RBI releases consultative document on MFI regulations

On 14 June 2021, the Department of Regulation of the Reserve Bank of India published a consultative document on the regulation of microfinance

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With the stated objectives of:

- **Protecting borrowers from over-indebtedness**
- **Reducing interest rates through competitive market forces**
- **Empowering borrowers to make informed decisions**

The RBI has a comprehensive regulatory framework for NBFC-MFIs, but it has identified concerns from the market that has called for action to review these regulations:

1. The current regulations are applicable only to NBFC-MFIs, which hold just 30% of the total microfinance loan portfolio (September 2020, Q-MF, Sa-Dhan).
2. Microfinance lenders are still susceptible to over-indebtedness through access to multiple loans from non-NBFC-MFI lenders who do not have a similar restriction on the number of loans or total amount lent to a single borrower.
3. While interest rate ceilings are defined for NBFC-MFIs based on their cost of funds, the other lenders in the market are not. This has led other lenders to set their rates at similar levels despite lower cost of funds, since there is not enough active competition force in the market.

These concerns have led the RBI to evaluate the introduction of lender agnostic, activity-based regulation in the microfinance sector.

What changes are proposed to be applicable to all RBI-regulated entities?

- Common definition of microfinance loans:
  - Collateral-free loans disbursed to a borrower with household annual income not exceeding INR 1,25,000 in Rural household and INR 2,00,000 in urban/semi-urban households can be classified as microfinance loans.
- Regulated entities need to have a Board-approved policy for household income assessment.
- Payment of interest and repayment of principal for all outstanding loan obligations of the household should not exceed 50% of the household income.
- Repayment frequency (weekly/fortnightly/monthly) shall be left to the borrower's preference.
- Simple and transparent pricing:
  - Only an all-inclusive interest rate shall be charged to the borrower. The pricing-related information needs to be disclosed in a standard simplified factsheet. The lender must display minimum, maximum, and average interest rates charged on their microfinance loans.
- The lender shall not charge any pre-payment penalty.

What changes are proposed to be applicable to NBFC-MFIs?

- While NBFCs have a minimum NOF requirement of INR 2 core, RBI had a differential approach with regards to the minimum NOF requirement for NBFC-MFIs – present requirement being INR 5 crore (unless the entity is registered in the North-Eastern region, in which case the requirement is INR 2 core).

  In January 2021, RBI proposed raising the Minimum Net Owned Funds (NOF) requirement for NBFCs from INR 2 crore to INR 20 crore. Now it is also under consideration if a similar differential approach should continue for the minimum NOF requirement by NBFC-MFIs or is INR 20 crore an appropriate requirement?
- Since the repayment amount (and hence the loan amount) is linked and capped with the household income, the requirement for limits on loan amount and minimum tenure shall be withdrawn.
- Limits regarding minimum 50% of loans for income generation purpose, which are presently applicable only to NBFC-MFIs, shall be withdrawn.
- Limit of lending by only two NBFC-MFIs to a borrower shall also be withdrawn.
- Withdrawal of all pricing-related instructions applicable to NBFC-MFIs:
  - Board of each NBFC-MFI shall adopt an interest rate model considering relevant factors such as cost of funds, margin and risk premium and determine the rate of interest to be charged for loans and advances.
  - The rates of interest and the approach for gradation of risks shall also be made available publicly through their websites or other mediums. The rate of interest must be annualised rate.
- NBFC-MFIs shall mention the penal interest charged for late repayment in bold in the loan agreement.

What does all this mean for the microfinance loan borrowers?

Standardisation of requirements (driven by regulations) across multiple lending sources that are RBI-regulated entities.

