

**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**



RESERVE BANK OF INDIA

January 2011

LETTER OF TRANSMITTAL

Chairman

**Sub-Committee of the Central
Board of Directors of Reserve
Bank of India to Study Issues and
Concerns in the MFI Sector**

**Reserve Bank of India
Central Office
Mumbai – 400 001**

January 19, 2011

Dr. D. Subbarao
Governor
Reserve Bank of India
Mumbai

Sir,

I have great pleasure in submitting the Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in MFI Sector. The Report has been prepared in accordance with the terms of reference given to the Committee.

On behalf of the Members of the Sub-Committee, and on my own behalf, I sincerely thank the Board for entrusting this responsibility to us. The Committee would also like to acknowledge the assistance it has received from the officers of the Reserve Bank in the preparation of this Report.

With regards,

Yours sincerely,



(Y.H.Malegam)

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1 Introduction

1.1 The Board of Directors of the Reserve Bank of India, at its meeting held on October 15, 2010 formed a Sub-Committee of the Board to study issues and concerns in the microfinance sector in so far as they related to the entities regulated by the Bank.

1.2 The composition of the Sub-Committee was as under:-

Shri Y.H. Malegam – Chairman

Shri Kumar Mangalam Birla

Dr. K. C. Chakrabarty

Smt. Shashi Rajagopalan

Prof. U.R. Rao

Shri V. K. Sharma (Executive Director) – Member Secretary

1.3 The terms of reference of the Sub-Committee were as under:-

- 1.** To review the definition of ‘microfinance’ and ‘Micro Finance Institutions (MFIs)’ for the purpose of regulation of non-banking finance companies (NBFCs) undertaking microfinance by the Reserve Bank of India and make appropriate recommendations.
- 2.** To examine the prevalent practices of MFIs in regard to interest rates, lending and recovery practices to identify trends that impinge on borrowers’ interests.
- 3.** To delineate the objectives and scope of regulation of NBFCs undertaking microfinance by the Reserve Bank and the regulatory framework needed to achieve those objectives.
- 4.** To examine and make appropriate recommendations in regard to applicability of money lending legislation of the States and other relevant laws to NBFCs/ MFIs.
- 5.** To examine the role that associations and bodies of MFIs could play in enhancing transparency disclosure and best practices
- 6.** To recommend a grievance redressal machinery that could be put in place for ensuring adherence to the regulations recommended at 3 above.
- 7.** To examine the conditions under which loans to MFIs can be classified as priority sector lending and make appropriate recommendations.
- 8.** To consider any other item that is relevant to the terms of reference.

2 The Microfinance sector

- 2.1** Microfinance is an economic development tool whose objective is to assist the poor to work their way out of poverty. It covers a range of services which include, in addition to the provision of credit, many other services such as savings, insurance, money transfers, counseling, etc.
- 2.2** For the purposes of this report, the Sub-Committee has confined itself to only one aspect of Microfinance, namely, the provision of credit to low-income groups.
- 2.3** The provision of credit to the Microfinance sector is based on the following postulates:
- a)** It addresses the concerns of poverty alleviation by enabling the poor to work their way out of poverty.
 - b)** It provides credit to that section of society that is unable to obtain credit at reasonable rates from traditional sources.
 - c)** It enables women's empowerment by routing credit directly to women, thereby enhancing their status within their families, the community and society at large.
 - d)** Easy access to credit is more important for the poor than cheaper credit which might involve lengthy bureaucratic procedures and delays.
 - e)** The poor are often not in a position to offer collateral to secure the credit.
 - f)** Given the imperfect market in which the sector operates and the small size of individual loans, high transaction costs are unavoidable. However, when communities set up their own institutions, such as SHG federations and co-operatives the transaction costs are lower.
 - g)** Transaction costs, can be reduced through economies of scale. However, increases in scale cannot be achieved, both for individual operations and for the sector as a whole in the absence of cost recovery and profit incentive.
- 2.4** Given the above considerations, the essential features of credit for Microfinance which have evolved are as under:-
- a)** The borrowers are low-income groups.
 - b)** The loans are for small amounts.
 - c)** The loans are without collateral.
 - d)** The loans are generally taken for income-generating activities, although loans are also provided for consumption, housing and other purposes.
 - e)** The tenure of the loans is short.

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- f) The frequency of repayments is greater than for traditional commercial loans.
- 2.5** The players in the Microfinance sector can be classified as falling into three main groups
- a) The SHG-Bank linkage Model accounting for about 58% of the outstanding loan portfolio
 - b) Non-Banking Finance Companies accounting for about 34% of the outstanding loan portfolio
 - c) Others including trusts, societies, etc, accounting for the balance 8% of the outstanding loan portfolio. Primary Agricultural Co-operative Societies numbering 95,663, covering every village in the country, with a combined membership of over 13 crores and loans outstanding of over ₹64, 044 crores as on 31.03.09 have a much longer history and are under a different regulatory framework. Thrift and credit co-operatives are scattered across the country and there is no centralized information available about them.
- 2.6** The SHG-Bank Linkage Model was pioneered by NABARD in 1992. Under this model, women in a village are encouraged to form a Self help Group (SHG) and members of the Group regularly contribute small savings to the Group. These savings which form an ever growing nucleus are lent by the group to members, and are later supplemented by loans provided by banks for income-generating activities and other purposes for sustainable livelihood promotion. The Group has weekly/ monthly meetings at which new savings come in, and recoveries are made from members towards their loans from the SHGs, their federations, and banks. NABARD provides grants, training and capacity building assistance to Self Help Promoting Institutions (SHPI), which in turn act as facilitators/ intermediaries for the formation and credit linkage of the SHGs.
- 2.7** Under the NBFC model, NBFCs encourage villagers to form Joint Liability Groups (JLG) and give loans to the individual members of the JLG. The individual loans are jointly and severally guaranteed by the other members of the Group. Many of the NBFCs operating this model started off as non-profit entities providing micro-credit and other services to the poor. However, as they found themselves unable to raise adequate resources for a rapid growth of the activity, they converted themselves into for-profit NBFCs. Others entered the field directly as for-profit NBFCs seeing this as a viable business proposition. Significant amounts of private equity funds have consequently been attracted to this sector.

3 The need for regulation

- 3.1** All NBFCs are currently regulated by Reserve Bank under Chapters III-B, III-C and V of the Reserve Bank of India Act. There is, however, no separate category created for NBFCs operating in the Microfinance sector.
- 3.2** The need for a separate category of NBFCs operating in the Microfinance sector arises for a number of reasons.
- 3.3** First, the borrowers in the Microfinance sector represent a particularly vulnerable section of society. They lack individual bargaining power, have inadequate financial literacy and live in an environment which is fragile and exposed to external shocks which they are ill-equipped to absorb. They can, therefore, be easily exploited.
- 3.4** Second, NBFCs operating in the Microfinance sector not only compete amongst themselves but also directly compete with the SHG-Bank Linkage Programme. The practices they adopt could have an adverse impact on the programme. In a representation made to the Sub-Committee by the Government of Andhra Pradesh, it has been argued, that the MFIs are riding “piggy-back” on the SHG infrastructure created by the programme and that JLGs are being formed by poaching members from existing SHGs. About 30% of MFI loans are purportedly in Andhra Pradesh. The Microfinance in India- A State of Sector Report 2010 also says that there are many reports of SHGs splitting and becoming JLGs to avail of loans from MFIs. The A.P. Government has also stated that as the loans given by MFIs are of shorter duration than the loans given under the programme, recoveries by SHGs are adversely affected and loans given by the SHGs are being used to repay loans given by MFIs. While we did not, as committee, examine each of these issues in depth, the fact that these complaints have been made reinforces the need for a separate and focused regulation.
- 3.5** Thirdly, credit to the Microfinance sector is an important plank in the scheme for financial inclusion. A fair and adequate regulation of NBFCs will encourage the growth of this sector while adequately protecting the interests of the borrowers.
- 3.6** Fourth, over 75% of the finance obtained by NBFCs operating in this sector is provided by banks and financial institutions including SIDBI. As at 31st March 2010, the aggregate amount outstanding in respect of loans granted by banks and SIDBI to NBFCs operating in the Microfinance sector amounted to ₹13,800 crores. In addition, banks were holding securitized paper issued by NBFCs for an amount of ₹4200 crores. Banks and Financial Institutions including SBIDBI also had made investments in the equity of such NBFCs. Though this exposure may not be

significant in the context of the total assets of the banking system, it is increasing rapidly.

- 3.7** Finally, given the need to encourage the growth of the Microfinance sector and the vulnerable nature of the borrowers in the sector, there may be a need to give special facilities or dispensation to NBFCs operating in this sector, alongside an appropriate regulatory framework. This will be facilitated if a separate category of NBFCs is created for this purpose.
- 3.8** **We would therefore recommend that a separate category be created for NBFCs operating in the Microfinance sector, such NBFCs being designated as NBFC-MFI.**

4 Definition

- 4.1** Once a separate category of NBFC-MFI is created, it becomes necessary to provide in the regulations a definition for such NBFCs. This definition must incorporate the distinctive features of a NBFC-MFI.
- 4.2** **The Sub-Committee therefore recommends that a NBFC-MFI may be defined as “A company (other than a company licensed under Section 25 of the Companies Act, 1956) which provides financial services pre-dominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf”.**

5 Regulations to be specified

- 5.1** A study of 9 large and 2 small NBFC-MFIs shows that loans constitute an average of 95% of total assets (excluding cash and bank balances and money market instruments). We may, therefore, accept that a NBFC pre-dominantly provides financial services to the Microfinance sector if its loans to the sector constitute not less than 90% of its total assets (excluding cash and bank balances and money market instruments). It is also necessary to specify that a NBFC which is not a NBFC-MFI shall not be permitted to have loans to the Microfinance sector which exceed 10% of its total assets.
- 5.2** Most MFIs consider a low-income borrower as a borrower who belongs to a household whose annual income does not exceed ₹50,000/-. This is a reasonable definition and can be accepted.

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- 5.3**
- a)** Currently, most MFIs give individual loans which are between ₹10,000 and ₹15,000. However, some large NBFCs also give larger loans, even in excess of ₹50,000 for special purposes like micro-enterprises, housing and education.
 - b)** It is important to restrict the size of individual loans as larger loans can lead to over-borrowing, diversion of funds and size of repayment installments which are beyond the repayment capacity of the borrower.
 - c)** It is, therefore, suggested that the size of an individual loan should be restricted to ₹25,000. Further, to prevent over-borrowing, the aggregate value of all outstanding loans of an individual borrower should also be restricted to ₹25,000.
- 5.4**
- a)** MFIs normally give loans which are repayable within 12 months irrespective of the amount of the loan. However, the larger the loan, the larger the amount of the repayment installment, and a large installment may strain the repayment capacity of the borrower and result in ever greening or multiple borrowing. At the same time, if the repayment installment is too small, it would leave cash with the borrower which could be directed to other uses and not be available for repayment when repayment is due.
 - b)** There has, therefore, to be a linkage between the amount of the loan and the tenure of the loan. It is, therefore, suggested that for loans not exceeding ₹15,000, the tenure of the loan should not be less than 12 months and for other loans the tenure should not be less than 24 months. The borrower should however have the right of prepayment in all cases without attracting penalty.
- 5.5**
- a)** Low-income borrowers often do not have assets which they can offer as collateral, and it is important to ensure that in the event of default, the borrower does not lose possession of assets which s/he may need for her/his continued existence.
 - b)** It is, therefore, suggested that all loans should be without collateral.
- 5.6**
- a)** It is often argued that loans should not be restricted to income generating activities but should also be given for other purposes such as repayment of high-cost loans to moneylenders, education, medical expenses, consumption smoothing, acquisition of household assets, housing, emergencies, etc. A recent study by Centre for Microfinance of borrowers in Hyderabad indicates that Microfinance is useful in smoothing consumption and relieving seasonal liquidity crises that visit poor families and that it obviates the need for high-cost borrowing from informal sources.

