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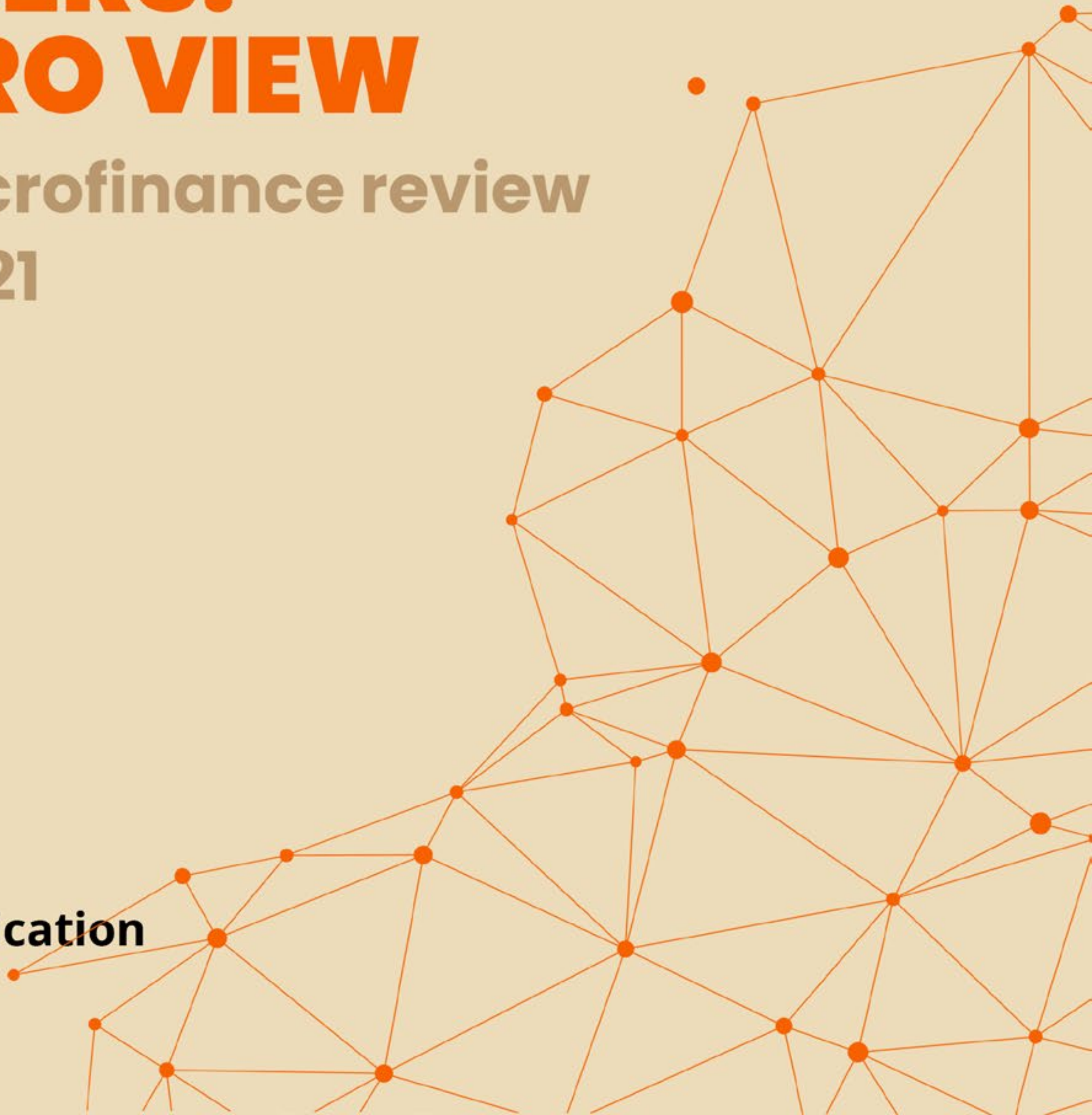
MICRO MATTERS: MACRO VIEW

INDIA microfinance review FY 2020-21



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India Microfinance Review
FY 2020-21

By

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Abbreviations

AePS	Aadhaar Enabled Payment System
AIFI	All India Financial Institution
AMFIRS	Assam Microfinance Incentive and Relief Scheme
APBS	Aadhaar Payment Bridge System
AS	Assam
ASLF	Additional Special Liquidity Facility
AV	Audio Visual
BC	Business Correspondent
BFIL	Bharat Finance Inclusion Limited
BFSI-SSC	Banking, Financial Services and Insurance
BH	Bihar
BOP	Bottom of Pyramid
BSBDA	Basic Saving Bank Deposit Account
CB	Credit Bureau
CC	Cash Credit
CGRM	Customer Grievance Redressal Mechanism
CICs	Credit Information Companies
CIR	Credit Information Report
CKYC	Central KYC
CKYCR	Central KYC Registry
CMS	Content Management System
COF	Cost of Fund
CP	Commercial Paper
Cr	Crore
CRL	Code for Responsible Lending
DDE	Digital Documents Execution
DFS	Department of Financial Services
DPD	Days Past Due
ECB	External Commercial Borrowing
ECLGS	Emergency Credit Line Guarantee Scheme
ECS	Electronic Clearing System
e-KYC	electronic Know Your Customer
EWS	Economically Weaker Section
FI	Financial Institution
FIP	Financial Inclusion Plan
FLDG	First Loan Default Guarantee

Abbreviations

FOIR	Fixed Obligation to Income Ratio
FPC	Fair Practice Code
FY	Financial Year
GDP	Gross Domestic Product
GLP	Gross Loan Portfolio
GNPA	Gross Non-Performing Asset
GOI	Government of India
GST	Goods and Services Tax
HFC	Housing Finance Companies
HH	Household
HR	Human Resources
ICT	Information and Communications Technology
IMF	International Monetary Fund
IMPS	Immediate Payment Service
IND	India
IRDP	Integrated Rural Development Programme
IT	Information Technology
IVR	Interactive Voice Response
KA	Karnataka
KUA	KYC User Agency
KYC	Know Your Customer
LFPR	Labour Force Participation Rate
LIH	Low Income Household
LMS	Loan Management System
MCC	Merchant Category Code
MEL	Microenterprise Loan
MFI	Microfinance Institution
MFIN	Microfinance Institutions Network
MH	Maharashtra
MIS	Management Information System
MoF	Ministry of Finance
MOHUA	Ministry of Housing and Urban Affairs
MOSPI	Ministry of Statistics and Programme Implementation
MP	Madhya Pradesh
MSME	Micro Small and Medium Enterprises
MUDRA	Micro Units Development and Refinance Agency
NABARD	National Bank for Agriculture and Rural Development

Abbreviations

NACH	National Automated Clearing House
NAFIS	NABARD All India Rural Financial Inclusion Survey
NBFC	Non-Banking Finance Company
NCD	Non-convertible Debentures
NEFT	National Electronic Funds Transfer
NNPA	Net Non-Performing Asset
NPA	Non-Performing Asset
NPCI	National Payments Corporation of India
NRC	National Register of Citizens
NSDC	National Skills Development Corporation
NSSO	National Sample Survey Office
OD	Overdraft
OD	Odisha
PAN	Permanent Account Number
PAR	Portfolio At Risk
PCGS	Partial Credit Guarantee Scheme
PE	Private Equity
PMAY	Pradhan Mantri Awas Yojana
PMGKY	Pradhan Mantri Garib Kalyan Yojana
PMMY	Pradhan Mantri Mudra Yojana
PMRPY	Pradhan Mantri Rojgar Protsahan Yojana
POS	Point of Sale
PSL	Priority Sector Lending
Q	Quarter
RBI	Reserve Bank of India
RE	Regulated Entity
RJ	Rajasthan
RRB	Regional Rural Bank
RTGS	Real Time Gross Settlement
SA	Statutory Auditor
SBLP	SHG Bank Linkage Programme
SCA	Statutory Central Auditor
SCB	Scheduled Commercial Bank
SFB	Small Finance Bank
SFMC	SIDBI Foundation for Micro Credit
SHG	Self Help Group

Abbreviations

SIDBI	Small Industries Development Bank of India
SLF	Special Liquidity Facility
SMS	Short Message Service
SRO	Self-Regulatory Organisation
SSC	Sector Skill Council
TLTRO	Targeted Longer-Term Refinancing Operations
TN	Tamil Nadu
UB	Unique Borrower
UNGA	United Nations General Assembly
UP	Uttar Pradesh
UPI	Unified Payment Interface
WB	West Bengal
YOY	Year on Year

About this Report

The microfinance sector in India perhaps receives more than its fair share of analysis and coverage. Many stakeholders – rating agencies, advisories, credit bureaus, market analysts, debt intermediaries, investors, media, researchers, and not least of all, industry associations, review and track the sector extensively. While most reports cover industry performance on operational parameters, some occasionally focus on specific themes like regulations, digitalisation, human resources, governance, risks, and many a times, some specific news.

Such a wide array of reports brings objective scrutiny and transparency in understanding the industry performance and issues and help in advancing the industry. Nonetheless, reviewing the sector from different mandates and fragmented angles often leads to a truncated picture and misses the full story. Many analyses also tend to overlook the broader complex context within which the industry operates.

Microfinance Institution Network's (MFIN) unique position as an RBI-recognised Self-Regulatory Organisation (SRO) and industry association gives us the privilege of engaging closely with the regulator, policymakers, lenders, customers, and various other key stakeholders. It also gives us unparalleled access to a broader and granular set of information and insights beyond performance standards, such as on customer grievances, employee practices and direct understanding of the issues at district and institution levels.

In this context, we felt the need and responsibility to present, metaphorically - a 'full elephant' perspective about the microfinance industry in India. In preparing this report, we draw from MFIN's knowledge and experience and leverage on numerous other reports on the industry.

This report presents the snapshot of the last financial year[1] and covers the most relevant and critical aspects and developments for the year that was, and still lingers on. To the extent possible, we try to cover the microfinance sector holistically and not just the NBFC-MFI[2] industry. However, the report does not cover the SHG-Bank Linkage programme. The report also raises questions that need examination and deliberation.

We hope that this report serves its purpose and look forward to inputs for making it better and more relevant in future editions.

Notes and References

1. However, where pertinent and data is available, we have updated the information upto Sep 2021
2. Non-Banking Finance Company-Microfinance Institution

PROLOGUE

Before we dive into specific developments and numbers for the year, it is worthwhile to contextualise the microfinance industry by zooming in on the customers. Microfinance customers come from the informal sector earning through self-employment or wage. Besides, the economic, social, educational, geographical, and cultural challenges significantly impair their access to formal financial services. These low-income customers greatly rely on microfinance to meet the financial needs for their livelihood. The sector has made immense contribution by reaching 60 million customers, yet a large section remains unserved. Even among those served, vulnerabilities to income from the shocks at the household, community or macro-level remain real and high.

The Financial Year (FY) 2020-21 saw their livelihoods challenged. The pandemic and mobility restrictions (and their multifold effects), combined with meagre buffers to withstand the shocks, adversely impacted the customers' repayment capacities. Consequently, the microfinance industry experienced the highest rate of moratorium (in upwards of 90%) within the financial sector. Even as the economic activity is limping back, many customers are still under stress and will only gradually be able to return to normalcy. Despite challenges, the sector backed by policy support played a yeoman role in mitigating the COVID-19 impact.

While during the year, microfinance customers have shown incredible resilience and ingenuity, the microfinance lenders have responded to the situation with empathy and trust as also learned new ways of doing a "high touch" business by accelerating innovation.

We all assess and engage with the industry, and rightly so, on the yardstick of standard financial parameters. However, as we look forward and build back for the future, sector stakeholders should remain mindful of the profile of the customer base. Above all, customers' well-being is fundamental to whatever we do. As we engage with the industry, we should not lose sight of that core objective and frame our risk and return expectations with broader and long-term perspective.

I take this opportunity to thank and congratulate everyone associated with the industry for their remarkable commitment and grit. With a note of hope, I quote - "Our greatest glory is not in never falling but in rising every time we fall."

I would also like to immensely thank my team members – Sugandh, Swetan and Radhika for putting together this report.

Warm Regards,

Dr Alok Misra
(CEO & Director)

CHAPTER - 1

Macro Context

The world has been facing an unprecedented health crisis created by the COVID-19 pandemic, which has in turn posed an extremely daunting economic challenge for the last 20 months. Global economic output is estimated to have declined by 3.9% in 2020[1]. Policy makers across the globe have been grappling with the dilemma of "lives versus livelihoods" since restrictions required for controlling the spread of the disease resulted in limiting economic activities. Governments and central banks deployed a range of policy tools such as lowering key policy rates, quantitative easing measures to increase the money supply, loan guarantees, and fiscal stimulus to support the economy.

1.1 Indian Economy Amid COVID-19

India suffered two major waves of the pandemic during this period with huge economic fallout. According to the Ministry of Statistics and Programme Implementation (MOSPI) data, India's Gross Domestic Product (GDP) increased by 4% in Financial Year (FY) 2019-20; however, it contracted by 7.3% in FY 2020-21, with decline in first two quarters, followed by expansion in the subsequent two quarters[2] as economic activity picked up with progressive easing of lockdown restrictions. In the first wave, the immediate restrictive measures adopted to contain the spread of the disease caused considerable immediate economic costs owing to almost full suspension of economic activity, curbed consumption and investment, as well as restricted labour supply and production. GDP continued upward trend in first quarter of FY 2021-22 even amidst the second wave that hit the country in April-May 2021[3].

This is the fourth contraction in India's GDP since 1960-61. However, all the earlier episodes coincided with wars/political uncertainty and droughts, with steep fall in agricultural output. The year 2020-21, on the contrary, had the agricultural sector emerging as the silver lining of the economy. The manufacturing sector was hit hard in the first quarter but later picked up though mining continued to remain impacted. Construction and Services sectors were hit the hardest due to the pandemic induced requirements of social distancing[4].

Headline inflation, which started picking up in second half of 2019-20, remained high during 2020-21 and peaked at 7.6% in October 2020. While agriculture was largely shielded from the impact of lockdown restrictions, supply chain disruptions impacted the flow of agricultural goods leading to high food inflation. Subsequently, with the lessening of these pressures, food inflation started easing from November 2020[5].

1.2 Geographical Variation of COVID-19 Impact

There were geographical variations in the spread of the COVID-19 health shock which together with the specific economic weaknesses of the

THERE WERE GEOGRAPHICAL VARIATIONS IN THE SPREAD OF THE COVID-19 HEALTH SHOCK WHICH TOGETHER WITH THE SPECIFIC ECONOMIC WEAKNESSES OF THE STATES CREATED DIFFERENCES IN THE ECONOMIC IMPACT OF THE PANDEMIC.

states created differences in the economic impact of the pandemic. Maharashtra, the highest contributor to the economic output in India, was the COVID-19 hotbed and suffered with high adverse impact in its contact-sensitive services sector (with 56% of its output coming from that sector) and labour market stresses given its higher percentage share of Micro Small and Medium Enterprises (MSMEs). States of Tamil Nadu and Kerala are sensitive to the construction sector shock, a manufacturing slowdown is cause of concern for economy of Gujarat and Jammu and Kashmir, Punjab fared better with reliance on agricultural sector, while services led informal sector shocks affect states like Delhi and Telangana. Uttar Pradesh, a leading economy and most populous state of the country, is dependent on construction led informal sector which was highly affected by lockdown restrictions[6].

1.3 Employment: Informal Sector Suffered

The poor and informal sector workers and self-employed are expectedly the worst hit with high food inflation coinciding with rising unemployment and declining wages. India Labour Force Participation Rate (LFPR) dropped to 46.3% in December 2020, compared with 49.3% in the previous year (CIEC data[7]). Considering the small farm size in India, the self-employed in agriculture can be assumed to be relatively unscathed by the pandemic. On the other hand, 40% of casual labourers in rural areas are employed in the construction sector, which came to a complete halt during the lockdown. Self-employed and casual labourers together account for 51.3% of the urban workforce, and hence, the pandemic had a disproportionate impact on urban areas. Contact-sensitive sectors like trade, hotels, transport, tourism, construction, mining etc. saw employment shock proportional to the respective employment share, with informal workers bearing the larger brunt. Majority of states recorded an improvement in employment conditions in the post-lockdown phase, supported by faster recovery in rural employment, reaching pre-lockdown period levels[8].

According to MOSPI, female LFPR in India was estimated at 17.5% in 2017-18, 18.6% in 2018-19 and 22.8% in 2019-20. The pandemic has adversely impacted the employment status of women across the world including in India. Female labour participation rate in urban India had fallen to a record low of 15.5% in April-June 2020, which was the first quarter of the lockdown and improved marginally to 16.1% during the July-September 2020 quarter and to 20.6% in the October-December quarter[9]. As per the 2021 Gender Gap Index[10], which employs parameters such as economic participation, political empowerment, health, survival, and education to determine the positions of various countries, India has fallen to the 140th position out of 156 countries.

1.4 Credit Flow

In the context of slowdown of economic activity due to the nationwide lockdown, the role of timely credit delivery to productive sectors, especially

agriculture and MSMEs, has been important for supporting recovery. The Government of India's stimulus focussed on the provision of eased access to credit through reduced rates of interest as well as credit guarantees. Overall credit growth of Scheduled Commercial Banks (SCB) for FY 2020-21 has remained positive with increase (YOY) of 5.4% (lowest in the last four financial years), despite contraction in GDP. New loans extended by SCBs showed recovery in the second half of the FY, especially for agricultural and personal purposes. Credit growth to agriculture and allied activities and personal loans fared the best in March 2021 with a double-digit increase. Credit to medium industries registered a robust growth in March 2021 as compared to a contraction a year ago[11]. In the current FY, credit to agriculture and allied activities continue to perform well[12]. **Table 1.1** provides Year on Year (YOY) growth rates of sectoral credit deployment for March and August 2021.

Table 1.1: Sectoral Credit Growth

Sector	March 2020	March 2021	August 2020	August 2021
Agriculture and allied	4.2%	12.3%	4.8%	11.3%
Personal Loans	15%	10.2%	8.5%	12.1%
Industry	0.7%	0.4%	0.4%	2.3%
Medium Industry	-0.7%	28.8%	4.4%	63.4%
Micro & Small Industry	1.7%	0.5%	-1.1%	10.1%

Source: RBI data on sectoral deployment of bank credit - March 2021 and September 2021

Further easing of monetary conditions since the onset of the pandemic and expanding the money supply led to lowering of interest rates. The cost of funds and yield on assets declined across bank groups to reach their lowest levels in the last two decades. Non Performing Assets (NPAs) of banks have declined by Rs 611.8 billion to Rs 8,340 billion at the end of March 31, 2021. The gross NPA (GNPA) ratio of commercial banks declined from 8.4% in March 2020 to 7.8% in March 2021. Macro stress tests indicate that the GNPA ratio of SCBs may increase to 9.8% by March 2022 under the baseline scenario; and to 11.22% under a severe stress scenario, although SCBs have sufficient capital, both at the aggregate and individual level, even under stress[13].

The priority sector lending (PSL) for scheduled commercial banks was 40.54% in FY 2020-21 (as on December 2020). Among bank groups, while public sector banks continued to achieve the prescribed PSL target of 40%, a marginal shortfall was observed for private sector banks and foreign banks[14]. Small Finance Banks (SFBs) have a higher PSL target of 75% and accordingly accounted for about 75% of the total credit to priority sectors (March 2020). Loans to the three sectors of agriculture, trade and professional services accounted for about 65% of the total credit of SFBs as compared to SCBs which lent about 66% of their credit to industry, personal loans and finance, indicating that SFBs are targeting sectors relatively underserved by commercial banks. SFB loans to MSME stood at 41% of total credit compared to 17% for commercial banks. In terms of their size wise distribution of loan portfolio, in March 2020 99.9% and 83% of their total loan accounts and total loan amount, respectively, had a credit limit of up to Rs 2.5 million[15], much exceeding the regulatory requirement of at least 50%.

The RBI undertook a review of PSL guidelines last year basis which several revisions are being done in the guidelines including phased increase in targets prescribed for "small and marginal farmers" and "weaker sections". Also noteworthy

is the decision to implement an incentive and dis-incentive framework by ranking districts based on per capita PSL credit to address regional disparities in the flow of priority sector credit[16].

1.5 Stimulus Measures in Response to COVID-19

The Government of India announced a slew of reforms and relief measures to address the economic crisis. The primary strategy underlying these relief measures was liquidity injection into the economy and government-backed loans to boost small businesses and aid private consumption, which had reduced owing to loss in incomes, movement restrictions, and supply limitations.

The first fiscal support package, intended to provide immediate relief during the lockdown, was the Pradhan Mantri Garib Kalyan Yojana (PMGKY) announced in March 2020. Under Atmanirbhar Bharat Abhiyan Package, government announced measures to strengthen infrastructure, logistics, capacity building, governance and administrative reforms for agriculture, animal husbandry, fisheries, and food processing. These measures include eight development schemes with fund allocation of Rs 1,600 billion, much higher as compared to funds allocated to the relevant schemes for the Union Budget 2020-21. In addition, the government announced governance and administrative reforms to attract investments in agriculture sector and make it competitive. The key highlight of the package pertaining to inclusive finance was the Emergency Credit Line Guarantee Scheme (ECLGS) to provide unsecured loans to MSMEs and business enterprises. MSMEs which were badly hit by the pandemic were supported through policies such as collateral free loan of Rs 3,000 billion, subordinate debt provision of Rs 200 billion and equity infusion via mother-fund-daughter fund model. Further, the change in definition of classification of MSMEs by including turnover as basis of definition was intended to allow MSMEs to expand without losing benefits and improve ease of doing business by aligning them with Goods and Services Tax (GST).

THE GOVERNMENT OF INDIA ANNOUNCED A SLEW OF REFORMS AND RELIEF MEASURES TO ADDRESS THE ECONOMIC CRISIS. THE PRIMARY STRATEGY UNDERLYING THESE RELIEF MEASURES WAS LIQUIDITY INJECTION INTO THE ECONOMY AND GOVERNMENT-BACKED LOANS TO BOOST SMALL BUSINESSES AND AID PRIVATE CONSUMPTION.

The 2021 stimulus package announced in June in response to the second wave of the pandemic focused on loan guarantees, concessional credit to pandemic hit sectors and health care infra. This included expansion of the existing ECLGS by Rs 1,500 billion, and a new Rs 75 billion scheme to guarantee loans up to Rs 125,000 to small borrowers through micro-finance institutions.

