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ho2099@sib.co.in

November 2014

Theme 276

MICROFINANCE SECTOR

A monthly publication from South Indian Bank

23rd Year of Publication

SOUTH INDIAN Bank
Experience Next Generation Banking
The South Indian Bank Ltd., H.O. : 'S.I.B. House', Thrissur, Kerala

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NOVEMBER 2014

Theme No. 276 : Microfinance Sector

A well informed customer will make the policy makers as well as organisations which produce goods and services more responsive to the customer needs. This will also result in healthy competition among organisations and improve the quality of goods and services produced.

The "SIB Students' Economic Forum" is designed to kindle interest in economic affairs in the minds of our younger generation. We highlight one theme in every monthly meeting of the "Forum". This month we discuss on the Microfinance Sector and the key recommendations to resolve the issues and strengthen the functioning of Micro finance Institutions.

What do you know about the Malegam committee?

The Reserve Bank of India set up a Sub-Committee of its Central Board of Directors to study the issues and concerns in microfinance sector, under the Chairmanship of Shri Y H Malegam, a senior member on the Reserve Bank's Central Board of Directors. The major purpose was to look into the accusations of fleece and use of coercive practices by Micro finance Institutions (MFIs) and the series of suicides in the state of Andhra Pradesh. The MFIs were performing well in the state, but due to the accusations, the state government had to take strict measures to control them which slowed down the recovery process and led to serious fiscal imbalances in the sector. The banks were not coming forward to help the MFI sector to tide over the serious mismatches that arose due to short recovery of loan instalments. In order to examine the setbacks faced by the sector, due to high interest rates, coercive recovery processes and multiple lending by some institutions in the state, RBI appointed the committee. The committee was asked to resolve these issues and suggest measures to strengthen and streamline the functions of the sector.

What are the key recommendations of the committee?

The Malegam committee submitted the following key recommendations in their report.

1. Create separate category of NBFCs operating in the microfinance sector.
2. Set individual loan ceiling of Rs.25,000 to single borrower
3. Cap MFIs from charging more than 24 percent from borrowers.
4. Limit lending to the same borrower by 2 MFIs
5. Set up Credit Information Bureau for MFIs.

What was the suggestion of the committee on setting up of exclusive NBFCs?
The committee has suggested setting up a separate category of NBFCs to provide financial services to low-income borrowers and exempting them from the provisions of Money-Lending Acts. The new type of NBFC may be set up as a company in the form NBFC-MFI, which satisfies the specified regulations. The company is to provide financial services pre-dominantly to low income borrowers, with loans and small amounts, for short terms, on unsecured basis, mainly for income generating activities, with repayment schedules that are more frequent than those normally stipulated by commercial banks. The committee clearly indicates that those which do not qualify as NBFC-MFI would not be permitted to give loans to the microfinance sector, which in the aggregate exceed 10 percent of its total assets. Regarding the annual income of the family of borrowers, the committee suggests that an NBFC classified as NBFC-MFI can extend finance only to those whose family income does not exceed Rs.50,000.

The Sub-Committee has also recommended some additional qualifications for NBFC to be classified as NBFC-MFI. These are:

1. The NBFC-MFI will hold not less than 90% of its total assets (other than cash and bank balances and money market instruments) in the form of qualifying assets.
2. The individual ceiling on loans to a single borrower of Rs.25,000.
3. Not less than 75% of the loans given by the MFI should be for income-generating purposes.
4. There is a restriction on the other services to be provided by the MFI which has to be in accordance with the type of service and the maximum percentage of total income as may be prescribed.

What was the recommendation on the size of individual loans?
Earlier there was no ceiling on individual loans to a single borrower. But the committee viewed that excess borrowings by the individual borrower without making any realistic assessment of the actual requirement, led to over financing and excessive interest burden to the borrowers. In order to address this, the committee suggested a ceiling on loans to a single borrower at Rs. 25,000.

What is the minimum capital requirement prescribed for the NBFC-MFI?
The committee suggests that MFIs with an outstanding credit portfolio of less than Rs.50crore should maintain a minimum net worth of Rs.15crore. The net worth so maintained should be in tier -1 form.

What was the proposal on interest rates and total charges?
The Malegam committee was very critical on the high interest rates charges by MFIs.