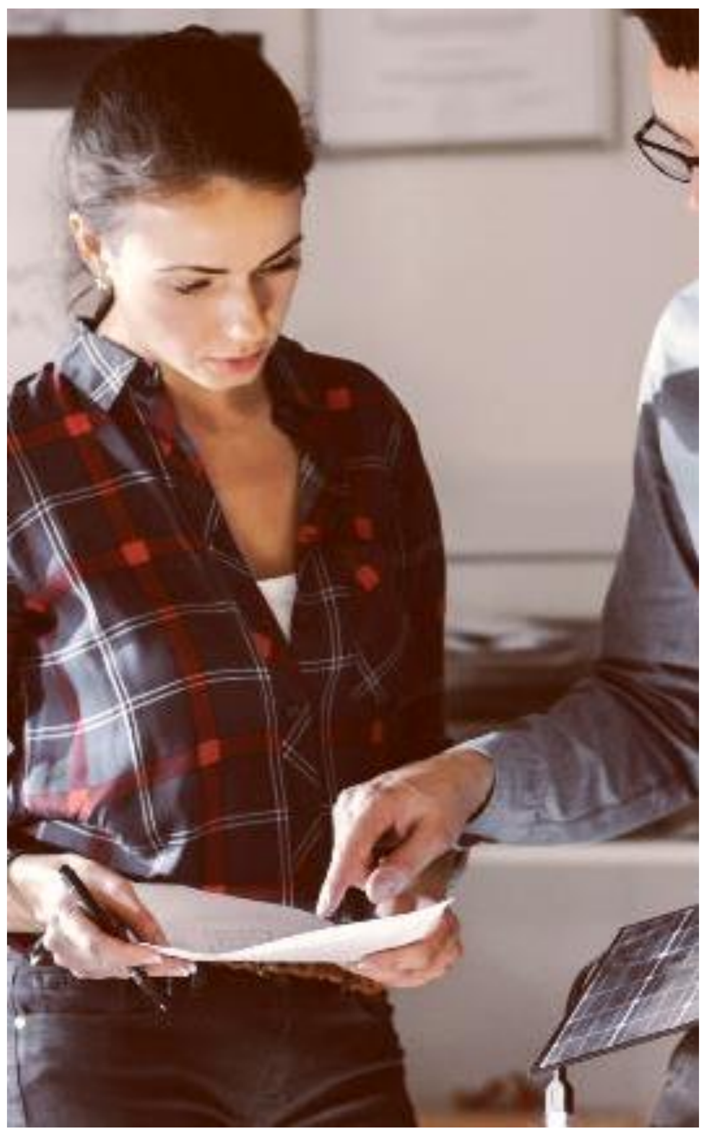
Borrowers having access to larger lending organisations shall potentially enjoy lower interest rates than the currently prevalent rates. Alternatively, lenders might charge higher interest rates, especially in remote locations with limited market options for borrowers since the interest cap shall be removed.