1.6 Financial Inclusion Architecture

The financial inclusion architecture which has made significant progress in terms of number of bank accounts, branch, and Business Correspondent (BC) outlet network, accessibility and use of digital payment systems supported

the delivery of services and transactions in India during the lockdown. The RBI recently introduced a composite Financial Inclusion Index (FI-Index) comprising of various dimensions within three broad differently weighted parameters - Access (35%), Usage (45%), and Quality (20%)- to capture the extent of financial inclusion across the country. The annual FI-Index for the period ended March 2021 stood at 53.9 (on a scale of 0 to 100) compared with 43.4 for the period ended March 2017[17]. The CRISIL Inclusix Index launched in 2013 provides a score of 58.0 in FY 2016 compared to 40.1 in FY2011 and 50.1 in FY2013[18] (Inclusix Vol IV - 2018[19]). This indicates considerable progress made through Jan Dhan account and mobile penetration along with strong growth in credit accounts. The report however indicated significant variation in the extent of inclusion among regions and states with south retaining its leadership with a sizable margin. The variation in states is evident with Kerala at a score of 90.9 (rank 1) and Bihar at 38.5 (rank 32).

The number of Jan Dhan Accounts in October 2021 stood at 436.4 million (55.6% belonging to women) with 67% operative accounts and an average deposit amount of Rs 3,400, a significant increase from Rs 1,279 in 2015[20] and only 8% being zero balance accounts. The RBI tracks progress of banks on their respective Financial Inclusion Plans (FIP), highlights of which are provided in **Table 1.2**.

Table 1.2: Progress on Financial Inclusion by Banks

Particulars	Mar 2010	Dec 2019	Dec 2020
No. of total banking outlets in villages – Branches	33,378	54,481	55,073
No. of Banking outlets in villages – BCs	34,174	512,844	1,236,809*
Number of BSBDA[21] accounts (Million)	7.4	596.7	649.2
BSBDA Amount (Rs Billion)	55	1,528.26	2,030.61
Number of Kisan Credit Cards (Million)	24.0	47.9	49.0
Number of General Credit Cards (Million)	1.0	20.0	19.9
ICT[22]-A/Cs-BC- No. of total transactions (Million)#	27.0	2,250	3,518
ICT-A/Cs-BC-Amount of Transactions (Rs Billion)#	7	6,066	8,288

** Significant increase due to reclassification done by one bank*

 # Transactions during the year

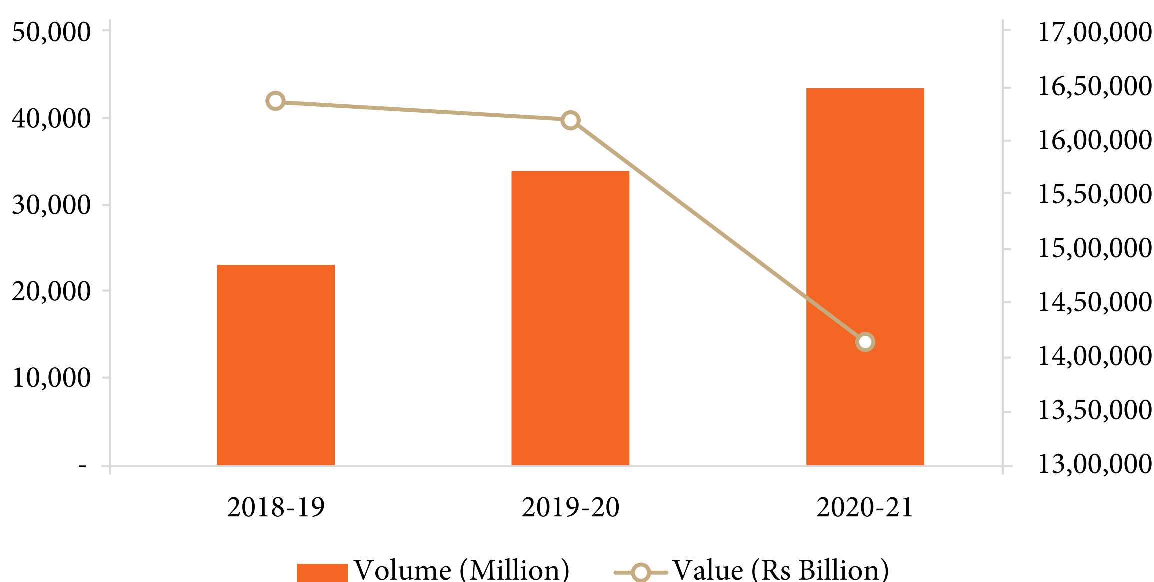
Source: RBI Annual Report 2020-21

The above table indicates an YOY increase of 56% (December 2020) in number of Information and Communication Technology (ICT) based BC transactions with a corresponding increase of 36.6% in value of transactions, in line with the overall growth in digital financial services in India. Digital payments across the country recorded a growth of 30.19% during 2020-21. In terms of value, digital payments in India reached a total of over Rs 53 billion in 2021, a significant increase from Rs 20.7 billion

in 2018. The RBI announced a composite Digital Payments Index (RBI-DPI) with March 2018 as base (100) to capture the extent of digitisation of payments across the country. The index for March 2021 stands at 270.59 as against 207.84 for March 2020 and 153.47 for March 2019, demonstrating rapid adoption and deepening of digital payments across the country in recent years[23].

Figure 1.1 provides an overview of the trend of digital payments[24] in India over the last three years. Digital payments recorded a growth of 22% during 2020-21 in terms of volume on top of the expansion of 32% in the previous year. In terms of value, the reverse trend which started in the previous year (-1%) further witnessed a drop of 15%, mainly on account of higher share of Unified Payment Interface (UPI) transactions. This indicates a positive trend towards usage of digital transactions in everyday life small size transactions also.

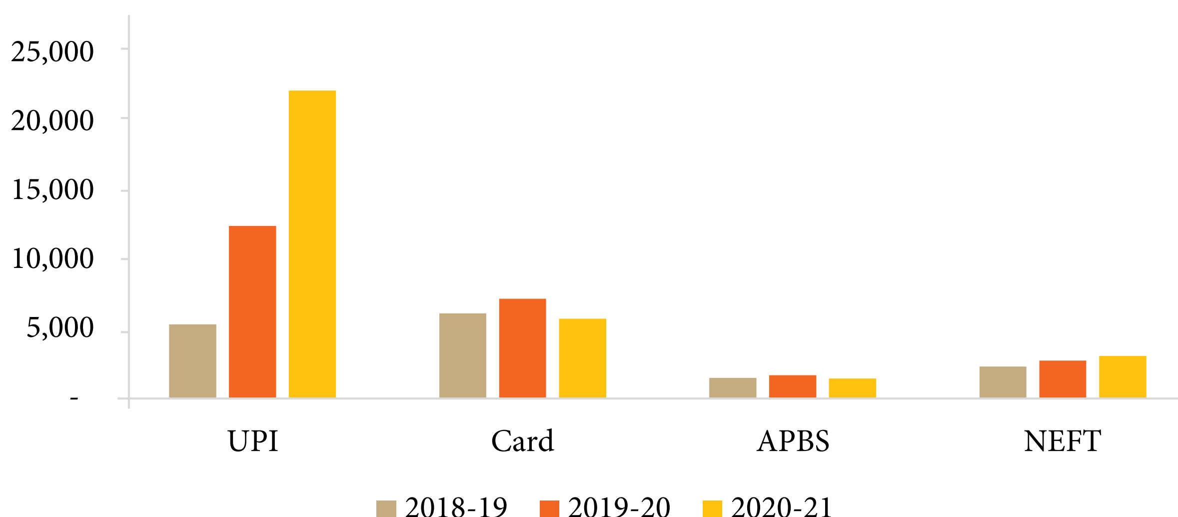
Figure 1.1: Digital Payments in India (Annual Turnover)



Source: RBI Annual Report 2020-21

Among important digital payment options (**Figure 1.2**), UPI overtook card payments in FY 2019-20 and continues significant growth in both value and volume, whereas debit card payments remain on a stable level. Aadhaar Payment Bridge System (APBS) used for credit transactions for Government disbursements shows stagnancy in terms of volume but has grown by 24% in value compared to 2019. The proportion of UPI transactions in total volume of digital transactions has grown from 23% in 2018-19 to 51% in 2020-21 compared to decrease in proportion of National Electronics Funds Transfer (NEFT) transactions from 10% to 7%. This together with average value of transaction for UPI at Rs 1,838 and for NEFT being much higher at Rs 81,256 in 2020-21 indicates that UPI is driving the growth of small value digital transactions[25].

Figure 1.2: Growth in Modes of Digital Payments Transaction Volume (Million)



Source: RBI Annual Report 2020-21

To boost the adoption and use of digital payments, the RBI proposes to introduce a framework for making retail digital payment in offline mode across the country[26]. This move comes based on three successful pilots conducted in different parts of the country during September 2020 to June 2021. This development augurs well for digital financial inclusion by enabling digital transactions in areas with low or no internet connectivity.

1.7 Future Outlook

With a potential of a revival in consumption and investment in the third quarter of 2021, India's GDP growth rate for FY 2022 is projected to be 11% (Economic Survey 2020-21[27]). As per the latest World Economic Outlook (International Monetary Fund) of October 2021, the global economy is projected to grow 5.9% in 2021 and 4.9% in 2022, 0.1% lower for 2021 than in the July forecast[28]. The IMF has however kept India's growth forecast unchanged at 9.5% in 2021-22 and 8.5% in 2022-23. The Asian Development Outlook (ADO) 2021[29] update forecasts India's GDP to grow by 10% for FY 2021-22, driven by a surge in domestic demand and exports.

The RBI has maintained its GDP growth target for this year at 9.5% (RBI policy statement, October 2021[30]). This consists of 7.9% in Q2, 6.8% in Q3 and 6.1% in Q4 of 2021-22. India's GDP had surged 20.1% in the April-June quarter of FY 2021-22.

The record incoming Foreign Direct Investment (FDI) into India during the pandemic year, driven mainly by mergers and acquisitions in the ICT industry shows investor confidence in Indian enterprises. The 95th round of the Reserve Bank's industrial outlook survey conducted during Q2 of FY 2021-22 indicates that manufacturers are optimistic on improvement in production, capacity utilisation, availability of finance, employment conditions and the overall business situation[31].

As per the RBI's Financial Stability Report (July 2021)[32], sustained policy support, benign financial conditions and the encouraging momentum of vaccination are nurturing an uneven global recovery. Policy support has globally helped in bolstering financial positions of banks and maintaining solvency and liquidity. In India, monetary, regulatory, and fiscal policy measures have helped curtail the solvency risk of financial entities, stabilise markets, and maintain financial stability.

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CHAPTER - 2

Extant Policy and Regulatory Environment

The macro context showed the disproportionate impact of COVID-19 on the informal sector and tiny entrepreneurs. As these segments are the integral microfinance market, the sector's role in economic recovery becomes critical.

Over the years, the microfinance sector in India has enjoyed robust policy and regulatory support. As part of the formal financial architecture, two distinct sets of the regulatory ecosystem have a bearing on the microfinance industry. First and foremost, the specific regulation for microfinance that applies to Non-Banking Finance Company – Microfinance Institutions (NBFC-MFIs) influences the microfinance market's universe. Second, NBFC and the much broader financial-sector[1] rules impact the market. This chapter outlines the extant policy and regulatory environment for the microfinance market and lists the steps taken by public policy to support the sector during the difficult year.

2.1 Microfinance Regulations[2]

The existing microfinance regulation[3] provided stability and discipline to the market. It, however, confronted two critical issues as the supply side evolved – narrow applicability of the regulation to NBFC-MFIs only (leaving out two-third of supply) and some specific micro rules less suitable to an evolving market dynamics.

The microfinance sector has been facing fragmented rules for over five years now. Specific regulations for microfinance (customer-protection norms on the income segment, pricing, products, and leverage) are only applicable to NBFC-MFIs accounting for less than a third of the business. A much larger share of microfinance portfolio under Banks, Small Finance Banks (SFBs) and NBFCs remains outside microfinance regulations undermining the very basis of regulations which is customer protection. In the last few years, collective efforts to bring together all industry players to voluntarily follow customer protection norms under the Code for Responsible Lending (CRL)[4] had not achieved desired success, owing to its voluntary nature[5]. While a few large players chose to remain outside the CRL, many were unwilling to be subjected to independent monitoring[6]. Developments in Assam in the last few months, where Banks and SFBs account for three-fourths of the business, clearly brought forth the challenges of fragmented regulations.

The second set of issues pertains to specific challenges in regulations itself where prescriptive norms on qualifying assets, pricing, product, customer indebtedness do not factor in the market realities.

Qualifying Assets: At least 85% of the net assets[7] of NBFC-MFIs are required to be in the

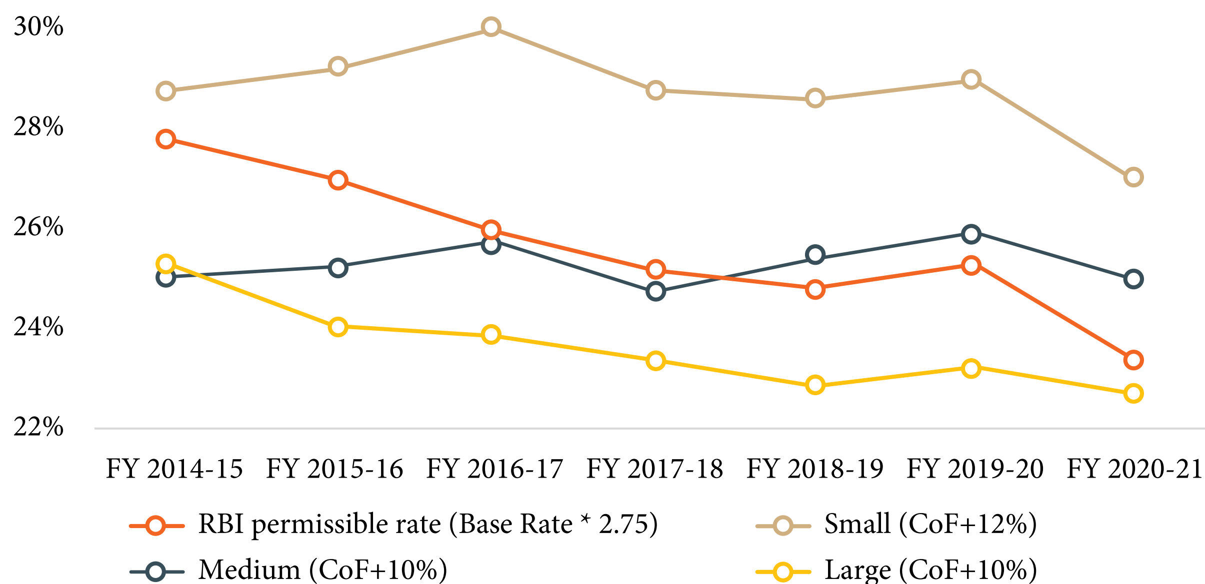
nature of 'qualifying assets'[8]. This is the defining criterion for NBFC-MFIs to ensure that this institutional segment specialises in and focuses on microfinance. However, this also leads to segment and product concentration risk with limited flexibility for offering innovative products to meet the diverse credit needs of the customers. Further, the qualifying asset rule for NBFC-MFIs was defined when the sector was under IGAAP[9], now however 85% of the NBFC-MFIs are under Indian Accounting Standard (IndAS). Under the IndAS, other than cash, bank and money market instruments, the balance of unamortised processing fees income, interest accrued on the portfolio but not collected, and much higher provisions required under ECL are also needed to be netted off against the portfolio. This leads to immense difficulties as the target of 85% is effectively much higher with these net offs. MFIN has represented to the RBI to relax this condition to a lower level (say 75% of the net assets) or revise it to a portfolio linked ratio (85% of balance sheet portfolio).

Pricing Cap: As per the regulations, the interest rates charged by an NBFC-MFI to its customers shall be the lower of the (a) The cost of funds (COF) plus margin (10% for NBFC-MFIs with loan portfolio > Rs 100 Cr (Rs 1 billion) and 12% for NBFC-MFIs with asset size < Rs 100 Cr) and (b) The average base rate of the five largest commercial banks by assets multiplied by 2.75. The average of the base rates of the five largest commercial banks is advised by the RBI on the last working day of the previous quarter, which determines interest rates for the ensuing quarter.

For NBFC-MFIs, pricing is a complex entangled issue with multiple dimensions:

- In the last eighteen months or so, the base rates of commercial banks have been decreasing and, therefore also the benchmark rate for pricing set for NBFC-MFIs by the RBI. Based on the base rates of five largest commercial banks, the benchmark rate is not entirely relevant for the NBFC-MFIs since these banks constitute a small proportion of the funding composition of NBFC-MFIs[10] and majority of their funds come from other sources including other banks and non-bank entities at higher rates. Additionally, the actual lending rate of MFIs does not reflect the downward revision of base rate; more so for small and medium NBFC-MFIs who are even more reliant on non-bank sources for their debt funding. As a result, the actual cost of funding to NBFC-MFIs remains well above the base rate of the five largest commercial banks.
- The formula of '2.75*base rate' means that the drop in one hundred basis point in the base rate results in reduction of 275 basis points in the benchmark rate.
- As a result of the above two factors (lower benchmark rate and high cost of funds), many NBFC-MFIs, especially those with portfolios less than Rs 500 Cr (Rs 5 billion), are forced to operate at unsustainable margins, lower than what is otherwise permissible under regulations.

Figure 2.1: Base Rate Vs COF+Margin of Small, Medium & Large MFIs



Source: Analysis by MFIN based on data collected from member MFIs

In a decreasing base rate environment, the base rate formula has now effectively become the ceiling for all sizes of NBFC-MFIs[11] with smaller MFIs having lower margins than large MFIs – because while their CoF is higher, the pricing cap-based limit remains same.

- The higher credit costs due to event risks in the last few years mean that margins are under stress even when NBFC-MFIs manage to bring efficiencies in the operational costs.
- Finally, only NBFC-MFIs are under the ambit of pricing norms while other regulated entities (REs) have complete freedom to price microfinance loans.

Multiple Lending and Indebtedness: Regulations oblige the NBFC-MFIs (but not other regulated entities) to follow the cap of 2 NBFC-MFIs and total indebtedness of Rs 125,000 per customer. Besides the regulatory arbitrage, the norms need a review to examine if they meet the intended objective and do not deny choices to customers. For example, if a customer needs a loan for Rs 100,000 and ticket size of lender is Rs 30,000, she is compelled to meet her need from other sources. Likewise, if a customer has loans from two NBFC-MFIs, she cannot borrow from other NBFC-MFIs even if her outstanding has come down and she needs an additional loan.

From another standpoint, looking at over-indebtedness from the angle of the number of lenders or absolute indebtedness amount (i. e. loan amount outstanding) can often mask the customer indebtedness experienced through high monthly debt obligations. Customer-level data shows that while about 2% of customers have more than three lenders or loan amount outstanding over Rs 125,000, nearly 20% have monthly debt obligations higher than Rs 5,000, which shows weak linkage between number of lenders and level of indebtedness.

RBI's Consultative Document – Paving a Level Playing Field or Sustainable Growth

Recognising these challenges, in June 2021, RBI put out a revised framework for microfinance regulations for discussion and feedback. The proposed framework is a paradigm shift to replace

the existing 'entity based' regulation with 'activity/product based' regulation. It defines microfinance as an unsecured small value loan to low-income households and brings all lenders under its ambit. It also entrusts greater freedom and responsibility on lenders for customer protection.

The revised regulations, expected anytime soon, will usher in a new era for the microfinance industry. As the industry awaits the new formulation, it is premature to foretell how the market will respond and adjust to the changed regulatory landscape. MFIN expects that product innovation, better segmentation, and risk-based pricing will define the new phase.

THE REVISED REGULATIONS, EXPECTED ANYTIME SOON, WILL USHER IN A NEW ERA FOR THE MICROFINANCE INDUSTRY. MFIN EXPECTS THAT PRODUCT INNOVATION, BETTER SEGMENTATION, AND RISK-BASED PRICING WILL DEFINE THE NEW PHASE.

Table 2.1 summarises the key points of proposed regulations applicable to all Regulated Entities (REs), compares it with existing regulation and provides suggestions from MFIN.

Table 2.1: MFIN'S Suggestions on Regulations Proposed for all REs

1. Definition of microfinance		
Existing regulation	**Proposed regulation**	**MFIN's suggestions**
Small unsecured loan up to Rs 125,000 to low-income customers with annual income Rs 125,000 in rural and Rs 200,000 in semi-urban/urban area. 75% of loans must be used for income-generation activities.	Same.	Household income up to Rs 300,000 per annum, irrespective of rural or urban location, as defined for EWS[12] under PMAY[13]. The logic behind this suggestion is that (a) it was last revised through a circular dated 8 November 2019, but being a static benchmark, it does not factor inflation and may lead to exclusion of several needy households, (b) the basis for income differentiation based on location is unclear as it gets blurred due to migration of members of rural households, and (c) being a maximum rather than minimum, it excludes many potential borrowers.

2. Definition of household		
Existing regulation	**Proposed regulation**	**MFIN's suggestions**
No specific norm	This shall be derived from the definition used by National Sample Survey Office (NSSO) i.e., a group of persons normally living together and taking food from a common kitchen will constitute a household. Even though the determination of the actual composition of a household will be left to the judgment of the head of the household, greater emphasis should however be placed on 'normally living together' than on 'ordinarily taking food from a common kitchen'.	Since it is difficult to have an absolute/ precise definition of a household, MFIN has suggested that a household be defined as: • Husband, wife and dependent children (including any migrant member) – can also be referred to as family • One household/family member shall be the borrower and others can be co-applicant(s)/co-borrower(s) (one or more) depending on who is an earning member and the choice of the borrower. Assessment of income and credit bureau checks may be applied to the household/ family members who have applied for microfinance loan as borrower/co-borrower. SRO should be involved in providing sector-wide guidance on household income assessment which the Board of REs can use for their organizational requirement.

3. Pricing		
Existing regulation	**Proposed regulation**	**MFIN's suggestions**
NBFC-MFIs to charge lower of the cost of funds+10%-12%[14] or 2.75 times of RBI benchmark rate published quarterly[15].	Pricing to be governed by the lender's Board approved policies. Lenders must disclose the pricing in a standard format to the customer.	Deregulation of pricing of NBFC-MFI loans along with the proposed common definition for microfinance borrower for all REs should pave the way for lowering of interest rates for customers in medium to long-term. However, MFIN is of the opinion that • Liquidity flow and availability of funds (debt and equity) at lower rates through targeted schemes particularly for NBFC-MFIs would also be a crucial factor for lowering of rates, as these institutions, unlike banks, do not have access to public deposits. As such, a special facility under NABARD/SIDBI should be created to provide funds to NBFC-MFIs at lower rates. • Creating differentiated infrastructure and environment for prompting digital/cashless methods will be important in enhancing the organisational efficiency and therefore lowering of cost of operations and rate of interest charged to borrowers. • Role for the SRO in providing guidance on interest rates/charges and its monitoring, should be included in the policy guideline. • RBI through SRO should monitor the interest rates to ensure that there is prevention of any un-even spread between Cost of Funds and lending rate across REs.

4. Loan size, tenure and cycle		
Existing regulation	**Proposed regulation**	**MFIN's suggestions**
For NBFC-MFIs, the limit of Rs 60,000 for the first cycle loan to a customer and more than 2-year tenure for loan size > Rs 30,000.	No restrictions related to tenure and loan cycle.	This is welcome, as it will allow greater flexibility and choice to customer and lender.