- b)** The need for loans for the above purposes cannot be denied. At the same time there are powerful arguments why loans by NBFC-MFIs should be confined to income-generating activities.
- i.** Firstly, the main objective of NBFC-MFIs should be to enable borrowers, particularly women to work their way out of poverty by undertaking activities which generate additional income. This additional income, after repayment of the loan and interest, should provide a surplus which can augment the household income, enable consumption smoothing and reduce dependence on the moneylender.
 - ii.** Secondly, if the loans are not used for repayment of high-cost borrowing, but are used for consumption, they will in fact add to the financial burden of the household as there will be no additional source from which the loan and interest thereon can be repaid.
 - iii.** Thirdly, borrowing for non-income generating purposes may tempt borrowers to borrow in excess of their repayment capacity.
 - iv.** Finally, if there is no identified source from which interest and installment can be paid, the rate of delinquency will increase. This additional cost will push interest rates upwards and may even result in the use of more coercive methods of recovery.
- c)** Therefore, a balance has to be struck between the benefits of restricting loans only for income-generating purposes and recognition of the needs of low-income groups for loans for other purposes.
- d)** According to “Access to Finance in Andhra Pradesh, 2010, CMF/IFMR, Chennai” the usage of loans given by JLGs and SHGs is as under:

Sr.No.	Particulars	JLG%	SHG%
i)	Income generation	25.6	25.4
ii)	Repayments of old debt	25.4	20.4
iii)	Health	10.9	18.6
iv)	Home improvement	22.1	13.0
v)	Education	4.4	5.7
vi)	Others	11.6	7.9

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- e) We would however suggest that not more than 25% of the loans granted by MFIs should be for non-income generating purposes.
- 5.7**
- a) Currently, some MFIs recover loans by weekly installments while other MFIs recover loans by monthly installments. The rules made under the Ordinance issued by the Andhra Pradesh Government specify that recovery should be made only by monthly installments.
- b) In a representation made by the Government of Andhra Pradesh to the Sub-Committee it has been argued that borrowers often have uncertain levels of income flows and they are put to great hardship to mobilize, accumulate and service a weekly repayment commitment. It has also been stated by some MFIs that they are able to reduce costs by moving from a weekly system of repayment to a monthly system of repayment.
- c) On the other hand, others have argued that some income-generating activities provide a constant flow of cash and leaving idle cash in the hands of borrowers increases the risk that the cash may be diverted to purposes other than repayment of loans. A weekly repayment schedule also means that the effective interest can be reduced. However, N. Srinivasan in the 2010 Microfinance India Report argues that there is enough evidence to suggest that repayment rates do not materially suffer if the repayments are set at fortnightly or monthly intervals.
- d) In our opinion, each purpose for which a loan is used would generate its own pattern of cash flows. Therefore, the repayment pattern should not be rigid but should be so designed as to be most suitable to the borrower's circumstances. We would, therefore, suggest that while MFIs should be encouraged to move to a monthly repayment model, freedom should be given to the MFI to fix a pattern of repayment which can be weekly, fortnightly or monthly depending upon the nature of the loan. The choice of a weekly, fortnightly or monthly repayment schedule should be left to the borrower to suit his/her individual circumstances.
- 5.8** We have observed that some MFIs operate not merely as providers of credit but also provide other services to the borrowers and others. These services include acting as insurance agents, acting as agents for the suppliers of mobile phones and telecom services, acting as agents for the sale of household products, providing agricultural advisory services etc. While these service can profitably be provided by MFIs along with the supply of credit, there is a risk that given the vulnerable nature of the borrower and his/her inadequate negotiating power, an element of

compulsion may creep in unless the provision of these services is regulated. It is, therefore, necessary that the regulator limit the nature of services which can be provided, as also the income which can be generated from such services, the latter as a percentage of the total income of the MFIs.

5.9 We would, therefore, recommend that a NBFC classified as a NBFC-MFI should satisfy the following conditions:

- a) **Not less than 90% of its total assets (other than cash and bank balances and money market instruments) are in the nature of “qualifying assets.”**
- b) **For the purpose of (a) above, a “qualifying asset” shall mean a loan which satisfies the following criteria:-**
 - i. **the loan is given to a borrower who is a member of a household whose annual income does not exceed ₹50,000;**
 - ii. **the amount of the loan does not exceed ₹25,000 and the total outstanding indebtedness of the borrower including this loan also does not exceed ₹25,000;**
 - iii. **the tenure of the loan is not less than 12 months where the loan amount does not exceed ₹15,000 and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases;**
 - iv. **the loan is without collateral;**
 - v. **the aggregate amount of loans given for income generation purposes is not less than 75% of the total loans given by the MFIs;**
 - vi. **the loan is repayable by weekly, fortnightly or monthly installments at the choice of the borrower.**
- c) **The income it derives from other services is in accordance with the regulation specified in that behalf.**

5.10 We would also recommend that a NBFC which does not qualify as a NBFC-MFI should not be permitted to give loans to the microfinance sector, which in the aggregate exceed 10% of its total assets.

6 Areas of Concern

The advent of MFIs in the Microfinance sector appears to have resulted in a significant increase in reach and the credit made available to the sector. Between

31st March 2007 and 31st March 2010, the number of outstanding loan accounts serviced by MFIs is reported to have increased from 10.04 million to 26.7 million and outstanding loans from about ₹3800 crores to ₹18,344 crores. While this growth is impressive, a number of studies both in India and abroad have questioned whether growth alone is effective in addressing poverty and what the adverse consequences of a too rapid growth might be. In particular, in the Indian context, specific areas of concern have been identified: These are:

- a) unjustified high rates of interest
- b) lack of transparency in interest rates and other charges.
- c) multiple lending
- d) upfront collection of security deposits
- e) over-borrowing
- f) ghost borrowers
- g) coercive methods of recovery

7 Pricing of Interest

- 7.1** There is universal agreement that the pricing of interest charges and other terms and conditions should be affordable to clients and at the same time sustainable for MFIs.
- 7.2** The difficulty in maintaining a balance between the two arises because the costs of credit delivery are relatively flat, that is, the delivery cost per loan remains more or less the same, irrespective of the size of the loan, whereas the income generated by the loan varies with its size. Therefore, when a uniform rate of interest is used, larger loans will yield a profit while smaller loans will show a loss. In the circumstances the options before a regulator are limited.
- 7.3** Given the vulnerable nature of the borrowers, it becomes necessary to impose some form of interest rate control to prevent exploitation. The easiest and simplest form of control would be an interest rate cap but this has its own drawbacks, as it could result in MFIs not providing services where the loss is unsustainable, or the mix of services being skewed in favour of larger loans. Moreover, it would be unfair to the MFIs when cost of funds is volatile and forms a large part of the interest cap. However, to prevent exploitation in individual cases, a ceiling on the rate of interest charged on individual loans is desirable.

7.4 Another system is to have a margin cap which provides a cap on the difference between the amount charged to the borrower and the cost of funds to the MFI. While this, too, suffers from the drawbacks of an interest cap, it is fairer to the MFI since it is not exposed to the risk of volatility of cost of funds. It also recognizes that the cost of funds can vary between different MFIs. We would, therefore, suggest that such a cap be mandated.

7.5 For the purpose of determining what would be an appropriate margin cap, we have examined the financials for the year ended 31st March 2010 of nine large MFIs which collectively account for 70.4% of the clients, and 63.6% of the loan portfolio of Microfinance provided by all MFIs. We also examined the financials for the same year of two smaller MFIs. The results of that analysis are as under:-

- a) For the larger MFIs the effective interest rate calculated on the mean of the outstanding loan portfolio as at 31st March 2009 and 31st March 2010 ranged between 31.02% and 50.53% with an average of 36.79%. For the smaller MFIs the average was 28.73%.
- b) For the larger MFIs, the average cost of borrowings calculated on the mean of the borrowings as at 31st March 2009 and 31st March 2010 ranged between 10.10% and 12.73% with an average of 11.78%. For the smaller MFIs the average cost was 11.71%
- c) For the larger MFIs, the average cost of borrowings calculated on the mean of the outstanding loan portfolio as at 31st March 2009 and 31st March 2010 ranged between 8.08% and 17.72% with an average of 13.37% For the smaller MFIs it was 11.94%
- d) For the larger MFIs, the staff cost as a percentage of the mean outstanding loan portfolio as at 31st March 2009 and 31st March 2010, ranged between 5.94% and 14.27% with an average of 8.00%. For the smaller MFIs it was 4.46%
- e) For the larger MFIs, the overheads (other than staff costs) as a percentage of the mean outstanding loan portfolio as at 31st March 2009 and 31st March 2010, ranged between 2.46% and 8.87% with an average of 5.72%. For the smaller MFIs it was 3.63%.
- f) For the larger MFIs, the provision for loan losses as a percentage of the mean outstanding loan portfolio as at 31st March 2009 and 31st March 2010 ranged between 0.09% and 7.23% with an average of 1.85%. For the smaller MFIs it was 1.07%.

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- g)** For the larger MFIs, the profit before tax as a percentage of the mean outstanding loan portfolio as at 31st March 2009 and 31st March 2010 ranged between 4.66% and 17.02% with an average of 10.94%. For the smaller MFIs it was 9.40%.
- h)** For the larger MFIs, the debt/equity ratio, as at 31st March 2010 ranged between 2.24 and 7.32 with an average of 4.92. For the smaller MFIs it was 5.61. If we assume a capital adequacy of 15%, the resultant ratio would be 5.67.
- 7.6 a)** In considering the staff and overhead costs, three factors need to be noted:
- i.** While the cost of the field staff may be largely variable with the size of the loan portfolio, the cost of the other overheads may not vary in the same proportion. Therefore, with increase in scale, the cost as a percentage of the outstanding loan portfolio should decline in the future.
 - ii.** The last few years have witnessed a very rapid growth in the operations of the MFIs. Thus, in 2009-10 alone, the outstanding loan portfolio of MFIs grew by 56%. To achieve this growth, there has been a rapid expansion in the branch network and development costs have been incurred before the branches broke even. This development cost is included in the staff and overhead costs. If these are excluded, the costs as a percentage of the mean outstanding loan portfolio would be lower.
 - iii.** Several MFIs have assigned/secured a significant portion of their portfolio. Therefore, while the size of the portfolio is reduced, the costs remain the same as the MFIs continue to operate as agent for collection for the purchasers of the securitized paper. Consequently, if the rates are to be calculated on the gross portfolio, both the rate of interest on lending as also the cost percentage would be lower.
- b)** The factors referred to in (a) (ii) and (a) (iii) above may partly account for the fact that the study referred to in para 7.5 above, shows that the overhead costs as a percentage of outstanding loans is higher in the case of larger MFIs as compared to smaller MFIs.
- 7.7** Based on the above study, we have attempted a normative cost structure which can form the basis for a mandated margin cap as under:

S.No.	Particulars	% of Loan Portfolio
(a)	Staff Costs (say)	5.00
(b)	Overheads (other than staff costs) say	3.00
(c)	Provision for loan losses, say	<u>1.00</u>
	Sub-total	9.00
(d)	Return on Equity (say):	
	15% post tax i.e. 22.6107% pre-tax on	
	15% of Loan Portfolio	<u>3.39</u>
	Total internal cost	12.39
(e)	Cost of Funds (say)	
	12% on borrowings i.e. 85% of 12% on	
	Loan Portfolio	<u>10.20</u>
	Total of internal and external costs	<u>22.59</u>
	Rounded off to	<u>22.00</u>

7.8 It may, therefore, be mandated that the margin cap should be 10% over the cost of funds for the larger MFIs i.e. those with a loan portfolio exceeding ₹100 crores and 12% over the cost of funds for the smaller MFIs i.e. those with a loan portfolio not exceeding ₹100 crores. This cap will be calculated on the average outstanding loan portfolio. While this margin cap may be considered slightly low in the context of the present cost structure, it can be justified on the following grounds:-

- a) There is no reason why the cost of development and expansion included in the present costs should be borne by current borrowers.
- b) As the size of the operations increase, there should be greater economies of scale and consequent reduction in costs in the future.
- c) In the last few years, not only has the growth of MFIs been financed out of interest charged to borrowers but they have also made profits which are in excess of what can be considered as reasonable, given the vulnerable nature of the borrowers. They, therefore, have the capacity to absorb these higher costs till the growth rates stabilize and they achieve the desired scale of operations.

