Malegam Committee report on the Microfinance Sector: Is it a new dawn?

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Reserve Bank of India had set up a sub-committee under the chairmanship of Shri Y.H Malegam, to address the several issues concerning the Microfinance Sector and RBI released the report of recommendations by the sub-committee on 19th January, 2011. The sub-committee was to review the scope and objectives of regulations governing MFIs with regard to interest rates, lending and recovery practices, applicability of existing money lending legislations, need for grievance redressal machinery and other issues concerning the sector.

Microfinance industry had recently come under the scanner when the Andhra Pradesh government passed an Ordinance calling the borrowers to stop paying their loans, making it illegal for the micro lenders to ask for weekly repayments and also required them to get a no objection from the local authorities before providing for a second loan to a borrower, bringing a jolting halt to the Rs. 20,000 crore industry in India and exposing the inherent problems in the sector.

Sub-committee recommended creation of a separate category of NBFCs, NBFC-MFIs, providing short term, and unsecured loans to the low income borrowers for income generating activities. Some of the qualifications for NBFC-MFIs are:

1. The NBFC-MFI to 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. The sub-committee also mentions that a non NBFC-MFI cannot have loans to the microfinance sector exceeding 10% of its total assets.
2. Individual ceilings to a loans to a single borrower of Rs.25,000 is applicable.
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.
5. The report recommends all NBFC-MFIs to have a minimum net worth of Rs. 15 crores.

Some of the recommendations of the committee are:

1. A borrower can be a member of only one Self-Help Group (SHG) or a Joint Liability Group (JLG). Not more than two MFIs can lend to a single borrower. Tenure of the loan to vary with amount.
2. There should be a minimum period of moratorium between the disbursement of loan and the commencement of recovery.
3. Problem of ghost borrowers be addressed by sanctioning and disbursement of loans from a central location.
4. A Credit Information Bureau has to be established to avoid multiple lending and over borrowing.
5. The primary responsibility for avoidance of coercive methods of recovery must lie with the MFI and its management. Regulators to monitor, MFIs have a proper code of conduct for field staff for prevention of coercive methods of recovery.
6. The Reserve Bank must prepare a draft Customer Protection Code to be adopted by all MFIs. All MFIs must observe a specified Code of Corporate Governance.
7. There must be grievance redressal procedures and establishment of ombudsmen may be recommended by RBI to lead banks.
8. For loans not exceeding Rs. 15,000, the tenure of the loan should not be less than 12 months and for other loans the tenure should not be less than 24 months, however there would be no preprayment penalty.
9. MFIs can charge insurance premium, interest charges and loan processing fees which should not exceed 1% of the gross loan amount. Also only the actual cost of insurance should only be recovered.
10. To improve transparency in providing loan and MFIs should make borrowers aware of the effective interest rate charged, this would enable comparability.
11. Provisioning of loans should not be maintained for individual loans but an aggregate provision for loan losses should be maintained by the MFIs.
12. Disclosures to be made in the financial statements of MFIs with regard to the outstanding loan pools securitized.
13. **Bank lending to MFIs would continue to be entitled to priority sector status. A cap of 24% is provided for interest on individual loans and an average margin cap of 10% for MFIs having loan portfolio of Rs.100 crores and above and cap of 12% for smaller MFIs.**
14. Sub-committee also recommended that entities governed by the proposed Act, (Micro Finance (Development and Regulation) Bill 2010 should not be allowed to do business of providing thrift services.

The report also recommends that all the recommendations must be accepted and implemented by 1st April, 2011.

The thought behind microfinance is to assist the poor to work their way out of poverty as the traditional sources of funding is not available to them. Microfinance provides easy and cheap access to loans, without the need for collateral. The constraints of catering to this sector are high transaction costs, no understanding of banking amongst the borrowers and need for the lenders to handhold the borrowers for generating income, savings and repayments.

The intent of the report is to ensure that right balance between the pursuit of social objective and interest of shareholder is maintained through responsible financing. MFIs cater to the vulnerable section of the society and are pivotal for achieving financial inclusion. The recommendations of the committee work towards achieving the purpose of financial inclusion in a proper business environment. The pertinent question here is will these recommendations resolve the grappling issued facing the industry today and achieve its purpose of financial inclusion yet being sustainable?