5. Multiple/over lending		
Existing regulation	**Proposed regulation**	**MFIN's suggestions**
NBFC-MFIs to ensure that customer does not have loans from than 2 NBFC-MFIs and loan outstanding is less than Rs 125,000.	No cap on number of NBFC-MFIs or lenders or total loan outstanding of the customer. Lenders to ensure that customers' debt obligations do not cross 50% of the household income.	While agreeing to norms of debt obligation, MFIN's suggestion is that • Lenders should take the comprehensive CIR[16] of borrower and co-applicant to assess the household/family income • Given the lenders' reliance on credit bureau report to verify the indebtedness, all REs must submit daily data to CICs[17] and reporting of Self-Help Group data to CICs must be implemented.

6. Qualifying assets		
Existing regulation	**Proposed regulation**	**MFIN's suggestions**
NBFC-MFIs to maintain 85% qualifying assets (i. e. microfinance loans)	Same as before.	For NBFC-MFIs, 75% of total on-book loan portfolio should be the qualifying assets and PSL to address the issue of concentration risk.

<table>
<tr><th colspan="3">7. SRO for NBFC-MFI</th></tr>
<tr><th>Existing regulation</th><th>Proposed regulation</th><th>MFIN's suggestions</th></tr>
<tr><td>Recognition of industry association as the SRO for the NBFC-MFIs.

SRO responsibilities to include formulating and administering a Code of Conduct, a grievance and dispute redressal mechanism for the customers of NBFC-MFIs, ensuring customer protection and education, monitoring compliance by NBFC-MFIs with the regulatory framework, surveillance of the microfinance sector, training and awareness programmes for the members, Self Help Groups, etc</td><td>No explicit guidance on the SRO framework</td><td>The proposed regulatory framework rightly entrusts confidence in the lenders and customers to make fair decisions and the right choices towards customer-protection, including indebtedness and pricing. Within this liberalised approach, the role of MFIN as SRO will be critical for:

• Capacity building support and handholding to REs
• Providing guidance and monitoring on key areas of a) economic potential of an area and related indebtedness level b) pricing c) customer protection
• Ensuring that all REs abide by the spirit of regulation.
• Providing regular feedback to the RBI
• Customer education on indebtedness, multiple loans etc. so that they can take informed borrowing decisions.

It is imperative that regulation should mandate all REs to be part of the SRO for a conducive roll out of the new regulatory framework and sustainable growth of microfinance.</td></tr>
</table>

2.2 Policy Measures to Mitigate COVID-19 Stress

Last year was notable for measures undertaken by the RBI and Government of India (GOI) to deal with the pandemic. The key ones which stand out for their impact on the microfinance industry, are summarised in this section.

The industry entered the financial year with an uncertain and unprecedented impact of COVID-19. Waves of infections and lockdown restrictions adversely impacted the customers' livelihoods and limited the mobility of lenders to operate. As the microfinance model heavily relies on frequent physical connect with customers at their doorstep in a group format, lockdowns brought the operations of MFIs to a complete standstill[18]. As a result, the repayments came under pressure, creating liquidity issues particularly for NBFC-MFIs.

BOX 2.1

Credit Guarantee Scheme for MFIs

Building on the experience of previous credit guarantee scheme and funding challenges of the NBFC-MFIs, MFIN worked closely with the Ministry of Finance (MoF) to carve out a dedicated credit guarantee scheme for MFIs. Under the new scheme, announced in July 2021, government provided 75% guarantee (totaling Rs 75 billion) to banks for term loans to MFIs subject to MFIs following certain norms including on disbursements and pricing. To ensure that the scheme benefits a wider set of MFIs, including small and medium, it mandates banks to lend at least half under the scheme to MFIs rated MFR2 and below. The scheme has been extremely successful and within three months of announcement, banks had utilized the entire guarantee amount. Though the Scheme benefited MFIs other than A rated ones, the data from MFIN member NBFC-MFIs however shows that much of the funds went to MFIs with up to MFR2 and several small and medium NBFC-MFIs with lower rating/grading did not receive funding.

RBI introduced swift measures around twin approaches to ease the situation. In March 2020, RBI allowed the lenders[19] to extend moratorium to customers up to May 2020 and extended it in June 2020[20] further until August 2020. RBI also directed lenders to maintain the account status in their reporting to credit bureau during the moratorium period to ensure that moratorium does not spoil the credit history of the customer which could adversely impact their access to credit in future. Later in August 2020, the RBI came up with 'Resolution Framework for COVID-19 related Stress[21]' as a one-time resolution of loans of borrowers[22] until 31 March 2021 that were standard but not in default for more than 30 days with any lending institution as on 1 March 2020. In May 2021, RBI released another resolution framework[23] for individuals and small businesses allowing lenders to restructure the loans. These COVID-19 related relief measures covered the microfinance loans in their ambit, providing much-needed relief to the customers.

Second much needed approach of the RBI was to support the lenders through special liquidity schemes and less stringent provisioning requirements. Ministry of Finance (MoF) supplemented the RBI's efforts through special schemes (**Box 2.3**) such as ex-gratia, credit guarantee, and PMSvanidhi. Refer to Annex 1 for the details of regulatory and policy measures related to COVID-19 in the context of microfinance.

BOX 2.2

Impact of Moratorium

RBI directions on moratorium had an adverse impact on NBFC-MFIs. While most customers opted for the moratorium and did not repay until September 2021, majority of NBFC-MFIs could not avail moratorium on their funding from banks and non-banks. A survey amongst MFIN member NBFC-MFIs in June 2021 reported NBFC-MFIs receiving moratorium for just over a third of their repayment instalments. As a result, NBFC-MFIs came under tremendous pressure to manage the liquidity. Since NBFC-MFIs align their debt funding closely with the tenure of the microfinance loans i. e. 1-3 year period, assets and liabilities of the NBFC-MFIs match very closely, and they heavily rely on repayments from customers to repay their debt obligations and manage the operational costs (which cannot be curtailed as much of it is related to employee salaries and infrastructure costs).

BOX 2.3

Schemes Initiated by RBI and GOI during the Pandemic

RBI's Targeted Longer-Term Refinancing Operations (TLTRO 2.0) for small and medium-sized entities including NBFCs and MFIs. Funds availed under TLTRO 2.0 were to be deployed in investment grade bonds, commercial paper (CPs) and non-convertible debentures (NCDs) of NBFCs. 10% of the total funds availed was to be deployed in securities/instruments issued by MFIs.

RBI's refinance to All India Financial Institutions (AIFIs) comprising Rs 250 billion to NABARD for refinancing Regional Rural Banks (RRBs), Cooperative Banks and NBFC-MFIs and Rs 150 billion to SIDBI for on-lending/refinancing. Later during the year, on realising that funding under these facilities is not reaching Small and Medium MFIs, RBI announced Additional Special Liquidity Facility (ASLF) with NABARD for refinancing small and medium sized NBFC-MFIs with an allocation of Rs 50 billion.

Government of India Special Liquidity Scheme of Rs 300 billion for investments in both primary and secondary market transactions in investment grade debt paper of NBFCs, Housing Finance Companies (HFCs) and MFIs.

Government of India Partial Credit Guarantee Scheme (PCGS) 2.0 of Rs 450 billion was launched on 20 May 2020 by Department of Financial Services, Ministry of Finance, Government of India for purchase of pooled assets of NBFCs/HFCs and portfolio guarantee for purchase of Bonds or CPs issued by NBFCs/HFCs/MFIs, by Public Sector Banks with the first 20% of the loss having a sovereign guarantee by the Government of India. The timeline to purchase the bonds and CPs was extended to 31 December 2020 in response to the emerging demands.

PM Svanidhi Scheme for lending to Street Vendors was launched by Ministry of Housing and Urban Affairs (MOHUA) on 2 July 2020 with SIDBI as the implementing partner. The key features of the scheme included (i) Working Capital term loans of tenure up to 12 months, (ii) loan amount of Rs 10,000 to street vendors registered with Urban Local Bodies, (iii) interest rate subsidy of 7%

for on-time repayment, (iv) incentives of up to Rs 100/month to vendors for digital transactions, monitored by National Payments Council of India (NPCI), (v) Credit guarantee by CGTMSE[24] free of charges – 100% of 1st loss of 5% and 75% of 2nd loss for the next 10% and (vi) integrated CIR and electronic-KYC checks on PM Svanidhi portal.

Government of India Ex-gratia Scheme to grant payment of difference between compound interest and simple interest for six months to borrowers in specified loan accounts. Borrowers with loan accounts with sanctioned limits and outstanding amount not exceeding Rs 20 million as on 29 February 2020 were eligible under the scheme for MSME, Education, Housing, Consumer durable, Automobile, Consumption, Personal Loans, and Credit Card dues.

Interest Subvention Scheme for Micro Units Development and Refinance Agency (MUDRA) Shishu Loans by SIDBI as a part of the Atmanirbhar Bharat Abhiyan of Government of India. The scheme was for MFIs who had reported outstanding Shishu loans to MUDRA as on 31 March 2020. The Scheme period was from 1 June 2020 – 31 May 2021 for all borrowers with loan outstanding as on 31 March 2020 but not NPA and 1 September 2020 – 31 August 2021.

While immensely helpful (particularly for the customers due to moratorium and restructuring), these measures could not fully address the liquidity challenges for lenders. The situation however started improving as repayments resumed from customers from September 2020 onwards. Nevertheless, the policy-level support recognised the significance of microfinance for inclusive growth, giving a strong signal to the market for future growth.

2.3 Policy Issues Requiring Attention

Current Account

In August 2020, RBI revised the Directions[25] for opening current accounts to ensure credit discipline and resolution and fair recovery for the lenders. The revised Directions instructed the banks to follow a graded approach with respect to opening and operating of current and CC/OD[26] account, the underlying principle being that customer's multiple debits from CC/OD accounts are routed through a single current account with a bank with which the customer has the highest exposure. The Directions, while well-intentioned, created significant operational challenges for the NBFC-MFIs.

Given their funding profile, most NBFC-MFIs have banking-sector exposure (for many in excess of Rs 500 million), making the Direction applicable. As microfinance operations are vastly spread in remote areas, which vary in terms of presence of bank branches, NBFC-MFIs have to maintain current accounts with multiple banks to cover their operational areas. NBFC-MFIs use these current accounts to deposit cash received from the customers towards repayment collections. In addition, NBFC-MFIs inevitably have CC/OD facilities to meet unexpected liquidity/emergency needs.

Since the Directions practically disallow the current accounts for the lenders, they have to completely rejig their cash-management with higher cost and operative difficulties to manage the cash collections. Most lenders have to open multiple collections-only[27] CC/OD accounts. This means paying the higher costs (fees and pledging of securities) for CC/OD accounts for the limited purpose of depositing frequent repayment collections. At locations where such CC/OD

accounts are central-office level with branches handling repayment cash deposits, there is a lack of support from the branch as these accounts do not directly profit the branch. The workarounds like Cash Management Services (CMS), Payment Banks or Business Correspondent channel are even more expensive. Though lenders are engaging with the Banks for optimum and cost-effective arrangements, the short-term pains are unavoidable.

Udyam Registration for MSMEs

In June 2020, the Ministry of Micro, Small and Medium Enterprises (MSME) issued Directions[28] revising classification criteria and mandating the filing of the Udyam registration for MSMEs[29] from July 2020. Udyam registration is a free online registration of MSMEs on a dedicated government portal[30] developed by the Ministry of MSME. On the portal, MSMEs can register by providing some basic details of the enterprise (i. e. Udyam) and Aadhaar number to receive an online permanent Udyam registration number and certificate. An enterprise registers on the basis of self-declaration and Permanent Account Number (PAN) and GST; details on investment and turnover of enterprises are taken automatically from Government databases. The MSME Ministry and District Industries Centre (DICs) provide the necessary support to facilitate the registration process and further handholding of MSMEs.

Undoubtedly, Udyam registration is necessary and critical to bring the MSMEs under the formal sector to spur their growth. However, the sheer vastness and diversity[31] of micro-enterprises and persisting stress on them due to COVID-19 make the timing of mandatory Udyam registration extremely challenging. In the microfinance sector, which invariably lends to very small, self/family employed MSMEs, the registration is even more difficult due to lack of awareness, perceived bias, and lack of incentive towards the 'formalisation'. Addressing these challenges will require enormous education and direct handholding support to customers.

99% OF INDIA'S ESTIMATED 63 MILLION MSMEs ARE MICRO-ENTERPRISES (INVESTMENT/ REVENUE OF RS 1 MILLION/RS 50 MILLION). THESE ARE FAIRLY EQUALLY DISTRIBUTED IN RURAL/URBAN AREAS AND SECTORS (MANUFACTURING, SERVICES, TRADE AND OTHER).

The timeline of 31 March 2021[32] which was later extended to 31 December 2021[33] is too short for these kinds of enterprises to register. As a result, failure to get the Udyam registration (and subsequent PAN/GST registration as required under the Direction) is depriving the smallest of all MSMEs of formal credit as these customers will become ineligible for credit by Banks and Non-Banks under the category of PSL[34] and/or MUDRA[35] loans.

MFIN has represented to the MSME Ministry highlighting these challenges and requested a 3-year timebound approach to facilitate the registration process. Otherwise, a well-meaning policy will end up with opposite outcomes, with most MSMEs being further pushed to the informal sector for their financing needs.

BOX 2.4

Impact on MUDRA Loans

In the last five years, Pradhan Mantri Mudra Yojana (PMMY) and Micro Units Development & Refinance Agency (MUDRA) have been catalytic in facilitating 'funding the unfunded'. PMMY brings the micro enterprises within the formal financial system and extends affordable credit to them, with credit titled Shishu (loan upto Rs 50,000), Kishor (Rs 50,000 – Rs 500,000) and Tarun (Rs 500,000 – Rs 1 million) through Banks, Non-Banking Finance Companies (NBFCs) and Micro-Finance Institutions (MFIs). Since its inception, the program has facilitated a cumulative amount of Rs 12,300 billion to 244.8 million loan accounts.

Based on latest data available for the FY 2019-20, the total sanctions under PMMY grew to Rs 3.3 billion and benefiting 62.2 million customers. Shishu remains the most popular product in terms of sanction volume, accounting for 88% of sanctions, followed by Kishor (10%) and Tarun (2%). The programme also helped in extending financial support to the weaker sections of the society, viz., SC/ST/OBC[36] (48% of sanctions by volume) and women entrepreneurs (43% of sanctions by volume) in large numbers.

Among other things, the requirement of Udyam registration, will adversely impact the financing covered under MUDRA in immediate to short-term as a large number of very-tiny entrepreneurs will not be able to get Udyam registration so quickly.

Statutory Auditors

RBI in April 2021 issued the Guidelines on Appointment of Statutory Central Auditors (SCAs)/Statutory Auditors (SAs)[37] of Commercial Banks (excluding RRBs), UCBs and NBFCs (including HFCs). The Guidelines, among other things, most notably, require the NBFCs with total assets of more than Rs 10 billion to:

- Adopt the guidelines by second half of FY 2021-22
- Rotate their auditors every three years, with reappointment possible only after a cooling period of six years. Further, NBFC-MFIs whose existing auditors have already served for 3 years or more would have to be replaced mid-year.
- Identify a new auditor if their existing auditor (even if within 3-year prescribed term) has been appointed by eight or more NBFCs.
- Get a minimum of Top 20 or Top 20% branches or branches with minimum of 15% of total gross advances covered by branch audit.

The guidelines aim to strengthen the audit governance and regulate the risks associated with it. However, its implementation is very challenging for the NBFC-MFIs for many practical reasons:

a. The applicability limit of Rs 10 billion would bring a number of entities (an estimated 20 NBFC-MFIs) under the purview of this regulation, in addition to several NBFCs and almost all banks (excluding RRBs) and UCBs. Together with limit on number of types of entities that an audit firm can concurrently audit, this would have a cascading effect on availability of suitable auditors, particularly for NBFC-MFIs.

   Most NBFC-MFIs have to regularly raise capital from a variety of investors, including international investors. The prescribed limits may result in the middle and large sized

auditing firms, with relevant sector expertise, not being able or willing to undertake audits of several member NBFC-MFIs (either due to unavailability of adequate slots given the ceiling of eight audits or due to commercial reasons), which could create more challenges for the smaller entities in their capital raise exercise.

b. The suggested applicability date is very challenging, due to the current economic environment and the management bandwidth for most of the member NBFC-MFIs being occupied in managing the business situation on ground. In such an environment, an added complexity of auditor rotation would be difficult to manage and put enormous strain on the management. Further, the auditor appointment has to be approved by the shareholders at their general meeting and there may not be sufficient time for the members to conduct a Request for Proposal (RFP) process and find suitable auditors with necessary skills and credentials post completion of annual audits.

c. The Guidelines set the norms for minimum number of branches to be audited – Top 20% or branches with minimum of 15% of total gross advances. This will create a huge operational issue for NBFC-MFIs, as unlike banks, the large NBFC-MFIs have hundreds of branches. As per MFIN Micrometer Q3 FY 2020-21, NBFC-MFIs have an average of 267 branches and Gross Loan Portfolio (GLP) per branch ranges from Rs 10 million to Rs 150 million depending on vintage. For an NBFC-MFI of GLP of Rs 50 billion around 100 to 125 branches would have to be covered. This will require the audit firm to have a massive bandwidth and an all-India presence as MFI branches are spread across multiple states. Such scale of audit exercise can be done only by top audit firms, and it will have a huge cost implication as well.

In view of the above mentioned challenges, MFIN has requested the RBI for review of the circular along the following lines.

- The applicability threshold be increased to total assets of Rs 50 billion[38].
- The applicability date for implementation of guidelines be deferred for a year, from FY 2022-23 onwards considering the practical issues in identifying a suitable auditor mid-year, in case rotation is required.
- The rotation policy be aligned to the auditor tenure of five years as permissible under the Companies Act followed by a cooling-off period of five years.
- The decision on minimum number of branches to be covered should be at the discretion of the audit firms and they should justify their audit coverage.
- The limit for eight NBFCs that can be concurrently audited by an audit firm, should be for NBFCs with asset size >Rs 50 billion. There should be no restriction for smaller institutions to hire the services of any audit firm.

Notes and References

1. Most notably policy framework for NBFCs (most of the provisions are applicable to NBFC-MFIs also), priority sector lending (PSL), Micro Small and Medium Enterprises (MSME), Know your Customer (KYC). Additionally, norms regarding provisioning, corporate governance, accounting standards, guarantee schemes, investments, securatisation etc. impact the microfinance institutions.
2. Refer to Chapter IX (pg 49-56) of RBI Master Directions for NBFCs available at https://rbidocs.rbi.org.in/rdocs/notification/PDFs/45MD01092016B52D6E12D49F411DB63F67F2344A4E09.PDF
3. Microfinance regulations came in Dec 2011 and have only seen minor incremental changes since then.
4. https://mfinindia.org/assets/upload_image/publications/IndustryStandards/Code%20for%20Responsible%20Lending_Aug%2020.pdf
5. By Oct 2021, 111 lenders accounting for estimated 70% of the market supply signed the CRL
6. Under CRL framework, lenders were expected to extract a quarterly adherence report from a credit bureau to capture their adherence on CRL norms regarding timely submission of data to CICs, multiple lending, total indebtendess, and not lending to delinquent customers for loans disbursed in the quarter.
7. Net assets means total assets other than cash and bank balances and money market instruments
8. 'Qualifying asset' means a loan which satisfies the following criteria:-

i. loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs 125,000 or urban and semi-urban household income not exceeding Rs 200,000;

ii. loan amount does not exceed Rs 75,000 in the first cycle and Rs 125,000 in subsequent cycles;

iii. total indebtedness of the borrower does not exceed Rs 125,000; provided that loan, if any, availed towards meeting education and medical expenses shall be excluded while arriving at the total indebtedness of a borrower.

iv. tenure of the loan not to be less than 24 months for loan amount in excess of Rs 30,000 with prepayment without penalty;

v. loan to be extended without collateral;

vi. aggregate amount of loans, given for income generation, is not less than 50% of the total loans given by the MFIs;

vii. loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower

9. Indian Generally Accepted Accounting Principles (IGAAP)
10. As of June 2020, on the basis of data from MFIN member NBFC-MFIs, proportion of lending from these Top 5 banks contributed 32.7%, 8.9% and 8.1% of debt funding for large, medium and small NBFC-MFIs respectively.
11. Chart here shows that for small NBFC-MFIs, base rate cap has always been lower than 12% margin formula and for medium NBFC-MFIs from 2018-19, base rate *2.75% has become the effective pricing cap. For large NBFC-MFIs, since Q3 FY 20-21 , for the first time base rate *2.75 has become the cap.
12. Economically Weaker Section
13. Pradhan Mantri Awas Yojana
14. NBFC-MFIs with loan portfolio < Rs 100 Cr (Rs 1 billion) can charge 12% and > Rs 100 Cr can charge 10% margin
15. Benchmark is average of base rate of 5 largest banks by asset size in the previous quarter.
16. Credit Information Report
17. Credit Information Companies
18. Though the government permitted non-banks to operate during lockdowns, movement of field employees to customers remained extremely limited due to local administrative rules and COVID-19 protocols.
19. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11835&Mode=0
20. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11902&Mode=0
21. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11942&Mode=0

22. The aggregate exposure, including non-fund based facilities, of banks and NBFCs to the borrower does not exceed Rs 25 crore (Rs 250 million) as on 1 March 2020
23. https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12085&Mode=0
24. Credit Guarantee Fund Trust for Micro and Small Enterprises
25. https://rbi.org.in/Scripts/NotificationUser.aspx?Id=12137&Mode=0
26. Cash credit (CC) and Overdraft (OD)
27. These collection-only account can only be credited and funds must be remitted/debited to CC/OD or escrow account
28. https://rbidocs.rbi.org.in/rdocs/content/pdfs/IndianGazzate02072020.pdf
29. India has an estimated 63 million MSMEs accounting for nearly one-third of the GDP and 0.11 billion jobs.
30. https://udyamregistration.gov.in/Government-India/Ministry-MSME-registration.htm
31. Refer to MSME Annual Report available at https://msme.gov.in/sites/default/files/MSME-ANNUAL-REPORT-ENGLISH%202020-21.pdf
32. As per latest available data on Uydam registration for May 2021, Udyam Registration portal registered just over 3 million MSMEs, of which 93% were micro-enterprises
33. https://www.pib.gov.in/PressReleasePage.aspx?PRID=1727980
34. Priority Sector Lending
35. Loan qualified under Micro Units Development and Refinance Agency Ltd
36. SC - Scheduled Caste, ST - Scheduled Tribe, OBC - Other Backward Caste
37. https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=51480
38. It is noteworthy that RBI in other regulations has considered asset size Rs 50 billion as the quantitative threshold for applicability of other requirements (such as maintenance of liquidity coverage ratio or appointment of a chief risk officer) that are aimed at mitigating risk and improving corporate governance.