7.9 The margin cap must be considered on an aggregate level and not as applicable to individual loans. The MFIs must be given the freedom to devise individual products and price them differently as also apply different rates in different regions so long

as the aggregate margin cap is maintained. This will also facilitate monitoring by the regulator on the basis of the Annual Financial Statements. If the regulator finds on examination of the Annual Financial Statements that the average margin has exceeded the “margin cap” the regulator can take such action as is considered necessary. Several options are available. For example,

- a) The MFI may be allowed to keep the excess income apart and adjust this in determining the interest rate structure in the succeeding year
- b) The regulator can create a Borrower Protection Fund and the MFI may be asked to transfer the excess income to the Fund. The Fund can be used for such purposes such as financial literacy, etc.
- c) Penalty could be imposed on the MFI.
- d) Access to priority sector loans may be suspended for a period of time during which commercial loans could still be available to the MFI to keep its business going.

7.10 However, in addition to the overall margin cap, there should be a cap of 24% on the individual loans.

7.11 **We would, therefore, recommend that there should be a “margin cap” of 10% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of ₹100 crores and a “margin cap” of 12% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding ₹100 crores. There should also be a cap of 24% on individual loans.**

8 Transparency in Interest Charges

8.1 MFIs generally levy a base interest charge calculated on the gross value of the loan. In addition, they often recover a variety of other charges in the form of an upfront registration or enrolment fee, loan protection fee, etc. They also recover an insurance premium. It is important in the interest of transparency that all stakeholders in the industry including borrowers, lenders, regulators, etc. should have a better understanding of comparative pricing by different MFIs. This requires the use of a common format.

8.2 It is, therefore, suggested that MFIs should levy only two charges apart from the insurance premium. These two charges should consist of an upfront fee towards the processing of the loan which should not exceed 1% of the gross loan amount, and an interest charge.

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- 8.3** To promote transparency and to make comparisons possible, the borrower must know what is the effective interest rate on the loan which s/he takes as also the other terms like repayment terms, etc. S/he should, therefore, be given a loan card which records all these terms and which is in the local language which s/he can understand. The card should be used to record acknowledgements for each installment paid by the borrower and the final discharge, duly authenticated by the lender, as also sufficient details to identify the borrower as also the SHG/JLG to which s/he belongs. It is also necessary that the effective interest rate charged by the MFI is prominently displayed in its offices and in literature issued by it and on its website.
- 8.4** The purpose of the insurance premium is to protect the MFI in the unlikely event of the death of the borrower during the pendency of the loan. Insurance to serve this purpose may be mandatory but beyond this purpose should be optional. The premium should also be recovered as a part of the loan repayment installment and not upfront and there should be regulations for the proper disposal of the policy proceeds in the event of the death of the borrower or maturity of the policy or for its assignment on the settlement of the loan. We have also noticed that some MFIs levy an insurance administration charge. We see no reason why such a charge should be levied. MFIs should recover only the actual cost of insurance.
- 8.5** We have observed that some MFIs recover a security deposit in cash from the borrowers. We are informed that no interest is paid on this deposit. As this deposit is recovered up front from the amount of the loan, this amounts to charging interest on the gross value of the loan when only the net amount is disbursed. The practice of security deposit, therefore, distorts the interest rate structure and should be discontinued. Further, the acceptance of such deposit is not permissible by the RBI Act.
- 8.6** Transparency and comparability would be considerably enhanced if MFIs use a standard form of loan agreement.
- 8.7 We would, therefore, recommend that:-**
- a) There should be only three components in the pricing of the loan, namely (i) a processing fee, not exceeding 1% of the gross loan amount (ii) the interest charge and (iii) the insurance premium.**
 - b) Only the actual cost of insurance should be recovered and no administrative charges should be levied.**

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- c) **Every MFI should provide to the borrower a loan card which (i) shows the effective rate of interest (ii) the other terms and conditions attached to the loan (iii) information which adequately identifies the borrower and (iv) acknowledgements by the MFI of payments of installments received and the final discharge. The Card should show this information in the local language understood by the borrower.**
 - d) **The effective rate of interest charged by the MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.**
 - e) **There should be adequate regulations regarding the manner in which insurance premium is computed and collected and policy proceeds disposed off.**
 - f) **There should not be any recovery of security deposit. Security deposits already collected should be returned.**
 - g) **There should be a standard form of loan agreement.**

9 Multiple-lending, Over-borrowing and Ghost-borrowers

- 9.1 The problems connected with multiple-lending, over-borrowing and ghost-borrowers are interlinked and can be considered collectively. There is considerable evidence that these practices are widely prevalent and various reasons have been advanced for the same.
- 9.2 It has been suggested that with the development of active competition between MFIs there has been a deluge of loan funds available to borrowers which has fuelled excessive borrowing and the emergence of undesirable practices. It is also claimed that the emergence of ring leaders as key intermediaries between MFIs and potential customers has distorted market discipline and good lending practices. There are reports that ghost loans have become epidemic in some states. Finally, it is believed that in consequence of over-borrowing, default rates have been climbing in some locations but these have not been disclosed because of ever-greening and multiple lending.
- 9.3 There can be several other reasons for multiple-lending and over-borrowing. However, three major reasons may be noted.
 - a) The loans are given for income-generation but often there is inadequate time given to the borrower between the grant of the loan and the commencement of the repayment schedule. This gives her/him insufficient time to make the

institutional arrangements necessary to be in a position to generate income. In the absence of such a period of moratorium, it is likely that the first few installments, particularly when the repayment is weekly, would be paid out of the loan itself, thus reducing the amount available for investment or paid out of additional borrowing. It is, therefore, suggested that borrowers should be given a reasonable period of moratorium between the disbursement of the loan and the commencement of repayment. This period should not be less than the frequency of repayment. 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.

- b) MFIs often use existing SHGs as the target to obtain new borrowers. This not only increases profit but also reduces their transaction costs. These borrowers are, therefore, tempted to take additional loans beyond their repayment capacity.

9.4 Many of the above adverse features would be minimized if borrowers are allowed to become members of only one SHG/JLG and also if MFIs are not allowed to give loans to individuals except as members of a JLG. Such a regulation would have two advantages namely,

- a) Multiple lending and over-borrowing can be avoided as the total loans given to an individual can be more easily ascertained and
- b) The risk is shared by other members of the JLG who can impose some peer pressure against over-borrowing.

9.5 Over borrowing can also be reduced if not more than two MFIs lend to the same borrower.

9.6 It is also necessary to provide that if a MFI gives an additional loan to a borrower who already has an outstanding loan from a SHG/MFI, whereby the prescribed aggregate borrowing limit is exceeded or gives an additional loan when existing outstanding loans have been given by two MFIs, then recovery of the additional loan shall be deferred till the earlier loans are fully repaid.

9.7 We would, therefore, recommend that:-

- a) **MFIs should lend to an individual borrower only as a member of a JLG and should have the responsibility of ensuring that the borrower is not a member of another JLG.**
- b) **a borrower cannot be a member of more than one SHG/JLG.**
- c) **not more than two MFIs should lend to the same borrower.**

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- d) **there must be a minimum period of moratorium between the grant of the loan and the commencement of its repayment.**
 - e) **recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid.**

9.8 Ghost borrowers generally arise in two sets of circumstances:-

- a) when the borrower on record is a benami for the real borrower and
- b) when fictitious loans are recorded in the books.

9.9 The first type of Ghost Borrower is often used as a device for multiple lending or over-borrowing. This can be cured only by a better discipline in the system of identification and data base of borrowers and better follow-up by the field worker.

9.10 The second type of Ghost Borrower can pose a much greater systemic problem as it would create fictitious assets and is often used to record fictitious repayments and thus hide the actual level of delinquencies.

9.11 One of the ways by which the problem of Ghost Borrowers can be minimized would be by better control in the structuring and disbursement of loans. These functions should not be entrusted to a single individual but should need the collective action of more than one individual and should be done at a central location. In addition, there should be closer supervision of the disbursement function.

9.12 We would, therefore, recommend that all sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition, there should be close supervision of the disbursement function.

10 Credit Information Bureau

10.1 An essential element in the prevention of multiple-lending and over-borrowing is the availability of information to the MFI of the existing outstanding loan of a potential borrower. This is not possible unless a Credit Information Bureau is established expeditiously.

10.2 The function of the Bureau should not be to determine the credit worthiness of the borrowers. Rather, it should provide a data base to capture all the outstanding loans to individual borrowers as also the composition of existing SHGs and JLGs. When more than one bureau discharges the role, adequate co-ordination between the bureaus will need to be established.

10.3 Micro Finance Institution Network (MFIN) formed in November 2009 is an industry association of MFIs which claims it has 44 members (with another 5 in pipeline) who collectively constitute 80% of the MFI business. Similarly Sa-Dhan is an association of community development finance institutions which also includes MFIs within its membership. Both institutions have a Code of Conduct for their members. Both institutions have represented to us that they are actively working with a Credit Information Bureau to build up a system whereby MFIs can report to the Bureau the status of all loans granted by them. Once such a Bureau starts functioning there is no reason why multiple lending and over borrowing cannot be controlled.

10.4 The issue is what can be done until such a Bureau starts functioning. We believe that until that time, MFIs should have the responsibility to make reasonable enquiries to find out a prospective borrower's outstanding loans. Given the fact that most loans are given to borrowers in a village and the fact that MFIs have field staff who have sources of information, this should not be too onerous a task.

10.5 We would therefore recommend that

- a) **One or more Credit Information Bureaus be established and be operational as soon as possible and all MFIs be required to become members of such bureau.**
- b) **In the meantime, the responsibility to obtain information from potential borrowers regarding existing borrowings should be on the MFI.**

11 Coercive Methods of Recovery

11.1 There are reports that MFIs or their employees and agents have used coercive methods of recovery and similar complaints have been made by many of the organisations which have made representations to us. While we did not seek any specific evidence about the extent of this malpractice, the very fact that such claims are widely made makes it obvious that the matter needs attention.

11.2 Coercive methods of recovery are, to some extent, linked with the issues of multiple lending and over-lending. If these issues are adequately addressed, the need for coercive methods of recovery would also get significantly reduced.

11.3 The primary responsibility for the prevention of coercive methods of recovery must rest with the MFIs. They have to accept responsibility for the good conduct of their employees and if employees or outsourced workers misbehave or resort to coercive methods of recovery, severe penalties must be levied on the MFIs and their

management. If this is done, the managements of MFIs, in their own interest, will establish a proper Code of Conduct for field staff and make greater investments in the training and supervision of the field staff to prevent such occurrences.

- 11.4** Coercive methods of recovery also surface when the growth of the MFI is faster than its ability to recruit the required staff of the right quality and to provide them adequate training. It also surfaces when the systems of control and inspection are inadequate. These are areas which will have to be monitored by the regulator.
- 11.5** It has been suggested that coercive methods of recovery have been encouraged by the practice of enforcing recovery by recovery agents visiting the residence of the borrowers. The Andhra Pradesh Micro Finance Institutions (Regulations of Money Lending) Act 2010 drafted by the State Government includes a list of actions which constitute “coercive action”. This includes “frequenting the house or other place where such person resides or works, or carries on business, or happens to be”. It also provides that “all tranches of repayment shall be made by the SHG or its members at the office of the Gram Panchayat or at a public place designated by the District Collectors only”.
- 11.6** We agree that recovery should not be made at the borrower’s place of residence or business as that may encourage coercive methods of recovery. At the same time we believe if the designated place of recovery is the Gram Panchayat office or any other place distant from the borrowers’ place of residence or work s/he would need to incur avoidable time and cost. There are advantages in requiring recovery from the group as a whole at a central location and this may be specified by the MFI. This will ensure that the privacy of the group is respected and that there is sufficient peer pressure on the borrower to make the repayments.
- 11.7** It is interesting in this context to consider the experience of banks which in respect of their retail portfolio had in the past faced similar problems of coercive recovery. We believe this problem was significantly reduced by the following measures:-
- a) The size of their portfolio was reduced to the levels which they could adequately control.
 - b) The use of out-sourced recovery agents was reduced and more of their own employees were used for recovery particularly in sensitive areas.
 - c) The types of products were examined and recovery methods were fine tuned to recognize the variances in these products.
 - d) Training and supervision were greatly enhanced

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- e) Compensation methods for staff were reviewed and greater emphasis was given to areas of service and client satisfaction than merely the rate of recovery.

