RBI's Microfinance Proposals

What is the issue?

RBI's **Consultative Document on Regulation of Microfinance** which aims to promote financial inclusion of the poor and competition among lenders is likely to unfavour the poor.

To know more about Consultative Document on Regulation of Microfinance, click here

Why is microfinance crucial for rural households?

- Microfinance is becoming increasingly important in the loan portfolio of poorer rural households.
- Unsecured or collateral-free loans from private financial agencies (SFBs, NBFCs, NBFC-MFIs and some private banks) forms the major chunk.
- These loans were of disproportionate significance to the poorest households and to persons from Scheduled Castes and Most Backward Classes.
- These microfinance loans were rarely for productive activity and used mainly for house improvement and meeting basic consumption needs.
- Poor borrowers took microfinance loans, at reported rates of interest of 22% to 26% a year against the low interest offered by institutional mechanisms such as PACS.

Why are microfinance loans costlier?

- **Method of repayment** - An official flat rate of interest used to calculate equal monthly instalments which rises the effective rate of interest over time.
- **Processing fee and insurance premium** – 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, the interest rate is higher in response to high risk of default.

What is different about the recent phase of growth of financial services?

- The privately-owned for-profit financial agencies are regulated entities and are promoted by RBI.
- Lending by small finance banks (SFBs) to NBFC-MFIs has been recently included in priority sector advances
- In the 1990s, given the lack of regulation and scope for high returns, several for-profit financial agencies such as NBFCs and MFIs emerged involving in malpractices.
- The microfinance crisis of Andhra Pradesh led RBI to formulate a regulatory framework for NBFC-MFIs in 2011 based on the recommendations of the Malegam Committee.
- Later RBI permitted SFBs to take banking activities to the “unserved and underserved” sections of the population.
- The RBI’s consultative document notes, 31% of microfinance is provided by NBFC-MFIs, and another 19% by SFBs and 9% by NBFCs.

What will be the implications for the poor?

- The current share of public sector banks in microfinance (SHG-bank linked microcredit) of 41%, is likely to fall sharply.
- This privatisation of rural credit will reduce the share of direct and cheap credit from banks and leave the poor borrowers at the mercy of private financial agencies.
- It has also raised concerns about the implications for women borrowers.
- To meet the credit needs of poorer households strengthening of public sector commercial banks and firm regulation of private entities is needed.

Source: The Hindu