CHAPTER - 3

Performance During a Tough Year

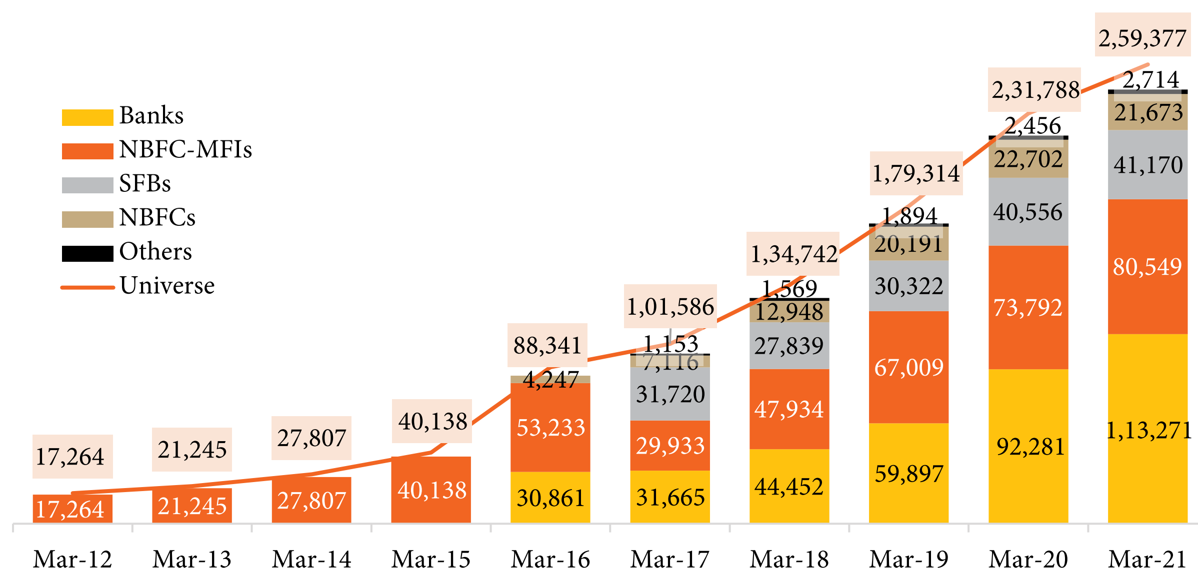
3.1 Retail Landscape

While the origin of organized finance in India can be traced back to 1904 with the Cooperative Societies Act for promoting thrift & help, it was the "not-so-successful" experiment of Integrated Rural Development Programme (IRDP) in the 1980s which laid the foundation of microfinance. However, it was NABARD's SHG Bank Linkage Programme (SBLP) in the mid-1990s followed by SIDBI Foundation for Micro Credit (SFMC) programme in 1999 on wholesale lending and capacity building support to MFIs (V1.0), that formed the backbone of the microfinance industry that we see today.

The industry grew rapidly in the first decade of 2000 with SIDBI/NABARD backing and strong interest shown by Private Equity (PE) investors. However, the quest of growth also led to its downfall with a major crisis in Andhra Pradesh in 2010, the hub of microfinance at the time, for reasons that are well documented. To navigate through the crisis, Malegam Committee was constituted by RBI in 2010 to review the microfinance framework, examine client protection practices, role of Self-Regulatory Organisation (SRO) etc. which resulted in creation of a separate category of Non-Banking Finance Company (NBFC) for microfinance designated as NBFC-Microfinance Institution (NBFC-MFI). This paved the way for the second innings of microfinance industry (V2.0) under a controlled regulatory environment with caps on pricing, customer indebtedness, number of loans and classification of microfinance loans as qualifying assets.

Riding on the back of the regulatory framework, V2.0 reignited the interest of funders for lending to NBFC-MFIs, fuelling the growth and resurgence of the industry. Several new entities were established with focus on good governance and client centric practices. Creation of a specialized credit bureau for microfinance, with MFIN's support, enabled the MFIs to adhere to RBI guidelines on indebtedness and multiple lending. NBFC-MFIs were the major providers of microfinance but things changed with banking licence to Bandhan in 2014 and Small Finance Bank (SFB) licence to 8 NBFC-MFIs in 2015. And with the merger of Bharat Finance Inclusion Limited (BFIL) with IndusInd Bank in 2019, the retail landscape for micro-credit supply had totally transformed. **Figure 3.1** below shows as to how the contribution of various types of entities operating in the microfinance segment has changed since 2012.

Figure 3.1: Microcredit Portfolio (Rs Cr)



Source: MFIN Micrometer, data from Mar-19 onwards based on portfolio originated after Feb-17 provided by Equifax

As evident from the above figure, the present (March 21) retail landscape of micro-credit supply is dominated by Banks (44%) and NBFC-MFIs which were the sole providers till 2015, now represent just 31% of the industry and SFBs, NBFCs and non-profit entities contribute the remaining 25% of the supply side. In the last financial year, as NBFC-MFIs struggled more with liquidity and funding challenges, the share of Banks has increased further.

It is worth noting that regardless of the type of lender, the underlying microfinance model remains the same - unsecured, small, short tenure loans to women through group model. However, data points to Banks' portfolios skewed towards higher ticket sizes. During FY 2020-21, the average loan size of banks was around Rs 40,000 in comparison to about Rs 34,000 of NBFC-MFIs and Rs 36,000 of SFBs. Further, the size of the lender is another critical lens to look at the supply. The larger sized lenders (GLP >Rs 500 Cr/5 billion) which are 26% in terms of numbers, contribute to around 97% of the microcredit business, as shown in **Table 3.1**.

Table 3.1: Contribution to Microcredit Market by Entities of Different Sizes (As on 31 March 2021)

GLP (Rs)	No. of Entities	Market size (% of entities)	(% of total GLP)
Very Large: > 5,000 Cr (50 billion)	14	7%	70%
Large: > 500 Cr to Rs 5,000 Cr (5-50 billion)	36	19%	27%
Medium: > 100 Cr to Rs 500 Cr (1-5 billion)	26	14%	2%
Small: Up to 100 Cr (1 billion)	112	60%	1%

Source: Equifax

The observation is similar for NBFC-MFIs. Data available on MFIN Members (Micrometer Q4 2020-21) show that 39% of the 56 NBFC-MFIs that are large (GLP >Rs 500 Cr) contributed to 93% of the GLP and 91% of the customers served by the member MFIs.

Given that supply covers less than a third of demand[1], all types of lenders have an opportunity to survive, thrive and find their niche. Size of an institution is an important factor as scale brings efficiencies as well as bargaining power in obtaining funds; smaller MFIs therefore strive to achieve scale for long-term sustainability. However, an increasingly competitive market and price sensitivity, besides the scale, management practices (HR, risks, controls, digitalisation, compliances) and above all, customer connect will differentiate the lenders for success.

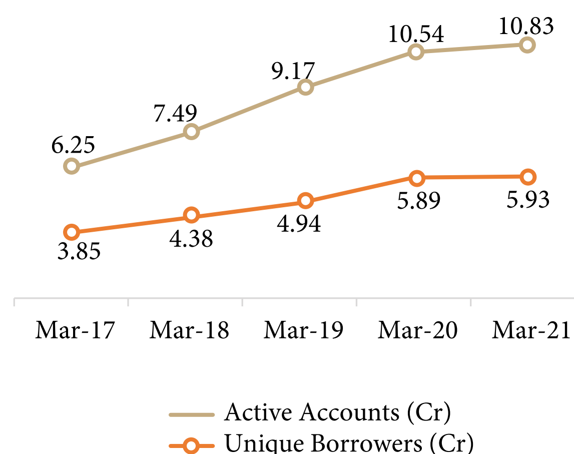
> GIVEN THAT SUPPLY COVERS LESS THAN A THIRD OF DEMAND[1], ALL TYPES OF LENDERS HAVE AN OPPORTUNITY TO SURVIVE, THRIVE AND FIND THEIR NICHE. SIZE OF AN INSTITUTION IS AN IMPORTANT FACTOR AS SCALE BRINGS EFFICIENCIES AS WELL AS BARGAINING POWER IN OBTAINING FUNDS; SMALLER MFIs THEREFORE STRIVE TO ACHIEVE SCALE FOR LONG-TERM SUSTAINABILITY.

RBI has come up with the "Consultative Document on Regulation of Microfinance", heralding the next phase (V3.0) of microfinance. It is expected that with the creation of a level playing field, the new regulations would enable co-existence of various type of players of different sizes and legal forms and would have a far-reaching impact on financial inclusion by promoting organic and responsible growth and outreach to excluded areas and communities.

3.2 Outreach – 60 Million Customers

As shown in **Figure 3.2**, the microfinance industry now serves close to 6 Cr (~60 million) customers who have nearly 11 Cr (110 million) active accounts with a loan outstanding of Rs 2.59 Lakh Cr (Rs 2,590 million)[2]. However, as per MFIN's estimate, microfinance is still covering less than one-third of potential households and only meeting a portion of household credit need (as low-income customers still meet the bulk of their credit needs informally). NABARD All India Rural Financial Inclusion Survey (NAFIS, 2018) report cites that about 41% of the surveyed households were dependent on non-institutional sources for their debt requirements.

Figure 3.2: Outreach of the Sector



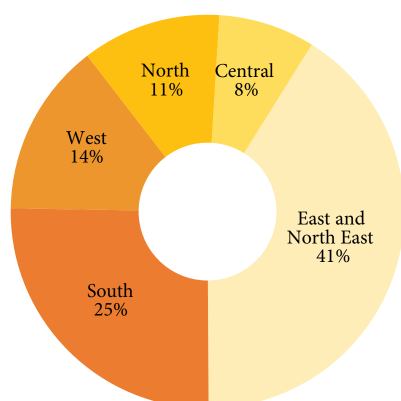
Source: Data from Equifax

Across the country, the industry has diversified across geographies to achieve a footprint across 633 districts in 28 states and 8 union territories. In recent years, eastern and north-eastern states have seen microfinance portfolios grow faster to account for >40% of the portfolio and more recently a movement towards the west

is observed. This achievement sits in positive contrast to the otherwise lower formal credit in the east and northeast region. Further, based on the data available for NBFC-MFIs, it is estimated that the reach of microfinance is predominantly in rural areas (~65%-70%) than in urban locations (~35%-40%). **Figures 3.3 & 3.4** show the regional break-up of the microfinance industry as on 31 March 2021.

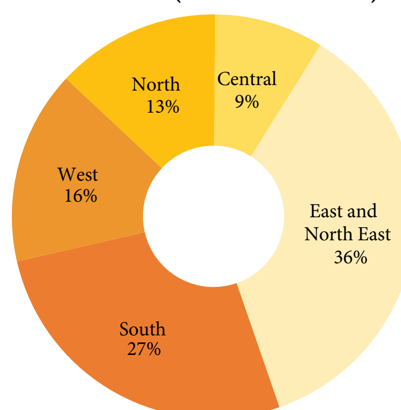
MICROFINANCE IMPACTS THE LIVES OF AROUND 270 MILLION INDIVIDUALS – CONSIDERING AN OUTREACH OF AROUND 60 MILLION CLIENTS WITH AVERAGE HOUSEHOLD SIZE OF 4.5 MEMBERS.

Figure 3.3: Regional Distribution of Portfolio (31 March 2021)



Source: Equifax

Figure 3.4: Regional Distribution of Unique Borrowers (31 March 2021)



Source: Equifax

As the market penetration increases and competition intensifies, the lenders will need to go deeper and wider to new geographies to reach new customer segments. More insights on geographical diversification/concentration and associated risks are provided in **Section 4.4** of this report.

3.3 Products - Ticket Size, Repayment Frequency, Tenure

While microfinance industry has matured over the last two decades having undergone several transformations, upheavals and disruptions, there has not been noteworthy product related innovations, beyond micro-housing, MSME and water/sanitation products. While NBFC-MFIs have the regulatory limitation of maintaining at least 85% of total net assets as qualifying assets, leaving limited scope/scale for product innovations, even the Banks/SFBs that ventured into offering microfinance directly or through Business Correspondent (BC) partners have not shown much progress. **Box 3.1** compares the small borrowal accounts (with credit limit up to Rs 200,000) of scheduled commercial Banks (SCBs) vis-a vis MFIs.

BOX 3.1

Small Borrowal Accounts of SCBs & NBFC-MFIs as on 31 March 2021

As on March 2021, SCBs had 228 million credit accounts with credit limit up to Rs 200,000, of which, microfinance comparable accounts (<Rs 25,000) account for 25%.

In Bihar, SCBs had 11.8 million small borrowal accounts, of which 25% comes to 2.95 million, while MFIN member NBFC-MFIs had an outreach to 3.9 million customers in the state.

Source: RBI, Basic Statistical Return on Credit by Scheduled Commercial Banks in India - March 2021

The differentiation comes in the form of ticket size, repayment frequency and tenor. Over the years, partly influenced by regulations and cost dynamics, the product mix has been inching towards higher ticket sizes, fortnightly/monthly repayments, and slightly longer tenures. While the average ticket size of loans disbursed during FY 2020-21 was Rs 36,149, **Figure 3.5** shows that the about 22% of the loans were above Rs 50,000 in terms of volume (no. of loans) and 43% in terms of value (amount of loan), a significant increase in comparison to FY 2019-20 from 15% (volume) and 30% (value).

In the recent past, the average loan size had hovered in the range of Rs 25,000 to Rs 30,000 but increased significantly since the onset of pandemic. The most plausible reasons seem to be increased credit needs of the borrowers to rebuild livelihoods and tendency of lenders to provide loans to borrowers who are generally in higher loan cycles and have a good repayment history. **Table 3.2** compares the average loan size of microfinance loans with repayment frequency and loan tenure.

Figure 3.5: Ticket sizes

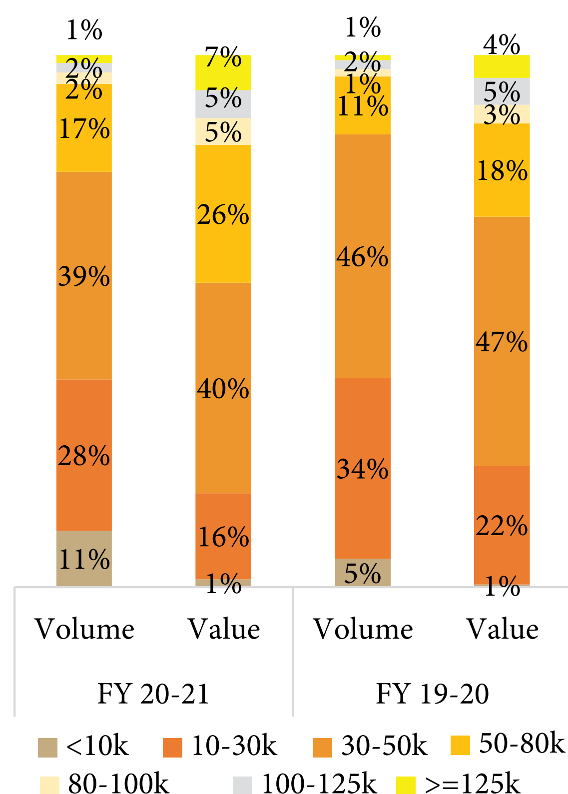


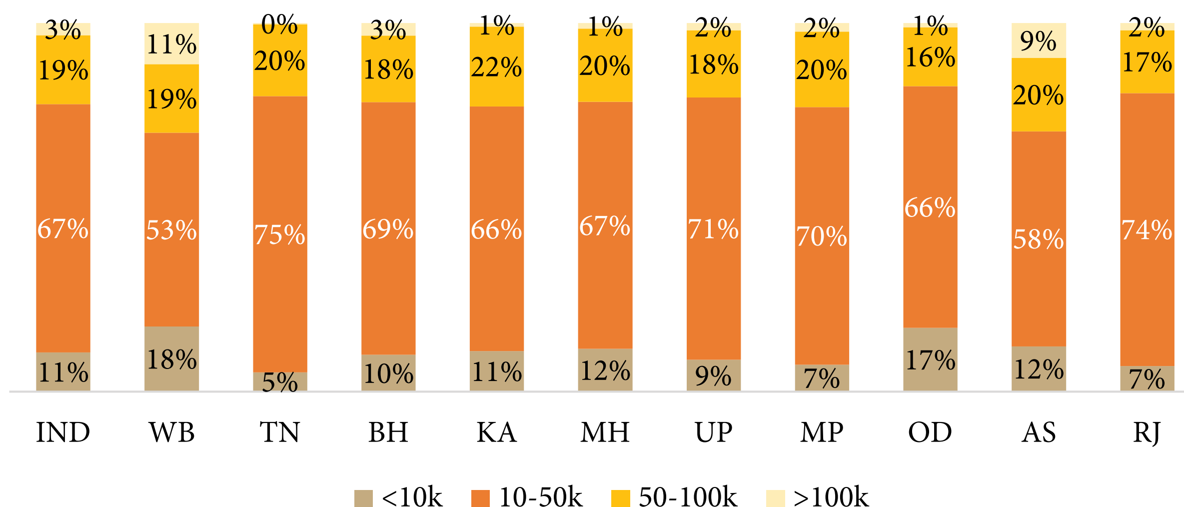
Table 3.2: Comparison of Average Loan Sizes by Repayment Frequency & Loan Tenure

Repayment frequency Vs Av. loan size (Rs)		Loan tenure (months)Vs Av. loan size (Rs)	
Weekly	35,912	<=12	29,669
Fortnightly	29,553	12-18	29,626
Monthly	38,501	18-24	47,586
Others	33,635	24-26	41,803
		Others	27,207
Total	36,149		36,149

Source: Equifax

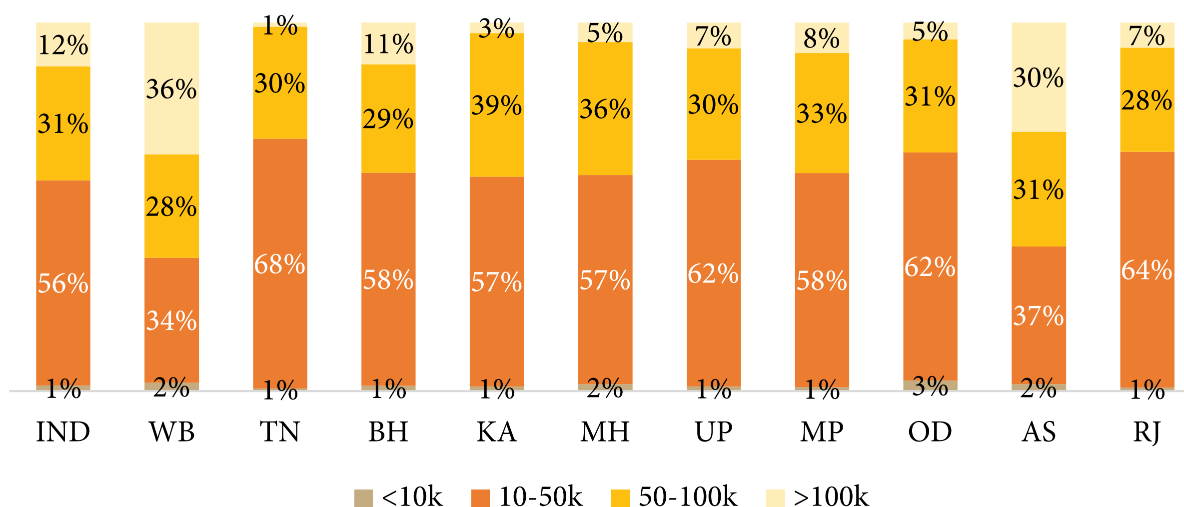
Product mix and ticket size of loans vary across geographies, driven by the offerings of the dominant players operating there and some market demands. This becomes evident from the higher ticket sizes in some states that have a predominant presence of Banks, as shown in **Figures 3.6a & 3.6b**. States like West Bengal and Assam show higher proportion of tickets sizes above Rs 100,000 both in volume and value, in comparison to other states.

Figure 3.6a: Ticket Size in Top 10 States (Volume, %)



Source: Equifax

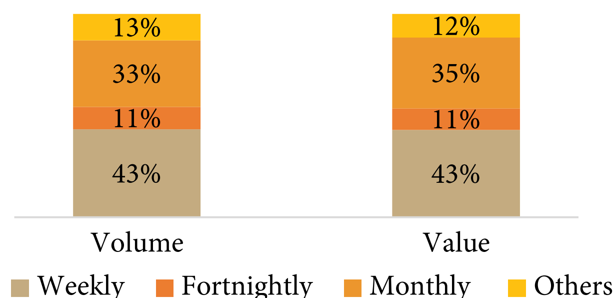
Figure 3.6b: Ticket Size in Top 10 States (Value, %)



Source: Equifax

Figure 3.7 analyses the product mix for loans disbursed during FY 2020-21 by loan repayment frequency. It shows that majority of micro-credit products are still weekly (43%) followed by monthly (33%) and fortnightly (11%) payments. The distribution of repayment frequency across weekly, fortnightly, monthly, and other is largely similar to previous year but there is a slight increase in loans disbursed with monthly frequency in terms of value.

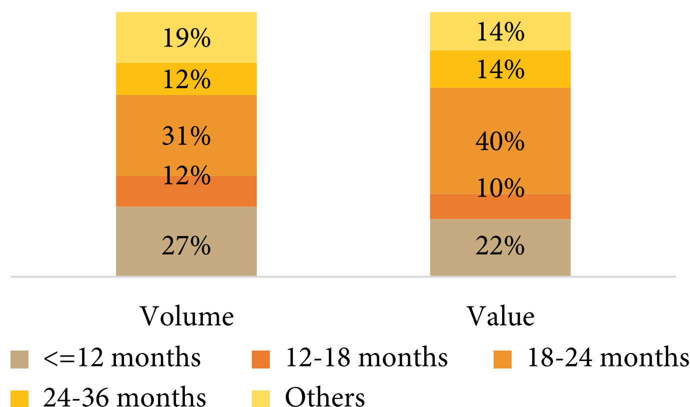
Figure 3.7: Repayment Frequency
(Disbursements, FY 2020-21)



Source: Equifax

Similarly, as shown in **Figure 3.8**, two-thirds of the loans have tenures of 18-24 months or <=12 months tenure. The choice of tenure by a lender is also driven by RBI's criteria for qualifying assets for NBFC-MFIs (and followed by some other type of lenders as well) which specify that tenure of the loan cannot be less than 24 months for loan amount more than Rs 30,000 and relates to the fact that around 61% of the number of loans disbursed are over Rs 30,000 as depicted in **Figure 3.5**.

Figure 3.8: Loan Tenure
(Disbursements, FY 2020-21)



Source: Equifax

BOX 3.2

Product Innovation

As per MFIN Micrometer (Q4 2020-21), around 60.8% of the loans were on-lent for agriculture and allied activities, around 37.0% for non-farm activities (trade & services, manufacturing/ production) and 2.2% for household finance needs (including education, health, house improvement and other lifecycle needs). It is evident that there has not been much product innovation or scaling-up of innovative products, mainly due to regulatory restrictions on qualifying assets. However, there are some noteworthy attempts as highlighted below.

