REGULATORY PRESCRIPTIONS

Microfinance: misunderstood, Malegamed

The Malegam panel's report disappoints not only in its inability to meet expectations, but also on fundamentals

COMMENTARY

By M.S. Sriram
feedback@livemint.com

A generally beleaguered microfinance industry was eagerly waiting for Yezdi Malegam for deliverance. Any conversation about the microfinance business would end with the expectation that the Malegam committee would deliver a healthy dose of oxygen to the choking microfinance industry. The report was expected to be the panacea for all that ails microfinance in India.

The report, which came out on Monday, disappoints not only in its inability to meet these expectations, but also on fundamentals. While each one of the recommendations may have merit when seen in isolation, together they are a lethal combination. It is difficult to accept that the collective wisdom of Malegam, Shashi Rajagopalan, an expert in cooperatives; **Aditya Birla Group** head Kumar Mangalam Birla; Reserve Bank of India (RBI) deputy governor K.C. Chakrabarty and former chief of India's space research organization U.R. Rao could have delivered this blow to the microfinance sector in the country.

First, the good things in the recommendations: The committee suggests retaining priority sector status for the microcredit business; keeping microfinance institutions (MFIs) out of the Moneylenders Act; keeping the regulatory role with RBI instead of state governments; enhancing the role of RBI in supervision; and engaging with industry associations on an ongoing basis.

However, there are several problems with the report. Chakrabarty, during his brief tenure as the central banker in charge of rural credit, provided progressive measures for financial inclusion in the banking sector by suggesting two radical steps in the rather conservative atmosphere of RBI—the first was to remove licensing requirements for opening branches in towns with a population less than 50,000 people; the second was to remove the interest rate cap on all loans as the base rate regime kicked in. The only area where there were some controls on interest rates was in the case of politically sensitive agricultural loans. As a member of the Malegam committee, he has signed off on a report that puts a cap on microfinance interest rates at 24%, without dissent. The question is not whether 24% is an appropriate cap; it is more about the principle.

RBI has taken bold steps in the banking sector; no other non-banking financial company (NBFC) has an interest rate cap; but the Malegam committee has moved one step backward in even thinking of such a measure. Even the dreaded Andhra Pradesh ordinance, which has no interest rate cap, looks better on this count.

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Little reason to smile? *A file photo of borrowers availing microfinance services in Tiruchirapalli, Tamil Nadu. According to the Malegam committee recommendations, the borrower should be eligible for a microfinance loan only if his or her household income is less than ₹50,000 per annum.*

According to the committee, the borrower should be eligible for a microfinance loan only if his or her household income is less than ₹50,000 (translating into an average household income of less than ₹140 per day). So, if a household crosses the threshold of full employment at a minimum wage for one person, none of its members can qualify for a microfinance loan. It does not take a supercomputer to arrive at the per capita income of an average household that is eligible for a microfinance loan.

For a moment, let us agree that the interest rate should be capped at 24% (this was the number that the finance ministry had advised the banks to put as end-use conditionality). Having put an upper limit on the interest rate, the committee has also decided to be careful to ensure that some MFIs do not make excessive profits and put a 10% cap on the difference between average borrowing cost and lending rate, thereby providing no incentive to companies in the business to push efficiency if the average cost of funds is less than 14%. (There is also a mention of 12% spread for small MFIs with a book size of less than ₹100 crore, but that is rendered almost irrelevant by the clause below.)

Then, the committee comes to the issue of who can lend to the poor. Using some strange calculations, the panel has indicated that only those who have a net worth of more than ₹15 crore should be dealing with the poor. This figure is higher than what was required of a local area bank, which was ₹5 crore, specified at the time when the net-owned funds requirements for NBFCs was hiked to ₹2 crore (circa 1997, when it was increased from a silent nil amount to ₹25 lakh for existing institutions and ₹2 crore for new NBFCs).

It is okay if you have a net worth (actually net-owned funds) of just ₹2 crore to be a truck financing firm or a leasing company or a lending firm. But being in the business of microfinance needs much more capital, based on a calculation of what a decent sized MFI is and does. The committee's calculation seems based on its sense that an MFI with a book size of ₹100 crore would need a capital of ₹15 crore and, ergo, this needs to be the minimum capital requirement. There would appear to be no other argument for this number, which makes a random appearance in the report.

In addition, the report has some other interesting recommendations. It says the microfinance industry association would need to have at least one-third of the registered entities in the business as members to be recognized and to engage in dialogue with the regulator. It says that 90% of the loans should not be of a ticket size of more than ₹25,000 (assuming the borrower is solely borrowing from the MFI) for those entities that wish to be classified as an NBFC-MFI. And it adds that for other MFIs, not more than 10% of the portfolio should be "microfinance". So, if you are anywhere between these numbers, nobody knows what will happen to you, but you are probably illegal!

The cap of ₹25,000 is further qualified by how the committee suggests the loan be sliced. It says not more than 25% should be given for non-income generating loans. This would mean a loan cap of ₹6,250 from all sources at all times on microloans for consumption, education, social expenses all bundled together. Indeed, the cap of ₹25,000 itself contradicts an old RBI notification that exempted not-for-profit companies registered under section 25 of the Companies Act and issuing loans of less than ₹50,000 from the requirements of registration as an NBFC.

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So, how many steps backward is the current recommendation?

The panel also has some suggestions on protecting the customer's interests. One of these is an interesting formulation on how the instalments would be structured. Any loan of more than ₹15,000 (and of course less than ₹25,000, which is the ceiling) will have to be necessarily structured for at least 24 months. Any lending of more than ₹25,000 will not be eligible for repayment till the overall liability is reduced to ₹25,000. And, there is a clause that a customer can borrow from no more than two microfinance sources.

It is indeed surprising that this report is coming from a sub-committee of the RBI board. From 1991 onwards, we have seen progress in the regime and here is a committee trying to control all that can be controlled. The loan size, the income of the borrower, the amount they can borrow for income generation and consumption, the overall indebtedness, the tenor of the loan, the period of moratorium, the membership for an association to be considered a representative of the industry...what else is there left that can be regulated? Does the committee take the role of RBI as a "regulator" literally, in that it regulates everything?

One of the concerns that led to the formation of the committee was that microfinance companies were profiteering from the poor and not treating them with dignity. As a central banker, a more non-invasive way of addressing the issue would have been in controlling the capital flow to these institutions both through the nature of equity investments and through the banking system, thereby giving the market an opportunity to experiment and provide diversity of services, improving transparency and enforcing a customer responsibility code. If the banking sector, the auto finance sector and the housing finance sector have plurality of institutions (and no loan size and interest rate caps and definitions of moratoriums) with the central bank stepping in whenever it seems to think a larger customer interest is involved (as it did in the case of teaser rates offered by housing finance companies), we see no reason why the same principles should not be applied to the poor. Dealing with poverty does not mean restricting choices and giving people what we think is good. Dealing with poverty means trying to give the poor as much dignity and diversity of choices that the non-poor enjoy. The report defies the plurality of institutions and choices. The Andhra Pradesh ordinance (as recommended by the sub-committee) can lapse because the panel has effectively completed the task that was started by the state government.

For not having abdicated the responsibility to supervise and inspect MFIs that have shown poor governance and indifferent behaviour towards customers, this antidote by the RBI committee appears populist and misplaced in what should be controlled and what should not be.

M.S. Sriram is an independent researcher based in Bangalore.

This is the first in a series of critiques on the Malegam committee report.