Some of these methods can be profitably used by MFIs.

- 11.8 It is also necessary that MFIs are sensitive to the reasons for a borrower's default. If this default is of a temporary nature or willful, the MFI may enforce recovery from other members of the Group but if there are external factors beyond the control of the borrower, some time for recovery may need to be given.
- 11.9 A key component in the prevention of coercive recovery is an adequate grievance redressal procedure. It is necessary that there should be a grievance redressal system established by each MFI and for this to be made known to the borrower in the literature issued, by display in its offices, by posting on the website and by prominent inclusion in the Loan Card given to the borrower. In addition, it is necessary that there should be independent authorities established to whom the borrower can make reference.
- 11.10 It has been represented to us that Sa-Dhan has at the national level an Ethical Grievance Redressal Committee. Similarly MFIN has an Enforcement Committee for dealing with Code of Conduct violations. While these initiatives are commendable it is necessary that there should be an institution like the Ombudsman to whom aggrieved borrowers can make reference. These Ombudsmen should be located within easy reach of the borrowers.
- 11.11 One suggestion made is that an officer of the lead bank in each district could be designated as the Ombudsman. This is justified since the banking sector has a large exposure to MFIs and also since the lead bank has the responsibility to promote financial inclusion in the district. Another suggestion is that there should be a system of mobile Ombudsmen who would visit each village by rotation on specified days. Both these suggestions need further examination.
- 11.12 **We would, therefore, recommend that:-**
 - a) **The responsibility to ensure that coercive methods of recovery are not used should rest with the MFIs and they and their managements should be subject to severe penalties if such methods are used.**
 - b) **The regulator should monitor whether MFIs have a proper Code of Conduct and proper systems for recruitment, training and supervision of field staff to ensure the prevention of coercive methods of recovery.**

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- c) **Field staff should not be allowed to make recovery at the place of residence or work of the borrower and all recoveries should only be made at the Group level at a central place to be designated.**
 - d) **MFIs should consider the experience of banks that faced similar problems in relation to retail loans in the past and profit by that experience.**
 - e) **Each MFI must establish a proper Grievance Redressal Procedure.**
 - f) **The institution of independent Ombudsmen should be examined and based on such examination, an appropriate mechanism may be recommended by RBI to lead banks.**

12 Customer Protection Code

12.1 Between the MFIs and the borrowers, the MFIs have an immeasurably superior bargaining power. It is, therefore, essential that MFIs are committed to follow a Customer Protection Code.

12.2 The Consultative Group to Assist the Poor (CGAP) established by the World Bank and supported by the 30 development agencies and private foundations who share a common mission to obviate poverty has published six core principles for client protection in microfinance. The Small Enterprises Education and Promotion (SEEP) network has also designed a template for a consumer protection code of practice to increase transparency in microfinance consumer policies and practices.

12.3 Using the material already available from these sources, it should be possible to prepare a Customer Protection Code which MFIs are mandated to adopt and follow. This code could have the following core principles.

a) Commitment

A statement to be made by the MFI which articulates the MFI's commitment to transparency and fair lending practices.

b) Avoidance of over-indebtedness

The commitment to take reasonable steps to ensure that credit is extended only if borrowers have demonstrated an adequate ability to repay the loans and the loans will not put borrowers at significant risk of over-indebtedness.

c) Capacity Building and empowerment

The commitment to capacity building and empowerment through skill training and hand holding.

d) Appropriate marketing

The assurance that non- credit financial products marketed are appropriate.

e) Transparent and Competitive Pricing

Pricing and terms and conditions of the financial product (including interest charges, insurance premia, fees etc.) which are transparent and disclosed in a form and language easily understood by the customer and pricing which is reasonable, that is, affordable to the customer and sustainable for the MFI.

f) Appropriate Collection Practices

Debt collection practices which are not abusive or coercive.

g) Ethical Staff Behaviour

The commitment that staff will comply with high ethical standards in interaction with customers and that there are adequate safeguards to detect and correct corruption or unacceptable behaviour.

h) Accountability

A declaration that the MFI will be accountable for strictly complying with prudential regulations and preventing inappropriate staff behavior together with details of a timely and responsive mechanism for grievance redressal.

i) Privacy of Client Data

The assurance that privacy of client data will be respected.

12.4 The Reserve Bank has already prescribed on September 28, 2006 broad guidelines on fair practices to be framed and approved by the boards of directors of all NBFCs. The relevant provisions of this Fair Practices Code need to be incorporated in the Customer Protection Code which NBFC-MFIs should adopt.

12.5 Similar provisions should also be made applicable to banks and financial institutions which provide credit to microfinance sector.

12.6 **We would, therefore, recommend that the regulator should publish a Client Protection Code for MFIs and mandate its acceptance and observance by MFIs. This Code should incorporate the relevant provisions of the Fair Practices Guidelines prescribed by the Reserve Bank for NBFCs. Similar provision should also be made applicable to banks and financial institutions which provide credit to the microfinance sector.**

13 Improvement of efficiencies

13.1 The purpose of regulation should not be confined merely to the prevention of abuses but should also examine methods by which the efficiency of operations can be improved. This will benefit both the MFIs and the borrowers as it will reduce costs and consequently interest charges and also increase the volume of business.

13.2 The key areas in improving efficiency are:-

- a) better operating systems
- b) simplification of documentation and procedures
- c) better training
- d) better corporate governance

13.3 The operations of MFIs can be broadly divided into two areas, namely, operations at the field level and back office operations. While efficiency at the field level will result in better service to borrowers and greater protection from abuse, efficiency in the back office can result in a greater saving in costs as also better control on the field staff. Information Technology is a powerful tool in building operating systems for identification of borrowers and communication of data and needs to be fully exploited. It will help in the operation of the Credit Information Bureau, reduce over-borrowing and control delinquency without resorting to coercive methods. The use of bio-metrics and the Unique Identification Programme hold great prominence in this area.

13.4 Early availability of credit is as important to the borrower as the terms on which credit is given. Therefore, there is also the need to re-examine the regulatory and other requirements to simplify documentation and reduce delays. Given the small amount of individual loans and the consequent spread of exposure, the cost saving will more than compensate for the risk of loss of control and consequent defaults.

13.5 **We would, therefore, recommend that MFIs review their back office operations and make the necessary investments in Information Technology and systems to achieve better control, simplify procedures and reduce costs.**

14 Support to SHGs/JLGs

- 14.1 The purpose of the formation of SHGs and JLGs cannot be merely to share the liability. More importantly the group is to be seen as the vehicle through which skill development and training are imparted to the members of the group. A SIDBI sponsored study over a seven year period from 2001-2007 records that there was a unanimous demand from group members in all villages visited that skill development and training was required for undertaking any income generating activity and that they felt that a loan alone would not help in improving their livelihood.
- 14.2 It is also necessary as pointed out in Microfinance India 2010 report, that, after the formation of groups, handholding is required to ensure that the group functions within the framework of group discipline and financial discipline. The report records that the past success of the SBLP was largely due to NGOs who worked with missionary zeal and motivation but that there is evidence that in recent times, this handholding is conspicuous by its absence in both the SBLP and the MFI model. Groups formed without professional inputs and without the requisite handholding cannot sustain the financial content of either model and can lead to an increase in defaults and consequent abuses in the system.
- 14.3 In a communication dated November 22, 2006 to the banks, the Reserve Bank has also noted that many MFIs supported by banks were not engaging themselves in capacity building and empowerment of the groups to the desired extent and as a result, cohesiveness and a sense of purpose were not being built up in the groups formed by these MFIs. This would be in addition to and complementary to the efforts of the State Governments in this regard.
- 14.4 In a submission made to us by the Ministry of Rural Development, it has been suggested that in order to make branchless banking models work, banks need to re-engineer front end processes and establish a support architecture to provide back-stopping support for cash management, technical training and trouble shooting, back-end business processing and channel control functions. This architecture should comprise of service branches operating the CBS platform and network of counseling centers. The National Rural Livelihood Mission has offered to co-invest in this concept.
- 14.5 **We would, therefore, recommend that under both the SBLP model and the MFI model greater resources be devoted to professional inputs both in the formation of SHGs and JLGs as also in the imparting of skill development and training and generally in handholding after the group is formed. This would**

be in addition to and complementary to the efforts of the State Governments in this regard. The architecture suggested by the Ministry of Rural Development should also be explored.

15 Corporate Size

- 15.1** As indicated earlier, transaction costs can only be decreased if economies of scale can be achieved. Also, to improve efficiency and improve control, significant back office investments are needed. It is, therefore, in the interest of the borrowers that MFIs should attain an optimal size and consolidation within the industry appears inevitable.
- 15.2** The representation made to us seem to suggest that MFIs which have an investment portfolio of ₹100 crores or less are considered as small MFIs. Given a Capital Adequacy ratio of 15% of risk weighted assets, this translates to a networth of ₹15 crores. Currently an MFI being a NBFC is required to have a minimum capital of ₹2 crores. We would suggest for a NBFC MFI this should be increased to a minimum Net Worth of ₹15 crores.
- 15.3** **We would, therefore, recommend that all NBFC-MFIs should have a minimum Net Worth of ₹15 crores.**

16 Corporate Governance

- 16.1** MFIs have twin objectives, namely to act as the vehicle through which the poor can work their way out of poverty and to provide reasonable profits to their investors. These twin objectives can conflict unless a fair balance is maintained between both objectives. This makes it essential that MFIs have good systems of Corporate Governance.
- 16.2** Some of the areas in which good corporate governance can be mandated would be:-
- a)** the composition of the board with provision for independent directors
 - b)** the responsibility of the board to put in place and monitor organisation level policies for:-
 - (i)** the growth of the loan portfolio including its dispersal in different regions
 - (ii)** the identification and formation of joint liability groups
 - (iii)** borrower training and education programmes

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- (iv) credit and assessment procedures
 - (v) recovery methods
 - (vi) employee code of conduct
 - (vii) employee quality enhancement programmes
 - (viii) compensation system for employees including limits on variable pay and the limit therein on weightage for business development and collection efficiency
 - (ix) customer grievance procedures
 - (x) internal audit and inspection
 - (xi) whistle blowing
 - (xii) sharing of information with industry bodies
- c) disclosures to be made in the financial statements including:
- (i) the geographic distribution of the loan portfolio, both in terms of number of borrowers and outstanding loans
 - (ii) analysis of overdues
 - (iii) the average effective rate of interest, the average cost of funds and the average margin earned
 - (iv) analysis of the outstanding loans by nature of purpose for which loans were granted
 - (v) composition of shareholding including percentage shareholding held by private equity

16.3 We would, therefore, recommend that every MFI be required to have a system of Corporate Governance in accordance with rules to be specified by the Regulator.

17 Maintenance of Solvency

17.1 While NBFC-MFIs do not accept public deposits, they have a very large exposure to the banking system. It is estimated that more than 75% of their source of funds comes from the banking system. It is, therefore, necessary to ensure that there are adequate safeguards to maintain their solvency. This may be examined in three areas.