WaterCredit: It is a product designed and promoted by Water.org for providing loans to microfinance borrowers for accessing safe water and sanitation facilities. Water.org provides funds to its partner MFIs to offer loans to its borrowers specifically for this purpose. Apart from this, technical assistance is also provided to enable MFI staff to create awareness among households on health and hygiene in which access to safe water & sanitation facilities is critical. Quite a few NBFC-MFIs as well as some Banks & SFBs offer this innovative product to their customers. These loans are used for accessing municipal water connection, installation of handpumps, borewells, rainwater harvesting structure, water purifier and construction/renovation of toilet and bathroom. Typically, the loan size ranges from Rs 2,500 to Rs 25,000 but at lower rate of interest in comparison to microfinance loans.

Micro housing loans: Like access to water and sanitation, housing is another important need of microfinance borrowers and in many cases, it is also a source of livelihood (like a small grocery store, looms installed inside the house etc.). Recognizing this need. a few MFIs offer micro housing loans to their customers for house renovation, expansion, and construction. The Housing Finance Companies (HFCs) provide wholesale loans to MFIs for underwriting microfinance loans for their borrowers. Typically, micro housing loans are of larger size and longer tenure in comparison to microfinance loans.

Microenterprise loans: The credit needs of microfinance borrowers increase with time which the microfinance products may not be able to support. For such customers who have graduated from microfinance, quite a few MFIs (particularly the very large ones) have started to offer microenterprise loan product (MEL). These are individual loans given to pre-identified clients who have shown good repayment history and have the ability to absorb larger loans. While these are bigger size loans with longer tenure for expanding micro-enterprises and underwritten individually, MFIs continue to offer them in group mode to retain and interplay the group dynamics for timely repayments.

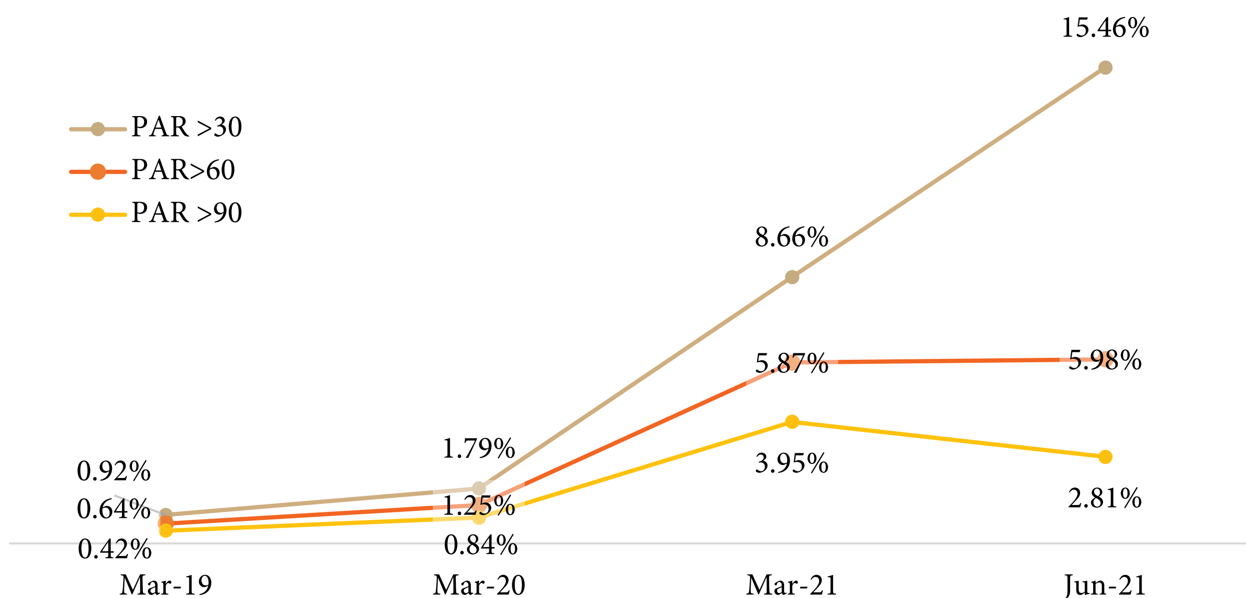
Among MFIN NBFC-MFI Members, 15 MFIs have MEL product, 6 offer water & sanitation loans and 3 have micro housing loans for their customers.

3.4 Portfolio Quality/Restructuring

The pandemic and its lingering economic consequences affected the portfolio quality. While industry entered the FY 2020-21 with a reasonably good portfolio quality of Portfolio At Risk (PAR) >30 days of 1.79% as on 31 March 2020, PAR>30 has significantly increased to 8.66% as on 31 March 2021 and to 15.46% as on 30 June 2021.

The portfolio quality trend of the microfinance universe (all lenders including Banks, NBFC-MFIs, SFBs, NBFCs and other non-profit entities) over the last three years is shown in **Figure 3.9**. *[For PAR analysis, delinquencies above 180 days have been removed to reflect a true picture of the portfolio quality.]*

Figure 3.9: PAR Trend (Microfinance Universe)



Source: Data from Equifax

But this is only a part of the story and to contextualize it is important to see trends in the portfolio at risk with respect to the disruption in collections during the first and second waves of the pandemic, moratorium provided to borrowers, reporting of delinquencies to the credit bureaus and restructuring of loans under the resolution plan framework prescribed by the RBI. Among these, the two factors which have probably impacted a fair assessment of portfolio quality the most, are moratorium and reporting of delinquencies (**Box 3.3**).

BOX 3.3

Factors Affecting a Fair Assessment of Portfolio Quality During the First Pandemic Year

Most lenders initially offered a blanket moratorium up to end-May 2020 to their microfinance customers due to a complete lockdown and as per provisions of the RBI circular. Later, the moratorium was extended by another three months up to 31 August 2020 by RBI. This provided the much-needed relief to the customers. After the moratorium was lifted, the reporting of delinquent accounts became sub judice, which delayed the accurate reporting of delinquencies to the credit bureaus. The restructuring of COVID-19 impacted loans further added to the complexity of a fair assessment of portfolio quality.

Data on restructured loans (status as on 30 June 2021) provided by Equifax, which reflects loans restructured up to 31 December 2020 (the last date for implementation of loans invoked for restructuring under the first resolution plan), shows that:

- 4.2 million accounts were restructured which is about 4.1% of the 103 million active accounts as on 30 June 2021. Of the restructured accounts, 80.6% were regular (no DPD) and the remaining 19.4% were in DPD (PAR >0 days).
- In terms of value, restructured loans worth Rs 77.43 billion were outstanding as on 30 June 2021 which is 3.3% of universe GLP of Rs 2,373.7 billion of the restructured loans, 81.8% were regular and 18.2% were in DPD (PAR >0 days).

The tagging of restructured loans to the credit bureaus was delayed due to the Hon'ble Supreme Court judgement on moratorium and Non-Performing Asset (NPA) classification and consequent delay in changes in credit bureaus to reflect restructured loans. The proportion of restructured loans appears small but points towards the lender's assessment that a vast majority of their customer base continues to show good credit behaviour and will be able to repay their loans. This is also reflected by the "customer activation" metrics, which shows that more than 90% customers showed good intent to repay the loan, by attending the group meeting and paying part amount, if not the full dues. With the opening of the economic activities over the last few months, resulting in better repayment ability of the customers and availability of funds with MFIs for fresh disbursements (like under the Credit Guarantee Scheme for MFIs of Department of Financial Services, Govt. of India (GOI)), it is expected that portfolio quality would normalize by end of the FY 2021-22. A similar trend was seen during the demonetisation period as well when the portfolio quality ratios spiked for a few months before normalizing. The proven resilience of the microfinance sector which has undergone multiple crises in the last 10-12 years gives confidence that this phase would be overcome too.

3.5 Equity/Borrowings (NBFC-MFIs)

The NBFC-MFIs are largely dependent on two sources of funds for their growth and expansion – equity and debt. This section analyses the equity position of the NBFC-MFIs and the external borrowings that they have been able to leverage, based on the data provided by 56 MFIN Members.

As on 31 March 2021, the total equity of the 56 NBFC-MFIs stands at Rs 186.6 billion which is 27.1% of their net owned portfolio of Rs 689 billion. At an aggregated level, domestic equity contributes 54% and foreign equity is 46% of total equity – a snapshot of equity deals during the year is shown in **Box 3.4**. The total outstanding borrowings of these NBFC-MFIs as on 31 March 2021 was Rs 640.8 billion. The contribution of Banks (other than the Top 5 banks by assets size) to the outstanding borrowings was 36.6%, followed by 24.0% from non-Bank entities, 19.9% from Top 5 Banks, 14.8% from All India Financial Institutions (AIFIs), 2.9% from External Commercial Borrowings (ECB) and 1.7% from other sources.

BOX 3.4

Equity Deals during FY 2020-21

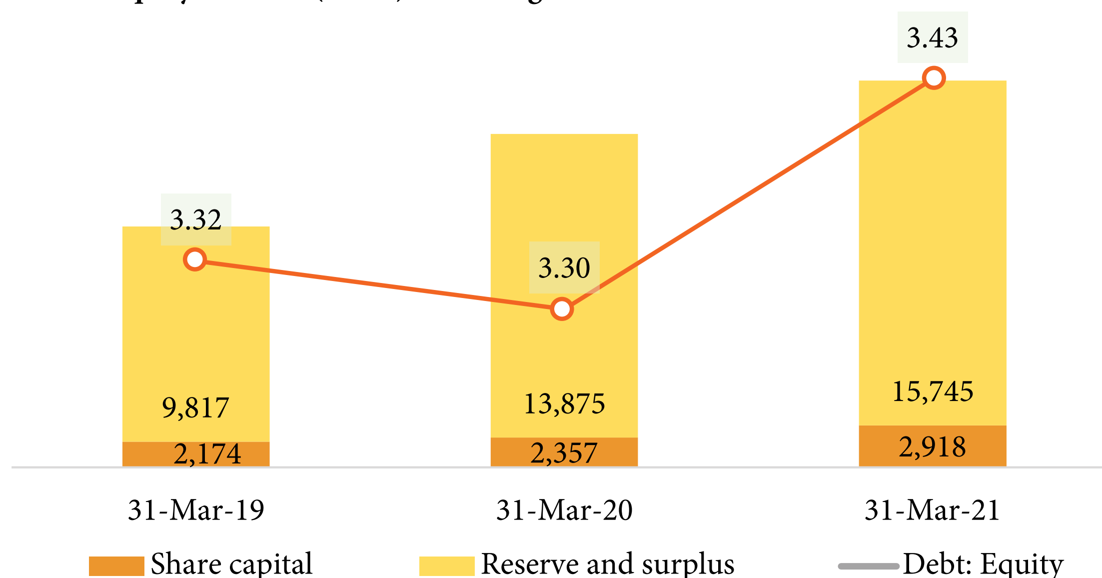
During the FY 2020-21, 16 out of 56 Member NBFC-MFIs reported fresh equity infusion worth Rs 9.76 billion of which 55% were in the form of equity shares and 45% were convertible preference shares. Some of the key aspects of the equity deals during FY 2020-21 are highlighted below.

- Institutional investors contributed around 59% of total equity investments followed by holding companies 37% and individual investors 4%.
- Overall, 13 different institutional investors were noted – the major ones (in terms of value of investment) were Aavishkaar Venture Management Services, Ambit Operations & Management Services Private Limited, GOJO & Company, INC., IIFL Finance Limited and Nuveen Global Impact Fund India S.à.r.l.
- Among the 8 holding companies who invested in their NBFC-MFIs, the notable investments were from Navi Finserv Private Limited (formerly Chaitanya Rural Intermediation Development Services Private Limited), Save Solutions Private Limited, Svatantra Holdings Private Limited and VAYA Trust.

Source: Members' data collected by MFIN for Micrometer

Figure 3.10 compares the equity position and the debt:equity ratio of the NBFC-MFIs over the last three years. As shown, about 84% of the equity as on 31 March 2021 is in the form of reserves and surplus which has been built over the years and the remaining 16% is the share capital. The total equity grew by 15% in comparison to previous year. The debt:equity ratio has remained consistently around 3.3 to 3.4 indicating that the MFIs are moderately leveraged and have a significant own investment in the business.

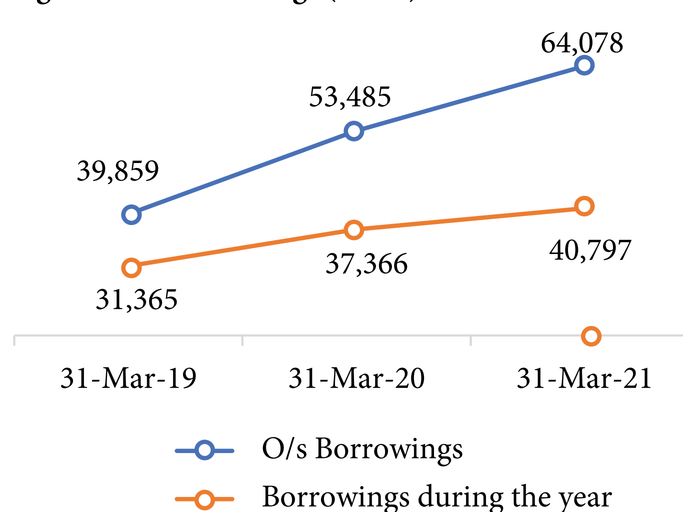
Figure 3.10: Equity Position (Rs Cr) & Leverage



Source: Members' data collected by MFIN for Micrometer

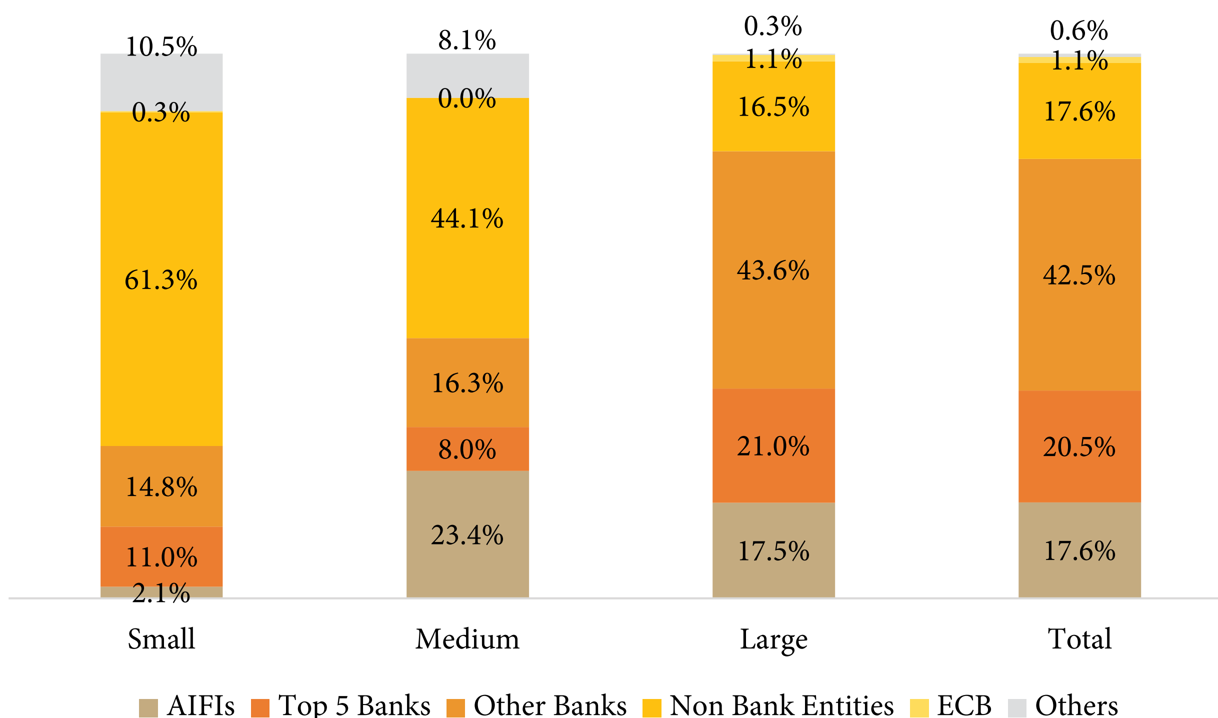
The total outstanding borrowings of these NBFC-MFIs increased by 20% in comparison to previous year. During FY 2020-21, they received a total of Rs 408 billion in debt funding, which was 9.2% higher than FY 2019-20. **Figure 3.11** shows the growth of borrowings outstanding as of year-end and the borrowings received during a financial year over the last three years. Among the funding instruments used, term loans contributed 70.8% of the debt outstanding, followed by debentures 20.7%, sub-debt 4.1%, commercial papers 0.4% and other instruments 4.0%. Data indicates greater reliance on term loans for smaller entities, but as the size of institution increases, diverse options of funding become available.

Figure 3.11: Borrowings (Rs Cr)



Source: Members' data collected by MFIN for Micrometer

Figure 3.12: Break-up of Borrowings Received during FY 2020-21



Source: Members' data collected by MFIN for Micrometer

The trend shows that the NBFC-MFIs were able to attract funding even during the pandemic period mainly because of two factors (i) belief in the resilience of the MFIs that they have shown time and again and (ii) policy push by RBI and GOI to ensure liquidity in the system, through various targeted schemes like special liquidity facility (SLF) through NABARD and SIDBI. As such, as shown in **Figure 3.12**, Banks (other than the Top 5 banks) contributed 42.5% of the borrowing received, Top 5 banks 20.5%, AIFIs and Non-Bank entities 17.6% each, ECB 1.1%, and other sources 0.6%. However, there was a clear distinction in terms of size of MFIs, as small MFIs (with portfolio <=Rs 1 billion) received small proportion of funds from AIFIs or Banks while medium MFIs (with portfolio Rs 1 billion to Rs 5 billion) were able to obtain reasonable proportion of funds from AIFIs & Banks. Majority of funding for small and medium MFIs was from non-bank entities, with a negative effect on their cost of funds.

Notes and References

1. Demand is basically the potential number of households that can be reached by microfinance. Potential households are assumed to be 70% of the total households in India (as per Census 2011 and extrapolated by a growth rate of 1.2% p.a. to March 2021, which calculates to about 20 Cr/200 million households), with the bottom 15% and the top 15% households in terms of economic wellbeing excluded. As such, 5.93 Cr (59.3 million) unique borrowers reached by microfinance as on 31 March 2021 cover 29.7% of the potential households.
2. It does not include microfinance clients covered under the SHG Bank Linkage Scheme and of non-profit entities (Societies, Trusts and some Section-25 Companies) that cannot report the data to the Credit Bureaus.

CHAPTER - 4

Client Protection & Market Developments

The pandemic primarily defined the market developments last year. Last year's events posed an entirely new set of challenges, some never imagined, forcing new ways of working and accelerating the trends towards digitalisation. These developments came with hard choices and difficult decisions. We touch upon some critical yet less covered aspects of the market here.

In our rush to resume 'normalcy', we tend to forget or underestimate what the sector went through. But it is worth reflecting on the challenges sector overcame, along with the choices made, and actions taken.

For a start, the spread of COVID-19, subsequent lockdowns/restrictions and changing pattern of social-economic-financial lives, ruined the livelihoods of low-income households. Though public and private support was provided for sustenance, evidence points to a precipitous loss of income, depletion of meagre savings, increasing indebtedness and negative coping strategies, risking millions back to poverty[1]. For microfinance customers came along the challenges of understanding the costs and implications of 'moratorium' and making hard choices to repay the loan or pay for daily needs or conserve cash for uncertain future, and not the least, take new credit to manage cashflows and restart the livelihoods.

For lenders, the challenges were wide and deep. To name a few – managing connect with customers, continuing operations amidst restrictions while ensuring the safety of employees, managing liquidity to pay for the operational costs and debt obligations, rejigging model for mobile working and digital payments, and above all, balancing expectations across stakeholders including employees and investors. The uncertainty and uneven nature of economic recovery mean factoring too many variables in a rapidly changing situation.

The fact that aggregate collections are nearing 90% and disbursements are also close to pre COVID-19 levels shows the tenacity of micro customers and the microfinance industry. The industry is not out of the woods yet, but the worst seems to be over, and "that does not kill us, makes us stronger".

4.1 Customer Protection

During last year, the loss of livelihoods[2] due to the pandemic and policy/operational measures taken to mitigate stress threw an entirely unimagined set of challenges for the customers of microfinance.

Transparency

While the moratorium gave immediate relief, customers found it extremely hard to understand its impact on their repayment, overall cost and make the right choice. Restriction on mobility and organising group meetings made it even harder for lenders to explain the terms. Customers also (rightly) questioned the logic and ethics of accrued interest as they felt that delayed repayment is beyond their control and entirely attributable to the pandemic. Varied approaches[3] amongst the lenders further confounded the customers. Lenders and MFIN took several efforts such as audio-visuals[4], direct calling to customers, awareness campaigns and dedicated customer mobile apps catering to specific needs of the customers[5]. In any case, given their circumstances[6], more than 90% of customers opted for a moratorium.

BOX 4.1

CGRM Mechanism

MFIN played a catalytic and supportive role to prioritise the customers interests. The Self-Regulatory Organization's (SRO) actions focused on understanding customers' concerns. The Customer Grievance Redressal Mechanism (CGRM) provided the SRO with a direct connect to the customers to understand their concerns and issues and MFIN leveraged the CGRM to undertake multiple topical surveys. MFIN then used these customer voices to design specific customer awareness videos to address common queries and concerns. Additionally, MFIN worked towards influencing the lenders' practices through multiple advisories and communications emphasising that all lenders follow the customer-protection standards and align their field-level operations to COVID-19 appropriate protocols. More details about SRO interventions are available in Annex 2.

Fair Interaction

Another critical challenge was to ensure fair and respectful interaction with customers. Higher delinquencies and pressure for collections on the lenders' side and hardships and confusion about loan information at the customer level often created stress in communications[7]. Handling the operations required a balanced approach combining transparency, patience and empathy. This meant educating customers about moratorium and implications of their choices for collections and applying objective assessment criteria for the stressed customers for offering extended deferment of the repayments if needed. At the employee level, this demanded higher controls to keep an eye on repayments and to avoid misinformation, misbehaviour, forced collections and embezzlement[8] by the field-level employees. Lenders also stepped up their CGRM to reach out to customers to inform them and address their queries and grievances. And above all, efforts were made to support customers with emergency aid for health, food, and essential supplies, where possible.

BOX 4.2

Use of AV for Communication with Clients

Microfinance model is built around close and frequent interaction with customers in a group at their doorstep. Maintaining those customer interactions while following the COVID-19 protocols required implementing new approaches. Lenders extensively used phone calls (employees calling as well as automated pre-recorded messages) to communicate with the customers. To ensure that employees interact with customers appropriately, lenders organized special trainings on customer interactions and 'phone etiquette'. MFIN also developed a special learning video for the field level employees focusing on COVID-19 appropriate behavior and customer engagement. For field interactions, lenders split the groups into smaller sub-groups and conducted the meetings in larger open spaces.