The recommendation is to cap the interest rate charged by MFIs at 24% and to implement the same effectively to all loans provided by MFIs after March 31, 2011. The committee has suggested an average net interest margin cap of 10% and 12%. Net interest Margin is the difference between the borrowing cost and lending cost. The MFIs with loan portfolio of Rs.100crore has to cap the margin at 10% and smaller ones at12%. The committee was of the view that there is no transparency in levying of the various charges by the MFIs. The unethical way of levying charges has aggravated the high interest burden on the loans. The Sub-Committee has recommended that bank lending to NBFCs which qualify as NBFC-MFIs will be entitled to "priority lending" status on individual loans. It has also proposed that, in the interest of transparency, an MFI can levy only three charges, namely, (a) processing fee (b) interest and (c) insurance charge.

What are the recommendations to mitigate the problems of multiple lending?
The Sub-committee has made a number of recommendations to mitigate the problems of multiple-lending, over borrowing, ghost borrowers and coercive methods of recovery.

1. A borrower can be a member of only one Self-Help Group (SHG) or a Joint Liability Group (JLG)
2. Not more than two MFIs can lend to a single borrower
3. There should be a minimum period of moratorium between the disbursement of loan and the commencement of recovery
4. The tenure of the loan must vary with its amount
5 A Credit Information Bureau has to be established
6. The primary responsibility for avoidance of coercive methods of recovery must lie with the MFI and its management
7. RBI must prepare a draft Customer Protection Code to be adopted by all MFIs
8. There must be grievance redressal procedures and establishment of ombudsmen
9. All MFIs must observe a specified Code of Corporate Governance

Under the proposed Micro Finance (Development and Regulation) Bill 2010, the committee has recommended that all entities covered by the Act should be registered with the proposed regulator, RBI or NABARD as the case may be. However, entities whose aggregate loan portfolio, including the portfolio of associated entities, does not exceed Rs. 10crore, may be exempted from registration. For monitoring compliance with regulations, the Sub-Committee has proposed a four-pillar approach with the responsibility being shared by (a) MFI (b) industry associations (c) banks and (d) the Reserve Bank.

While reviewing the proposed Micro Finance (Development and Regulation) Bill 2010, the Sub- Committee has recommended that entities governed by the proposed

Act should not be allowed to do business of providing thrift services. It has also suggested that NBFC-MFIs should be exempted from the State Money Lending Acts and also that if the recommendations of the Sub-Committee are accepted; the need for the Andhra Pradesh Micro Finance Institutions (Regulation of Money Lending) Act will not survive.

The Sub-Committee has cautioned that while recognising the need to protect borrowers, it is also necessary to recognise that if the recovery culture is adversely affected and the free flow of funds in the system interrupted, the ultimate sufferers will be the borrowers themselves as the flow of fresh funds to the microfinance sector will inevitably be reduced. The responsibility to ensure that coercive methods of recovery are not used should rest with MFIs . The managements should be subject to severe penalties, if such methods are used.

What is the present state of MFI sector?

The Finance Minister has called upon the MFI sector to work with the Government for Financial inclusion to provide financial services to the poor. He stated that the Government's role is to provide both an enabling policy framework and funds for the sector's growth. The proposed MFI (Development & Regulation) Bill would provide policy support and guidelines for the healthy development of the sector. MFIN (Microfinance Institutions Network) is of the view that RBI should allow NBFC-MFIs to become Business Correspondents (BCs) and open savings accounts on behalf of banks. There are as many as 46 NBFC-MFIs whose combined business accounts for 80% of the Indian MFI sector as the member-organisations of MFIN. Micro-finance Institutions (MFIs) should be given special banking licences to accept small deposits, according to Nobel Laureate Muhammad Yunus. Speaking to newspersons during a global conference, the pioneer of micro-credit in Bangladesh and founder of Grameen Bank said deposits should be used only for micro-lending purposes. "On mobilising funds, tapping capital markets might not be good for micro-lenders as it would put pressure on them to show returns to the investors," he said. When asked on the recent sanction of a banking licence to Bandhan, a Kolkata-based MFI, he said it was good, but a regular banking licence should be differentiated from an exclusive licence for MFIs to collect deposits.

MAJOR IMPACTS OF THE LEGISLATION

1. Fresh Disbursements have come to a standstill

2. The Recovery rate of NBFC-MFI has come down sharply.

3. Non recovery spilling over to other channels including SHGs.

4. Huge disparity in minimum capital requirement among regular NBFC, local area bank and NBFC-MFI.

5. High operating costs and cost of funds may compel MFIs to go for higher size loans which means the poor sections will be left out, thereby defeating the very purpose of MFIs

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