



# **Comparative Study of Approaches and Strategies adopted by Financial Institutions to Implement the Master Direction by RBI on Regulatory Framework for Microfinance Loans**

**(A Case of Uttar Pradesh)**

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## Executive Summary

The Indian microfinance sector is one of the largest and most successful in the world. According to the latest Microfinance Information Exchange (MIX) data, it has the highest reach globally, followed by Bangladesh. It provides financial access to over 72% of the adult population. The sector is served by multiple players, including Commercial Banks, Small Finance Banks (SFBs), Regional Rural Banks (RRBs), Cooperative Banks, Non-Banking Financial Companies (NBFCs) and Microfinance Institutions (MFIs) registered as NBFCs, as well as in other forms. As of March 31, 2023, 235 microlenders of various categories serve a combined micro credit portfolio of Rs. 3,51,521 crores across 730 districts in 36 States and Union Territories in the country.

The sector has undergone significant regulatory changes to ensure fair and transparent client service. The first major reform in 2011, following the Andhra Pradesh microfinance crisis under the chairmanship of Shri Y.H. Malegam, led to the creation of a separate category for Non-Banking Financial Companies (NBFCs) known as NBFC-MFIs. This framework applied exclusively to NBFC-MFIs, constituting approximately 36% of the microfinance loan portfolio as of March 2022. The remaining 64% of lenders were excluded from these regulatory conditions.

To address evolving dynamics and customer protection concerns, the RBI issued a consultative paper in June 2021, proposing a unified regulatory framework for all entities involved in microfinance. Subsequently, on March 14, 2022, through Circular no: RBI/DOR/2021-22/89 DoR.FIN.REC.95/03.10.038/2021-22, the RBI issued Master Directions on Regulatory Framework for Microfinance Loans, applicable to all Regulated Entities (REs) engaged in micro-lending with effect from April 1, 2022. The Master Directions focused mainly on six major areas: enhancement of income range, mandatory assessment of household income and expenditure, prevention of over-indebtedness based on Fixed Obligation to Income Ratio (FOIR), removal of pricing cap, restriction on usage of loans, and enhancement of qualifying assets limit (applicable for NBFC-MFIs).

The present study attempts to examine the extent of the mechanism adopted by all concerned REs in the light of revised microloan guidelines, the challenges REs face in adopting the guidelines, and the role played by Self-Regulatory Organisations (SROs) in monitoring the adoption of guidelines. The study also measures the impact of revised guidelines on the Indian microfinance industry and analyses the clients' feedback related to the products and processes of the REs.

The findings of the study are based on both primary and secondary data. As part of the primary survey, the study was conducted by covering 360 micro borrowers across 18 REs (3 from each category, i.e., Commercial Banks, RRBs, Rural Cooperative Banks,



SFBs, NBFCs, and NBFC-MFIs) and 18 branches in all geographical regions of Uttar Pradesh. The study findings are derived from RE-level, branch-level, client-level, and overall industry-level data.

**The findings of the study are as follows:**

- The adaptation of revised guidelines is examined using five key parameters: awareness of revised guidelines, adaptation of income assessment, process of income and expenditure assessment, interest on loans, and adaptation of fair practice code. The study found that out of the 18 branches of various REs, 10 branches are fully aware of the new guidelines, while the remaining 4 branches are partially aware or unaware of the guidelines. The awareness level has varied across the various REs. NBFC-MFIs, NBFCs, and SFBs were fully aware of the guidelines. This is due to their strong association with SROs and their adherence to certain regulations since their inception. While none of the Rural Cooperative Banks (RRBs) and Regional Rural Banks (RRBs) were fully aware which has translated into a low adaptation of significant part of the guidelines, like mandatory assessment of income and expenditures prior to sanction of loan, assessment of Fixed Obligation to Income Ratio (FOIR) for measuring over indebtedness and dedicated grievance redressal system for addressing the issues related to micro borrowers. It is observed that NBFC-MFIs, NBFCs, and SFBs have developed their own system of capturing households' income and expenditure using electronic device and seamlessly determine borrowers' eligibility of loan. Variations in manpower at the branch level among REs pose another obstacle, particularly in RRBs and RCBs where a shortage of staff at the branch level hinders the adoption of harmonized microfinance guidelines. The study assesses the active borrowers-to-total staff ratio as a measure of staff productivity. It is observed that SFBs (600) and NBFC-MFIs (402) show a higher number of active borrowers per staff member, suggesting a potentially larger client base or high staff efficiency. Alternatively, Commercial Banks, RRBs, and RCBs exhibit lower ratios, possibly attributed to limited manpower at the branch level, with RRBs and RCBs averaging only three staff per branch, indicating need for tailored strategies to address specific challenges faced by various REs in the microfinance sector.
- As far as interest rates are concerned, the data reveals significant variations across Regulated Entities (REs). Microfinance loans from Commercial Banks, Regional Rural Banks (RRBs), and Rural Cooperative Banks (RCBs) generally have lower interest rates compared to other REs, which can be attributed to their reliance on their own funds for lending.
- As regards the pricing plus guidelines recommended by RBI, none of the surveyed REs imposes pre-payment penalties, indicating a borrower-friendly practices. Moreover, the display of effective interest rates is widespread, though there is

room for improvement in some institutions, particularly RRBs and RCBs.