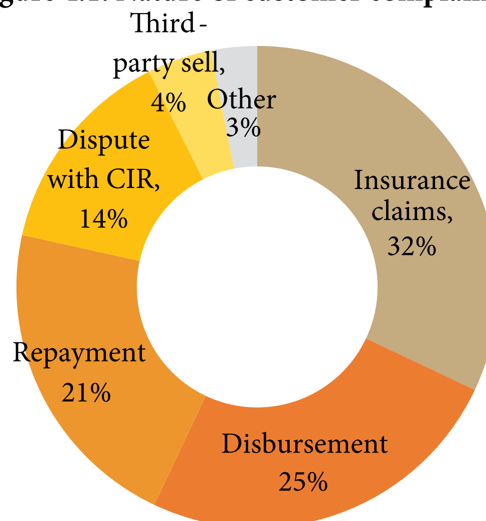
Grievance Redressal

Customer Grievance Redressal Mechanism (CGRM)[9] is a critical aspect of customer protection in microfinance with clear regulatory and industry standards. Customers of MFIN member NBFC-MFIs, in addition to the lender's CGRM, have access to MFIN CGRM to seek support in resolving their complaints. Customers also have access to regulatory mechanisms and Ombudsman[10] for escalation. Due to mobility restrictions last year, the CGRM became instrumental in connecting with customers and resolving their queries/complaints. Both MFIN and member NBFC-MFIs ably leveraged the CGRM to seek customer feedback and understand the specific risks.

CUSTOMER GRIEVANCE REDRESSAL MECHANISM (CGRM)[9] IS A CRITICAL ASPECT OF CUSTOMER PROTECTION IN MICROFINANCE WITH CLEAR REGULATORY AND INDUSTRY STANDARDS. CUSTOMERS OF MFIN MEMBER NBFC-MFIS, IN ADDITION TO THE LENDER'S CGRM, HAVE ACCESS TO MFIN CGRM TO SEEK SUPPORT IN RESOLVING THEIR COMPLAINTS.

Though MFIN does not have CGRM available for the entire microfinance industry, data for nearly 27,000 complaints received by member NBFC-MFIs[11] and MFIN CGRM[12] is large enough to provide a fair sense of customer issues. As a start, overall complaints volume was just about 20 complaints per lakh (0.1 million) accounts, varied

Figure 4.1: Nature of customer complaints



Source: Data from MFIN member NBFC-MFIs for FY 2020-21

widely across lenders, and does not reveal much about customer grievances[13]. The major reasons for complaints were insurance claims settlement, dispute with Credit Information Report (CIR) and loan repayment/disbursements. At an aggregated level, 85% of complaints received on CGRM were resolved within 15 days. There are no significant variations across NBFC-MFIs or regions, though the pattern of complaints may vary over the different quarters.

SRO Enforcement Framework

Based on RBI Guidance for the SRO[14] issued in 2015, SRO Enforcement Framework has progressively evolved in MFIN over the years.

The cornerstone of the SRO Enforcement Framework is objectivity and independence to ensure that NBFC-MFIs adhere to regulatory and industry standards, especially on the customer-protection norms.

Towards this, a dedicated SRO team regularly and extensively monitors the industry's practices. The monitoring tools include company data, credit bureaus data/insights, media reports, third-party evaluation, issues flagged by lenders and other stakeholders, customer complaints, and field-level intelligence gathered through MFIN's state/ district level work.

SRO team puts all specific cases of lapses by member NBFC-MFIs to an independent Enforcement Committee (EC). EC consists of three independent members and two industry members with an independent member as the Chair[15]. EC examines each case on a well-defined Enforcement Framework[16] encompassing the nature of lapse with respect to regulatory and industry standards, the response by the NBFC-MFI, impact on customers, and systemic impact on the industry, and takes a decision on the case. NBFC-MFIs must follow the EC's decision. If the concerned NBFC-MFI is not satisfied with the decision of the EC, it can appeal to the SRO Committee (SROC)[17] against the EC's decision as per the procedure laid out in the Enforcement Framework. SROC takes the final decision on the matter.

Indebtedness

Over the years, over indebtedness has been a paramount challenge for the industry and the regulator, and industry standards set explicit norms to address this through caps on multiple lending and total indebtedness. However, the scale and prognosis of the problem are complex and imprecise. As per guestimates, depending on how one measures, over-leverage among customers varies from 2% to 25%. Moreover, lack of evidence on income (due to assessment challenges) and true indebtedness (due to informal credit and fragmentation of formal credit information[18]), vulnerabilities and 98% repayments, make it hard to understand the problem. Research[19] and anecdotal evidence suggest that Low Income Households (LIHs) take loans and adjust expenses to repay the existing loans on time. Group liability also masks the repayment stress at the customer level to some extent. In any case, it is still a core issue as it brings reputational, political, regulatory and credit risks, with potential to undermine trust in the microfinance industry[20].

So far, the industry has a satisfactory record of meeting the regulatory standards on indebtedness **(Figures 4.2, 4,3 and 4.4[21])**. Despite two-thirds of the business being technically outside of regulatory norms, the indebtedness level remains well under the norms[22]. Data for March 2021 shows that 70% of customers have a relationship with a single lender, and 74% of customers have loans outstanding of Rs 50,000 or less.

Figure 4.2: Lenders per Customer (March 2021)

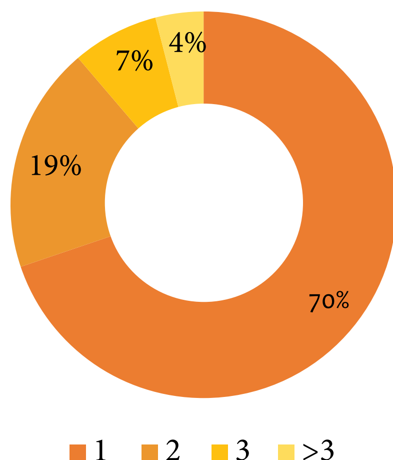


Figure 4.3: Loan Amount Outstanding (Rs) Across Customers (March 2021)

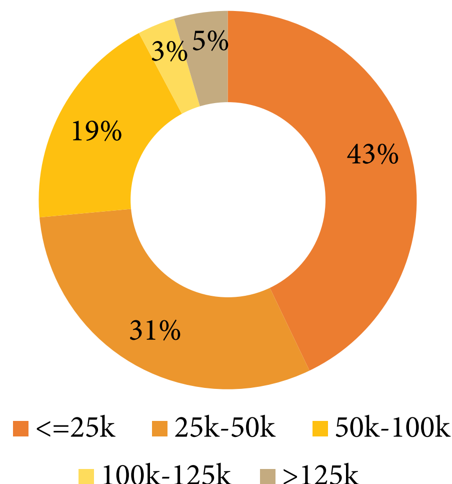


Figure 4.4: Monthly Debt Obligation (Rs) Across Customers (March 2021)

Source: Equifax

The sector however has limited insight into the customer indebtedness issue. The current quantitative approach to understanding and measuring indebtedness, though straightforward, is inadequate to provide the overall picture. The industry needs collaborative efforts to identify more nuanced approaches combining elements of qualitative indicators and metrics for indebtedness. The emphasis of the proposed RBI regulation on household income assessment and debt service obligations (rather than absolute indebtedness and number of lenders) offers an opportunity to build a more robust framework.

BOX 4.3

Customer Protection – Work in Progress

MFIN's insights from the field and customer interactions assure us that lenders by and large prioritised the customers' needs and followed the customer protection standards. Lenders responded to fast-evolving field-level situations with agility and maturity, focusing on the customer relationship. It is essential to highlight here that microfinance is known for its deep understanding of customers and the local-level social-economic-political context in which they operate. During a crisis like last year, these insights and knowledge, above all, become the critical differentiating factor in navigating the challenges successfully. As the sector prepares and adapts to an ever-uncertain order, building on its experience, the industry will need new tools, products and collaboration to sustainably meet the customer financial needs for a better living.

4.2 Assam

As the industry was dealing with the pandemic, a vital sideshow in Assam got much attention. Reasonably so, Assam is a case study of the success and challenges of microfinance and collective strength of the industry to navigate them with much to learn.

To put things in perspective, the microfinance sector is the primary source of formal credit to low-income-households in Assam who otherwise lack access to formal credit. In less than a decade, the state's microfinance sector increased its outreach from just over Rs 10 billion in FY 2011-12 to cross Rs 120 billion[23] in FY 2020-21 – making Assam the sixth largest state in India. The success of the microfinance industry in Assam is also noteworthy because the state has lagged in financial inclusion[24]. Forty lenders (Banks, Small Finance Banks, NBFC-MFIs and NBFCs) regulated by the Reserve Banks India (RBI) operate in Assam, reaching nearly 2.5 million customers, an estimated half of the potential low-income-households. Importantly, portfolio quality has been extremely good with PAR >30 of 0.61% until March 2019[25]. Further, supply-side has a dominance of Banks (including SFBs) who account for over three-fourth of the market. With fragmented regulation around leverage norms in the market, Assam saw higher overall leverage amongst the customers, including 10% customers with loan outstanding over Rs 125,000. **Table 4.1** provides the status of microfinance portfolio in Assam as on 31 March 2021.

Table 4.1: Microfinance in Assam (31 March 2021)

Entities	Loan amount O/s		Share in loan amount O/S	PAR>30	Avg. ticket size[26] (Rs.)
	Rs Crore	Rs Billion			
Banks (8)	7,032	70.32	61%	11%	51,226
NBFC-MFIs (24)	2,341	23.41	20%	23%	30,009
SFBs (5)	1,636	16.36	14%	17%	41,700
NBFCs (3)	585	5.85	5%	35%	35,015
Total (40)	**11,594**	**115.94**	**100%**	**15%**	**45,851**

The microfinance industry in Assam saw the first sign of stress in August 2019 as repayment issues surfaced in few pockets in the districts of upper Assam, mainly in the tea-garden area. The prognosis of events and circumstances that led to the crisis is complex and imprecise. A combination of factors such as episodic tension between local associations and lenders, the slowing economy in the tea-garden area with closure of tea factories, consequent deterioration in customers' livelihoods[27], borrowing for consumption, high tickets loans in few cases, siphoning of loans by ringleaders[28] created an environment where some customers were unable to repay. With a strong influence on communities in these areas, the local associations quickly capitalised on the situation. They instigated non-repayments in north Assam and to a smaller extent, in other parts of Assam. Subsequent events, including agitation around National Register of Citizens (NRC) and electoral promises for loan-waiver, followed by the pandemic, only worsened the situation with PAR 30 reaching 39% in March 2021[29].

To salvage the situation, MFIN brought together all lenders together to constructively engage with the state government. After closely reviewing the data and pros and cons of state intervention

and operational issues, the Government announced the Assam Micro Finance Incentive & Relief Scheme (AMFIRS) in June 2021 with a budgetary allocation of Rs 75 billion. The Scheme is premised on incentive and relief rather than 'waiver', giving a strong message on credit discipline and responsible lending. The Scheme covers the customers for their loans from up to three lenders and loan outstanding of up to Rs 125,000 and provides the incentive/relief in three broad categories (**Table 4.2**). Currently, the lenders are sending necessary data from a designated credit bureau to the Government for the implementation of the Scheme.

Table 4.2: AMFIRS Relief Categories

Category: Eligibility of customer[30]	Relief/Incentive
Category 1: Regular (dpd 0)	Rs 25,000 or loan amount outstanding, whichever is lower, directly to the customers.
Category 2: Overdue (dpd <90)	Overdue amount to lenders. Reward of Rs 25,000 or loan outstanding, whichever is lower (after observing prompt repayment behavior)
Category 3: NPA (dpd > 90)	Partial or full relief to stressed and destitute borrowers based on evaluation

The Assam events and the Scheme have many lessons, some still unfolding, but three need special mention for now.

Assam most strongly brought forth the need for a comprehensive regulatory framework to bring all microfinance lending under uniform rules. The proposed regulations along the lines of the RBI Consultative Document will hopefully address this sooner than later.

All too familiar but sometimes overlooked dependence of the business on the customer well-being/vulnerabilities and economic/social/political ecosystem and importance to tread with each of them carefully and responsibly.

And finally, the importance of SRO to bring together diverse interest groups and stakeholders for a fair and sustainable market environment to create a win-win situation.

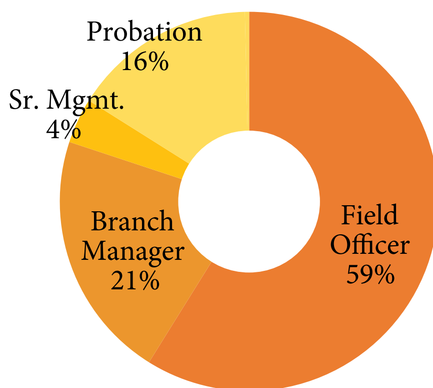
4.3 Employee Engagement

Reasonably priced, high touch and doorstep delivery of micro-credit to low-income-household (LIHs) requires a distinct delivery model that heavily relies on field-level[31] employees. The edifice of microfinance rests on the field-level employees who shoulder the wheels of business and interface with the customers. Though technology is playing an increasing role, the field-level employees still have the responsibility to source customers, assess them for credit risk and loan, provide support with loan application process and information, and service them for repayments. They also bring the local knowledge, are the company's face in the community and share compliance obligations. The industry employs an estimated 300,000 people, more than two-third as field-level employees.

MFIN HAS BEEN WORKING WITH THE INDUSTRY TO STRENGTHEN THE ECOSYSTEM AROUND EMPLOYEE ENGAGEMENT IN THE LAST FEW YEARS. IN ADDITION TO SKILL/OCCUPATION STANDARDS, EMPLOYEE BUREAU, AND TRAINING PROGRAM, MFIN IS PROGRESSIVELY BUILDING INDUSTRY NORMS. THESE AIM TO IMPROVE THE WORKING ENVIRONMENT FOR EMPLOYEES FOR BETTER CONNECT AND MAKE THE INDUSTRY ATTRACTIVE EMPLOYMENT AVENUE.

In line with the context and business model of microfinance, field-level employees are generally young, first-time entrants to the job market, have 10th/12th standard education and come from local communities. Such a profile makes them well suited for the job requirements, and reciprocatively, microfinance gives them respectful and gainful work closer to their home with learning and career growth opportunities.

Figure 4.5: Employee Distribution
(30 June 2021)



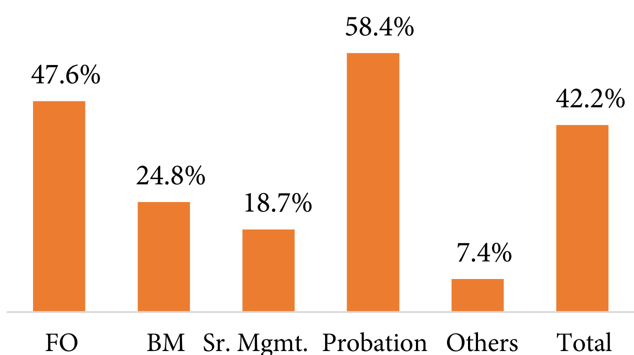
Source: MFIN Micrometer Q1 FY 2021-22

An ever-evolving market, high growth rate and high attrition make employee engagement critical. As employee costs account for half of the operational costs, improving their performance and productivity is an imperative.

The pandemic presented a unique set of challenges requiring infrastructure/training support for transition to work-from-home, mobility restrictions, challenging operative atmosphere with high delinquencies to say nothing of safety and security of employees. Besides the practical challenges, it also required constructive and open engagement to keep them motivated and support to their families, many of whom suffered from the pandemic. The lenders at their level took several steps like providing health care and insurance facilities for employees and their families, protecting employees' salaries and orienting for a challenging environment. It is worth pointing out that lenders shielded their employees financially and otherwise despite the pressures of liquidity, cashflows, and worsening portfolio quality. Data from NBFC-MFIs even show an increase in the employee base over the year – at a time when other sectors witnessed job losses.

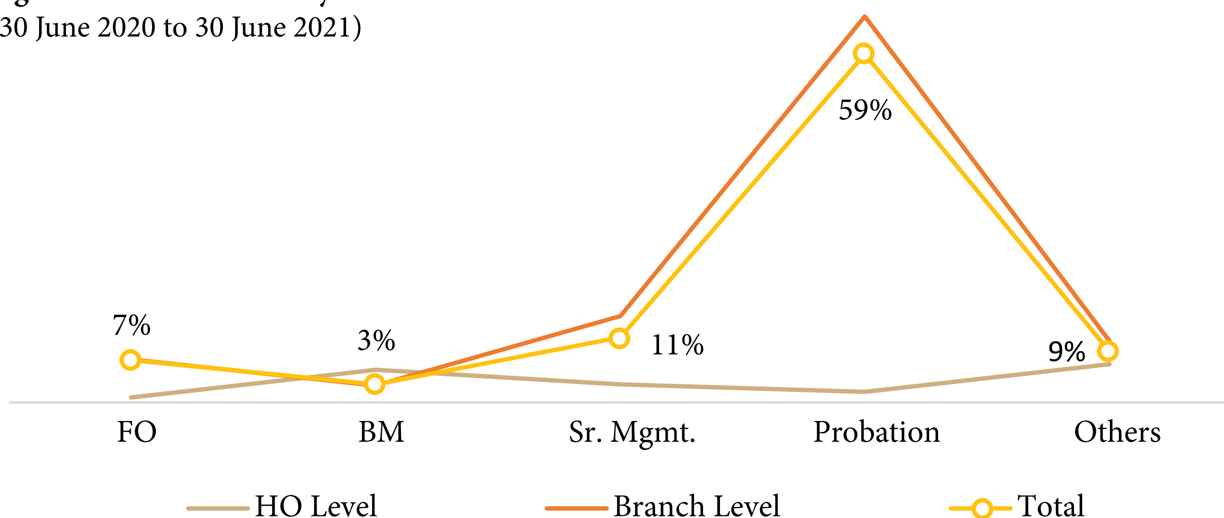
In addition to pandemic specific measures, two developments on the employee engagement front need special mention, progress on employee bureau and the training ecosystem.

Figure 4.6: Attrition Rate by Position
(30 June 2020 to 30 June 2021)



Source: MFIN Micrometer Q1 FY 2021-22

Figure 4.7: Staff Growth by Position
(30 June 2020 to 30 June 2021)

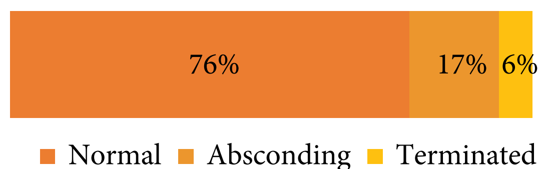


Source: MFIN Micrometer Q1 FY 2021-22

Employee Bureau

MFIN in 2017 collaborated with Equifax (a credit bureau) to launch an Employee Bureau for the microfinance industry. Given employee responsibilities for financial transactions, customer interface, and compliances, hiring talent with the right attitude and integrity is of utmost importance. The Employee Bureau pitches here by providing a common platform to share employee details (personal information and employment history) for greater efficiency and integrity in hiring. Such a platform provides incentive and deterrence to employees for appropriate professional behaviour. MFIN has mandated its members to submit data to the Employee Bureau and encourage its use for the hiring process to support the initiative. As a result, The Employee Bureau now has a database of over half a million microfinance employees, and more than 40 lenders use it to verify the candidates' credentials with 15,000 average monthly enquiries per month. With a focus on quality and timely submission, the Employee Bureau has become a critical building block in the recruitment process of lenders. Data reported to the Employee Bureau shows over 20% negative exits[32]- clearly establishing its critical role in weeding out inappropriate candidates. Besides, new use cases are emerging, such as reference check facilities, tagging employees for training/ certification and real-time alerts on employees to mitigate risks. As more lenders onboard, the Employee Bureau will become an even more powerful tool to improve the trust and integrity of the recruitment process. However, for universal coverage, a regulatory backing to the Employee Bureau just like the one for the Credit Bureau will be required.

Figure 4.8: Employee Exits



(Source: Equifax, data on cumulative exits reported on employee bureau)

Training/Certification

The microfinance industry mostly hires young professionals, the majority of whom have no or minimal experience. They also have limited skill-set as per the demand of the jobs. This, along with changes in the business process and environment, means a continuous need to train the people. Developments in technology infrastructure and greater accessibility of smartphones coupled with COVID-19 restrictions have accelerated the training through digital/online means. Digital training programs offer consistent quality and innovative content, flexibility, customisation and monitoring at lower costs on a scale. Lenders are increasingly adopting learning management systems (LMS) to integrate learning and knowledge delivery for better learning experiences and outcomes.

Since a large portion of training needs are similar, there is a strong case to develop industry-level training modules which lenders can leverage to complement their own training program. On this premise, MFIN has been working on framing training standards for field level employees. A few years back, MFIN worked on framing the National Occupational Standards[33] for micro-credit officers and developed a training program for loan officers focussing on customer protection[34].

Building on this experience of developing digital content and administrating training and certification programs, last year, MFIN collaborated with the lenders to formulate a comprehensive training program for loan officers (available in Hindi) with online proctored certification. MFIN also developed shorter courses around COVID-19 safety protocols, credit-linked life insurance, dos and don'ts of operations during elections and customer grievance redressal. For easier and broader adoption amongst existing and prospective employees, the entire content is publicly available[35]. Lenders can forward the content to their employees or integrate it with their Learning Management System (LMS).

4.4 BC Partnerships

In the last few years, BC partnerships have emerged as an alternative channel for Banks to provide microfinance directly. Supportive regulations[36] and business drivers for Banks and BCs have led to the growth of BC partnerships, and the estimated microfinance portfolio under this channel is to the tune of Rs 380 billion as on March 2021[37, 38] (17% of the overall business).

Under this model, broadly, Banks and BCs agree on operational, financial, and risk-sharing arrangements. BC takes care of customer interface (selection, onboarding, repayment collection and servicing) within a framework and oversight mechanism set by the Bank. BC and Bank share the income (processing fee and interest), and usually, BCs get 40-50% of income. BC and Bank agree on a risk-sharing arrangement under which BC has to hypothecate/earmark a guarantee (First Loan Default Guarantee, FLDG) for the losses up to a certain percentage of the portfolio defaulting[39] and other event losses[40]. Based on negotiations, FLDG could vary between 2%-10%. In most cases, Bank requires BC to keep this guarantee in the form of a fixed deposit lien with the Bank. The FLDG aims to ensure BC originates a credit-worthy pool and has risk participation.

In the microfinance industry, we can classify BC under three distinct categories.

a. **NBFC-MFIs/NBFCs/MFIs as BC:** Many NBFC-MFIs/NBFCs/MFIs in addition to on-balance sheet portfolio, create off-balance-sheet BC portfolios on behalf of one or multiple Banks. As per the latest data available for June 2021 for 56 MFIN member NBFC-MFIs, 29 NBFC-MFIs[41] have BC partnerships with a portfolio of Rs 25.74 billion. A few smaller NBFCs[42] also work as BCs. Many non-profit MFIs[43] and section 8 companies[44] also function as BCs for Banks.

b. **Multi-Bank Corporate BCs:** These are dedicated BC companies[45] (not NBFCs but corporate entities) who work as BCs for multiple Banks.

c. **Single-Bank Corporate BCs:** These BCs are usually owned by the Bank and work for a single Bank. Examples are RBL FinServe[46], BFIL[47], IDFC Bharat[48].