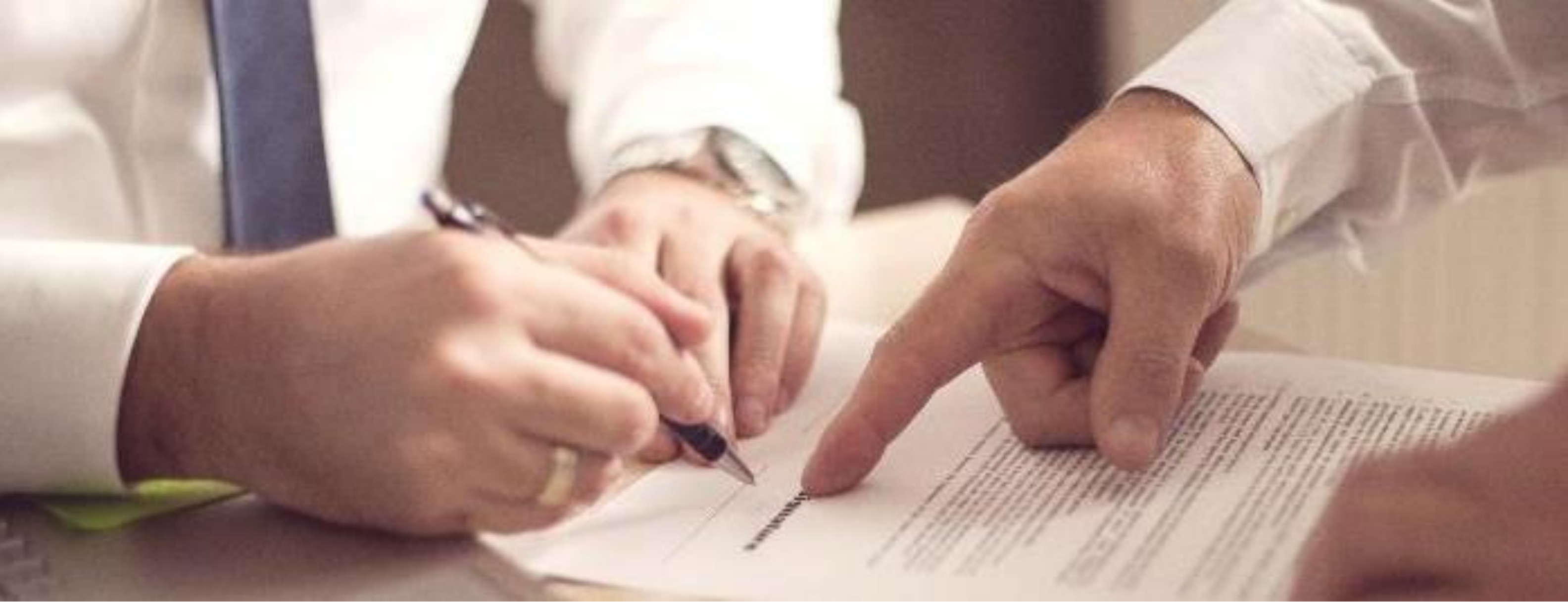
Ability to choose the periodicity of repayment based on their income pattern and requirements even when borrowing from any RBI regulated entities.

A simplified one-page disclosure having all the relevant information on the pricing of loans shall be available for the borrowers, to help them make a more informed decision.

Borrowers cannot be penalised for pre-payment of microfinance loans by any RBI-regulated entity.

Borrowers need to be cautious of penal interest charges on late repayment even on loans from NBFC-MFIs.





What does all this mean for the microfinance lenders?

These proposals aim to encourage more competition-driven pricing in the market, thereby driving organisations such as banks and large MFIs having economies of scale to reduce their interest rates to stay competitive.

All regulated entities shall be required to devise a mechanism/framework to efficiently assess household incomes of their customers. This could pose a significant challenge to many organisations, given the lack of structured or digital data available in this regard for this customer group.

With the repayment burden capped as 1% of the household income (which again is capped under the definition of microfinance loans), the pricing strategy for microfinance loans needs to be re-designed by financial institutions to balance the ticket size, tenure, and interest rates.

With the repayment burden on a household being capped at 50% of its income, regulated entities (other than NBFC-MFIs) that handled large ticket sizes under their microfinance portfolio, shall potentially be required to restructure their asset portfolio to continue servicing such customers by moving them from microfinance portfolio to other Priority Sector Lending (PSL) products. NBFC-MFIs shall find it difficult to retain customers who require higher ticket size loans and have higher household income levels than the prescribed limit.

Under the current regulations, NBFC-MFIs are not permitted to charge any penalty for delayed payment. As per the proposed framework, NBFC-MFIs can charge penal interest on late repayments after mentioning them in bold in the loan agreement.

Our point of view

The proposals put forth by RBI in the discussion note is with the borrower's interest at heart and to ensure that the regulations meant for microfinance loans are made applicable to all regulated entities operating in the space, instead of just the NBFC-MFI which holds just 30% of India's microfinance loan portfolio.