17.2 Firstly, there should be appropriate prudential norms. Currently, since MFIs are not considered as a separate class of NBFCs, no separate set of prudential norms have been prescribed. Thus, loans are classified as NPAs if interest or repayment is overdue for 180 days. This means that a loan where repayment is weekly becomes an NPA only when 24 installments are overdue.

17.3 Given the small size of individual loans, their large number, their short tenure, the frequency of repayment and the lack of collateral, it is clear that the existing prudential norms for the provision for loan losses are inadequate and must be replaced by simpler norms which apply to the universe of loans and not to individual loans.

We would, therefore, recommend that provisioning for loans should not be maintained for individual loans but an MFI should be required to maintain at all times an aggregate provision for loan losses which shall be the higher of:

- i. 1% of the outstanding loan portfolio or**
- ii. 50% of the aggregate loan installments which are overdue for more than 90 days and less than 180 days and 100% of the aggregate loan installments which are overdue for 180 days or more.**

17.4 Secondly, currently all NBFCs are required to maintain Capital Adequacy Ratio to Risk Weighted Assets of 12%. Considering the greater risks in the Microfinance Sector, the high-gearing, and the high rate of growth, it is necessary that this ratio should be suitably increased. It is also necessary that subject to our comments in para. 21.3 below the total Net Owned Funds should be in the form of Tier I Capital.

17.5 **We would, therefore, recommend that NBFC-MFIs be required to maintain Capital Adequacy Ratio of 15% and subject to our comment in para. 21.3 below all of the Net Owned Funds should be in the form of Tier I Capital.**

18 Need for Competition

18.1 While regulations are important, they cannot by themselves be the sole instruments to reduce interest rates charged by MFIs or improve the service provided to borrowers. Ultimately, this can only be done through greater competition both within the MFIs and without from other agencies operating in the Microfinance sector.

18.2 The agencies operating in the Microfinance Sector can be broadly grouped in two classes namely

- a) The SHG-Bank Linkage Programme (SBLP) and
- b) MFIs including NBFC-MFIs, trusts, societies, etc. whereof NBFC-MFIs hold more than 80% of the outstanding loan portfolio.

18.3 The relative share of these two classes in the last three years as reported by ACCESS is as under:-

Particulars	FY 2008	FY2009	FY2010	% Growth over 2 years
<i>No. of Customers (million)</i>				
SBLP	50.8	59.1	64.5	26.96
MFI	<u>14.1</u>	<u>22.6</u>	<u>26.7</u>	<u>189.36</u>
Total	<u>64.9</u>	<u>81.7</u>	<u>91.2</u>	<u>140.52</u>
<i>Portfolio Outstanding (₹ Billion)</i>				
SBLP	166.99	226.79	272.66	63.27
MFI	<u>59.54</u>	<u>117.34</u>	<u>183.44</u>	<u>308.09</u>
Total	<u>226.53</u>	<u>344.13</u>	<u>456.10</u>	<u>201.34</u>
<i>Incremental Loans Outstanding (₹ Billion)</i>				
SBLP	46.33	56.80	45.87	(0.01)
MFI	<u>24.98</u>	<u>57.80</u>	<u>66.10</u>	<u>246.61</u>
Total	<u>71.31</u>	<u>114.60</u>	<u>111.97</u>	<u>157.01</u>

18.4 Though there may be some duplication in the number of customers, the following needs to be noted:

- a) The share of SBLP in terms of customers has dropped from 78.27% in 2008 to 70.72% in 2010. Even more significantly its share of outstanding loans has dropped from 73.71% to 59.78%.
- b) The share of SBLP in incremental loans has dropped from 64.96% to 40.96% and in actual terms is lower in 2010 than in 2008.
- c) While the total number of customers between 2008 and 2010 increased by 140.52%, the outstanding portfolio increased by 201.34%. This shows that the average size of the loan per borrower has increased by 43.28%. This suggests

that there is either an increase in the size of the average individual loan given to the borrower or is an indication of multiple lending/over borrowing resulting from more than one loan being given to the same borrower.

- 18.5** The reasons for the increasing dominance of the MFI Group vis-à-vis bank linkage need to be examined. Five possible reasons have been suggested.
- a)** First, it is believed MFIs have been able to achieve a deeper reach as they tend to have a more informal approach as opposed to banks which still operate through traditional branches.
 - b)** Second, MFIs are said to be more aggressive in securing business as they use more of the local population as field workers which gives them better access to borrowers as opposed to banks which still largely use traditional staff.
 - c)** Third, the procedures used by MFIs are said to be simpler and less time-consuming whereas the procedures used by banks tend to be bureaucratic and laborious.
 - d)** Fourth, bank loans to SHGs have a longer repayment period and during that period if SHG members need loans, they approach MFIs.
 - e)** Finally, it is believed that banks find it easier to use MFIs to meet their priority-sector targets. This is particularly true near the year end where banks invest in securitized paper issued by MFIs to meet targets.
- 18.6** Given the lower cost of funds which banks enjoy, there is no reason why banks cannot acquire a larger share of the market and thereby provide more effective competition to the MFIs. This could result in a general reduction in interest rate for borrowers.
- 18.7** Reserve Bank has recently taken a number of steps for furthering financial inclusion through mainstream financial institutions by offering a minimum of four financial products, namely, (a) a savings cum overdraft account, (b) a remittance product, (c) a pure savings product-ideally a recurring deposit, and (d) a general purpose Credit Card or Kisan Credit Card.
- 18.8** In addition, banks have been advised to put in place a board-approved Financial Inclusion Plan to be rolled out over the next three years. The plans and the self-set targets are being closely monitored by the Reserve Bank.
- 18.9** To facilitate this programme of financial inclusion, Reserve Bank has also announced the following measures:-

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- a) Banks are permitted to utilise the services of intermediaries to extend penetration outreach by providing financial and banking services through the use of business facilitators and business correspondents, including SHGs.
 - b) Domestic scheduled commercial banks including Regional Rural Banks have been permitted to freely open branches in Tier 3 to Tier 6 centres with population of less than 50,000 persons.
 - c) In the North Eastern States and Sikkim, domestic scheduled commercial banks are permitted to open branches in rural, semi-urban and urban centres.
 - d) Banks are required to draw-up a road map whereby banking services will be provided by March 2012 to 72,825 un-banked villages which have population in excess of 2000 persons.

These measures should give the necessary opportunity to banks to treat financial inclusion as a viable business proposition and to increase their penetration in the microfinance sector.

18.10 We would therefore recommend that bank lending to the Microfinance sector both through the SHG-Bank Linkage programme and directly should be significantly increased and this should result in a reduction in the lending interest rates.

19 Priority Sector Status

- 19.1** Currently all loans to MFIs are considered as priority sector lending. It has been suggested that there is no control on the end use of these funds and that there is significant diversion of these funds from the purposes intended to other purposes. It is also suggested that in determining priority sector lending what needs to be considered is not the availability of credit but rather the availability of affordable credit. Considering the high rates at which MFIs lend funds, it has been suggested that advances to MFIs should not qualify as priority sector lending.
- 19.2** As at 31st March 2010, the total funds made available by banks and Financial Institutions including SIDBI amounted to ₹18,000 crores. This includes the securitized portfolio of these institutions amounting to ₹4200 crores. In the context of the total outstanding loans and advances of all scheduled commercial banks at ₹34,97,054 crores as at March 31, 2010, this is not a significant amount.
- 19.3** However, removal of “priority sector” lending to loans given to MFIs would not, in our opinion be advisable for the following reasons:-

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- a) If the recommendations made by us are accepted, there should be significant reduction, both in the diversion of funds and in the rates of interest.
 - b) Even though “priority sector” loans are not made available at concessional rates, banks are under some pressure to meet targets of priority sector lending. There is therefore competition among the banks to find MFI customers for securitisation or lending. This competition could drive down borrowing costs and with the ceiling on “margin gap” recommended, could reduce interest rates.
- 19.4** There are existing Reserve Bank guidelines for lending to the priority sector. It may be necessary to revisit these guidelines in the context of the recommendations.
- 19.5** **We would, therefore, recommend that bank advances to MFIs should continue to enjoy “priority sector lending” status. However, advances to MFIs which do not comply with the regulation should be denied “priority sector lending” status. It may also be necessary for the Reserve Bank to revisit its existing guidelines for lending to the priority sector.**

20 Assignment and Securitisation

- 20.1** We have noted that in addition to the direct borrowing by MFIs from banks, financial institutions and SIDBI, significant portions of the loan portfolio have been assigned to or securitised to banks, mutual funds and others with the MFI remaining as an agent for recovery. While the exact amount of such assignments and securitisation is not available, the assigned and securitised portfolios held by banks as at 31st March 2010 are believed to aggregate to around ₹4200 crores.
- 20.2** Assignment and securitisation can be in two forms namely (a) with recourse and (b) without recourse. When the assignment/securitisation is with recourse, the MFI remains fully exposed to the risk of default of the underlying loans though the loans themselves are not reflected in its financial statements. When the assignment or securitisation is without recourse, the MFI has no exposure on the loan portfolio but it is customary for the MFI to offer credit enhancement in the form of a dedicated fixed deposit or in other forms.
- 20.3** It is, therefore, necessary that for the purposes of calculation of the Capital Adequacy Ratio, when the assignment or securitisation is with recourse, the full value of the portfolio assigned or securitised is considered as a risk weighted asset and where the assignment or securitisation is without recourse but credit enhancement is given, the value of the credit enhancement is deducted from the Net Owned Funds. It is also necessary that disclosure is made of the amount of the outstanding loan portfolio which is assigned or securitised but the MFI continues as an agent for collection.

20.4 When banks acquire assigned or securitised loans, they become the owners of those loans. They have therefore an obligation before they acquire the assigned or securitised loans, to ensure that the loans have been made in accordance with the terms of the specified regulations.

20.5 We would, therefore, recommend that:-

- a) **Disclosure is made in the financial statements of MFIs of the outstanding loan portfolio which has been assigned or securitised and the MFI continues as an agent for collection. The amounts assigned and securitised must be shown separately.**
- b) **Where assignment or securitisation is with recourse, the full value of the outstanding loan portfolio assigned or securitised should be considered as risk-based assets for calculation of Capital Adequacy.**
- c) **Where the assignment or securitisation is without recourse but credit enhancement has been given, the value of the credit enhancement should be deducted from the Net Owned Funds for the purpose of calculation of Capital Adequacy.**
- d) **Before acquiring assigned or securitised loans, banks should ensure that the loans have been made in accordance with the terms of the specified regulations.**

21 Funding of MFIs

21.1 It has been suggested that the entry of private equity in the microfinance sector has resulted in a demand for higher profits by MFIs with consequent high interest rates and the emergence of some of the areas of concern which have been discussed earlier.

21.2 Without expressing any opinion on the matter, it is necessary to understand the circumstances in which private equity has entered the sector. On the one hand, there was a huge unsatisfied demand for microfinance credit and on the other, there was a limitation on the capacity of not-for-profit entities to meet this demand. When for-profit entities emerged, microfinance was seen as a high-risk entity but venture capital funds are not allowed to invest in MFIs and private equity rushed in to fill this vacuum.

21.3 We believe it is necessary to widen the base from which MFIs are funded in respect of the Net Owned Funds needed for Capital Adequacy and for that purpose the following need to be examined.

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- a) It has been suggested that a “Domestic Social Capital Fund” may be permitted to be established. This fund will be targeted towards “Social Investors” who are willing to accept “muted” returns, say, 10% to 12%. This fund could then invest in MFIs which satisfy social performance norms laid down by the Fund and measured in accordance with internationally recognized measurement tools.
 - b) MFIs should be encouraged to issue preference capital which carries a coupon rate not exceeding 10% to 12% and this can be considered as Tier II capital in accordance with norms applicable to banks.

