



Module-C Unit-5

JAIIB PAPER-1

**Indian Economy and Indian
Financial System (IE & IFS)**



JAIIB IE & IFS Module C Unit 5 – Micro Finance Institutions

Introduction

Microfinance is a form of financial service, which provides small loans and other financial services to poor and low-income households.

It is an economic tool, designed to promote financial inclusion, which enables the poor and low-income households, to come out of poverty, increase their income levels and improve their overall living standards.

Microfinance consists of

- Micro-savings,
- Micro-credit,
- Microinsurance and
- Micro-pensions.

Evolution Of Microfinance In India

MICRO SAVINGS

MICRO CREDIT

MICRO ENTERPRISE

MICRO INSURANCE

MICRO REMITTANCE

MICRO PENSIONS

- The microfinance sector has evolved from micro savings to micro credit and then to micro enterprises and now to micro insurance, micro remittances and micro pensions.
- Process has given a boost to the rural poor in India to reach reasonable economic, social, and cultural empowerment, leading to better life of participating households.

The development of the microfinance sector in India can be divided into three phases as under:

The first phase started in the pre-independence days

- The Agriculture Credit Department was set up in the Reserve Bank of India to promote rural credit.
- In its early days, the government sought to promote rural credit, by strengthening the cooperative institutions.

The second phase started in the late 1960s

- **Dec, 1969:** The Lead Bank Scheme was introduced 1969, thereby, starting a process of district credit plans and coordination among different financial intermediaries.

- Nationalisation of 14 commercial Banks
- **1975:** RRBs were conceptualised ,to augment the delivery of financial services in rural areas. This has resulted in the creation of a wide network of banks, which is one of the largest globally.
- **1980-81:** The government initiated the Integrated Rural Development Programme (IRDP)
- **Objective:** To direct subsidised loans to poor self-employed people, through the banking sector.
- **1982:** NABARD was established
- It was around this time, the first Self Help Groups (SHGs) started emerging in the country, mostly as a result of non-government organisations' (NGO) activities.
- Commencement of the modern microfinance movement.
- The Mysore Resettlement and Development Authority (MYRADA) was one of the pioneers of the concept of SHGs.
- In 1984-85, MYRADA started linking SHGs with banks.
- SHGs, in turn, were also very responsive and flexible to the needs of their **members.**
- While MYRADA did not directly intervene in the credit market for the poor, it facilitated banking with micro institutions established and controlled by the poor.
- SHGs were a step in that direction.
- This marked the beginning of the current microfinance movement.

The third phase marked the modern microfinance movement

- **1992:** The SHG–Bank Linkage Programme was formally launched by NABARD, with its guidelines to banks for financing SHGs, under a pilot project that aimed at financing 500 SHGs across the country, through the banking system.
- While the banks had financed about 600 SHGs by March 1993, they continued to finance even more SHGs in the subsequent years
- This encouraged RBI to include financing SHGs as a mainstream activity of banks under their priority sector lending in 1996.
- However, as the sector grew, certain inadequacies and failures became apparent culminating in the Andhra Pradesh (AP) microfinance crisis in 2010.
- This crisis was attributed to the irrational exuberance of some MFIs who, in their eagerness to grow business, had given a go by to the conventional wisdom and good practices such as due diligence in lending and ethical recovery practices.

- Over the last decade, the landscape of the microfinance sector has changed significantly.
- One out of two entities granted approval for starting a universal bank in 2014 was a microfinance institution (MFI), while eight out of ten entities granted approval for starting small finance banks in 2016 were MFIs.

