India

POLICY, REGULATORY, AND SUPERVISORY COVID-19 RESPONSES FOR MICROFINANCE

CGAP BACKGROUND DOCUMENT

JUNE 2020

This note is part of a series of CGAP background documents that examine the impact of the COVID-19 crisis on microfinance at the country level and focus on policy and regulatory responses adopted by financial authorities in each country. The notes are based on interviews and review of publicly available materials, and, in some cases, with written input from key stakeholders in the microfinance sector. Coverage is from the onset of the crisis through mid-June, although the situation continues to evolve.

Country context and COVID-19 containment measures

In the early days of the pandemic, there were fears that India with its large population, many poor people, and global connections would soon have a very heavy load of COVID-19 coronavirus cases and many deaths. So far, the worst has not happened, aided by an early national lockdown, which started on 24 March 2020, when there were 571 confirmed cases of the disease and 10 reported deaths. Eleven weeks later, the pace at which cases were doubling in number had slowed to every 16 days by 4 June 2020, down from 10 days on 18 April 2020.[1] However, given the size and density of India's population, the number of cases has continued to grow as the lockdown restrictions are lifted. By 24 June 2020, the total number of active cases stood at 456,183 and total deaths had reached 14,476.[2]

During the first two lockdown periods from 24 March to 3 May, only food and pharmaceutical shops, banks, utility and telecommunications companies, and a limited number of transport companies were allowed to operate, albeit at partial capacity. As the economy ground to a near standstill, supply chains were severely disrupted. In urban areas, migrant workers were stranded without jobs or adequate support for shelter and accommodation. The third lockdown period, which started on 4 May, saw an easing of restrictions. Easing continued in the fourth period starting 17 May when more sectors were allowed to resume activity, though none were yet operating at pre-lockdown levels. Limited domestic commercial flights, as well as limited train services, had resumed by the end of May. The lockdown was lifted on 8 June, and economic activity began to resume even in the worst affected areas. While not at 100 percent capacity, offices are gradually reopening, retail restarting, and interstate transport has resumed.

GDP growth has been severely hit. The IMF revised downward its projection for India's GDP growth rate for FY 2020 to 1.9 percent from 5.8 percent before the pandemic, against an estimated 4.8 percent seen in FY2019. But if lockdowns are extended in the cities or reintroduced should the disease flare up again, this prediction may be revised further.

Nearly 90 percent of India's workforce of 465 million is in the informal sector[3] and more than 80 percent of microfinance borrowers[4] are in the informal economy. The official unemployment rate rose to 23.52 percent in April from 8.74 percent in March with numbers rising in both urban and rural areas; but seems to be moving back down.

The microfinance sector

For the purpose of this report, the Reserve Bank of India (RBI's) definition of microfinance has been used: "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their

[1] Based on analysis by Prof. Shamika Ravi of the Brookings Institution
[2] https://www.mohfw.gov.in
[3] ILO 2018
[4] BWTP Member COVID sample survey

income levels and improve their living standards".[5] This segment of customers is primarily served by these types of institutions:

1. Regulated Microfinance Providers (MFPs)

- Deposit-taking
    - Commercial Banks lend directly to microfinance clients usually through business correspondents, but occasionally also to individual small ticket borrowers, using special refinancing schemes like MUDRA loans.
    - Commercial banks lend indirectly to microfinance clients via non-bank financial companies (NBFCs) or NBFC MFPs. In this case, the bank underwrites the wholesale loan to the NBFC, while the NBFC underwrites the retail loans. There is usually a First Loss Default Guarantee (FLDG) of around 20 percent of the portfolio that NBFC MFPs provide commercial banks.
    - Small Finance Banks (SFBs) are licensed by the RBI under the Banking Regulation Act, with a limited scope of operations. Eight of the 10 SFBs were previously licensed as NBFC MFPs.These banks lend directly to joint liability group clients, small individual loans and microenterprises. They underwrite these loans.
    - Cooperative banks accept deposits from the public and can disburse small loans.
    - Regional rural banks primarily serve rural India with basic bank services. They are regulated indirectly by the RBI through the National Bank for Agriculture and Rural Development (NABARD).
- Non deposit-taking
    - Non-bank financial companies are licensed by the RBI under the RBI Act.
        - NBFC microfinance providers have a specialized regulatory framework differentiating them from other NBFCs (including minimum capital, capital adequacy, loan loss provisioning, margin cap etc.).
        - Other NBFCs whose core business is not about serving group or small ticket uncollateralised loans: these could be asset financing companies that provide lending for two-wheelers and tractors, or those that offer sachet-size gold loans. NBFCs have their own regulatory framework.