21.4 We would, therefore, recommend that:

- a) **The creation of one or more “Domestic Social Capital Funds” may be examined in consultation with SEBI.**
- b) **MFIs should be encouraged to issue preference capital with a ceiling on the coupon rate and this can be treated as part of Tier II capital subject to capital adequacy norms.**

22 Monitoring of Compliance

- 22.1** The success of any regulatory framework ultimately is determined by the extent to which compliance with the regulations can be monitored.
- 22.2** We believe the responsibility for compliance with the regulations will have to be borne by four agencies as mentioned below.
- 22.3** First, the primary responsibility for compliance must rest with the MFI itself. It will, therefore, have to make organisational arrangements to assign responsibility for compliance to designated individuals within the organisation and establish systems of internal control and inspection to ensure that compliance exists in practice. Allied to this, there has to be, as stated earlier, a system of levy of penalties both on the MFI and on individual members of the management in the event of non-compliance.
- 22.4** Secondly, (a) Industry associations must also assume greater responsibility in ensuring compliance. A possible scheme which may be considered would be as under:
- i. The Regulator will recognize only those industry associations which have a minimum membership, for example, in excess of 33 1/3 % of the total number of MFIs registered with the Regulator for the purpose of consultation, dialogue and information sharing to promote healthy and balanced growth of the sector.

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- ii. The association will have a code of conduct in accordance with the Client Protection Code as stipulated by the Regulator.
 - iii. The association will have an Enforcement Committee to check violations of the Code brought to its attention by its own inspection system or by outsiders including the State Government and the Regulator.
 - iv. The association will discipline its members by removing them from membership if there is persistent violation of the Code and will publicise the fact of removal
 - v. The members will publicly acknowledge their membership of the association in their letter heads and in all their communications.
- b) If the above steps are effectively implemented, membership of these associations will be seen by the trade, borrowers and lenders as a mark of confidence and removal from membership can have adverse reputational impact. This can be a major deterrent to non-compliance.
- c) There are also other organisations in the trade which cover other functions like data gathering, assist development NGOs, etc. These can act as “whistle blowers” to highlight violations of the regulations or the Code of Conduct.

22.5 Thirdly, banks which lend funds to MFIs and which purchase securitised paper also have a role to play in compliance. Reserve Bank communication of November 22, 2006 to banks specifically states that banks, as principal financiers of MFIs do not appear to be engaging with them with regard to their systems, practices and lending policies with a view to ensuring better transparency and adherence to best practices nor in many cases is there a review of MFI operations after sanctioning the credit facility. In the case of securitized loans, banks are the owners of the loans and the MFIs are their agents for recovery. They can therefore be considered as responsible for the acts and defaults of their agents and they have therefore every right to enforce compliance. In the case of loans, while they may not own the loans given by MFIs, as lenders they can mandate compliance and have the right to enforce it. Banks also have, through their branch network, the ability to supervise the functioning of MFIs and SHGs to whom they lend funds. They must therefore accept this responsibility. Banks should also be encouraged to give loans to MFIs and buy securitized paper largely in the districts where they have a branch network so that compliance is made possible.

22.6 Lastly, as Regulator, the Reserve Bank has a role to play.

- a) As at 31st March, 2010, the top 10 MFIs owned 64.48% of the total loan portfolio and the top 5 MFIs owned 49.93% of the total loan portfolio. Therefore, by supervision of the larger MFIs which are few in number, Reserve Bank can actively supervise a large part of the Microfinance sector financed by MFIs
- b) The nature of this supervision should be both off-site and on-site. However, given the wide geographic spread, the small value of individual loans and the large number of operating points, it may not be possible to do on-site inspection of the branches of MFIs, except on sample basis. Supervision should therefore concentrate on the existence and operation of the organisational arrangements, the reporting systems, corporate governance etc and a review of the financial statements to ensure compliance with regulatory norms. To give further strength to this supervision, the Reserve Bank should have the power to remove the CEO and / or the directors in the event of persistent violation of the regulations quite apart from the power to deregister the MFI and thereby prevent it from operating in the microfinance sector.
- c) Since the industry association is one component of the compliance system, the Reserve Bank should also inspect the industry associations to ensure that their compliance mechanism is functioning.
- d) Another possibility which needs to be explored is the use of outside specialized agencies for inspection of MFIs in place of or in addition to inspection by Reserve Bank. Such agencies exist and if they are used, the cost of these services can be recovered from MFIs.
- e) If the Reserve Bank is to adequately discharge its responsibilities to ensure compliance of the NBFC-MFIs with its regulations, it will also need to considerably enhance its existing supervisory organisation dealing with NBFC-MFIs.

22.7 We would, therefore, recommend that:-

- a) **The primary responsibility for ensuring compliance with the regulations should rest with the MFI itself and it and its management must be penalized in the event of non-compliance**
- b) **Industry associations must ensure compliance through the implementation of the Code of Conduct with penalties for non-compliance.**

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- c) **Banks also must play a part in compliance by surveillance of MFIs through their branches.**
 - d) **The Reserve Bank should have the responsibility for off-site and on-site supervision of MFIs but the on-site supervision may be confined to the larger MFIs and be restricted to the functioning of the organisational arrangements and systems with some supervision of branches. It should also include supervision of the industry associations in so far as their compliance mechanism is concerned. Reserve Bank should also explore the use of outside agencies for inspection.**
 - e) **The Reserve Bank should have the power to remove from office the CEO and / or a director in the event of persistent violation of the regulations quite apart from the power to deregister an MFI and prevent it from operating in the microfinance sector.**
 - f) **The Reserve Bank should considerably enhance its existing supervisory organisation dealing with NBFC-MFIs.**

23 Moneylenders Acts

- 23.1** There are Acts in several states governing money lending but these were enacted several decades ago. They do not, therefore, specifically exempt NBFCs though they do exempt banks, statutory corporations, co-operatives and financial institutions.
- 23.2** As a Technical Committee of the Reserve Bank has pointed out, despite the legislation, a large number of money lenders operate without license and even the registered moneylenders charge interest rates much higher than permitted by the law, apart from not complying with other provisions. The report states that “Signs of effective enforcement of the legislation are absent”.
- 23.3** The Technical Committee states that in many international jurisdictions, for example, Hong Kong, Singapore, Lesotho, there are specific provisions in the law for exemption to certain entities. The Technical Committee has recommended that since NBFCs are already regulated by the Reserve Bank, they should also be exempted from the provisions of the money lending acts. We endorse that recommendation.
- 23.4** **We, therefore, recommend that NBFC-MFIs should be exempted from the provisions of the Money-Lending Acts, especially as we are recommending interest margin caps and increased regulation.**

24 The Micro Finance (Development and Regulation) Bill 2010

- 24.1** The Central Government has drafted a 'Micro Finance (Development and Regulation) Act 2010' which will apply to all microfinance organisations other than:
- a)** banks;
 - b)** co-operative societies engaged primarily in agricultural operations or industrial activity or purchase or sale of any goods and such other activities;
 - c)** NBFCs other than licensed under Section 25 of the Companies Act, 1956;
 - d)** co-operative societies not accepting deposits from anybody except from its members having voting rights or from those members who will acquire voting rights after a stipulated period of their making deposits as per the law applicable to such co-operative societies.
- 24.2** The proposed Act provides that the Central Government will constitute a Micro Finance Development Council to advise NABARD on the formulation of policies, schemes and other measures required in the interest of orderly growth and development of microfinance services.
- 24.3** The proposed Act also provides that a microfinance organisation which is providing thrift services or which intends to commence the business of providing thrift services should be registered with NABARD.
- 24.4** NABARD has the responsibility under the proposed Act to promote and ensure orderly growth of microfinance services provided by the organisations covered by the Act. In furtherance of this responsibility it has the power to issue directions to such organisations and to carry out inspection of such organisations.
- 24.5** In our opinion, the following matters need consideration:
- a)** We are in agreement with the purpose of the proposed Act "to provide for promotion, development and regulation of the micro finance organisations in rural and urban areas." In this context, it is necessary to note, as we have earlier pointed out, that it is estimated that 58% of the outstanding loan portfolio in the micro finance sector is owned by the SHG- Bank linkage model and 34% of the portfolio is owned by the NBFC-MFIs. Both banks and NBFCs are outside the scope of the proposed Act, and are infact regulated by Reserve Bank.
 - b)** Therefore, the organisations which are not regulated by the Reserve Bank account for an estimated 8% of the outstanding micro finance loan portfolio. Since co-operative societies which have voting rights to members are excluded from the provisions of the proposed Act, this percentage may be even lower.

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- c) These residual entities will have a wide variety of constitutional forms, namely, trusts, societies, partnership, sole proprietorship, etc., each governed in some form by different regulatory authorities. They would also represent a large number of entities, with many entities being of very small size.
 - d) If these entities are not regulated, a regulatory gap would be created and therefore we support the proposal in the proposed Act that these entities be regulated. In order that this regulation is in place, there should be a specific provision in the proposed Act for such entities to be registered with the regulator. However given the large number of entities, we would suggest registration should be made mandatory only for entities which have an outstanding micro finance loan portfolio of ₹10 crore or more. In calculating this limit, care needs to be taken to ensure that the outstanding loan portfolios of associated entities are aggregated.
 - e) The proposed Act provides that NABARD shall be the regulator for the entities covered by the Act. In our opinion, the following need consideration.
 - i) NABARD currently is not only the agency responsible for the development of the micro finance sector but is also a participant, in that it finances the sector. There may be a perceived conflict of interest if NABARD is also a regulator. If therefore, NABARD is to act as a regulator, it may be required not to participate in the financing of the sector.
 - ii) If NABARD is to remain the regulator as provided in the proposed Act, then it is necessary that there should be close co-ordination between Reserve Bank and NABARD in the formulation of the regulations issued by each regulator. This is very necessary to ensure against the risk of entities taking advantage of regulatory arbitrage.
 - f) We have serious concerns regarding permitting entities to carry on the business of providing thrift services and thereby attracting public deposits. At present, the size of the loan portfolio owned by such entities is small but there is a real risk that microfinance institutions which are currently NBFCs may use this facility to do business through non-NBFC entities and gather large public deposits. This could in time create a systemic risk. There is also the risk that once this facility is given to entities governed by the Act, pressure will build up from NBFC-MFIs that they must also be given similar facilities and it may prove difficult to resist this pressure.

24.6 Disagreeing with the Sub-Committee Smt. Rajagopalan feels that given the small number of entities likely to be brought within the ambit of such a law, union government may reconsider introducing such a law. It may recommend to state governments instead to introduce grievance redress mechanisms in state moneylending laws, for all such MFI entities that are currently proposed to be covered by the draft Bill - that is, MFIs that do not fall in the ambit of RBI regulation or state cooperative laws. Further, as moneylending and cooperatives are matters for states to legislate on, she felt that it might be inappropriate for Parliament to enact a law in this matter. At any rate, she is in full agreement with the Committee that public savings ought not to be accessed by any such entity and that a regulator cannot also be a market player.

24.7 **Subject to Smt.Rajagopalan’s reservations as expressed in para. 24.6 above, we would, therefore, recommend the following:**

- a) **The proposed Act should provide for all entities covered by the Act to be registered with the Regulator. However, entities where aggregate loan portfolio (including the portfolio of associated entities) does not exceed ₹10 crores may be exempted from registration.**
- b) **If NABARD is designated as the regulator under the proposed Act, there must be close co-ordination between NABARD and Reserve Bank in the formulation of the regulations applicable to the regulated entities.**
- c) **The micro finance entities governed by the proposed Act should not be allowed to do the business of providing thrift services.**

25 The Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act.

25.1 The Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act was passed by the Andhra Pradesh Legislative Assembly on 14th December 2010. It replaces the Ordinance in the same matter issued on 15th October 2010. The Act applies to NBFCs.