- Regarding the adoption of Fair Practice Code (FPC), the study finds that all REs have implemented a grievance redressal mechanism. However, there are variations in the different components of the grievance redressal system. SFBs, NBFC-MFIs and NBFCs follow structured and dedicated grievance redressal systems for their micro clients, likely due to their association with industry associations. Commercial banks and RRBs are yet to establish dedicated mechanisms for microfinance clients.
- The study reveals that all REs have standardized loan agreements in vernacular languages and display effective interest rates on loan cards. However, there are slight variations in the extent of information provided across different REs.
- The harmonised guidelines for microfinance loans have undeniably ushered in a fair, transparent, and competitive environment for Regulated Entities (REs) engaged in micro-lending. These measures are aimed at preventing clients from falling into over indebtedness, while instilling a culture of fair and responsible lending within the sector. However, despite these commendable changes, REs are suffering challenges in implementing these guidelines. One significant hurdle arises in the assessment of income and obligations. Microfinance borrowers predominantly belong to the lower strata of society and often lack access to formal income sources. The lending institutions predominantly rely on self-reported income, which can sometimes be underreported, potentially impacting the accuracy of loan limits. The predominance of cash transactions for monthly expenses, excluding loan instalments, further complicates the evaluation of household income. This scarcity of authentic expenditure sources remains a critical challenge.
- The SROs have played a key role in ensuring compliance with the revised guidelines in the Indian microfinance landscape. They have diligently fostered awareness among member institutions regarding the updated regulatory framework through a series of events, comprehensive training sessions, and advisory services.
- The RBI Master Directions have brought a few positive transformations in the Indian microfinance industry. The expanded range of annual household income has increased the industry's outreach. The client outreach reached its all-time high at 13 crores, with a net addition of 0.8 crore new borrowers in the industry, resulting in a 23% growth in outstanding credit compared to the previous year. Further, the increased competition among the REs, leading to NBFC-MFIs to overtake banks in terms of gross outstanding loan portfolio by the end of March 2023.
- The mandatory measurement of household income and obligations has reduced the loan burden among the micro-borrowers and improved the portfolio quality. The industry delinquency rate (PAR > 30) has decreased from 5.27% in March 2022 to 2.16% in March 2023.



- A comparative analysis on product and service delivery among the sample REs shows that Indian microfinance sector has a deep outreach. Overall, 91 percent of sampled borrowers are women, 66 percent located in rural areas, and 84 percent belong to economically disadvantaged sections of society, indicating industry's commitment to financial inclusivity and poverty alleviation.
- In terms of diversified credit product, REs have served a significant proportion of clients, beyond microcredit, including deposits, micro-insurance, and micro-pension etc.

### **Suggestions:**

Based on the findings, the study has come up with suggestions for the policymakers to improve the adaptation of revised guidelines across the studied REs.

- **State level sensitisation programmes for the REs:** The study observed that a lack of awareness and shortages of manpower at the branch level, particularly at RRBs and RCBs, are key challenges in adopting the revised guidelines for microfinance loans. They are extending micro loans in their traditional way of lending, without any prior assessment of income and obligations. Considering this, it is suggested to conduct state-level sensitization program for Public Sector Commercial Banks, RRBs, and RCBs involving key stakeholders, such as NABARD, SROs, industry associations, and SLBCs of each state, etc.
- **Membership with SROs and Industry Association for Microfinance:** The study encourages Commercial banks, RRBs, and RCBs to become members of SROs for centrally framing policy guidelines in line with the revised circular on microfinance loans. SROs may conduct frequent training of branch staff involved in micro-lending and also offer advisory services to REs.
- **Formation of a district level committee for monitoring microfinance:** To monitor the activities of REs in the microfinance sector at the district level and to address the client protection in multiple issues, it is suggested that a committee may be formed involving representatives of NABARD, SROs, LDMS, and NRLM officials. The committee may meet quarterly to review the activities of REs in the microfinance space.
- **Exploring BC partnership with non deposit taking NBFCs:** Considering the shortages of manpower, RRBs and RCBs may consider partnering with non-deposit taking NBFCs (NBFCs-ND) through a BC agreement to extend credit facilities to micro borrowers. A suitable business model for this may be developed in consultation with regulated bodies.



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