2. Unregulated MFPs

- Not-for-profit MFPs established as non-governmental organizations (NGOs).
- Self-help groups (SHGs) that do internal lending based on group savings and also borrow subsidized capital from banks to finance lending to members.

Two important industry bodies are the Microfinance Institutions Network (MFIN) and Sa Dhan. Both are membership-based associations that have been recognized by the RBI as self-regulatory organizations (SROs). As SROs, these organizations issue directives and a code of conduct and have powers to enforce them. All of MFIN's 55 members are NBFC MFPs, while Sa Dhan's 120 members are NBFC MFPs, NBFCs, SFBs, cooperatives, and credit-rating agencies.

India's banking law accommodates a differentiated banking structure with commercial banks, SFBs, payments banks, cooperative banks and regional rural banks. NBFC MFPs are licensed by RBI's non-banking supervision department.

[5] See Microfinance Pulse report for details

As of September 2019, the total microcredit portfolio was ~$26 billion, broken down as follows:

Institution type	Portfolio (USD millions)	Share of total portfolio	Total number of borrowers (millions)	Share of borrowers
Commercial Banks	10,737	40%	24.4	34%
SFBs	4,572	17%	13.4	19%
NBFC MFPs	8,453	32%	23.9	34%
Other NBFCs	2,601	10%	8.7	12%
Not-for-profit MFPs	263	1	.849	1%
Total	**26,625**	**100**	**71.2**	**100**

Source: Microfinance Pulse January 2020

Bandhan Bank's share of the commercial banks' microfinance loan portfolio dominates at 25 percent of the total and 14.56 million borrowers.[6] Bandhan lends at 17.95 percent a year while other lenders usually charge more than 20 percent. Bandhan started its journey as a NBFC MFP in 2001 and was the largest MFP among NBFC MFPs when RBI approved its conversion into a commercial bank in 2015. It is now a publicly listed entity.

The SHG Bank Linkages Program organizes the rural poor into savings groups that lend to their own members. They can add capital to their internal resources by borrowing from banks. There are over 10 million SHGs that reach over 125 million households. In 2017-18, they borrowed about $7.7 billion from banks.[7] (This amount is not included as microcredit in the table above).

While both economic growth and credit flow slowed between April 2019 and March 2020 for the economy as a whole, NBFC MFP portfolios continued to grow aggressively by more than 35 percent[8] in that period.

Sources of funding

Most commercial banks are publicly listed. Their main source of funding is customer deposits, but they have regulatory flexibility to raise funding from market instruments. Specialised government-owned institutions like the National Bank of Agricultural and Rural Development (NABARD) and the Small Industries Development Bank of India (SIDBI) provide funding for known excluded groups such as farmers. Refinancing schemes from agencies like the Micro Units Development Refinance Agency (MUDRA) are used to provide restricted funding to banks to on-lend to microenterprises.