25.2 In terms of this Act:-

- a) every MFI has to register before the Registering Authority of the district.
- b) no member of an SHG can be a member of more than one SHG.
- c) all loans by MFIs have to be without collateral
- d) all MFIs have to display the rates of interest in their premises.
- e) the recovery towards interest cannot exceed the principal amount

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- f) no MFI can give a further loan to a SHG or its member without the approval of the registering authority where there is an outstanding bank loan.
 - g) there has to be a standard form of the loan contract
 - h) every MFI has to give to the borrower a statement of his account and acknowledgements for all payments received from him.
 - i) all repayments have to be made at the office of the Gram Panchayat or at a designated public place
 - j) MFIs cannot use agents for recovery or use coercive methods of recovery.
 - k) all MFIs have to submit to the Registering Authority a monthly statement giving specified details
 - l) in each district, a Fast-Track Court is to be established for protection of debtors and settlement of disputes.
 - m) These are penalties for failure to register and for coercive acts of recovery.
 - n) Loan recoveries have to be made only by monthly installments.

25.3 The statement of Objects and Reasons states that the MFIs

- a) are using SHGs to expand their borrowers
- b) are charging usurious rates of interest
- c) are using weekly recovery system, recovery agents and coercive methods

It also refers to a letter dated 19th July 2010 of the Governor, Reserve Bank of India which has confirmed certain malpractices in MFI functioning for which banks have been asked to take corrective actions and which also states “State Government is the best agency for regulation of the interest rates.”

25.4 It will be noticed from the preceding paragraphs of this report that we have recognized and addressed the issues which are mentioned in the Statement of Objects and Reasons. Our recommendations offering solutions for these issues are also not inconsistent with the provisions of the Act except in certain areas where the procedures we have suggested are perhaps simpler to operate than the provisions of the Bill but which nonetheless achieve the same results. We cannot of course provide for punishment for coercive recovery as provided in the Act but we believe we have recommended sufficient safeguards to minimize this risk. In any event, if in the process of coercive recovery, criminal acts are committed, action can always be taken under the criminal laws and if the provisions in the existing laws are not adequate to deal with those situations, those laws can be amended.

25.5 As regards the reference in the Reserve Bank letter to the fact that the State Government should control irregularities in regard to coercive interest rates, we believe it could not have been the Reserve Bank's intention to declare that they have no concern with interest rates. What is perhaps intended is to say that as a matter of policy the Reserve Bank does not mandate interest rates charged by different entities in the financial system. Incidentally even the Act does not make any mention of interest rates except that the total interest cannot exceed the principal amount of the loan. On the other hand, we have specifically recommended a "margin cap" and a ceiling on individual loans which will reduce the effective rate of interest to very reasonable levels.

25.6 While we can understand the circumstances in which the Andhra Pradesh Government felt it necessary to promulgate the Ordinance of 15th October 2010, we would request that the Act be withdrawn for the following reasons:

- a) Experience has shown that the State is often not the best agency to act as a regulator and this task is best left to an independent regulator. This is because the actions of bureaucrats may be subject to political pressures or seen to be subject to such pressures even when no such pressure exists. Therefore, there is a better acceptance of decisions of independent regulators.
- b) When regulations are enshrined in legislation, they acquire a certain rigidity and change, even when desired, is sometimes not possible. If freedom to regulate is given to an independent regulator, s/he can react faster to changing circumstances.
- c) There are serious problems when the responsibility for regulation is given to more than one agency and there are grave risks that those who are regulated will take advantage of regulatory arbitrage. The responsibility for regulating NBFCs has been given to the Reserve Bank under the Reserve Bank Act and therefore the Reserve Bank is already the regulator for NBFC-MFIs. While it may be true that perhaps in the past the Reserve Bank did not regulate this sector as vigorously as it should have done, with the lessons which have been learnt, there is no reason why it should not adequately regulate this sector in the future. If there is also going to be regulation of the sector by the State Government under the Act, there will be risks of regulatory arbitrage.
- d) The problems get multiplied several-fold when we consider that the example of the Andhra Pradesh Government could be followed by other State Governments. If there are separate regulations governing NBFC-MFIs in individual states, the task of regulation by Reserve Bank of MFIs operating in more than one state will become well-nigh impossible.

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- e) Ideally there should be a single regulator regulating microfinance activity in the whole country. However, given the fact that depending upon their constitution, each type of MFI is governed under the law by a different regulator, such a single co-ordinated regulation may not be possible. Nonetheless, considering the fact that banks through the SHG-Bank Linkage programme and the NBFC-MFIs together cover over 90% of the microfinance sector and the fact that the Reserve Bank regulates both the banks and NBFCs, the next best approach is for the Reserve Bank to be the sole regulator for NBFC-MFIs.
 - f) As we have already pointed out, our recommendations in substance cover almost all the provisions of the Act and therefore the need for a separate Act applicable to NBFC-MFIs will not exist if our recommendations are accepted.
 - g) If there still remain some areas of concern, we would recommend that these can be resolved through a co-ordination committee consisting of the representatives of the State Government, the Reserve Bank and NABARD. Such a co-ordination committee has proved very effective in the case of Urban Co-operative Banks and is largely responsible for improvement in their health.

25.7 We would, therefore, recommend that if our recommendations are accepted, the need for a separate Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act will not survive.

26 Transitory Provisions

26.1 We believe that if our recommendations are accepted, the MFIs, the banks and the Reserve Bank as regulator will have to make organisational arrangements for which they must be given time. However, we must also recognize that the borrowers are currently suffering some hardships for which relief must be provided at an early date.

26.2 We would therefore recommend that:

- a) **1st April 2011 may be considered as a cut- off date by which time our recommendations, if accepted, must be implemented. In particular, the recommendations as to the rate of interest must, in any case, be made effective to all loans given by an MFI after 31st March 2011.**
- b) **As regards the other arrangements, Reserve Bank may grant such extension of time as it considers appropriate in the circumstances. In**

particular, this extension may become necessary for entities which currently have activities other than microfinance lending and which may need to form separate entities confined to microfinance activities.

27 Concluding observations

- 27.1** There have been many surveys, both in India and abroad as to the impact of microfinance on the lives of the poor people it is intended to reach. The results have been both conflicting and confusing. These surveys report many success stories, but they also create fears that microfinance has in some cases created credit dependency and cyclical debt. Doubts have also been expressed as to whether lending agencies have in all cases remained committed to the goal of fighting poverty or whether they are solely motivated by financial gain.
- 27.2** In a recent study commissioned by Grameen Foundation and published in May 2010, Dr. Kathleen Odell has made a survey of several significant microfinance impact evaluations released or published globally between 2005 and 2010. She cautions that microfinance is not a single tool but a combination of tools and that MFIs around the world serve different types of clients, operate in diverse environments and offer different combination of services. This extreme heterogeneity, therefore, requires that we appreciate that the results of these surveys have application in a very specific context. Nevertheless, her general conclusion is that while these studies suggest that microfinance is good for micro business, its “over-all effect on the incomes and poverty rates of microfinance clients is less clear, as are the effects of microfinance on measures of social well-being such as education, health and women’s empowerment”. The lesson, therefore, to note, is that mere extension of micro-credit unaccompanied by other social measures will not be an adequate anti-poverty tool.
- 27.3** There are conflicting estimates regarding the total demand for microfinance in the country and the extent of penetration. However, all these estimates confirm the fact that the present amount of microfinance provided by both SHGs and MFI is a small portion of the total demand. ACCESS in its “Microfinance India-State of the Sector Report 2010” gives an estimate of the distribution of microfinance penetration in the country. For this purpose it has published a Microfinance Penetration among Poor Index (MPPI) which measures the share of a region in microfinance clients

divided by the shares of the region in the total population of poor in the country. The index is as under:

Region	MPPI
North	0.41
North East	0.71
East	0.74
Central	0.32
West	0.81
South	3.40

This shows that the level of penetration in the South is more than four times the penetration in the second highest region, namely the West and over ten times the penetration in the least penetrated region, namely the Central.

27.4 This concentration of total microfinance activity in the South is paralleled by the distribution of MFI portfolio as between the regions. This distribution is as under:

Region	% of Portfolio
North	4.27
North East	1.75
East	22.53
Central	9.88
West	6.75
South	54.81

While this also shows that the Southern region has an overwhelmingly large share of the MFI portfolio, it also shows that this share is only a little over twice the share of the region with the next highest share, namely the East but significantly higher than the share of other regions. This supports the complaint that MFIs have been concentrating in the Southern region where SHGs are well developed while neglecting the other regions.

27.5 However, the picture is slightly more encouraging when we look at the rates of growth in 2010 in the different regions. These are:

Region	% Growth
North	88.52
North East	163.62
East	66.42
Central	25.81
South	37.09

This index shows that while the level of penetration is high in the Southern Region as compared to other regions, there are encouraging signs that MFIs are diversifying into other regions at a rate of growth which is higher than the rate of growth in the Southern Region. The relatively lower rate of growth in the Southern Region may be due to the base effect of much larger level of penetration.

27.6 The growth in the combined loan portfolio of both the SBLP model and the MFI model was 51.91% in 2008-09 and 32.53% in 2009-10. The MFI model alone grew by 97.07% and 56.33% in those years. The rate of growth of the SBLP model was therefore much smaller.

27.7 It is, therefore, obvious that (a) the over-all penetration of microfinance in the country is inadequate (b) there is undue concentration of effort in the Southern Region to the relative neglect of other regions and (c) in the SBLP model a much more sustained effort is needed by banks both through this model and directly. This is the context in which our recommendations have been made.

27.8 It is reported that the high rate of growth achieved by the MFIs - and perhaps because of it - has been accompanied by the emergence of several disturbing features such as unaffordable high rates of interest, over-borrowing and coercive recovery practices. Our recommendations are directed towards mitigating these adverse features. While we, therefore, see the need for moderation of the rate of growth of the MFI model, we also see the need for greater efforts in those regions which have hitherto been neglected.

27.9 A moderation of the growth in the MFI model must necessarily be accompanied by a much more vigorous growth of the SBLP model. We have earlier referred to some

of the reasons why the SBLP model has lagged behind and these need to be addressed.

- 27.10** In a utopian society, all microfinance credit would be extended only by not-for-profit making entities. However, the ground realities dictate otherwise. Both the SBLP model and the MFI mode, therefore, need to co-exist as do co-operatives, trusts and societies. The SBLP and MFI models must be viewed not as competitive but as complementary models both sharing a common cause.
- 27.11** MFIs need to find the right balance between the pursuit of the social objective of microfinance and the interests of their shareholders. Responsible finance has meaning only in that context. While several MFIs have published vision statements, not many have demonstrated their commitment to that vision. We, however, believe that there is now a growing acceptance within the MFI community that mistakes have been made in the past and we hope that these will translate to a desire to learn from these mistakes. We are encouraged in this belief by the steps taken for the formation of industry associations and the declared agenda for these associations.
- 27.12** In making our recommendations, we have recognised the need to protect the borrowers who represent a vulnerable section of society. We must however, also, recognise that MFIs can only function effectively in a proper business environment. This means that while the lender has a responsibility to provide timely and adequate credit at a fair price in a transparent manner, the borrower also has the responsibility to honour his commitment for payment of interest and repayment of principal. A financial system depends ultimately on the circulation of funds within the system. If the recovery culture is adversely affected and free flow of funds is interrupted, the system will break down. This will adversely affect the borrowers themselves as the slow-down of recovery will inevitably reduce the flow of fresh funds into the system.
- 27.13** Microfinance is an important plank in the agenda for financial inclusion. The future cannot be left entirely to the stating of good intentions. It, therefore, calls for strong regulation. We believe that if the recommendations made by us are implemented and if MFIs honour the commitments they have proposed in the agenda of the industry associations and if these efforts are accompanied by adequate and effective regulation, a new dawn will emerge for the microfinance sector and the need for State intervention will no longer exist.

28 Summary of Recommendations

A summary of recommendations is given in the Annexure.