Grameen Bank Model

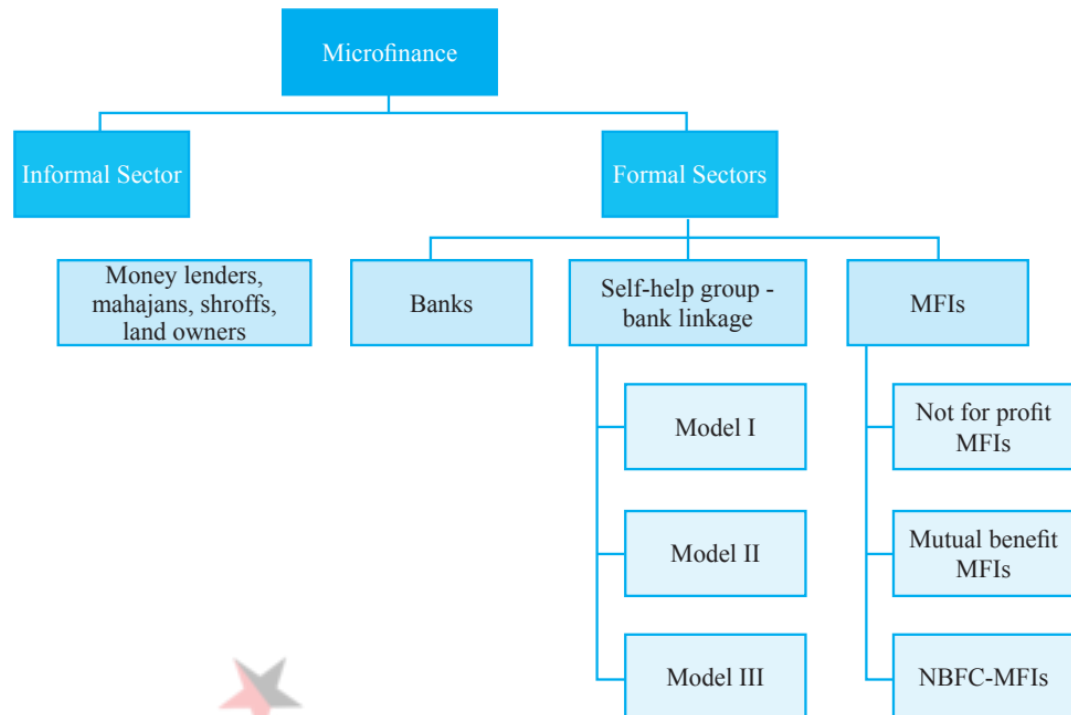
- The global pioneer of microfinance was Professor Muhammad Yunus, who experimented with concept in 1976 and established the Grameen Bank in 1983, in the village of Jobra in Bangladesh.
- Professor Yunus, who was awarded the Nobel Prize in 2006, while he was on a field visit, came across a lady called Sufia, working with bamboos.
- He was surprised to know that she was not able to manage even five takas (22 US cents) to buy raw materials and Sufia explained that the local money lenders charged 10% per week and, sometimes even 10% per day and people who start borrowing with them only got poorer.
- The next day, Professor Yunus lent 856 taka to 42 people of the Jobra village and told them to repay without interest.
- This emotional support of Prof. Yunus was institutionalised by establishing Grameen Bank in Bangladesh, in the year 1983.
- Today, Grameen Bank has about 2,600 branches and operates in over 80,000 villages and has 9 million borrowers, with repayment rate of over 99%.
- In the Grameen Bank model, members of the group are also the owners of the bank. The group normally consists of five members and the liability to repay the loan lies with the individuals.
- The loan is given directly on the basis of trust and no agreement or document is required.
- The success of Grameen Bank proved that the poor needed access to financial services, rather than the cheap subsidised credit.

Delivery Of Microfinance

- **Today, there are two broad types of entities, which are instrumental in delivery of microfinance,**

The informal ones and the formal ones.

- **The informal entities:** Are those which are built into the social and economic fabric of the country, especially the rural areas.
- Consist of money lenders, mahajans, shroff and land owners
- **Formal sector:** Is broad and consists of entities like commercial and cooperative banks, joint liability groups and microfinance institutions (MFIs).