Since SFBs started operating only in 2016, their deposit base is not as large as that of commercial banks. SFBs collect corporate deposits through current accounts and retail deposits through savings accounts, with a cost of capital ranging from 0-6 percent. They do, however, have debt, private equity and fixed deposits from which they can raise funds as commercial banks do. The regulations for SFBs require them to list on the stock exchanges

[6] Based on conversation with an industry expert.
[7] https://www.nabard.org/auth/writereaddata/tender/3107191001NARpercent202018-19percent20(E),percent20Web-RGBpercent20(Checkedpercent20-percent20Final),percent202019.07.29,percent200830hrs.pdf
[8] https://www.inclusivefinanceindia.org/uploads-inclusivefinance/publications/1067-1001-FILE.pdf

within three years of reaching a net worth of ~$66 million. As of now, only one (AU SFB) out of the 10 operating SFBs has listed.

NBFCs are funded through private equity and impact investor funds, as well as commercial bank debt.

Impact of national lockdown on microfinance providers

When restrictions were eased and MFPs were able to restart collections in the third week of May, repayments began to trickle in at about 10 percent of amounts due.[9] These figures do not differ much from the 12 percent repayment rate that was [reported] at the end of April. This is significantly lower than the typical 99 percent rate.[10] NBFC MFPs were permitted by the RBI to extend a three-month loan moratorium to their clients, the same as other lending institutions -- and many of them did. But no loan moratoria were extended to them by their bank lenders. In the instances where their clients are able and prefer to repay their loans, some MFPs are explaining to their clients that they are unable to collect repayments because of the lockdown-related restrictions. This is seen mostly in rural areas where loan disbursal and repayments are mostly in cash. MFPs are struggling as a result. A study in April looked at 29 NBFC MFPs representing 70 percent of the total NBFC MFP portfolio (by value) and found that only seven of them had adequate liquidity to repay their loans for April. This study also predicts that credit will become more expensive for NBFC MFPs, adding 3-5 percent to their cost of funds.

Policy and regulatory measures

Operations

While banks and ancillary services (such as ATMs, cash management companies, and bank agents) were declared essential services at the outset of the lockdown, there was uncertainty about whether NBFC MFPs were permitted to operate. Even after the Ministry of Home Affairs clarified on April 16 that NBFC MFPs were to be included as financial service providers, rules set by local administrations still sometimes made it difficult to resume operations.

The Microfinance Institutions Network (MFIN) issued a broad set of (non-enforceable) advisory guidelines, including:

- No on-site operations in areas identified by local administration as hotspots or containment zones.
- No group meetings. Staff were instructed to contact customers by phone, and branch staff were trained on how to address queries if they chose to come to the branch.
- Organize movement passes from government authorities to enable employees to travel for the purpose of providing essential services.
- Work from home and staggered work hours.
- Significantly reduced staffing where branch presence is necessary.
- Physical distancing, masks, and hand washing hygiene measures for employees and customers at branches, as well as regular branch disinfecting.

[9] Based on a conversation with MFIN.
[10] Based on a conversation with Sa Dhan, this figure applies to Sa Dhan members who include different types of MFPs.

Client relief

On 27 March, the RBI announced several measures for financial institutions, including banks and NBFC MFPs. They were permitted to allow a loan moratorium until 31 May 2020, on pre-existing term loans, though borrowers would have to pay additional interest should they choose to avail themselves of the moratorium as interest would still accrue. This becomes more of an issue with repeated extensions of the moratorium. On 22 May, the loan moratorium was extended until 31 August 2020. The 90-day non-performing asset (NPA) norm excludes the moratorium period for these loans[11].

MFIN's guidelines indicate that their members were asked to extend moratoria to their borrowers. The advice was for MFPs to offer the moratorium to their clients and to give them the option to opt out. However, it is not clear at this time if this guideline was implemented by all members of MFIN. In any case, the guideline instructs MFP staff to obtain consent from customers on their decision to opt in or opt out, and to communicate if the moratorium was approved or not. Where approved, the guideline also requires that the MFP inform their customers about the revised repayment terms.

