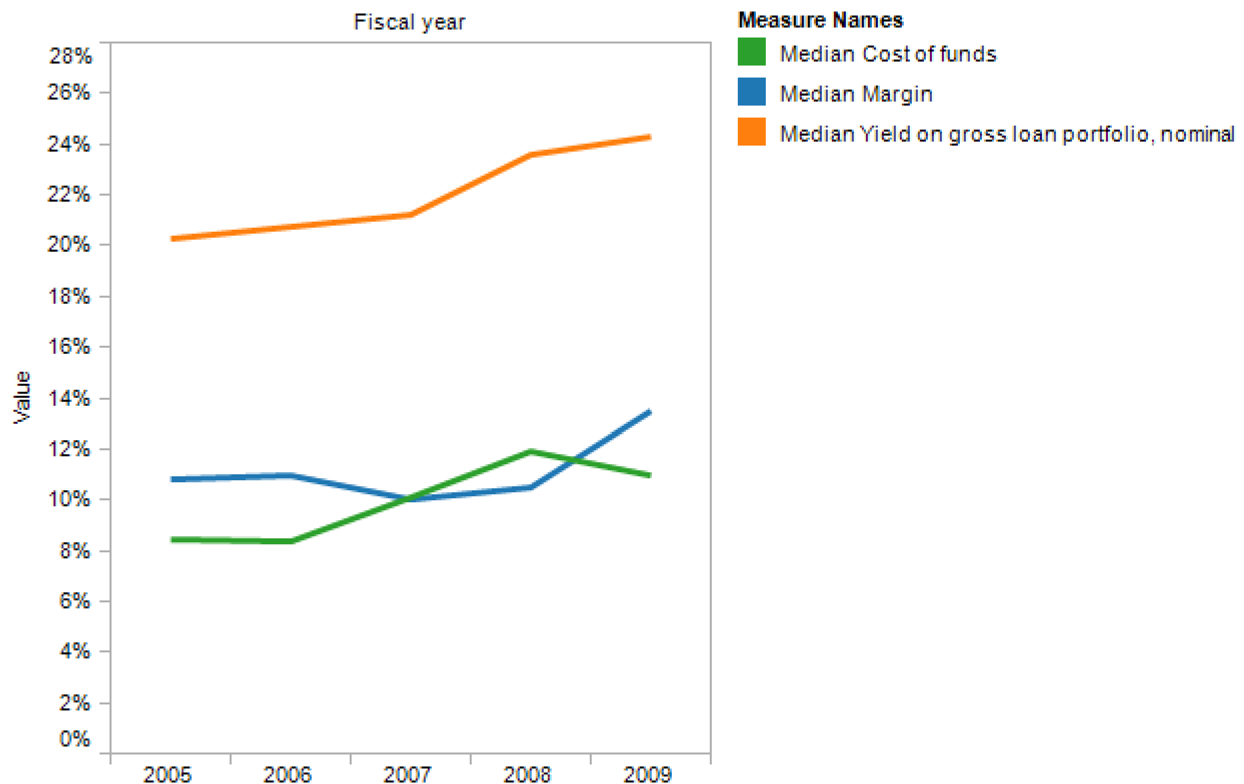
MIX Microfinance World: Reviewing the Reserve Bank of India's Microfinance Framework

Last week, the Reserve Bank of India (RBI) issued new regulations for microfinance providers, based on the conclusions of the Malegam Committee. Since the regulations contain several provisions that can be analyzed using public data on the sector, we take the opportunity to investigate two main components of the regulation:

- "that banks should ensure a **margin cap of 12 per cent** and an **interest rate cap of 26 per cent** for their lending to be eligible to be classified as priority sector loans." Fn1

Data from the past several years indicates that most MFIs are within these levels. However, for larger MFIs, we can see evidence that interest rates and profits have increased over time. Thus, it remains to be seen what effects the regulation will have on future levels.

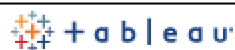
When one examines the sector as a whole, the data suggests that MFIs have been well within the prescribed 26 percent interest rate levels, although margins have crept 1 - 2 percent higher than what RBI has mandated (as in the chart below).



This isn't a bad picture overall. However, one has to segregate the data to see what it actually says. Practitioners have expressed concerns that smaller MFIs will not be able to meet the regulations. In addition, the original Malegam committee report distinguished between large and small MFIs based on a threshold of a 100 crore loan portfolio (roughly 22 million USD). We segment the MFIs into small and

large groups using this criterion for 2005 - 2009. The table below shows the number of MFIs that comply with the interest rate and margin cap provisions in each class over time.

