De Jure

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Microfinance: A New Regulatory Regime

Rajani Associates
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INTRODUCTION

On March 14, 2022, the Reserve Bank of India ("***RBI***") had notified the Reserve Bank of India (Regulatory Framework for Microfinance Loans) Directions, 2022 ("***Microfinance Directions***") based on the feedback received from the stakeholders on the Consultative Document on Regulation of Microfinance ("***Consultative Paper***") put out by the RBI on June 14, 2021.

APPLICABILITY OF THE MICROFINANCE DIRECTIONS

The Microfinance Directions are applicable to the following entities ("***Lenders***"):

- All Commercial Banks (*including Small Finance Banks, Local Area Banks, and Regional Rural Banks*) excluding Payments Banks;
- All Primary (Urban) Co-operative Banks/ State Co-operative Banks/ District Central Co-operative Banks; and
- All Non-Banking Financial Companies (including Microfinance Institutions and Housing Finance Companies) while advancing Microfinance Loans (*defined below*).

OLD REGIME

Prior to the introduction of the Microfinance Directions, the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 ("***Master Directions***") regulated loans advanced by Non-Banking Financial Companies - Microfinance Institutions (NBFC-MFIs) to borrowers with a rural household annual income not exceeding Rs. 1,25,000 or urban and semi-urban household income not exceeding Rs. 2,00,000, subject to a ceiling of Rs. 75,000 in the first cycle and Rs.1,25,000 in subsequent cycles, for specific tenures without collateral and which was repayable at fixed intervals, amongst others. It would be pertinent to note that, under the Master Directions, the above restrictions were only applicable to NBFC-MFIs.

CONSULTATIVE PAPER

In June 2021, the RBI released the Consultative Paper which emphasized the need for regulating all lenders who were not subject to regulatory restrictions (*while advancing loans to low-income borrowers*), such as the maximum amount that could be lent to a single borrower, a maximum of two NBFC-MFIs lending to a single borrower, caps on loan processing fees, pricing of loans and adoption of non-coercive methods of recovery, which are applicable to NBFC-MFIs. In the absence of these regulatory restrictions, low-income borrowers were able to obtain multiple loans from different lenders leading to overburdening of such borrowers and by extension, their household.

The Microfinance Directions now make this a reality by regulating all Lenders, not just NBFC-MFIs, while advancing Microfinance Loans (*defined below*).

NEW REGIME

From April 01, 2022, the Microfinance Directions regulate all collateral-free loans advanced for any purpose by any Lender (*whether NBFC-MFI or not*) to borrowers who have an annual household[1] income not exceeding Rs. 3,00,000 ("***Microfinance Loans***").

[1] An individual family unit consisting of a husband, wife and their unmarried children.

KEY CHANGES BROUGHT BY THE MICROFINANCE DIRECTIONS

Key changes brought about by the Microfinance Directions have been set out below. For the key compliances under the Microfinance Directions, please refer to the diagram annexed to this De Jure.

1. **Pricing of Loans:** While advancing Microfinance Loans, Lenders are required to, amongst others, set a ceiling on the interest rate and other charges applicable, disclose pricing related information and charges to prospective borrowers through a standard simple factsheet in the prescribed form, abstain from levying pre-payment penalties and charge penalty for delayed payment only on the overdue amount and not the whole loan amount.

   Under the Master Directions, the interest rate charged by NBFC-MFIs was required to be the lower of the cost of funds plus margin and the average base rate of the five largest commercial banks by assets multiplied by 2.75. The Microfinance Directions have removed this requirement, subject to the interest rate and other charges being justified by a policy formulated in that regard. Further, the interest rate and other charges are now subject to the supervisory scrutiny of the RBI.

   Additionally, there was no provision under the Master Directions for limiting the penalty for delayed payments charged by NBFC-MFIs to the overdue portion of the loan only.

2. **<u>Factsheet:</u>** Lenders (*including NBFC-MFIs*) are now required to provide standard simple factsheets to potential borrowers of Microfinance Loans and also in case of collateralized loans extended to low-income households i.e. households having an annual income of up to Rs. 3,00,000.