Technically speaking, the term BC is for the Banks. However, NBFCs[49] may also have similar partnerships downstream with smaller NBFCs/ NBFC-MFIs/MFIs and Corporate BCs for the microfinance portfolios.

BC partnership emerged and evolved based on different strategic, business, and commercial drivers of Banks and BCs. Banks and BCs arrive at risk-sharing mechanisms and financial returns based on historical trends in the microfinance business model, including losses that have remained under 1% on a diversified geographical base. These assumptions have worked well for the model in a steady state.

However, in recent times, idiosyncratic risks such as demonetisation, COVID-19, lockdowns and more frequent/damaging natural disasters have challenged assumptions based on historical data, putting enormous strain on the model. The pandemic brought a triple whammy to the BCs. Challenges around liquidity (as revenue streams choked due to loss of interest income while operational costs are still standing), returns (defaults are crossing 5% and more) and solvency (need for capital to maintain the FLDG commitments). The Banks often implement the FLDG to optimise their recovery from losses by putting quarterly/annual thresholds with roll-overs and insisting on maintaining a fixed FLDG at all times. As a result, BCs end up taking majority of the loss. Further, absolute lack of standards leads to disparate and lopsided arrangements, including reporting of loans settled through FLDGs to credit bureaus.

BC model builds on bringing the complementary strengths of the Bank and BCs to deliver microfinance and other financial products to the low-income segment. The unviable value proposition to either partner will only jeopardise the model, forestalling the growth. The very fact that the BC model has not scaled up (BC portfolio excluding Bank-own BCs is less than Rs 100 billion and decreasing) implies the presence of cracks in the model.

In the background of the above challenges, the BC model needs to reshape. To begin with, there is a need to review the calculus of risk mechanisms to ensure fair distribution of losses between the Bank and BC. Banks and BC need to come together to standardise the contracts for fair and transparent sharing of responsibilities and liabilities[50], including reporting to credit bureaus.

4.5 Risks

Risks are intrinsic to any business and in particular, for lending institutions. In microfinance, the most common risks are :

- Credit risk (due to non-payment or delays in payment of debt by the borrower),
- Liquidity risk (due to funding and cash flow issues which may create problems in meeting the obligations associated with organisation's financial liabilities)
- Social performance risk (if the business operations do not result in socially desired outcomes, particularly related to responsible lending and client protection) and
- Operational risk (due to gaps/deficiency in the operational processes like operations, HR, accounts, audit, IT etc.).

The credit risk, depicted by portfolio quality indicators as discussed in **Section 3.4**, has been impacted by the pandemic. Considering past trends, the sector (along with the millions of microfinance borrowers) takes pride in maintaining a high-quality portfolio and has always come back strongly after a crisis. The customer activation levels and recovery given in **Chapter 3** provide evidence to support this.

Similarly, liquidity stress increased substantially as a result of the pandemic due to a combination of factors including moratorium/non-payment by clients, selective back-to-back moratorium from the lenders while the operating expenses remained at similar levels, and high dependence of external debt for MFIs for growth and sustenance. The liquidity stress had been particularly high for the small and medium MFIs as debt was not easily available for them, despite several measures by the GOI/RBI to infuse liquidity into the sector. The Banks did not face this issue due to a deposit-based financing structure.

In terms of social performance, the sector places high importance on customer protection. MFIN as the SRO, through its Code for Responsible Lending (CRL) initiative, close supervision of adherence to Industry Code of Conduct, and its Customer Grievance Redressal (CGRM) has also ensured that its member NBFC-MFIs are fully entwined with the principles of customer and staff protection.

Events associated with operational risks are much more within organisational control and depend on the strength of the systems in identifying process lapses and promptness of the corrective actions to address them. At the sector level, the major factor that increases operational risks is geographical concentration which may fuel unhealthy competition among the lenders. A few indicators that provide insights into geographical concentration risk are analysed below.

Density of Financial Institutions ('000 potential HHs per FI): This ratio analyses number of potential households (HHs) served per financial institution (FI) in a district. The lower the ratio, the greater the risk implying that multiple FIs are targeting common households leading to unhealthy competition.

As on 31 March 2021, 188 FIs were offering microfinance services across 634 districts in 37 states and union territories. At an all-India level, the density of FIs is 1,061 which means that for every 1,061 thousand potential households there is one active financial institution. **Table 4.3** shows the number of districts in various categories of density of FIs – only 8% of the districts have relatively high concentration with one FI per 3,000 households while 31% districts have one FI per 3,000 to 6,000 households. It is true that some pockets have high concentration of FIs targeting the same client base, by and large financial services are yet to reach many households and there is sufficient scope for FIs to expand their outreach.

Table 4.3: Density of FIs

Category^ (No. of HHs)	No. of districts
<=3	48
>3 to <=6	197
>6 to <=9	176
>9 to <=12	73
>12	140
Total	**634**

^ Note: Depicts no. of '000 HHs for which there is one active FI

Source: Equifax

MICROFINANCE SERVICES ARE ALSO BEING PROVIDED IN 112 OUT OF 115 ASPIRATIONAL DISTRICTS AND THEIR CONTRIBUTION TO THE UNIVERSE GLP IS ABOUT 14.3%, THOUGH THE DEPTH OF OUTREACH IS LOWER THAN THE TOP 300 DISTRICTS INDICATING GOOD SCOPE OF EXPANSION IN THESE DISTRICTS.

Depth of outreach (Unique borrowers to potential HHs): This ratio points towards saturation level in terms of the proportion of potential borrowers reached by microfinance. For each district, the potential households are assumed to be 70% of the total households (as per Census 2011 and extrapolated by a growth rate of 1.2% p.a. to March 2021), with the bottom 15% and the top 15% households in terms of economic well-being excluded.

Table 4.4 shows the number of districts in various saturation level categories. In about 23% of the districts, more than 50% of the potential households have been reached by the FIs and at the country level less than 30% of potential households are covered which suggest enough opportunities for FIs to expand outreach.

When analysed at the state level, the Top 10 states[51] in terms of GLP contributed to 82% of total GLP as, 81% of total accounts and 91% of unique borrowers (UBs) on 31 March 2021. Analysis at district level shows that the operations are concentrated in the Top 300 districts, which contribute to almost 89% of the universe GLP. **Table 4.5** shows the district level geographical concentration of microfinance operations.

Table 4.4: Depth of Outreach

Potential HHs reached	No. of districts
<10%	172
10-25%	113
25-35%	85
35-50%	119
>50%	145
Total	**634**

Source: Based on data from Equifax

Table 4.5: District Level Concentration of Microfinance Operations[52]

Districts	GLP		GLP (% of Univ.)	Unique Borrowers		UB (% of Univ.)	Depth of outreach
	Rs Crore	Rs Million		Crore	Million		
Top 100	1,34,301	1,343.0	51.8%	3.21	32.1	54.1%	51.7%
Top 200	1,94,484	1,944.8	75.0%	4.79	47.9	80.8%	49.2%
Top 300	2,30,820	2,308.2	89.0%	5.82	58.2	98.1%	45.7%
Remaining 334	28,558	285.6	11.0%	0.86	8.6	14.4%	12.5%
Aspirational 112	37,191	371.9	14.3%	1.00	10.0	16.9%	34.7%
Universe	**2,59,377**	**2,593.8**		**5.93**	**59.3**		**29.7%**

Source: Equifax

From the risk management perspective, while there is enough space for each FI to grow and expand, it is important that they start looking at districts which are underreached in terms of depth of outreach as well as density of FIs.

4.6 Fintech/Digitalizations

The microfinance sector caters to nearly 60 million unique customers and can play a major role in shaping behaviour change of borrowers, majority of whom belong to low socio-economic strata, for adopting digital payment methods. Technology (Aadhaar, e-KYC, e-Sign, Digital Document Execution, Core Banking System, Loan Origination and Management Systems etc.) is also playing an increasingly significant role in day-to-day operations of MFIs from customer acquisition, awareness generation, cashless loan disbursements, to the management of HR/training, audit, accounting, risk and MIS processes.

In the context of microfinance lending operations, digitalisation of disbursements and repayment collections are two key aspects. While the MFIs have transformed largely to cashless disbursements, the collection process is still mostly cash based – a brief description of the existing situation on disbursements and repayment collections is provided below.

Disbursements

As per MFIN Micrometer (Q4 FY 20-21), in FY 2020-21, about 98% of the loans were disbursed through cashless mode and about 91% of 53 Member NBFC-MFIs reported that more than 90% of their disbursement is cashless.

NBFC-MFIs avail services of various banks for disbursements to the savings account of the borrowers. The key features of such services include National Electronic Funds Transfer (NEFT), Real Time Gross Settlement (RTGS) and Immediate Payment Service (IMPS) for loan disbursement, penny drop check for verifying the authenticity of a user's bank account and recall facility for wrongly credited amount. The main challenge that the MFIs face is the delay in crediting money to the borrower's account, especially in case of co-operative banks and penny drop service for such bank accounts. Another challenge is the identification of dormant accounts of borrowers.

Repayment Collections

Information on the use of digital methods for repayment collections is not readily available as most of the NBFC-MFIs are at the experimentation stage and trying out various options to assess the suitability of digital methods and client acceptance. MFIN had done a survey in June 2020 to understand the use of digital repayment collection methods and the extent of adoption of technology in microfinance (**Box 4.4**).

BOX 4.4

Key Findings of MFIN Survey on Digital Repayments

- Ten different methods were tried out by the MFIs to collect repayments: Aadhaar Pay, Point of Sales (POS) using debit card swipe, Unified Payments Interface (UPI), Bharat Bill Pay, National Automated Clearing House (NACH), BC Point, Mobile wallet, Cheque/Demand Draft, Internet banking (SMS Link, Payment Gateway, NEFT, IMPS) and Cash.
- Cash was the predominant mode (~95%) of repayment collection
- Among the digital modes of collection, the most popular mode seems to be deposits at BC points, E-NACH and Aadhaar Pay. As per feedback from practitioners, UPI mode shows a lot of promise.
- Challenges include reconciliation of payments, limited borrowers' awareness of use of digital payments methods particularly UPI, and NACH bounce charges.

In another paper, **"Rejuvenating Microfinance in India – Embracing Digital[53]"** by KMPG (commissioned by MFIN) which explores the evolution of technology in microfinance and suggests a future roadmap for building on digital innovations, the key challenges cited for adoption include:

- Talent gap - limited understanding of staff/ business correspondents of the banking infrastructure and available digital services leads to limited adoption in the ecosystem.
- Cash based ecosystem discourages customers to hold their money in digital format, and therefore the loan repayments are also made in cash.
- Cost of technology (software as well as hardware plus staff training)
- Finding the balance between human touch, which is critical in microfinance, and technology
- Lack of infrastructure that supports digital adoption, particular in rural India
- Regulatory – lack of specific IT guidelines, including business continuity, data protection and security and cybersecurity for MFIs.

The MFIs, mostly from their own initiative and with the hope to become more efficient, have been trying out various methods. Policy push and support would enable greater adoption and use of technology in microfinance, both at the institutional level as well as customer level helping them in digital mainstreaming. Some areas where policy support is required are discussed below.

- **Use of Aadhaar and e-KYC:** Aadhaar has been a unique identifier for microfinance borrowers and is crucial in not only identity authentication but also in assessing indebtedness level of customers. MFIN has been advocating to the Department of Financial Services (DFS) and RBI for allowing e-KYC facility for NBFC-MFIs, ever since Honourable Supreme Court's verdict in September 2018 on restricted use of Aadhaar and the subsequent amendment of Master Direction on KYC. In a positive development, RBI has issued a circular dated 13 September 2021 on "Application for Aadhaar e-KYC Authentication Licence", providing an opportunity for NBFCs to become KUA/ Sub-KUA[54] to carry out authentication of client's Aadhaar number using e-KYC facility provided by Unique Identification Authority of India (UIDAI). Instructions also need to be given to Credit Information Companies (CICs) to accept the Aadhaar number from MFIs as a unique client identifier field in their regular reporting.
- **Credit bureau data submission on microfinance customers:** The RBI's consultative document on uniform regulations for all regulated entities (REs) in microfinance space, rightly places focus on addressing indebtedness through Fixed Obligation to Income Ratio (FOIR) rather than number of lenders. For this to succeed, it is critical that all lenders report borrowers' data to Credit Bureaus (CBs) uniformly and in a timely manner. MFIN has gradually moved the NBFC-MFIs towards daily reporting, while Banks report to CBs on a monthly basis and NBFCs on a weekly basis. This data asymmetry at the time of loan origination leaves data gaps as a borrower may have loans from other REs which are not reported at the time of loan origination. This becomes a major issue with low-income microfinance clients. As such, the reporting of borrowers' data to CBs should move to at least a weekly basis to start with, moving to daily in a stipulated time frame, say by March 2022, by all REs. Further, non-profit entities (including SHGs) should be permitted to be part of credit bureau ecosystem.

- **CKYC[55] could be the additional unique identifier in future, but it needs to be made cost-effective for MFIs:** At present, the fee for upload, download and update for microfinance clients' CKYC is prohibitive for MFIs as they follow strict pricing norms. Waiver of the fee for an initial period of 1-2 years will help the industry to comply with the mandate quickly without worrying about costs/operational viability. MFIs also need financial assistance from RBI/ DFS for development of a common software for integration with CKYC system.

- P**romotion of cashless payments:** The following solutions would lead to a long-term benefit for the microfinance borrowers as well as institutions working with marginalised segment of society in promoting and fast tracking financial/digital inclusion.

  o Creation of a separate Merchant Category Code (MCC) by NPCI for NBFC-MFIs and all other types of entities active in microfinance space: This will help issuer banks, NPCI and regulators to easily identify the institutions working in the space and pass on the targeted benefits to those institutions for microfinance transactions affected through digital means.

  o Waiver of the NACH failure charge on these MCCs: Directions should be given to banks to not charge the NACH failure penalty from customers on transactions initiated from these MCCs. This would provide a huge boost to financial/digital inclusion.

BOX 4.5

NACH: A Potential Catalyst for Digital Inclusion of Microfinance Customers

Recently MFIs have started using NACH paper based mandate and e-mandate as a repayment collection tool with their borrowers. From the microfinance borrowers point of view, it is a very appropriate product as it does not require any payment infrastructure or smart phone or any other equipment. All it requires is an Aadhaar based Digital NACH or a signature on a NACH mandate paper. This provides a lot of ease for both MFIs and borrowers, and is, hence gaining adoption.

Biggest issue which MFIs face in NACH is the charge levied by the issuer (borrower's) bank for each NACH transaction failure on account of insufficient funds. However, if we consider the socio-economic condition of microfinance borrowers it is possible that (many times) their account may not have sufficient funds to honour the NACH mandate despite follow-up and reminders from the MFIs. It happens because:

a. Microfinance borrowers primarily earn in cash, and they must go to a bank branch or a BC point to deposit cash to ensure the required balance in their account

b. Due to other issues like health, loss of daily wage, single ownership of shop, other pressing need of the money etc. it is likely that they are not able to deposit money in their account.

However, if the NACH mandate is presented by an institution and gets dishonoured due to insufficient funds, the issuer bank has the authority to charge amounts ranging from Rs 150 to Rs 500 or more per failure.

As per the Section 138 of Negotiable Instrument Act 1881, an institution may initiate a court case or can close the bank account of the customer if there are frequent failures on an account. RBI has also issued a notification[56] regarding this on 9 November 2009, stating that banks must have a board approved policy to deal with Electronic Clearing System (ECS, now NACH) failure and take it up with the same rigour as dishonour of cheque. Further, NPCI vide Circular 57, issued on 7 October 2014 has also clarified that NACH will be treated equal to cheque failures to instil trust in the newly created system which replaces the earlier ECS systems.

MFIN believes that NACH is a tailor-made product for the microfinance sector and it can catalyse digital and banking behaviour among millions of microfinance borrowers. However, the failure charges which the issuer bank can levy to the microfinance customer is a bottleneck and would slow down the digital adoption process as well as banking behaviour of the low-income segment.

- **Promotion of Digital Documents Execution (DDE) using e-Sign**: At present, DDE would cost MFIs around Rs 20-25 per execution and not viable under the existing pricing regulations for them. Further, MFIs would have to create customer awareness which is costly as well as a time taking process. A review of RBI's Fair Practice Code (FPC) is required – in the context of RBI guidelines for NBFC-MFIs which require three documents, namely loan application, sanction letter and loan passbook, to be given in writing in vernacular language to borrowers. DDE will therefore not make much difference unless there are changes in the master direction for NBFC-MFIs.

In sum, the market stayed focused on strengthening the core aspects of microfinance – customer protection, employee engagement, risk management and adoption of digitalisation. As the sector recovers and adapts for the new normal, including a new regulatory regime, these building blocks will be even more critical. MFIN has played a catalytical role in bringing knowledge, standards, resources and collaborations around these crucial pillars. We hope to further enhance the scope and scale of our work in the coming years.

Notes and References

1. https://www.dvara.com/research/wp-content/uploads/2020/06/COVID-19-Impact-on-Daily-Life-CIDL-Survey.pdf
2. A survey conducted in April 2020 by MFIN showed incomes of 90% customers to be impacted either highly/partially. A subsequent survey in May 2020 captured 84% respondents reporting non-payment and lack of money was reported as the top reason (77% of respondents).
3. Lenders had varied approach to moratorium in terms of accrual of interest, revising the tenure, installment amount, and collecting interest for the moratorium period upfront, towards the end or spread over the remaining tenure of loans.
4. Refer to https://www.youtube.com/channel/UCsFL4uW_vTucJ13Xgg0AuWg/playlists for customer awareness videos developed by MFIN
5. These apps allow customer to view details of the loans, make digital repayments/pre-closures/closure, apply for new loans, and raise a complaint, among other things.
6. Uncertainity, lack of safety nets and need to preserve the limited cash to meet essential needs.
7. In an internal MFIN survey conducted in Mar 2021, 9% customers reported experiencing employee misbehavior related to recovery of loans in the last six months.
8. On the basis of customer complaints on MFIN CGRM for disputes pertaining to repayments and customers not having receipts of repayment, MFIN integrated a customer awareness message in the IVR system of its CGRM. The message educated the customers to always take the receipt of each transaction.
9. https://mfinindia.org/assets/upload_image/publications/IndustryStandards/MFINCustomerGrievanceRedressalMechanismCGRM.pdf
10. RBI expanded the Ombudsman Scheme for NBFCs in 2019 to allow the customers of NBFCs (customer interfacing with assets size more than Rs 1 billion), can access the Ombudsman to escalate their unresolved complaints; https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11546&Mode=0
11. 52 member NBFC-MFIs who shared their CGRM data for the year
12. Received 1,409 complaints last year
13. For example, low volume may be an outcome of lack of awareness/confidence to complain. In one of our surveys, 50% customers who experienced employee misbehaviour, did not complain for various reasons
14. https://rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=30052
15. The current composition of EC is available at https://mfinindia.org/about/leadership
16. https://mfinindia.org/assets/upload_image/publications/IndustryStandards/FrameworkforSROEnforcement.pdf
17. SROC is the highest level committee under the SRO framework to guide and oversee the SRO function. It also acts as an appelate body for the EC decisions. SROC is chaired by an independent member of the MFIN Board and consists of 3 independent members (2 independent members of the Board and 1 person of eminence appointed by Board) and 2 industry members (from amongst the industry members on MFIN Board).
18. The way, credit bureau information is structured, often lenders look at customers' micro-credit loans and not her or household's loans under the consumer segment.
19. When Is Microcredit Unsuitable, Guidelines using primary evidence from low-income households in India, Prathap and Khaitan, 2016 available at https://www.dvara.com/research/wp-content/uploads/2017/01/When-is-Microcredit-Unsuitable-Guidelines-for-Lending.pdf
20. Issues of overindebtedness in Andhra Pradesh in 2011 and Assam last year clearly manifested these risks and so do smaller localized episodes.
21. Based on data from Equifax for Mar 2021 for over 60 million customers with active microfinance loan
22. Though there are state specific variations; some states particularly West Bengal and Assam have higher share of high-leverage customers compared to other states.
23. As per data from Equifax for Jan 2021

24. The latest available CRISIL Inclusix report (which captures the financial inclusion at the state/district level across India) consistently ranks Assam at the tail end (27th place amongst 36 Indian states and union territories and lowest amongst the large states).
25. Data sourced from Equifax
26. Avg ticket size for disbursements in Apr – Sep 2020 to indicate the differences in ticket size amongst the lenders.
27. Due to earlier floods in May 2019 and overall slowdown in economic activities in the state
28. Unscrupulous intermediaries who siphoned the microfinance loans from multiple customers for own use
29. On the basis of data sourced from Equifax for Assam as of March 2021. On the basis of latest data available with MFIN for August 2021, PAR 30 is 48%.
30. Customer elegibility is based on her worst dpd across open tradelines as on 31 March 2021
31. Field-level employees work at the branch level, usually as loan officers and branch managers and take care of business operations.
32. Terminated or absconding
33. MFIN worked with BFSI-SSC and NSDC to frame the national occupation standards for micro-credit officer in 2017.
34. MFIN worked with BFSI-SSC under PMRPY of Ministry of Skill Development and Entrepreneurship to develop an online training/certifcation program in Hindi focusing on customer-protection. This program trained over 5,000 candidates in 2019.
35. Please browse through MFIN youtube channel at https://www.youtube.com/channel/UCsFL4uW_vTucJ13Xgg0AuWg/playlists
36. In Sep 2010, RBI allowed the Banks to enrol coporate entitites as BCs, and in Jun 2014 NBFCs were allowed to become BCs.
37. Based on MFIN estimates
38. Excluding SKDRDP, a not profit, which has large BC portfolio of over Rs 150 billion
39. Usually it is dpd > 90 but dpd threhold can be less also.
40. It is worth noting that Bank has a broader definition of defaults to include losses from employee frauds, non-compliances/lapses from the contract and has the power to deduct such losses from FLDG. In addition to FLDG, Bank may require corporate/personal guarantees from the BCs.
41. 9 large (of 22), 12 medium of 19) and 8 small (of 13)
42. Kamal Fincorp, Buldana Urban Coop. Credit Society, Sampark, Dvara
43. The biggest is SKDRDP
44. Cashpor is a noted example
45. Examples are NOPCL, Basix Sub-K, SaGgraha
46. RBL bought Swadhaar Finserve which was a NBFC-MFI and converted it to BC
47. IndusInd Bank bought BFIL, one of the largest NBFC-MFI as the fully-owned subsidiary
48. IDFC Bank bought Grama Vidiyal and renamed it as IDFC Bharat to work as its dedicated BC.
49. Example Tata Capital, Vivriti Capital, Northern Arc Capital, MAS Financial Services
50. Indian Banks Association (IBA) has developed a model BC contract for libaility BCs
51. West Bengal, Tamil Nadu, Bihar, Karnataka, Maharashtra, Uttar Pradesh, Madhya Pradesh, Odisha, Assam and Rajasthan
52. Data for GLP and customers sourced from Equifax. Depth of outreach is estimated assuming 70% of households are low-income households and hence potential size of the market.
53. Available at https://mfinindia.org/Resources/studyreport
54. KYC User Agency
55. Central KYC
56. RBI, Nov 9, 2009. DBOD.No.Leg.BC.59 /09.07.005/2009-10. “Dealing with incidents of frequent dishonour of cheques”

CHAPTER - 5

Lessons and Way Forward

5.1 The Year Gone By

While this report pertains to FY 2020-21, the fact that we are almost in mid of next FY gives the benefit of hindsight and objectivity stemming from distance. The FY 2020-21 started with such a gloom of COVID-19 pandemic and consequent public health issues that initially one felt like being in unchartered territory. Opinions and conjectures flied thick and fast, and the impact left no sector untouched. The impact on microfinance which relies on "high touch" in delivering last mile financial services was severe causing disruptions to a well-oiled field machinery. A combination of lockdown and moratorium led to a sense of despair with few opinions bordering on extreme pessimism. This led to specific problem for non-deposit taking NBFC-MFIs, whose asset-liability matching primarily depends on loan repayments, with repayments under moratorium but not having matching moratorium for institutions wholesale borrowings. While institutions are an integral part of the microfinance sector, the two key elements often neglected are field staff and customers. The concern was more about the livelihood shock to 60 million clients and ensuring health and safety of staff. To be honest, this was a challenge never anticipated and it was clear that to ride through this, combined efforts of public policy and Institutions will be required.