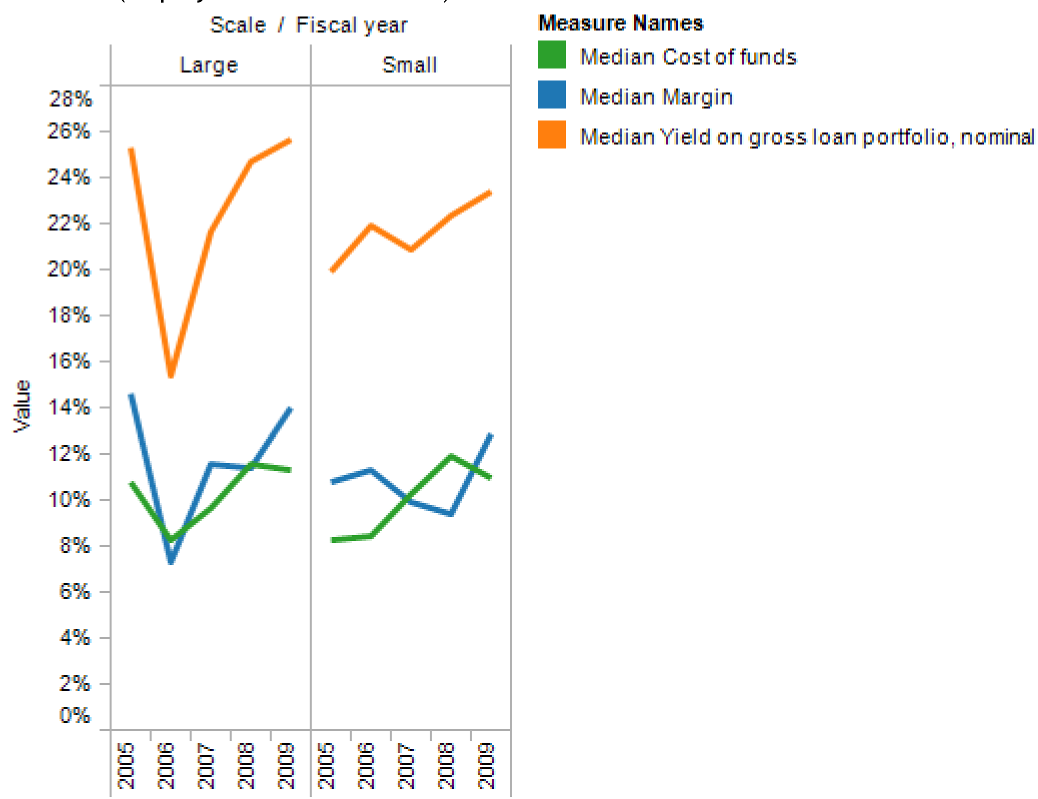
	Scale / Compliance			
	Large		Small	
Fiscal year	Yes	No	Yes	No
2005	2	3	20	16
2006	6	3	18	14
2007	6	5	24	20
2008	9	7	28	18
2009	7	14	26	31



- In 2006, two-thirds of large MFIs met the RBI requirements for interest and margin caps. By 2009, only one-third still met this requirement which confirms some of the concerns raised that large MFIs have been charging higher interest rates with higher profit margins.
- Small MFIs initially charged higher interest rates to ensure profitability, but by 2009, 46 percent were operating within the framework guidelines. Though once the framework is implemented, they may face tough competition from any larger MFIs that reduce rates.

These results cover the same period that led up to the present crisis and present regulation. Updated results for the 2010 fiscal year (ending March 31) will be available soon, and updates through December 2010 are available for 25 of the leading MFIs now.

It should come as no surprise that large MFIs generally have access to cheaper funds than small MFIs, although there is little difference overall. Large and small MFIs have both increased lending rates, although lending rates have been higher for larger MFIs. Consequently, large MFIs have earned higher profit margins than smaller MFIs and will thus be more affected by the new regulations. The following charts compare yield, cost of funds and margin metrics for small and large MFIs using a few different statistics (displayed in different tabs).



The question remains if this regulation is the right way to respond to the crisis. Banks have already begun to hike lending rates in the face of inflation, which will further squeeze margins. If institutions cannot adjust their pricing, we may see declining profits and perhaps the eventual the closure of some institutions. With restricted access to credit, potential borrowers may choose to resort to more expensive sources of financing. Other research indicates that, when there is an interest rate cap, lenders may see this as an opportunity to *raise* prices, not lower them - caps can allow institutions to collude at a maximum allowable price level.

While MFIs may currently be largely compliant with the guidelines, the proposed caps will affect the evolution of the sector. Research indicates that the caps may lead to worse options for borrowers overall, even if their impact is muted at the present.

Fn1: *For interest rates, we use yield as a proxy, although the regulation does not exactly specify how interest rates are to be measured. More on the difference between these metrics can be found here. The margin cap is defined as: "the difference between the amount charged to the borrower and the cost of funds to the MFI." In this case, we take the yield as the amount charged to the borrower and the cost of funds as the financial expense on borrowings (debt) over the average borrowings for the year. Since MFIs in India cannot mobilize voluntary deposits, we can focus solely on the cost of debt funding.*

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