3. **<u>Recovery of Loans</u>:** The Microfinance Directions set out revised guidelines for recovery of loans which require Lenders to, amongst others: (i) put in place a mechanism for: (a) guiding the borrowers facing repayment related difficulties, and (b) redressal of recovery related grievances, and (ii) make recovery only at designated/central designated places mutually decided by the borrower and the Lender. The Microfinance Directions also set out the considerations for the Lenders while engaging recovery agents.

4. **<u>Assessment of Household Income</u>:** Lenders are required to put in place a policy for assessing the household income of borrowers and report the assessed household income to the Credit Information Companies. The assessment of household income assumes importance while sanctioning Microfinance Loans because Lenders are required to ensure that monthly repayments of all loans advanced to a single household, in aggregate, does not exceed 50% of the monthly household income.

5. **<u>Other Provisions</u>:** Similar provisions forming part of the Master Directions, which were specifically applicable to NBFC-MFIs/NBFCs only, have now been extended to other Lenders while advancing Microfinance Loans under the Microfinance Directions. These provisions include formulation of policies for recruitment, training and monitoring of employees, formulation of a Fair Practices Code, providing loan cards to borrowers, etc.

6. **Qualifying Assets:** The requirement of qualifying assets being at least 85% of the total assets, in case of NBFC-MFIs, has now been relaxed to 75% of the total assets. Further, other NBFCs (*not being NBFC-MFIs*) can now extend Microfinance Loans up to 25% (*previously 10%*) of their total assets.

7. **Minimum Net Owned Fund**: The Microfinance Directions also set out a roadmap for NBFC-MFIs to achieve a minimum net owned fund of Rs. 10 crores by March 31, 2027, in line with the Scale Based Regulation[2].

CONCLUSION

The Microfinance Directions are a transition from an entity-based regulation model to a product-based regulation model and are a step in the right direction, aimed to drive a coordinated effort to achieve enhanced applicability, better accountability and also protect the interests of the borrowers

CONTRIBUTED BY:

Poorvi Sanjanwala, Partner: poorvi@rajaniassociates.net

Rutvik Rajagopal, Associate: rrajagopal@rajaniassociates.net

[2] The Scale Based Regulation, which will become effective from October 01, 2022, has been notified by the RBI on October 22, 2021 with an aim to reclassify NBFCs based on their size, activity and risk involved, into four layers: Base Layer, Middle Layer, Upper Layer and Top Layer. This reclassification is a departure from the classification under the existing regulations which is primarily based on the asset size of the NBFCs.

Key Compliances under the Microfinance Directions

Branch and Website Disclosures

- Display the minimum, maximum and average interest rates charged on microfinance loans at all its offices, in literatures issued by it and on its website
- Display the Fair Practices Code at all its offices and on its website
- Display up-to-date details of recovery agencies engaged by the Lender on its website

Other Compliances

- Disclose the household income of the Borrower to Credit Information Companies
- Provide a simplified standard factsheet to the Borrower
- No penalty to be levied on prepayment
- Penalty on delayed payment, if any, shall be levied only on the overdue amount and not on the entire loan amount
- Maintain a Standard Form Loan Agreement
- Provide a Loan Card to the Borrower
- Issuance of non-credit products shall be with full consent of the Borrowers and fee structure of such products shall be specified in the Loan Card

Policies to be Formulated

- Policy for Providing Flexibility of Repayment periodicity on Microfinance Loans as per Borrower's requirement
- Policy for Assessment of Household Income
- Policy to limit outflows on account of repayment of loan obligations by households
- Policy for Pricing of Microfinance Loans
- Fair Practices Code
- Policy for regulating conduct of employees and system for their recruitment, training and monitoring
- Mechanism for identification of, engagement with and guiding Borrowers facing repayment related difficulties
- Mechanism for redressing recovery related grievances of Borrowers
- Due diligence process for engagement of recovery agents covering individuals involved in the recovery process

NOTES:

1. These Compliances are applicable to Lenders while advancing Microfinance Loans.
2. Borrower(s) shall mean the borrowers of Microfinance Loans.

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Contact US

Rajani Associates

simple solutions

Address:	Krishna Chambers 59 New Marine Lines Churchgate Mumbai 400020 Maharashtra, India
Telephone:	(+91-22) 40961000
Facsimile:	(+91-22) 40961010
Email:	dejure@rajaniassociates.net
Website:	www.rajaniassociates.net