Kumar Mangalam Birla
(Member)



Y.H. Malegam
(Chairman)



Dr. K.C. Chakrabarty
(Member)



Shashi Rajagopalan
(Member)



U.R. Rao
(Member)



V.K. Sharma
(Member-Secretary)

Mumbai
January 19, 2011

Annexure : Summary of Recommendations

Sl. No.	Para. No.	Recommendations
1	3.8	<p>The need for regulation</p> <p>A separate category be created for NBFCs operating in the Microfinance sector, such NBFCs being designated as NBFC-MFI</p>
2	4.2	<p>Definition</p> <p>A NBFC-MFI may be defined as "A company (other than a company licensed under Section 25 of the Companies Act, 1956) which provides financial services pre-dominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf". Provision should be made in the regulations to further define each component of this definition.</p>
3	5.9	<p>Regulations to be specified</p> <p>A NBFC classified as a NBFC-MFI should satisfy the following conditions:</p> <ol style="list-style-type: none"> a) Not less than 90% of its total assets (other than cash and bank balances and money market instruments) are in the nature of "qualifying assets." b) For the purpose of (a) above, a "qualifying asset" shall mean a loan which satisfies the following criteria:- <ol style="list-style-type: none"> i. the loan is given to a borrower who is a member of a household whose annual income does not exceed ₹50,000; ii. the amount of the loan does not exceed ₹25,000 and the total outstanding indebtedness of the borrower including this loan also does not exceed ₹25,000; iii. the tenure of the loan is not less than 12 months where the loan amount does not exceed ₹15,000 and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases; iv. the loan is without collateral; v. the aggregate amount of loans given for income generation purposes is not less than 75% of the total loans given by the MFIs; vi. the loan is repayable by weekly, fortnightly or monthly installments at the choice of the borrower. c) The income it derives from other services is in accordance with the regulation specified in that behalf.
4	5.10	<p>Regulations to be specified</p> <p>A NBFC which does not qualify as a NBFC-MFI should not be permitted to give loans to the microfinance sector, which in the aggregate exceed 10% of its total assets.</p>

5	7.11	<p>Pricing of Interest</p> <p>There should be a “margin cap” of 10% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of ₹100 crores and a “margin cap” of 12% in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding ₹100 crores. There should also be a cap of 24% on individual loans.</p>
6	8.7	<p>Transparency in Interest Charges</p> <p>a) There should be only three components in the pricing of the loan, namely (i) a processing fee, not exceeding 1% of the gross loan amount (ii) the interest charge and (iii) the insurance premium.</p> <p>b) Only the actual cost of insurance should be recovered and no administrative charges should be levied.</p> <p>c) Every MFI should provide to the borrower a loan card which (i) shows the effective rate of interest (ii) the other terms and conditions attached to the loan (iii) information which adequately identifies the borrower and (iv) acknowledgements by the MFI of payments of installments received and the final discharge. The Card should show this information in the local language understood by the borrower.</p> <p>d) The effective rate of interest charged by the MFI should be prominently displayed in all its offices and in the literature issued by it and on its website.</p> <p>e) There should be adequate regulations regarding the manner in which insurance premium is computed and collected and policy proceeds disposed off.</p> <p>f) There should not be any recovery of security deposit. Security deposits already collected should be returned.</p> <p>g) There should be a standard form of loan agreement.</p>
7	9.7	<p>Multiple-lending, Over-borrowing and Ghost-borrowers</p> <p>a) MFIs should lend to an individual borrower only as a member of a JLG and should have the responsibility of ensuring that the borrower is not a member of another JLG.</p> <p>b) a borrower cannot be a member of more than one SHG/JLG.</p> <p>c) not more than two MFIs should lend to the same borrower.</p> <p>d) there must be a minimum period of moratorium between the grant of the loan and the commencement of its repayment.</p> <p>e) recovery of loan given in violation of the regulations should be deferred till all prior existing loans are fully repaid.</p>
8	9.12	<p>Multiple-lending, Over-borrowing and Ghost-borrowers</p> <p>All sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. In addition, there should be close supervision of the disbursement function.</p>
9	10.5	<p>Credit Information Bureau</p> <p>a) One or more Credit Information Bureaus should be established and be operational as soon as possible and all MFIs be required to become members of such bureau.</p>

		b) In the meantime, the responsibility to obtain information from potential borrowers regarding existing borrowings should be on the MFI.
10	11.12	<p>Coercive Methods of Recovery</p> <p>a) The responsibility to ensure that coercive methods of recovery are not used should rest with the MFIs and they and their managements should be subject to severe penalties if such methods are used.</p> <p>b) The regulator should monitor whether MFIs have a proper Code of Conduct and proper systems for recruitment, training and supervision of field staff to ensure the prevention of coercive methods of recovery.</p> <p>c) Field staff should not be allowed to make recovery at the place of residence or work of the borrower and all recoveries should only be made at the Group level at a central place to be designated.</p> <p>d) MFIs should consider the experience of banks that faced similar problems in relation to retail loans in the past and profit by that experience.</p> <p>e) Each MFI must establish a proper Grievance Redressal Procedure.</p> <p>f) The institution of independent Ombudsmen should be examined and based on such examination, an appropriate mechanism may be recommended by RBI to lead banks.</p>
11	12.6	<p>Customer Protection Code</p> <p>The regulator should publish a Client Protection Code for MFIs and mandate its acceptance and observance by MFIs. This Code should incorporate the relevant provisions of the Fair Practices Guidelines prescribed by the Reserve Bank for NBFCs. Similar provision should also be made applicable to banks and financial institutions which provide credit to the microfinance sector.</p>
12	13.5	<p>Improvement of efficiencies</p> <p>MFIs should review their back office operations and make the necessary investments in Information Technology and systems to achieve better control, simplify procedures and reduce costs.</p>
13	14.5	<p>Support to SHGs/JLGs</p> <p>Under both the SBLP model and the MFI model greater resources should be devoted to professional inputs both in the formation of SHGs and JLGs as also in the imparting of skill development and training and generally in handholding after the group is formed. This would be in addition to and complementary to the efforts of the State Governments in this regard. The architecture suggested by the Ministry of Rural Development should also be explored.</p>
14	15.3	<p>Corporate Size</p> <p>All NBFC-MFIs should have a minimum Net Worth of ₹15 crores.</p>
15	16.3	<p>Corporate Governance</p> <p>Every MFI should be required to have a system of Corporate Governance in accordance with rules to be specified by the Regulator.</p>

16	17.3	<p>Maintenance of Solvency</p> <p>Provisioning for loans should not be maintained for individual loans but an MFI should be required to maintain at all times an aggregate provision for loan losses which shall be the higher of:(i) 1% of the outstanding loan portfolio or (ii) 50% of the aggregate loan installments which are overdue for more than 90 days and less than 180 days and 100% of the aggregate loan installments which are overdue for 180 days or more.</p>
17	17.5	<p>Maintenance of Solvency</p> <p>NBFC-MFIs should be required to maintain Capital Adequacy Ratio of 15% and subject to recommendation 21 below, all of the Net Owned Funds should be in the form of Tier I Capital.</p>
18	18.10	<p>Need for Competition</p> <p>Bank lending to the Microfinance sector both through the SHG-Bank Linkage programme and directly should be significantly increased and this should result in a reduction in the lending interest rates.</p>
19	19.5	<p>Priority Sector Status</p> <p>Bank advances to MFIs shall continue to enjoy “priority sector lending” status. However, advances to MFIs which do not comply with the regulation should be denied “priority sector lending” status. It may also be necessary for the Reserve Bank to revisit its existing guidelines for lending to the priority sector in the context of the Committee’s recommendations.</p>
20	20.5	<p>Assignment and Securitisation</p> <p>a) Disclosure is made in the financial statements of MFIs of the outstanding loan portfolio which has been assigned or securitised and the MFI continues as an agent for collection. The amounts assigned and securitised must be shown separately.</p> <p>b) Where the assignment or securitisation is with recourse, the full value of the outstanding loan portfolio assigned or securitised should be considered as risk-based assets for calculation of Capital Adequacy.</p> <p>c) Where the assignment or securitisation is without recourse but credit enhancement has been given, the value of the credit enhancement should be deducted from the Net Owned Funds for the purpose of calculation of Capital Adequacy.</p> <p>d) Before acquiring assigned or securitised loans, banks should ensure that the loans have been made in accordance with the terms of the specified regulations.</p>
21	21.4	<p>Funding of MFIs</p> <p>(a) The creation of one or more “Domestic Social Capital Funds” may be examined in consultation with SEBI.</p> <p>(b) MFIs should be encouraged to issue preference capital with a ceiling on the coupon rate and this can be treated as part of Tier II capital subject to capital adequacy norms.</p>
22	22.7	<p>Monitoring of Compliance</p> <p>a) The primary responsibility for ensuring compliance with the regulations should rest with the MFI itself and it and its management must be penalized in the event of non-compliance</p>

		<ul style="list-style-type: none"> b) Industry associations must ensure compliance through the implementation of the Code of Conduct with penalties for non-compliance. c) Banks also must play a part in compliance by surveillance of MFIs through their branches. d) The Reserve Bank should have the responsibility for off-site and on-site supervision of MFIs but the on-site supervision may be confined to the larger MFIs and be restricted to the functioning of the organizational arrangements and systems with some supervision of branches. It should also include supervision of the industry associations in so far as their compliance mechanism is concerned. Reserve Bank should also explore the use of outside agencies for inspection. e) The Reserve Bank should have the power to remove from office the CEO and / or a director in the event of persistent violation of the regulations quite apart from the power to deregister an MFI and prevent it from operating in the microfinance sector. f) The Reserve Bank should considerably enhance its existing supervisory organisation dealing with NBFC-MFIs.
23	23.4	<p>Moneylenders Acts</p> <p>NBFC-MFIs should be exempted from the provisions of the Money-Lending Acts, especially as we are recommending interest margin caps and increased regulation.</p>
24	24.7	<p>The Micro Finance (Development and Regulation) Bill 2010</p> <p>Subject to Smt.Rajagopalan's reservations as expressed in para.24.6 above, we would, therefore, recommend the following:</p> <ul style="list-style-type: none"> a) The proposed Act should provide for all entities covered by the Act to be registered with the Regulator. However, entities where aggregate loan portfolio (including the portfolio of associated entities) does not exceed ₹10 crores may be exempted from registration. b) If NABARD is designated as the regulator under the proposed Act, there must be close co-ordination between NABARD and Reserve Bank in the formulation of the regulations applicable to the regulated entities. c) The micro finance entities governed by the proposed Act should not be allowed to do the business of providing thrift services.
25	25.7	<p>The Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act</p> <p>If the Committee's recommendations are accepted, the need for a separate Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act will not survive.</p>
26	26.2	<p>Transitory Provisions</p> <ul style="list-style-type: none"> a) 1st April 2011 may be considered as a cut- off date by which time our recommendations, if accepted, must be implemented. In particular, the recommendations as to the rate of interest must, in any case, be made effective to all loans given by an MFI after 31st March 2011. b) As regards other arrangements, Reserve Bank may grant such extension of time as it considers appropriate in the circumstances. In particular, this extension may become necessary for entities which currently have activities other than microfinance lending and which may need to form separate entities confined to microfinance activities.

Appendix : Sources of Data

Para. No. of the Report	Sources	Pages Numbers
2.5	Reserve Bank of India, Report on Trend and Progress of Banking in India 2009-10	123
3.4	Microfinance in India- A State of the Sector Report 2010	48,49
	Sa-Dhan Quick Report 2010	16,17
3.6	Sa-Dhan Quick Report 2010	44,45
3.6	Microfinance in India- A State of the Sector Report 2010	133
5.3	Sa-Dhan Quick Report 2010	18
5.6 (d)	Microfinance in India- A State of the Sector Report 2010	39
6.9	Microfinance in India- A State of the Sector Report 2010	2, 3, Table 1.1 and Figure 1.2
7.5	Microfinance in India- A State of the Sector Report 2010	32
7.6	Microfinance in India- A State of the Sector Report 2010	2
18.3	Microfinance in India- A State of the Sector Report 2010	
18.9, 19.2	Reserve Bank of India	
27.3	Microfinance in India- A State of the Sector Report 2010	28
27.4	Microfinance in India- A State of the Sector Report 2010	48,49
27.5	Microfinance in India- A State of the Sector Report 2010	48,49
27.6	Microfinance in India- A State of the Sector Report 2010	2