In addition, on 13 May, the finance minister announced a series of measures. Part of this was to redefine MSMEs by raising the maximum capital for companies to remain categorized as MSME and eliminating the distinction between manufacturing and service sectors. This is expected to give MSMEs headroom for growth while continuing to remain classified as MSMEs and claim the associated benefits.

The finance minister also said that dues by government and public sector undertakings to MSMEs will be released in 45 days.

Liquidity measures

The RBI on 27 March reduced the cash reserve ratio from 4 percent of deposits to 3 percent for all banks[12], including SFBs, in order to pump liquidity into the banking system. The same day, the RBI announced a Targeted Long Term Repo Operations (TLTRO) of ~$10 billion[13] in three separate auctions starting that day. On 17 April, the RBI announced another TLTRO to make available ~$6.4 billion to ensure NBFCs (including NBFC MFPs) have access to liquidity.[14] The commercial banks need to invest these funds into investment-grade corporate debt, with 50 percent of this amount required to go to small and mid-sized NBFCs. The 17 April announcement included ~$3.3 billion to NABARD to refinance regional rural banks and cooperatives, as well as NBFC MFPs, and ~$2 billion to SIDBI for on-lending/ refinancing.

NBFC MFPs that were not investment grade (most NBFC MFPs are not investment grade) voiced concerns that their lenders were not passing on the benefit of RBI's liquidity support. There has been a general erosion of confidence in NBFCs due to defaults in that last couple years[15], even though NBFC MFPs were performing better than other NBFCs. The poor

[11] https://rbidocs.rbi.org.in/rdocs/Content/PDFs/GOVERNORSTATEMENTF22E618703AE48A4B2F6EC4A8003F88D.PDF
[12] https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=3847
[13] https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=49583
[14] TLTRO allows entities to borrow one- to three-year funds from the RBI at the repo rate. This capital is cheaper than what is normally available from the RBI.
[15] https://economictimes.indiatimes.com/wealth/personal-finance-news/defaults-aplenty-what-is-ailing-indias-nbfc-sector/articleshow/70001015.cms?from=mdr

response to the auction targeted at improving the liquidity of NBFC MFPs seems to suggest that banks remain reluctant to lend to them.[16]

A series of policy measures announced by the finance minister on 13 May included:

- The availability of up to $4 billion in borrowing from banks to NBFC MFPs, which can then be made available to MSMEs that have outstanding loans up to $3.3 million and a turnover of less than $13.3 million under the Emergency Credit Line Guarantee Scheme. These loans to the NBFC MFPs have a 4-year tenor and a repayment moratorium of 12 months. The government has backed this with a 100 percent credit guarantee in an attempt to instil confidence in banks to on-lend to NBFC MFPs.
- $6.6 billion equity infusion into MSMEs through a fund of funds with a corpus of $1.3 billion.
- To help MSMEs increase their business, general financial rules for procuring goods and services by the government have been amended to disallow global tenders in procurement of goods and services with a value below $26.6 million. This is to encourage local manufacturing by raising a barrier against cheap imports.

While it is still not clear how all of this will impact MFPs, the measures have generally been welcomed by industry and experts.

Solvency

On 17 May the finance minister announced important changes to the Insolvency and Bankruptcy Code (IBC). First, the government decided to suspend the IBC for one year for fresh cases and spare COVID-related debt from the definition of default. This measure applies to firms of all sizes and has raised some alarm bells with experts saying that a blanket suspension is counterproductive for the very firms that would be seeking insolvency. Even so, this measure will provide relief to MSMEs.

Second, the government increased the threshold of default required for triggering bankruptcy one hundred-fold, from ~$1,333 to ~$133,333. This has been more widely welcomed as a helpful measure.

Lastly, a special insolvency resolution framework for MSMEs is expected to be notified in the insolvency code to provide leniency to MSMEs. The specific measures of this framework will only be determined once the notifications have been released.

[16] https://economictimes.indiatimes.com/markets/stocks/news/rbi-receives-poor-response-for-first-auction-under-tltro-2-0/articleshow/75322819.cms