IFMR Research | CENTRE FOR MICRO FINANCE

CMF Policy Memo

Rethinking Reserve Bank of India (RBI) Regulations for MFIs: An analysis of microfinance clients from urban and semi-urban communities.

Introduction

The Microfinance Institutions (Development and Regulation) Bill, if approved, will require Microfinance Institutions (MFIs) to register with the Reserve Bank of India (RBI).[1] This would expand the capacity of the RBI to manage interest rates, set prudential norms, and even ensure fair practices. The RBI has already released specific guidelines regarding the eligibility of microfinance institutions for priority sector lending.[2]

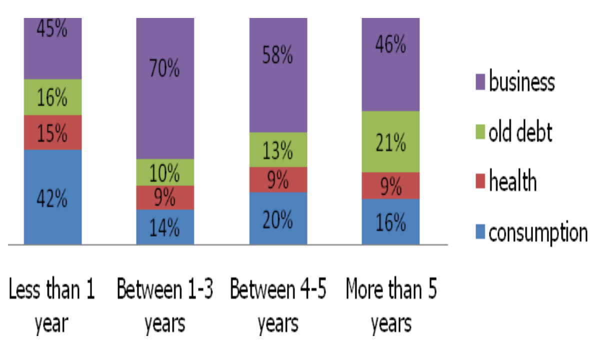
CMF interviewed 928 urban and semi-urban clients to investigate the borrowing and saving practices of existing microfinance clients, inclusion within a formal banking system, and spending patterns in relation to microloans. To some extent, this study tried to understand whether the RBI guidelines regarding the eligibility of microfinance institutions for priority sector lending align with the profiles of microfinance clients. The study was conducted in the states of Karnataka (Bangalore slums, Tumkur), Maharashtra (Satara), Tamil Nadu (South Chennai), Uttar Pradesh (Loni, Gaziabad), and West Bengal (Howrah, North 24 Parganas) between January-March 2012 using a convenience sampling method and thus the selection of the sample of this study is not the representative of the whole population of microfinance clients.

Entrepreneurial activity was not the major source of income for the majority of the households of interviewed clients.

Only 24% of the interviewed clients indicated that the primary source of income for their households was from micro-enterprise activities. 32% of the interviewed clients indicated the wage employment as the main source of income for their households and 42% of clients indicated their households' reliance on multiple sources of income such as wage employment as well as seasonal micro-enterprise activities.

By classification of the sampled clients by the length of MFI membership, we found that the prevalence of entrepreneurship was greatest amongst clients who had been with an MFI for between 1-3 years. Surprisingly, we found that as the age of the membership increased, clients involvement in enterprises decreased (figure 1).

Figure 1



[1] Parliament of India, The micro finance institutions (Development and Regulation) Bill, 2012, As introduced in Lok Sabha, Bill no 62 of 2012. URL: http://164.100.24.219/BillsTexts/LSBillTexts/asintroduced/62_2012_LS_ENG.PDF

[2] Reserve Bank of India, Bank loans to Micro Finance Institutions (MFIs) – Priority Sector status. http://rbidocs.rbi.org.in/rdocs/Notification/PDFs/CIMAC030511.pdf

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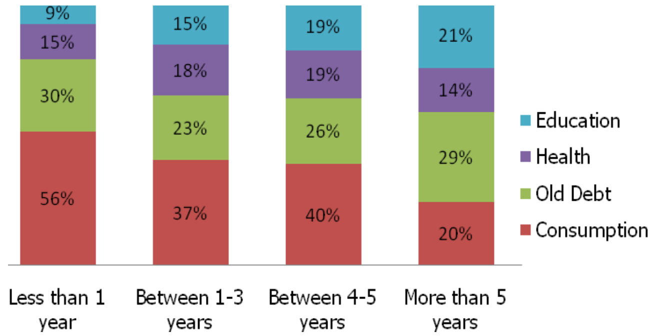
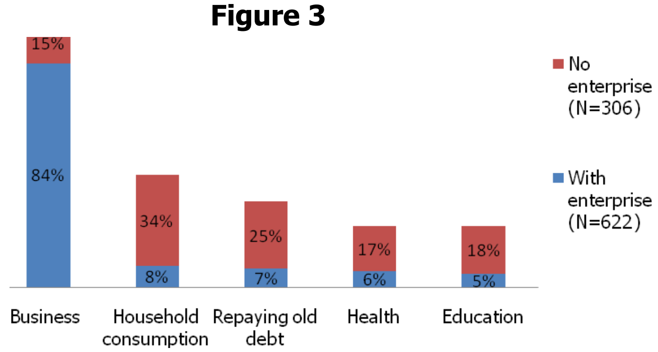
Figure 2



It was found that those interviewed who had been MFI members for longer periods of time had a higher propensity to invest in other areas such as healthcare and education. While considering a sub-sample of those clients without any entrepreneurial activity at the time of survey, we found that the proportion of loans spent on education increased jointly with length of MFI membership (figure 2). Perhaps it is appropriate to note here that health and education are not in all ways different from investment in a purely business activity. While traditional conceptions of microfinance might imagine clients employing microloans for the initial capital needed for their business, it might be argued that healthcare and education are also forms of *human capital* that increase income generation at some point in the future.

It might also be interesting to note that those with already existing businesses were more likely to employ microloans to their business, whereas those without were more likely to spend on other things as depicted in Figure 3.