Banks

- The network of banks provide microfinance.
- The cooperative banks and the regional rural banks were set up specifically to cater to the needs of both rural as well as urban poor.
- The commercial banks, both in the public sector and the private sector extend finances for agricultural as well as other allied activities, as part of their priority-sector lending, which has been mandated by RBI.

Self-Help Groups (SHGs)

- SHGs are small informal group of 10-20 individuals, who are homogenous with respect to social and economic background and come together voluntarily, for promoting savings habit among members and for a common cause to raise and manage resources, for the benefit of group members.
- However, in hilly tracts and regions and predominantly tribal dominated areas, where communities are dispersed, economically weaker and physically challenged persons, smaller groups of minimum 5 members are also formed into SHGs.
- It is preferred that all members are from Below Poverty Line level (BPL). However, there can be up to 20%, or in exceptional cases, up to 30% of the members from Above Poverty Line (APL), provided they live contiguous to the BPL members.
- The members of the SHG come together voluntarily to save small amounts regularly to a common fund and to meet their emergency needs.

- This common fund may not, often, be sufficient enough to lend to its members and hence, the SHG seeks an external funding from banks to support the income-generating activities.

Microfinance Institutions (MFIs)

As per NABARD, MFIs are defined as 'those which provide thrift, credit and other financial services and products of very small amounts, mainly to the poor in rural, semiurban or urban areas, for enabling them to raise their income level and improve living standards.

- **Not for profit MFIs** - These are societies registered under the Societies Registration Act, 1860, or similar Acts. They also include trusts set up, under the Indian Trust Act, 1882 and 'Not for Profit companies' established under Section 25 of the Companies Act, 1956 (now section 8 of the Companies Act, 2013).
- **Mutual benefit MFIs** - These include State and National Cooperatives and Mutually Aided Cooperative societies, set up under the Mutually Aided Cooperative Societies Act, which was enacted by the Government of Andhra Pradesh, in the year 1955.
- **For profit MFIs (NBFC-MFIs)** - These are non-banking financial companies (NBFCs), which are registered under the Companies Act and regulated by the RBI. Most of the microfinance in India are through MFIs that fall in this category. They form the largest category of MFIs.

SHG - Bank Linkage Programme



Linkage for Saving

- The SHGs which are engaged in promoting savings habits among their members are eligible to open savings bank accounts with banks. These SHGs need not necessarily have already availed of credit facilities from banks, before opening savings bank accounts, and the account will be opened in the name of the SHG.

- In terms of the current RBI guidelines under Simplified norms for Self Help Groups (SHGs), Customer Due Diligence (CDD) of all the members of SHG as mentioned in the above Direction are not required while opening the savings bank account of the SHG.
- CDD of all the members shall be necessary at the time of credit linking of SHGs (Amendment vide RBI MD: KYC 2016)

Linkage for Borrowing

- As per guidelines issued by NABARD, SHGs may be sanctioned savings linked loans by banks (varying from a saving to loan ratio of 1:1 to 1:4).
- However, in case of matured SHGs, loans may be given beyond the limit of four times the savings, as per the discretion of the bank.
- The loan would be in the name of the SHG and it is the SHG which is responsible for repayment of the loan. Loan may be granted by the SHG for various purposes to its members.
- The bank does not decide the purposes for which the SHG gives loans to its members.
- The purpose can be emergency needs like illness in the family, marriage, etc., or buying of assets for income generation acquisition of assets.
- Defaults by a few members of SHGs and/or their family members to the financing bank should not ordinarily come in the way of financing SHGs perse by banks, provided the SHG is not in default.
- No loan related and ad hoc service charges/inspection charges should be levied **on priority sector loans up to Rs 25,000.**
- In the case of eligible priority sector loans to SHGs/ JLGs, this limit will be applicable per member and not to the group as a whole.
- **No Collateral:** RBI/NABARD guidelines stipulate that no collateral security should be taken from SHGs, by banks.
- **Part of PSL:** Lending to SHGs constitute part of priority sector lending of banks and such advances should be included as part of their lending to the weaker sections. Financing to SHGs by banks are refinanced 100% by NABARD

