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GUEST VIEW

What micro lenders must do to safeguard their customers

It is in the interest of all micro-financiers to pledge adherence to the industry's self-regulatory 'code for responsible lending'

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Microfinance is broadly defined as the delivery of financial services to low-income households to build assets, enhance livelihoods, manage cash flows, and meet social and emergency needs. In India, microfinance is mostly identified with micro-credit, which refers to unsecured small-ticket loans to low-income customers, 99% of whom are women. These loans are given under a joint-liability model, where group members, among others, share the responsibility of repayment discipline and the risk of default.

The micro-credit industry in India has come a long way since its inception. Inspired by the success of the Grameen Bank model in Bangladesh, it started out in the 1990s with small but influential entrepreneurial efforts of non-profit organizations, which offered unsecured micro-credit to women in joint-liability groups. The group model pooled social collateral and small loans to grant the benefits of minimizing risk and optimizing costs, which are essential conditions for financial intermediation. In the 2000s, many of these entities began converting into for-profit, regulated companies in their quest for scale, professionalism and capital. Many new entrants followed their path.

This transition catalysed India's global leadership of micro-credit in terms of outreach (largest customer base with smallest loan sizes), commercialization, efficiency (lowest costs) and standards (transparency, code of conduct, credit bureaus). Today, the industry reaches over 50 million low-income women customers across 600 districts, with an average loan size of ₹30,000 and aggregate loan outstanding of ₹2 trillion, as estimated.

Behind this success of micro-credit, however, lies a chequered past. The interests of some customers have been compromised in the single-minded pursuit of scale and profits by lenders with an inadequate focus on the well-being of borrowers. Off and on, the micro-credit industry in India has seen some customers misinformed, overcharged, and left over-leveraged beyond their repayment capacity and need. Such episodes have led to dire outcomes for borrowers and exposed the industry to enormous reputational, political and credit risks. Therefore, from all perspective, safeguarding customer interests is critical.

In recognition of the need to protect customers of micro-credit in a new way, in 2011, the Reserve Bank of India (RBI) came out with comprehensive regulations on micro-credit with "master directions" for non-banking financial company-microfinance institutions (NBFC-MFIs), which covered market segments, products, leverage limits, pricing and the interface with customers.

With this framework, the industry, through its ingenuity and diligence, has tapped the vast demand for credit in low-income market segments, and expanded at a phenomenal 38% compounded annual growth rate over the past seven years. In the past four years, the industry also started joining the broader financial sector. Some of the largest NBFC-MFIs became banks or small finance banks (SFBs), while some others were bought over by banks and large NBFCs. Banks and NBFCs also started building their own micro-credit portfolios, through business correspondent partnerships. Due to this mainstreaming, the micro-credit sector today is competitive and served by a diverse set of players.

Still, the sector poses a unique challenge to the principles of customer well-being. Under the current regulatory framework, micro-credit-specific rules from the perspective of customer well-being are only defined for NBFC-MFIs, because when this regulation was framed, these were the only source of supply. But now micro-credit is offered by banks, SFBs and NBFCs as well, and these rules do not apply to them. The problem with this is that lenders follow different sets of rules on total indebtedness, number of lenders, etc., even though they cater to the same set of customers with similar products. The lack of uniform customer-protection regulations across all such lenders creates systemic risk for the industry, undermines the well-being of customers and, thus, threatens the very basis of micro-credit.

Aware of this, lenders in the micro-credit industry have come together to voluntarily adopt a Code of Responsible Lending (CRL) and to pledge their adherence to five globally-acceptable, customer-protection principles, namely, fair interaction, suitability, transparency, privacy and grievance redressal. In the specific context of micro-credit, they have agreed to follow caps on total indebtedness (₹1 lakh) and multiple lenders (three) per customer, and maintain discipline on the submission of data to information commissioners.

What makes this act of "self-regulation" even more special is its monitoring mechanism, by which independent data from a credit bureau will be used to measure a lender's adherence to key norms of the Code and certify them with a "Responsible Lender" stamp. It is facilitated by industry bodies, MFIN and Sa-Dhan (industry bodies for the micro-credit industry and RBI-recognized self-regulatory organizations of NBFC-MFIs) and FIDC (industry body for NBFCs), and will be guided and overseen by a steering committee representing banks, SFBs, NBFC-MFIs and NBFCs. So far, 98 lenders, representing over 60% of the micro-credit business, have committed to implementing the CRL.

Low-income customers have fragile financials and ill-suited credit can worsen their vulnerability. By adopting the CRL, the micro-credit industry has made customer well-being its foremost priority. In the true spirit of self-regulation, the code offers a blueprint for profit with prudence. The customer is at the heart of this initiative, the very reason why micro-credit was born. The success of this collective action now calls for a firm commitment by all lenders.

QUICK READ

Micro-finance has been a huge success in India, with over 50 million customers who're mostly women and total advances estimated at ₹2 trillion.

However, given the lack of uniform regulation and how the interests of the low-income customers have been compromised at times, it's for micro-lenders to adopt a strict code of ethical conduct.

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Micro-finance has been a huge success in India, with over 50 million customers who're mostly women and total advances estimated at ₹2 trillion **(Photo: Mint)**

Opinion | What micro lenders must do to safeguard their customers

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Sugandh Saxena

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