THE IMPACT ON MICROFINANCE WHICH RELIES ON "HIGH TOUCH" IN DELIVERING LAST MILE FINANCIAL SERVICES WAS SEVERE CAUSING DISRUPTIONS TO A WELL-OILED FIELD MACHINERY.

While the details of how policy support combined with institutional support has been provided in the previous chapters, as a concluding piece, it is worthwhile to recap the tango briefly. Liquidity was crucial for non-deposit taking MFIs and help for the sector came swiftly from the RBI which announced Targeted Longer-Term Refinancing Operations (TLTRO 2.0) for NBFCs and MFIs as early as April 2020. Simultaneously, it leveraged the All-India Financial Institutions (AIFIs) infrastructure within the country, by placing

refinance facilities with NABARD and SIDBI for on-lending/refinancing. Further, considering that small MFIs faced difficulties in availing these funds, the RBI allocated Rs 5,000 crore to NABARD for refinancing them. The government backed it up with Partial Credit Guarantee Scheme (PCGS) which enabled 14 NBFC-MFIs to raise Rs 4,011 crore through Bonds/Commercial Paper (CPs)/Non-convertible Debentures (NCDs). These measures enabled the sector to get some liquidity though smaller institutions continued to face liquidity stress as they could not meet the eligibility norms for availing these funding facilities. By July/August 2020, customer level repayments also started resuming and a combination of cash at hand, liquidity support and lower disbursements saw the MFIs scrape through the first wave. RBI backed up liquidity measures by providing guidance on COVID-19 stressed loan accounts resolution framework. Institutionally, all lenders adapted to the new normal by adopting newer ways. Reaching customers through phone calls to continue contact and educate them about COVID-19 precautions, developing short AV films explaining moratorium as also assuring them of continued support. While the industry has moved to cashless disbursements, repayments puzzle remains largely unsolved, but the pandemic gave a thrust to trying out various digital options and technical preparedness. Reassuring the field warriors was also deftly handled and to the credit of the industry, data shows that hiring increased post pandemic – at a time when job losses were the order of the day. MFIN played its part through policy advocacy, robust customer grievance redressal mechanism and supporting the industry through AVs and advisories.

Though, the second wave came in FY 2021-22, the response was almost similar from policy in terms of liquidity support and resolution framework with one exception. Based on last year's experience, MFIN requested Government of India to include term loans from banks to MFIs under guarantee cover. The request was made to benefit smaller MFIs as these institutions normally do not raise funds through NCDs or CPs- which were the only eligible instruments in FY 2021-22 PCG scheme. Government of India took the suggestion and announced Credit Guarantee Scheme for MFIs covering term loans from banks and stipulating that 50% of bank lending should go to MFIs rated MFR2 or below. The scheme has been a resounding success with around Rs 10,000 crore of sanctions, however the benefit has largely remained at MFR2 level graded MFIs.

HON'BLE PRIME MINISTER IN HIS ADDRESS TO THE 75TH UNITED NATIONAL GENERAL ASSEMBLY (UNGA) SESSION SAID "LARGE SCALE EFFORTS ARE BEING MADE IN INDIA TO PROMOTE WOMEN ENTERPRISE AND LEADERSHIP. INDIAN WOMEN, TODAY, ARE THE BIGGEST BENEFICIARIES OF THE LARGEST MICRO FINANCING SCHEME OF THE WORLD" .

This level of financial policy support has also to be seen with policy support for microfinance coming from statements and speeches of none else than the Honourable Prime Minister and the RBI Governor. Hon'ble Prime Minister in his address to the 75th United National General Assembly (UNGA) session said "Large scale efforts are being made in India to promote Women Enterprise and Leadership. Indian women, today, are the biggest beneficiaries of the largest Micro Financing Scheme of the world"[1]. The RBI Governor in his televised address as early as on 17 April 2020 recognised the problem of MFIs and said "The disruptions caused by COVID-19 have, however, more severely impacted small and mid-sized corporates, including non-banking

financial companies (NBFCs) and microfinance institutions (MFIs), in terms of access to liquidity."[2] This policy recognition at the highest levels is what makes the industry vibrant and take pride in serving low-income customers.

As the report goes to print, all indicators point towards recovery. Vaccinations have touched 1 billion, customer activation level is inching toward pre covid level, liquidity stress has also eased out and disbursements are picking up. However, all lenders will have to provide for much higher delinquency as certain percentage of customers have seen severe impact on their livelihood. At policy level also, there is a mood of buoyancy in the sector as it awaits the harmonised regulations for microfinance. The RBI Consultative Document (CD) placed for comments earlier in the year rightly underlined that any prescriptive regulatory norms for the country, as vast and diverse as India, cannot address market complexities and are prone to tick-box approach. It also acknowledges the extant regulatory arbitrage and aims to create a level playing field. The CD, moving away from a prescriptive approach only for NBFC-MFIs, rightly places emphasis on harmonised framework for all lenders and puts onus on lenders and their boards to assume responsibilities for customer protection. The expected policy will pave the way for V.3 of microfinance [pre 2011 can be said to be V.1 and Post Malegam Committee (2011) as V.2].

While the mood is upbeat, the year also had some critical lessons for the sector and policy. The lessons might sound cliched but nevertheless are worth incorporating:

Back to Basics; Deeper Customer Connect

Disruption in field outreach for months highlighted the need to have alternative modes of customer connect, and the experience showed that this helped institutions to cope well. Amidst the digital shift taking place in disbursements and repayments, it is imperative for the sector to stay rooted to the foundation. Changes will be required to the 'business as usual' approach; as an example, time saved by digital collection can be used to educate customers about financial literacy, livelihood opportunities, health and credit discipline. Group level cohesion and attendance of group meetings are key cornerstones.

Focus on Governance and Customer Level Outcomes

Governance came to the fore during the year on account of COVID-19 induced stress and financial issues with an MFI whose license has been cancelled by the RBI. While sound governance focussing on organisation vision with code of ethics is relevant for the entire economy, it is more so for the microfinance sector focussing on Bottom of Pyramid (BOP) customers. Institutional governance aided by SRO and regulatory oversight must ensure that customers are kept at the core and there is no mission-drift.

INSTITUTIONAL GOVERNANCE AIDED BY SRO AND REGULATORY OVERSIGHT MUST ENSURE THAT CUSTOMERS ARE KEPT AT THE CORE AND THERE IS NO MISSION-DRIFT. IT APPLIES TO ALL ENTITIES OPERATING IN MICROFINANCE. MISSION DRIFT HAPPENS WHEN INSTITUTIONAL PRIORITIES ARE PLACED ABOVE CUSTOMER LEVEL OUTCOMES. COVID-19 REINFORCED THIS: INSTITUTIONS CAN DO ONLY AS WELL AS THEIR CUSTOMERS, IT HAS TO BE A WIN-WIN SITUATION.

It applies to all entities operating in microfinance. Mission drift happens when institutional priorities are placed above customer level outcomes. COVID-19 reinforced this: institutions can do ONLY as well as their customers, it has to be a win-win situation. Given the sensitive ecosystem in which the sector operates, a small incident also receives disproportionate attention.

Event Risk and Risk Management

Last 5 years saw two upheavals – demonetization which was short term and now COVID-19. Both events impacted microfinance customers, with COVID-19 impact continuing even after eighteen months. Climate change impact is also disproportionate on microfinance customers by way of floods, unseasonal rains etc. and the severity might increase in near future. Institutions need sound risk management policies and capital buffer to withstand such shocks and investors and funders should also refocus their analytical lens from a standard <1% delinquency as normal to accommodate such force majeure events. Dealing with vulnerable customers, in such situations, institutions have no alternative to being empathetic to their customers' situation. Credit costs go skywards in such events and policy needs to steer away from a prescriptive margin regime to enable institutions to price their risk suitably. MFIN on its part is working on a pilot project on Natcat (Natural Calamity) insurance with support from ADB, GIZ, Weather Risk Management Services (WRMS), Swiss Re and Cholamandalam, to cover some of the natural risks.

Criticality of Public Policy

The year saw critical role of public policy on more than one occasion. The liquidity stress could have had serious consequences on both customers and institutions but for the support from the RBI and Government of India. The consultative document on harmonized regulation for microfinance will define the future and it is hoped that suggestions made by the sector through MFIN [Chapter 2] will find place in the final document creating a win-win situation. The development in Assam reinforced the global policy lesson[3] that distorting years of credit discipline through promise of loan waiver leads to adverse consequences. While the Government's scheme is now modelled on helping overdue customers and giving incentive to regular customers, the effect is visible with Portfolio at Risk (PAR) >1 day hovering around 40% in Assam, which was among the top states in India in microfinance credit culture.

5.2 What does the Future Hold?

Not many would have thought that India's aspiration of becoming a $5 trillion economy is inextricably linked to microfinance, but it is. While GDP growth is the primary measure for powering India towards its $5 trillion aspiration, it has to happen with reduced inequalities in income distribution. In its absence, growth will not be inclusive. Microfinance with its estimated market size of ~350 million has vast territory to cover from its current outreach of 60 million in order to make the growth inclusive - the link between access to finance and growth is so well established that it does not need any elaboration. Further, Indian growth story has a structural weakness in low participation of women in the workforce[4]. Microfinance addresses this by lending to women and thereby making them part of the mainstream economy. By being focused on financially excluded, women and primarily rural customers, microfinance also has a critical role in stemming migration. Broad based Inclusive growth and higher share of women entrepreneurs in economy are the foundation on which India's growth should happen.

At the same time, it is to be acknowledged that "Finance is necessary but not sufficient for growth and development". For an optimum result, it requires stable macro-economic conditions and a facilitating regulatory architecture. For this reason,

the harmonized regulation for microfinance is so crucial – it will define whether microfinance will be able to achieve its full potential or not. Going by the Consultative Document, it is expected that regulation will create a level playing field for all micro-lenders in terms of pricing and target customer, as also provide operational freedom to spur innovation. The microfinance ecosystem has completely changed since 2011 when the regulations came in – as also matured with time in operations, funding, credit bureau, and SRO. While there are ~150 lenders active in the space, the current outreach analysed in Chapter 3 along with market size estimation shows enough space for banks, NBFC-MFIs and NBFCs to grow and serve the unaddressed need. Till now, the regulation is prescriptive only for NBFC-MFIs but post harmonized regulations, it is expected that all will play by the same rules and compete. Like what has happened in other sectors of the economy – freedom has placed the consumer as king, same has to happen in microfinance. The sector awaits the proposed regulations with bated breath.

The technology trends are a clear pointer that the future of microfinance will also be bionic-technology and human capability have to integrate to deliver outcomes. While a lot has been happening in this aspect in microfinance [details in Chapter 4 and a study report by KPMG and MFIN[5]], future will see more of it. Ecosystem changes in the form of Account Aggregator, Fintech focused on specific aspects of financial intermediation value chain as well as data being the new king unleashing immense possibilities of predictive analysis, behaviour scoping and credit underwriting/monitoring will usher new possibilities. With customer as the focus, lenders can provide an array of financial services in partnership with specialized fintech companies.

These technology advancements from the perspective of microfinance have two challenges as well. First, it will lead to modularization of financial services delivery value chain as against earlier model of build-retail-service. Under this new paradigm, various aspects like product design, underwriting, retailing, and servicing can be with a different company – all brought together under one brand. From customer protection perspective, it will be important to have a well-defined grievance redressal system, so that customer has one point interface irrespective of the back-end tie ups. Secondly, staff capabilities will need to be addressed through trainings as they in turn will train the customers on digital adoption.

THESE ARE EXCITING TIMES AND THE FUTURE BECKONS THE SECTOR AIDED BY ENABLING TECHNOLOGY AND SUPPORTIVE REGULATION IN BUILDING “BHARAT”.

Notes and References

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4. https://data.worldbank.org/indicator/SL.TLF.CACT.FE.ZS
5. https://mfinindia.org/Resources/studyreport#

Annex 1

Chronology of Relevant Policy and Regulatory Developments

RBI

Mar 16, 2020: Operational and business continuity measures: After the World Health Organization declared the outbreak of covid as a pandemic, the notification advised to take stock of critical processes and revisiting Business Continuity Plan and to devise strategy and monitoring mechanism concerning the spread of the disease within the organisation. It also emphasised on encouraging the customers to use digital banking facilities.

Mar 27, 2020: Covid-19, Regulatory Package: The regulatory package included rescheduling of payments – term loans and working capital facilities and easing of working capital financing. It allowed to grant a moratorium of three months to the customers on payment of all instalments falling due between Mar 1, 2020, and May 31, 2020.

Apr 17, 2020: COVID-19 Regulatory Package - Asset Classification and Provisioning: Guidelines on the Asset Classification under the Prudential norms on Income Recognition, Asset Classification (IRAC) and provision on the context of covid-19 regulatory package.

Apr 17, 2020: Refinance facilitates to All India Financial Institutions (AIFIs): RBI announced special refinance facilities for a total amount of Rs 500 billion to NABARD, SIDBI and National Housing Bank (NHB). Rs 250 billion was given to NABARD for refinancing Regional Rural Banks (RRBs), Cooperative Banks and NBFC-MFIs; Rs 150 billion was offered to SIDBI for on-lending/ refinancing; and Rs 100 billion was given to NHB for supporting housing finance companies (HFCs).

Apr 17, 2020: Targeted Long-Term Repo Operations 2.0 (TLTRO 2.0): Funds availed under TLTRO 2.0 were to be deployed in investment grade bonds, commercial paper (CPs) and non-convertible debentures (NCDs) of NBFCs. 10% of the total funds availed was to be deployed in securities/instruments issued by Microfinance Institutions (MFIs).

May 23, 2020: Covid-19, Regulatory Package: The regulatory package included rescheduling of payments – term loans and working capital facilities and easing of working capital financing. It allowed extension of moratorium of three months to the customers on payment of all instalments from 1 June 2020, to 31 August 2020.

Aug 06, 2020: Micro, Small and Medium Enterprises (MSME) sector – Restructuring of

Advances: Instructions for restructuring advances of the MSMEs and their provisioning

Aug 06, 2020: Resolution Framework for COVID-19 related Stress: This was released with the intent to facilitate revival of real sector activities and mitigate the impact on the ultimate borrowers. It was decided to provide a window under the prudential framework to enable the lenders to implement a resolution plan in respect of eligible corporate exposures.

Aug 06, 2020: Opening of Current Accounts by Banks - Need for Discipline: The notification advised banks to have only 1 current account for their customers and no current accounts for customers who have availed credit facilities in the form of cash credit (CC)/ overdraft (OD) from the banking system and all transactions to be routed through the CC/OD account.

Sep 07, 2020: Resolution Framework for COVID-19 related Stress – Financial Parameters

Apr 07, 2021: Asset Classification and Income Recognition following the expiry of Covid-19 regulatory package: The notification was for refund/adjustment of 'interest on interest' and norms on asset Classification.

May 05, 2021: Resolution Framework – 2.0: Resolution of Covid-19 related stress of Individuals and Small Businesses & Jun 04, 2021: Resolution Framework - 2.0: Resolution of Covid-19 related stress of Individuals and Small Businesses – Revision in the threshold for aggregate exposure

Aug 06, 2021: Resolution Framework for COVID-19 related Stress – Financial Parameters – Revised timelines for compliance: In view of the resurgence of the Covid-19 pandemic in 2021 and recognising the difficulties for the borrowers in meeting the operational parameters, it was decided to defer the target date for meeting the specified thresholds in respect of the four operational parameters, viz. Total Debt / EBIDTA, Current Ratio, DSCR and ADSCR, to 1 October 2022.

Jan 22, 2021: Discussion Paper on Revised Regulatory Framework for NBFCs - A Scale-Based Approach: To invite feedback on revised regulatory framework for the NBFCs based on scale.

May 05, 2021: Priority Sector Lending (PSL) - On-lending by Small Finance Banks (SFBs) to NBFC-MFIs: The notification allowed PSL classification to the fresh credit extended by SFBs to registered NBFC-MFIs and other MFIs (Societies, trusts etc.) which are members of RBI recognised 'Self-Regulatory Organisation' of the sector having a 'gross loan portfolio' of up to Rs 5 billion as on 31 March 2021, for the purpose of on-lending to individuals.

Jun 14, 2021: Consultative Document on Regulation of Microfinance: To invite feedback to review the regulatory framework for microfinance.

Government of India

May 20, 2020: Partial Credit Guarantee Scheme (PCGS) 2.0: It was launched by the Department of Financial Services, Ministry of Finance, Government of India for purchase of pooled assets of NBFCs/HFCs and portfolio guarantee for purchase of Bonds or CPs issued by NBFCs/ HFCs/MFIs, by the Public Sector Banks with the first 20% of the loss having a sovereign guarantee by the Government of India.

June 26, 2020: Notification for MSME: Issued by the Ministry of MSME, it revised certain criteria for classifying the enterprises as micro, small and medium enterprises and specified the form and procedure for Udyam Registration.

Jul 01, 2020: Special liquidity scheme for NBFCs/ HFCs: Special Liquidity scheme of Rs 300 billion

was authorised by the Government of India for investments in both primary and secondary market transactions in investment grade debt paper of NBFCs, HFCs and MFIs.

Jul 02, 2020: PM Svanidhi Scheme: The PM SVANidhi Scheme for lending to Street Vendors was launched by Ministry of Housing and Urban Affairs (MOHUA) with SIDBI as the implementing partner.

Oct 23, 2020: Ex-gratia scheme: Scheme for grant of ex-gratia payment of difference between compound interest and simple interest for six months to borrowers in specified loan accounts which mandates ex-gratia payment to certain categories of borrowers by way of crediting the difference between simple interest and compound interest for the period between 1 March 2020 to 31 August 2020 by respective lending institutions.

Annex 2

Steps by the SRO for Customer-Protection

Advisories and Communications

SRO released several Advisories and communication in the context of Covid to ensure that microfinance operations remain fully aligned to industry standards with respect to customer engagement, employee engagement and risk/ internal controls during the pandemic situation.

- Advisory in context of a surge in Covid cases (Pg 28, 29)
- Advisory on incentives to the employees for recoveries Pg 23, 24)
- Advisory for moratorium on microfinance loans to customers in the context of Covid (Pg 19, 20)
- Advisory on microfinance operations post moratorium period (Pg 21, 22)
- Communications for extension of the coverage of credit linked life insurance upon extended term of the loan where a moratorium is given. Extra premium to cover the extended period to be clearly communicated to the customer and collected. If coverage is not extended, customers should be kept informed.

Customer Awareness Initiatives

- 2 animated videos on moratorium (Part 1 and Part 2) covering the aspects of moratorium in simple and easily comprehendible manner in various vernacular languages.
- A video on benefits of credit discipline to create awareness amongst the customers in accessing credit and credit-related reliefs provided by government and/or the companies.
- A short video on resuming loan repayments post moratorium for the customers dealing with loss of income in the past few months, to emphasise on the importance of timely repayment of loans, given that the moratorium period is over and the incomes are improving.
- A playlist of videos on credit awareness for customers broadly covering microfinance, credit discipline, multiple/over-lending and customer's responsibilities and rights.
- A specific IVR message on taking proof of all the repayments made to the lenders was incorporated in the IVR of the MFIN Toll-free helpline in 10 vernacular languages.

Customer Surveys

Leveraging on MFIN CGRM, the SRO conducted series of surveys to understand the impact of covid, drivers of customer's repayment behaviours, gaps in information/awareness, and employee behaviour issues.

- **April 2020:** Impact of Covid across states, occupations, rural/urban and coping mechanism[1].
- **May 2020:** Impact of lockdown on customers income/repayment/concerns
- **July 2020:** Recovery in customers' income/ repayments/concerns
- **September 2020:** Recovery in customers' income/ repayments/access to credit/future credit need
- **March 2021:** Coercive recovery practices/ misbehaviour – the extent of the problems and issues in the context of stress in repayment during the pandemic

Reference

1. This survey was done in partnership with lenders and associates and covered over 20,000 customers.

About MFIN

Microfinance Institutions Network (MFIN) is an industry association of Microfinance entities and an RBI-recognized Self-Regulatory Organization (SRO). MFIN Members are RBI regulated entities comprising the Non-Banking Financial Companies - Microfinance Institutions (NBFC-MFI), Banks, Small Finance Banks, NBFCs, Banking Correspondents, Credit Bureau, Fintech companies, among several others.

Keeping the larger objective of financial inclusion in mind, MFIN focuses on creating an enabling policy and business environment for its members to pursue responsible finance with the highest standards of customer protection and corporate governance. Towards this objective, MFIN works closely with the microfinance providers, regulators, Government and other key stakeholders across 35 states and union territories, spanning 591 districts to ensure that credit reaches the low-income households.

The impact of Microfinance on borrowers can be gauged by the fact that over 6 crore women are at present being reached through these small, easily serviceable, collateral free loans, impacting as many as 300 million families. As a result, a vast unbanked and unserved population of India today has access to formal credit even in the remotest districts of India.

For more information about MFIN and its work, please refer to www.mfinindia.org

4 Floor, Emaar Palms Spring Plaza, Sector 54, Golf Course Road
Gurugram 122 003, Haryana
T +91 124 457 6800 | E contact@mfinindia.org

www.mfinindia.org