Figure 3

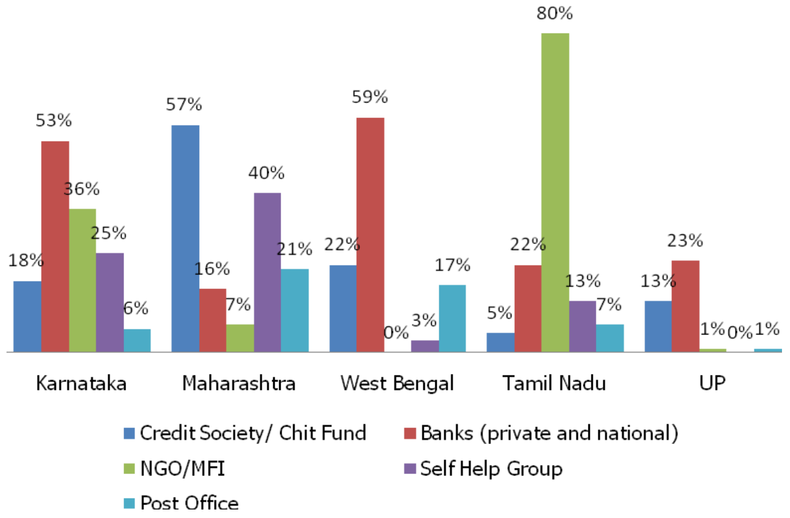


Although a majority of MFI clients had access to a formal banking system, it was not a primary source of credit.

This study found that a majority of interviewed clients (62%) had access to a formal banking system. Despite the prevalence of formal banking amongst the sample, only 11% of those with bank accounts had ever taken loans from formal banks. This was especially striking in the Loni and Gaziabad areas of Uttar Pradesh where only 1% of the sample had ever taken bank loans. The primary reasons clients suggested for not using the bank as a primary source of credit were clients did not require the type of credit that banks provide (30%), clients found application procedures to be complicated (25%) and clients had little knowledge about the products and services provided by the banks (11%). Among those who did not have any bank account, 20% reported that they did not open bank accounts due to their low savings and/or low income, 19% reported that they had no idea about credit availability from banks or their financial products and 13% reported that their applications were rejected. These findings extend beyond explaining why few clients use formal banking services, they establish the critical importance of MFIs as a source of credit amongst India's poor.

Saving was prevalent amongst the sampled clients and there was an increase in savings rate among those who had access to a formal banking system.

Figure 4



A significant amount of the interviewed clients (75%) had saved in at least one form as shown in Figure 4 in the three months prior to the interview.

The most interesting fact is that those who had access to a formal banking system saved significantly more than those who did not. Results from this study show that 88% of those clients with bank accounts saved in the past three months, out of which 47% saved with the national banks, 10% with private banks, 17% with chit funds and 16% with SHGs. When we examined the savings behaviour of those clients who did not have any bank account, we found that only 54% were saving out of which 35% were saving with NGO/MFI, 11% with chit fund and 10% with SHGs.

Pure income might not be the best metric to regulate this industry. A majority of microfinance clients' household income likely to be more than the RBI's recommended household income

A limiting factor of this study was the inability to capture income data from enterprise activities. We found that the incomes of the majority of our clients' households fluctuated during the past year and especially in urban economies, income flow of our respondents was very irregular which led them not able to recall incomes for the entire year. 57% of clients with at least one form of enterprise mentioned that the amount they spent and revenue generated from their enterprises varied from month to month in three months prior to the survey. The majority of clients who had enterprises did not correctly report the exact investment and revenue amount which has led the income statistics from our study to be of low quality. The Progress out of Poverty Index (PPI) tool was used to measure the likelihood that clients fell below the national poverty lines as and we found that 85% of the clients had less than 10% likelihood of being below national poverty line.

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Key Policy Recommendations

- As it is difficult to acquire the accurate income data from the clients, pure income might not be the best metric to regulate this industry. It is perhaps more suitable to calculate overall welfare of a household using core indicators such as assets. A set of such assets may then be weighted, perhaps, to form an index assessing the overall welfare of a household.

- The concept of equating maximum annual household income bar still raises a big question on the described RBI's bar of Rs. 60,000 in rural and Rs. 120,000 in urban households. It is very much possible that a typical microfinance client's household income is more than the suggested bar, however, further study is needed to understand the accessible sources of finance for the households that are at the par or a little above the suggested annual income bar.

- Entrepreneurial investment peaked amongst those clients who had been with the MFI for two to three years. Further rigorous research is needed to confirm the validity of this trend of entrepreneurial investment. Amongst those who did not invest in business, there was a direct correlation between education spending and length of MFI membership. These findings suggest that as clients mature, MFIs should be able to offer them with different sets of financial products, as for example, education loans. We also suggest that the education loan portfolio of the MFIs be considered as a part of qualified asset by the RBI.

- Among the clients who did not invest in business activities; those who borrowed from an MFI noted a usage of loans in consumption. If by regulation MFI loans were capped at 75% for income generating activities, further research studies are needed to understand if families with unmet credit needs due to this cap rely on informal sources. .

- It was found that those clients who had bank accounts reported higher rates of savings than their counterparts who did not. There might be value in encouraging formal banking not as a means to borrow but as a means to save. For those who did not have access to formal banking, primary reasons included a lack of need, complicated application procedures, and a lack of awareness. Reasons such as complicated procedures and lack of awareness should not hinder the inclusion of these groups into the formal banking system. Therefore greater awareness campaigns might be useful in promoting savings. Furthermore, relaxing KYC guidelines might accommodate larger section of the population as many clients do not have the required documents.