Microfinance institutions (MFIs)

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In news– The Reserve Bank of India (RBI) has removed caps on the pricing of small loans given by non-banking financial company-microfinance institutions (NBFC-MFIs), bringing them to the same level as other such lenders, including banks recently.

What are the directions issued by RBI?

- With this, the **underwriting of loans will be done on a risk-based analysis, and a risk premium will be charged based on the borrower.**
- The **existing guidelines prescribe a maximum interest rate that a microfinance lender could charge on loans.**
- This is 10-12 percentage points above the institution's cost of funds, or 2.75 times the average base rate of the five-largest commercial banks, whichever is lower.
- All microfinance lenders must now put in place a board-approved policy for the pricing of loans.
- The policy should include a well-documented interest rate model and the different interest rate components, such as cost of funds, risk premium, and margin.
- It should also contain the range of spread of each component for categories of borrowers and a ceiling on the interest rate and all other charges applicable to the microfinance loans.
- **RBI has also raised the annual household income level to Rs.3 lakh for classification of eligibility to avail of microfinance loans**, thus increasing the market size.
- **The central bank has also put a limit on the maximum repayment value to 50% of the monthly household income** to curtail over-lending to customers.
- Thus, if the household income is Rs.3 lakh, the maximum

loan instalment that a borrower needs to pay cannot exceed Rs.1.5 lakh per year. **RBI also said that there would be no prepayment penalty on microfinance loans.**

- **RBI has also given a breather to NBFC-MFIs by reducing the minimum requirement of microfinance loans of total loan assets to 75 % from 85% earlier,** in sync with the harmonization of microfinance regulation for all lenders.
- **The central bank has also increased the maximum limit on microfinance loans given by NBFCs** that are not qualified as NBFC-MFIs to 25% from 10% earlier.
- This would allow lenders such as L&T Finance and Fullerton to increase lending to the MFI sector.

What are microfinance institutions?

- Microfinance Institutions, also known as MFIs, are businesses that provide financial services to low-income people.
- Typically, they operate in rural areas and among low-income people in urban areas, spreading small loans.
- MFIs offer much-needed assistance to the economically disadvantaged, who would otherwise be at the mercy of high interest rates and the local moneylender.
- In India, all loans that are below Rs. 1 lakh can be considered as microloans.
- There are several types of groups organised by microfinance institutions for offering credit, insurance, and financial training to the rural population in India, they are Joint Liability Group (JLG), Self Help Group (SHG), Grameen Model Bank, Rural Cooperatives.
- An NBFC-MFI has been defined as a non-deposit taking NBFC with minimum net owned fund of Rs.5 crore (Rs.2 crore for NBFC-MFIs registered in the North Eastern Region) and having minimum 85 per cent of its net assets (assets other than cash, bank balances and money market

instruments) in the nature of ‘qualifying assets’.

Further reading: https://journalsofindia.com/micro-finance-institutions-mfis/