The SHG–bank borrowing linkage programme operates three models, which are:

- **Model I:** NABARD–Bank–SHG. Under this model, SHGs are formed and directly financed by banks. There is no NGO intervention.
- **Model II:** NABARD–Bank–SHG (with NGO as a facilitating agency). Under this model, the NGOs will promote SHGs and link them with banks. SHGs formed by NGOs are also directly financed by banks. This is the most popular model and a majority of the SHGs were financed by banks under Model II.

- **Model III:** NABARD–Bank–NGO–SHG (with NGO as the financial intermediary). Funds flow from banks to NGOs, and the SHGs are, thereafter, financed by banks through the NGOs.

Joint Liability Groups (JLGs)

- A group of 4-10 people of same village/locality of homogenous nature and of same socio-economic background who mutually come together to form a group
- **Purpose:** Availing loan from a bank, without any collateral.
- A few members of SHGs may graduate faster to start or expand economic activities, requiring much higher levels of loans than other SHG members.
- In such cases, other members may not like to stand mutual guarantee for large sized loans for these members, and in such cases, a "Joint Liability Group (JLG)" may be created consisting of such members of one or more SHGs.
- The members of JLG will continue to remain members of the SHGs and continue to participate in the activities of SHGs as earlier

Regulatory Framework for Microfinance Institutions

- Till the beginning of the 21st century, the activities of the MFIs were largely unregulated. The rapid growth and demand for their services, unfortunately, led to a crisis in the sector in 2010, largely in Andhra Pradesh, where the activity was concentrated.
- During the said period, the lending by MFIs had escalated exponentially and this led to a very high level of borrowing, per family.
- The high level of borrowings led to increase in defaults which motivated some of the MFIs to resort to coercive recovery methods. This culminated into a spate of suicides in the State and during 2010, there were 30 suicides by women borrowers, in **the short space of 45 days.**

In order to ascertain the reasons for the crisis and in an order to bring in discipline and control in the microfinance sector, the RBI appointed a Committee to Study Issues and Concerns in the MFI Sector (Chairman: Y H Malegam). **The Committee submitted its findings in January 2011 and some of the key recommendations of the Malegam Committee are listed here:**

- Creation of a separate category of NBFC operating in the microfinance sector to be designated as NBFC-MFI
- Criteria for defining 'microfinance loans' classified as 'qualifying assets'
- Prudential norms on capital adequacy and provisioning requirements
- Prescriptions related to pricing of credit, in terms of a margin cap and interest rate ceiling on individual loans
- Transparency in interest charges as well as other terms and conditions of the loan
- Measures to address multiple lending, over-borrowing and coercive methods of recovery

- Establishment of a proper system of grievance redressal

Reserve Bank Of India (Regulatory Framework For Micro Finance Loans) Directions 2022

RBI, in exercise of the powers conferred by

- Section 21, Section 35 A and Section 56 of the Banking Regulation Act, 1949,
- Chapter IIIB of the Reserve Bank of India Act, 1934 and
- Sections 30A and Section 32 of the National Housing Bank Act, 1987,
- issued fresh directions to banks/NBFCs including micro finance institutions and housing finance companies in March, 2022

Definition of micro finance loans

- A micro finance loan is defined as a collateral-free loan given to a household, having annual household income up to **Rs. 3 lakh**.
- For this purpose, the household shall mean an individual family unit, i.e., husband, wife and their unmarried children.
- All collateral free loans, irrespective of end use and mode of applications/processing/disbursal (either through physical or digital channels), provided to low-income households.
- To ensure collateral free nature of the microfinance loans. the loan shall not be linked with a lien on the deposit account of the borrower.
- The regulated entities (REs) shall have a board-approved policy to provide the flexibility of repayment periodicity on microfinance loans as per the borrowers requirement

Assessment of household income

- Each RE shall put in place, a board-approved policy, for assessment of household income.
- Self-regulatory organisations and other associations/agencies may also develop a common framework, based on the indicative methodology.
- The REs can adopt/modify the above framework suitably, as per their requirements with approval of their boards.
- Each RE shall mandatorily submit information regarding household income to the credit information companies (CICs).
- The reasons for any divergence between the already reported household income and assessed household income shall be specifically ascertained from the borrower/s before updating the assessed household income with the CICs.

