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RBI MICROFINANCE PROPOSALS THAT ARE ANTI-POOR

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

In June 2021, the Reserve Bank of India (RBI) published a "Consultative Document on Regulation of Microfinance". While the declared objective of this review is to promote the financial inclusion of the poor and competition among lenders, the likely impact of the recommendations is unfavourable to the poor. If implemented, they will result in an expansion of microfinance lending by private financial institutions, in the provision of credit at high rates of interest to the poor, and in huge profits for private lenders.

The consultative document recommends that the current ceiling on rate of interest charged by non-banking finance company-microfinance institutions (NBFC-MFIs) or regulated private microfinance companies needs to be done away with, as it is biased against one lender (NBFC-MFIs) among the many (commercial banks, small finance banks, and NBFCs). It proposes that the rate of interest be determined by the governing board of each agency, and assumes that "competitive forces" will bring down interest rates. Not only has the RBI abandoned any initiative to expand low-cost credit through public sector commercial banks to the rural poor, the bulk of whom are rural women (as most loans are given to members of women's groups), but, in addition, it also proposes to de-regulate the rate of interest charged by private microfinance agencies.

According to current guidelines, the 'maximum rate of interest rate charged by an NBFC-MFI shall be the lower of the following: the cost of funds plus a margin of 10% for larger MFIs (a loan portfolio of over 100 crore) and 12% for others; or the average base rate of the five largest commercial banks multiplied by 2.75'. In June 2021, the average base rate announced by the RBI was 7.98%. A quick look at the website of some Small Finance Banks (SFBs) and NBFC-MFIs showed that the "official" rate of interest on microfinance was between 22% and 26% — roughly three times the base rate.

Microfinance is becoming increasingly important in the loan portfolio of poorer rural households. In a study of two villages from southern Tamil Nadu, done by the Foundation for Agrarian Studies, we found that a little more than half of the total borrowing by households resident in these two villages was of unsecured or collateral-free loans from private financial agencies (SFBs, NBFCs, NBFC-MFIs and some private banks).

There was a clear differentiation by caste and socio-economic class in terms of source and purpose of borrowing. First, unsecured microfinance loans from private financial agencies were of disproportionate significance to the poorest households — to poor peasants and wage workers, to persons from the Scheduled Castes and Most Backward Classes. Second, these microfinance loans were rarely for productive activity and almost never for any group-based enterprise, but mainly for house improvement and meeting basic consumption needs.

Our data showed that poor borrowers took microfinance loans, at reported rates of interest of 22% to 26% a year, to meet day-to-day expenses and costs of house repair. How does this compare with credit from public sector banks and cooperatives? Crop loans from Primary Agricultural Credit Societies (PACS) in Tamil Nadu had a nil or zero interest charge if repaid in eight months. Kisan credit card loans from banks were charged 4% per annum (9% with an interest subvention of 5%) if paid in 12 months (or a penalty rate of 11%). Other types of loans from scheduled commercial banks carried an interest rate of 9%-12% a year. As even the RBI now recognises, the rate of interest charged by private agencies on microfinance is the maximum permissible, a rate of interest that is a far cry from any notion of cheap credit.

The actual cost of microfinance loans is even higher for several reasons. First, on account of the method of repayment: a loan of, say, 30,000 from an NBFC-MFI has to be repaid in 24 equal monthly instalments of 1,640. Every month, a principal of 1,250 and an interest of 390 is repaid. In the first month, the simple interest on this loan is 15.6% per annum but by the end of the first year, the interest rate is 31%. This is because every month the principal is reduced (by 1,250) but the interest charge is the same. In short, an “official” flat rate of interest used to calculate equal monthly instalments actually implies a rising effective rate of interest over time.

In addition, a processing fee of 1% is added and the insurance premium is deducted from the principal. As the principal is insured in case of death or default of the borrower or spouse, there can be no argument that a high interest rate is in response to a high risk of default.

Does the borrower understand this mechanism? In line with RBI regulations, we found that all borrowers had a repayment card with the monthly repayment schedules. On their regular visit, the loan collector would tick off the instalment paid. This does not mean that borrowers understood the charges.

Further, contrary to the RBI guideline of “no recovery at the borrower’s residence”, collection was at the doorstep. Note that a shift to digital transactions refers only to the sanction of a loan, as repayment is entirely in cash. Many borrowers said the debt collector used bad language in a loud voice, shaming them in front of their neighbours.

If the borrower is unable to pay the instalment, other members of the group have to contribute, with the group leader taking responsibility. In our survey, there was no organic connection of microfinance to any group activity or enterprise. As an agent of a NBFC-MFI told us, “we have used the groups formed earlier for other activities solely to show that we lend to a group”.

While microfinance lending has been in place since the 1990s, what is different about the recent phase of growth of financial services is that the privately-owned for-profit financial agencies are “regulated entities”. In fact, they have been promoted by the RBI. Lending by small finance banks (SFBs) to NBFC-MFIs has been recently included in priority sector advances. And, post-COVID-19, the cost of funds supplied to NBFC-MFIs was lowered, but with no additional restrictions on the interest rate or other parameters affecting the final borrower.

In the 1990s, microcredit was given by scheduled commercial banks either directly or via non-governmental organisations to women’s self-help groups, but given the lack of regulation and scope for high returns, several for-profit financial agencies such as NBFCs and MFIs emerged. By the mid-2000s, there were widespread accounts of the malpractices of MFIs (such as SKS and Bandhan), and a crisis in some States such as Andhra Pradesh, arising out of a rapid and unregulated expansion of private for-profit micro-lending.

The microfinance crisis of Andhra Pradesh led the RBI to review the matter, and based on the recommendations of the Malegam Committee, a new regulatory framework for NBFC-MFIs was introduced in December 2011. A few years later, the RBI permitted a new type of private lender, SFBs, with the objective of taking banking activities to the “unserved and underserved” sections of the population.

Today, as the RBI’s consultative document notes, 31% of microfinance is provided by NBFC-MFIs, and another 19% by SFBs and 9% by NBFCs. These private financial institutions have grown exponentially over the last few years, garnering high profits, and at this pace, the current share of public sector banks in microfinance (the SHG-bank linked microcredit), of 41%, is likely to fall sharply.

The proposals in the RBI's consultative document will lead to a further privatisation of rural credit, reducing the share of direct and cheap credit from banks and leaving poor borrowers at the mercy of private financial agencies. This is beyond comprehension at a time of widespread post-pandemic distress among the working poor. The All India Democratic Women's Association, in its response to this document, has raised concerns about the implications for women borrowers and demanded that the rate of interest on microfinance not exceed 12% per annum. To meet the credit needs of poorer households, we need a policy reversal: strengthening of public sector commercial banks and firm regulation of private entities.

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