While the proposal shall have a positive impact, there could also be few inadvertent consequences that must be taken into consideration. The benefit themes targeted by RBI through these proposed changes are:

1 Protecting borrowers from over-indebtedness

The current MFI regulation (applicable only for NBFC-MFIs) caps the total indebtedness of a microfinance borrower at an absolute value of INR 1,25,000 and this ceiling was applicable only to loans availed from NBFC-MFIs. This poses two major risks:

a. A borrower could potentially source up to INR 1, 25,000 from NBFC-MFIs even when his/her household's repayment capacity is insufficient.

b. A borrower could source additional debt from entities other than NBFC-MFIs.

These risks could drive microfinance borrowers to over-indebtedness.

The proposed framework seeks to ensure that the repayment burden on a microfinance borrower is not more than 50% of his/her household income and extends the purview of these regulations to all RBI-regulated entities (RE). With this, the regulator is ensuring that despite the burden of microfinance debt from any RE, a household shall be left with at least 50% of its income to meet their basic needs.

With the emphasis on the repayment burden (and hence the loan amount) being linked to the household income, the borrowers shall not be left with any motivation to understate their household income levels, since it shall only limit their access to credit. Now with borrowers, who potentially could have been understating their household income to qualify for microfinance loans from NBFC-MFIs shall move out of the definition of microfinance loans.

The impact of such a change needs to be understood from two perspectives:

a. For NBFC-MFIs

Since the NBFC-MFI entities have a strict cap on the non-MFI loans that they are allowed to offer, they will find it difficult to retain customers whose household income is now reported accurately thus taking them above the defined limits in the proposed framework.

For an NBFC-MFI who is effectively improving the livelihood of their customers, they shall eventually lose the customers as their household income increases along with their credit requirement.

Customers whose household income is not rising beyond the set limits can continue to avail credit from NBFC-MFI entities but with restrictions on the total repayment burden being less than 50% of their household income (and hence the loan ticket size).

b. For regulated entities other than NBFC-MFIs

For such regulated entities, a large portion of their current loan portfolio which were large ticket microfinance loans shall not continue to qualify under the microfinance loan definition. Since, these entities can offer alternate products under Priority Sector Lending, they can continue to service these customers having household income over the limits defined in the proposed MFI framework. While this would lead to a significant shift in the classification of loans with a significant depletion expected on the assets tagged as microfinance loans.

Since household income is a crucial element of the proposed framework, it would be advisable for the RBI to define the guidelines on accurate and efficient estimation of household income, to avoid possibility of over-estimation of the household income by lenders to disburse larger loan amounts.

This shall ensure a level playing field for financial institutions and leave minimum room for 'creativity' in income assessment.

Additionally, the need for differential limits on rural and urban household income limits to qualify for microfinance loans should be reconsidered now that the repayment burden is directly linked to household income level. Considering the difference in cost of living in urban and rural regions, the RBI could consider setting a uniform value cap on household income level to qualify for microfinance loans and a differential cap as a per cent of household income for outstanding loan obligations.

2 Reduce interest rates through competitive market forces.

In a market where there are multiple alternatives, there is a strong possibility of institutions moderating their interest rates to gain a competitive advantage, thus bringing down the interest rates for microfinance borrowers.

With the current model of operations, microfinance lending/borrowing has a dependency on geographic coverage. Since access to microfinance credit is dependent on the geographic presence of lenders, borrowers in remote locations are left with limited options. With limited competition and absence of a rate ceiling, there is a possibility of lenders increasing interest rates instead of reducing it in such areas.

Given that India has the second-largest unbanked population in the world (estimated to be 19 crore in 2018) and the geographic profile of microfinance borrowers in India today, a large share of these borrowers shall potentially be exploited.

As per the proposed framework, NBFC-MFIs can charge penal interest on late repayments after mentioning them in bold in the loan agreement. This shall help these entities, who are currently not allowed to charge any penalty on delayed payments, to ensure borrowers repay on time or else receive additional interest on such delayed payments.

3 Empowering borrowers to make informed decisions.

With the added emphasis on disclosure of rates of interest and gradation of risks, terms and conditions including the disbursement schedule and all relevant charges in vernacular language, there shall be more transparency and clarity in the information conveyed to microfinance borrowers, thus helping them in making better informed decisions.