Limit on loan repayment obligation of a household

- Each RE shall have a board-approved policy regarding the limit on the outflows on account of repayment of monthly loan obligations of a household as a percentage of the monthly household income.
- This shall be subject to a **limit of a maximum 50% of** the monthly household income.
- The computation of loan repayment obligations shall take into account all outstanding loans (collateral-free microfinance loans as well as any other type of collateralized loans) of the household.
- **The outflows capped at 50% of the monthly household income** = repayments (including both principal as well as interest component) towards all existing loans as well as the loan under **consideration**.
- **Each RE shall provide timely and accurate data to the CICs and use the data available with them to ensure compliance with the level of indebtedness.**

Pricing of Loans

Each RE shall put in place a board-approved policy regarding pricing of microfinance loans which shall, inter alia, cover the following:

I) A well-documented interest rate model approach, for arriving at the all-inclusive interest rate;

II) delineation of the components of the interest rate such as cost of funds, risk premium and margin, etc., in terms of the quantum of each component based on objective parameters;

III) The range of spread of each component for a given category of borrowers;

IV) A ceiling on the interest rate and all other charges applicable to the microfinance loans

- Interest rates and other charges/ fees on microfinance loans should not be usurious.
- These shall be subjected to supervisory scrutiny by the Reserve Bank.
- Each RE shall disclose pricing related information to prospective borrower in a standardised simplified factsheet.
- The borrower shall not be charged any amount which is not explicitly mentioned in the factsheet.
- The factsheet shall also be provided for other loans (i.e., collateralised loans) extended to borrowers from low-income households.
- There shall be no pre-payment penalty on microfinance loans.
- Penalty, if any, for delayed payment shall be applied on the overdue amount and not on the entire loan amount.

- Each RE shall prominently display the **minimum, maximum and average** interest rates charged on microfinance loans in all its offices, in the literature (information booklets/ pamphlets) issued by it and details on its website.
- Any change in interest rate or any other charge shall be informed to the borrower well in advance and these changes shall be effective only prospectively.

Guidelines on Conduct towards Microfinance Borrowers:

- A Fair Practices Code (FPC) based on these directions shall be put in place by all REs with the approval of their boards.
- The FPC shall be displayed by the RE in all its offices and on its website.

Qualifying asset criteria

- Under the latest guidelines of RBI, the definition of qualifying assets of NBFC-MFI is aligned with the definition of micro finance loans.
- **The minimum requirement** : 75% of the total assets.
- Under the earlier guidelines, an NBFC that does not qualify as an NBFC-MFI, cannot extend micro **finance loans exceeding 10%** of its total assets.
- The **maximum limit** on microfinance loans for such NBFCs (i.e.. finance loans for NBFC-MFIs therefore stands revised **to 75 per cent of the total assets**.
- Under the earlier guidelines, an NBFC that does not qualify as an NBFC-MFI, cannot extend micro finance **loans exceeding 10 per cent of its total assets**.
- **The maximum limit on microfinance** loans for such NBFCs (i.e.. NBFCs other than NBFC-MFIs) now stands revised **to 25% of the total assets**.

RBI's Fair Practices Code For NBFC-MFIS

- A Fair Practice Code (FPC) for any industry, is a set of criteria that justifies the functioning of that industry, in compliance with the guidelines of the regulatory body and that they are not carrying out any activity, which is prohibited/barred/forbidden by the regulator.

