food from a common kitchen. Even though the determination of the actual composition of a household shall be left to the judgment of the head of the household, emphasis should be placed on 'normally living together' rather than on 'ordinarily taking food from a common kitchen' II. Other related instructions a) Each RE shall have a board-approved policy for - • household income assessment • 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 maximum limit of 50 per cent i.e. fixed obligations to income ratio (FOIR) cannot exceed 50% • periodicity of repayments • all-inclusive interest rates charged from the borrowers b) No prepayment penalty c) Disclosure of pricing-related information in a standard simplified fact sheet d) Display of minimum, maximum and average interest rates charged on microfinance loans	• With the proposed changes, the **definition of microfinance loans (qualifying assets) stands aligned** across all REs • With a cap on the FOIR at 50% and while meeting the household income criteria of Rs. 1,25,000 and Rs. 2,00,000 for rural and urban/semi-urban areas, respectively, the **maximum permissible indebtedness of rural microfinance borrowers could be lower** than the current levels unless the tenor is extended *(currently about 24 months)* while the same could increase for microfinance borrowers in urban/semi-urban areas Assuming a tenure of 24 months and interest rate of 20-21% p.a., the maximum permissible household-level loan comes to around Rs. 1,00,000 in rural areas and around Rs. 1,60,000 in urban/semi-urban areas • Harmonisation of regulations across all REs is expected to **avoid excess leveraging and protect borrowers' interest** • The criteria of minimum 50% of loans as income-generating loans and the cap on the number of lenders to the same borrowers stand withdrawn. The **focus shifts to borrowers' overall repayment capacity in relation to their household income**

	Existing Framework for NBFC–MFIs	Proposed Regulations for all REs	Impact on the Sector
			• **NBFC-MFIs will need to have well-documented policies for household income assessment**. In addition, the operating cost may increase slightly for gathering more data and undertaking more comprehensive credit bureau data checks vis-à-vis the data currently accessed by the MFIs
Pricing of microfinance loans	I. Maximum interest charged by an NBFC-MFI shall be the lower of - a) The cost of funds plus a margin cap of 10% for MFIs with loan portfolio of Rs. 100 crore or above and 12% for others b) The average base rate of the five largest commercial banks by assets multiplied by 2.75 The average base rate of the five largest commercial banks is announced by the RBI at the end of each quarter, which determines the interest rate for the ensuing quarter II. The average interest rate on loans sanctioned during a quarter does not exceed the average borrowing cost during the preceding quarter plus the margin III. The maximum variance permitted for individual loans between the minimum and maximum interest rate cannot exceed 4 per cent IV. The average interest paid on borrowings and charged by NBFC-MFIs are to be calculated on the average monthly balances of the outstanding borrowings and the loan portfolio, respectively. Figures to be certified annually by statutory auditors and disclosed in the balance sheet	I. The board of each NBFC-MFI shall adopt an interest rate model taking into account relevant factors such as cost of funds, margin and risk premium, and determine the rate of interest to be charged for loans and advances. The rate of interest and the approach for gradations of risk and rationale for charging different rates of interest from different categories of borrowers shall be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter II. The rates of interest and the approach for gradation of risks shall also be made available on the website of the companies or published in relevant newspapers. The information published on the website or otherwise published shall be updated whenever there is a change in the rates of interest III. The rate of interest must be an annualised rate so that the borrower is aware of the exact rates that would be charged on the account IV. Though interest rates are not regulated by the RBI, rates of interest beyond a certain level may be seen to be excessive and can neither be sustainable nor conforming to normal financial practice. Boards of NBFC-MFIs, therefore, shall lay out appropriate internal principles and procedures for determining interest rates and processing and other charges. In this regard, the directions in the fair practices code	• The proposed regulations aim to **align the pricing guidelines** for NBFC-MFIs with that prescribed for NBFCs in general. This is **expected to create a level playing field** for all the players • NBFC-MFIs, like any other NBFCs, would get **more flexibility in the pricing of loans**; however, they would need to have board-approved policies and enhanced disclosures • The interest rate ceiling had been working as a de facto interest rate in the industry for all the players and the removal of the same is expected to make the players compete on the pricing of loans. **ICRA expects the market forces to work to benefit the borrowers in the long-term but because of the borrowers being less sensitive to interest rate, transmission of the same from lenders may take time**. • The provision for the levy of delayed payment charges is **likely to help enforce discipline among borrowers**

	Existing Framework for NBFC–MFIs	Proposed Regulations for all REs	Impact on the Sector
	V. Processing charges shall not be more than 1 per cent of gross loan amount. Processing charges need not be included in the margin cap or the interest cap VI. NBFC-MFIs shall recover only the actual cost of insurance for group or livestock, life, health for borrower and spouse. Administrative charges, where recovered, shall be as per the Insurance Regulatory and Development Authority's (IRDA) guidelines II. No penalty shall be charged on delayed payments	about transparency in respect of terms and conditions of the loans are to be kept in view V. NBFC-MFIs shall give notice to the borrower in the vernacular language or a language understood by the borrower of any change in the terms and conditions including disbursement schedule, interest rates, service charges, prepayment charges, etc. NBFC-MFIs shall also ensure that changes in interest rates and charges are effective only prospectively. A suitable condition in this regard must be incorporated in the loan agreement VI. NBFC-MFIs shall mention the penal interest charged for late repayment in bold in the loan agreement	• Enhanced disclosures in a simplified format are **expected to provide clarity to borrowers** to help them make informed decisions
Criteria for exemption of non-profit MFIs	I. Exemption from Sections 45-IA, 45-IB and 45-IC of the RBI Act, 1934 to a microfinance company which is- a) engaged in microfinancing activities i.e. providing credit not exceeding Rs. 50,000 for a business enterprise and Rs. 1,25,000 for meeting the cost of a dwelling unit to any poor person for enabling him to raise his level of income and standard of living; and b) registered under Section 8 of the Companies Act, 2013; and c) not accepting public deposits	I. Exemption from Sections 45-IA, 45-IB and 45-IC of the RBI Act, 1934 to a microfinance company which is - a) engaged in microfinancing activities i.e. providing 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, provided the payment of interest and repayment of principal for all outstanding loans of the household at any point of time does not exceed 50 per cent of the household's income; and b) registered under Section 8 of the Companies Act, 2013 c) not accepting public deposits; and d) having an asset size of less than Rs. 100 crore	The proposed criteria aim to **align the definition of microfinance for Section 8 companies** with that prescribed for other lenders In addition, the **removal of the exemption for larger Section 8 entities brings them under regulatory supervision**. However, most of the Section 8 entities operating in the microfinancing space have an asset size of less than Rs. 100 crore and would continue to enjoy exemptions

Source: RBI Consultation Paper on Regulation of Microfinance dated June 14, 2021, ICRA research

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