Objective of RBI's Fair Practice Code

The main purpose of the Fair Practices Code is to:

- Adopt practices which are considered best for dealing with the customer;
- Ensure customer satisfaction, by setting higher standards and achieving them;
- Follow methods of business operations that are transparent, fair, ethical and legally justifiable;
- Provide business-related information to the public, which is in their interest; and
- Avoid using unfair practices.

RBI's FPC for NBFCs details the following areas for adherence:

- Obtention of loan applications and their processing

- Loan appraisal and terms and conditions of sanction
- Disbursement of loans and change of terms and conditions of sanction
- Request for transfer of borrowal accounts
- Avoiding use of coercive measures and methods for recovery of loans
- Resolving complaints and grievances of customers
- Language to be used and mode of communication of the FPC
- Avoiding charging of unreasonably high rate of interest
- Use of various methods for re-possession of hypothecated vehicles

For NBFC-MFIs, the FPC elaborates of the following criteria:

General

- The FPC in vernacular language shall be displayed by an NBFC-MFI, in its office and branch premises,
- A statement shall be made in vernacular language and displayed by NBFC-MFIs in their premises and in loan cards, articulating their commitment to transparency and fair lending practices,
- Field staff shall be trained to make necessary enquiries with regard to existing debt of the borrowers,
- Training, if any, offered to the borrowers shall be free of cost. Field staff shall be trained to offer such training and also make the borrowers fully aware of the procedure and systems related to loan/other products.
- The effective rate of interest charged and the grievance redressal system set up by the NBFC-MFI should be prominently displayed in all its offices and in the literature issued by it (in vernacular language) and on its website,
- A declaration that the MFI will be accountable for preventing inappropriate staff behaviour and timely grievance redressal shall be made in the loan agreement and also in the FPC displayed in its office/branch premises,
- The KYC Guidelines of RBI shall be complied with. Due diligence shall be carried out to ensure the repayment capacity of the borrowers,
- As specified in the RBI's directions for NBFC-MFIs, all sanctions and disbursement of loans should be done only at a central location and more than one individual should be involved in this function.
- In addition, there should be close supervision of the disbursement function,
- Adequate steps may be taken to ensure that the procedure for application of loan is not cumbersome and that loan disbursements are done, as per pre-determined time structure.

Disclosures in loan agreement/loan card

All NBFC-MFIs shall have a Board-approved, standard form of loan agreement. The loan agreement shall preferably be in vernacular language.

In the loan agreement the following shall be disclosed:

- All the terms and conditions of the loan,
- That the pricing of the loan involves only three components viz; the interest charge, the processing charge and the insurance premium (which includes the

administrative charges in respect thereof), **that there will be no penalty charged on delayed payment,**

- That no Security Deposit/Margin is being collected from the borrower,
- That the borrower cannot be a member of more than one SHG/JLG.
- The moratorium period between the grant of the loan and the due date of the repayment of the first instalment would be as guided by RBI's directives for NBFC-MFIs, and
- assurance that the privacy of borrower data will be respected.

The loan card should reflect the following details:

- The effective rate of interest charged,
- All other terms and conditions attached to the loan,
- Information which adequately identifies the borrower and acknowledgements by the NBFC- MFI of all repayments including Instalments received and the final discharge,
- The loan card should prominently mention the grievance redressal system set up by the MFI and also the name and contact number of the nodal officer,
- Non-credit products issued shall be with full consent of the borrowers and fee structure shall be communicated in the loan card itself,

Non-Coercive Methods of Recovery

- As specified in RBI's directions for NBFC-MFIs, recovery should normally be made only at a central designated place.
- Field staff shall be allowed to make recovery at the place of residence or work of the borrower only if borrower fails to appear at central designated place on two or more successive occasions.
- NBFC-MFIs shall ensure that a Board approved policy is in place with regard to Code of Conduct by field staff and systems for their recruitment, training and supervision.

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