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Robust microfinance, key to financial inclusion

A dedicated funding facility and providing MFIs some scope for diversification will help expand market outreach

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The link between access to finance and economic development has been repeatedly brought out through field research as well as macro studies. It is also well-acknowledged that mere growth is not enough; it needs to be broad based. For the last nearly three decades, formal (RBI regulated) microfinance has been making this possible.

As of September 2024, microfinance credit services reached 8.1 crore low-income clients in 722 districts including 108 aspirational districts with credit outstanding of nearly ₹4 lakh crore — NRLM (National Rural Livelihood Mission) is in addition to this. The development role of microfinance is evidenced by a study conducted by NCAER in 2022, which showed that microfinance contributes to 2.03 per cent of India's GDP and sustains 13 million jobs.

Despite this impressive reach, the enormity of the future agenda looms large. Microfinance by regulation is mandated to cover clients below annual household income up to ₹3 lakh. An estimate for the size of this segment can be deduced from the Household Consumption Expenditure Survey (HCES) 2022-23 by making a few assumptions. While the survey captured the per capita expenditure, if we make two assumptions: (i) 60 per cent of income as consumption; and (ii) 5/4 person household size in rural/urban areas respectively, we find that nearly 80-90 per cent people in rural areas and 70 per cent in urban areas are covered by microfinance income definition. If these numbers are compared to the current market outreach of microfinance, the enormity of future agenda becomes evident.

FUNDING FROM BANKS

While banks and SFBs (small finance banks) have deposits as their core funding source, NBFC-MFIs and NBFCs rely on borrowings from banks and capital market. Experience shows that despite the long track record of the sector, the funding from banks dries up fast in case the sector goes through temporary stress periods. For example, at present, due to increase in delinquency, debt funding to MFIN NBFC-MFI members shrunk to ₹13,508 crore in the second quarter of FY 24-25 as compared with ₹22,736 crore in the corresponding year-ago period. The inability of MFIs to give fresh loans can trigger default as borrowers see no incentive to repay. A sector which is playing a humongous role in reaching credit services to the last mile needs a dedicated funding facility which adopts a holistic cost-benefit approach over short term risk aversion.

CREDIT. Delivering to the doorstep

Microfinance operates on a win-win formula, wherein clients find the services beneficial, and REs (regulated entities) also find the business viable. However, the sector frequently faces disruptions at the local level, such as inciting borrowers not to repay, placing restrictions on microfinance operations like group meetings, etc.; the last one year has seen many such incidents. These acts vitiate credit discipline, and the sector needs the support of the State to ensure that external inciters are nipped in the bud.

All REs active in microfinance provide doorstep service — though microfinance operations have become digital, the nature of clients is such that they are more comfortable with a mix of physical and digital. This necessitates a large field force and consequent operational cost. Notably, Indian microfinance is globally the most efficient in terms of cost and services, with doorstep services being provided at 23.5-24 per cent per annum on reducing balance.

Of the four components of pricing, REs have little or no control on three factors — cost of funds, transaction cost and risk cost. There's a perception that MFIs make huge profits, but facts indicate otherwise. An analysis of the top 15 NBFC-MFIs over the last eight-and-a-half years shows that the weighted average RoA was a mere 2.2 per cent. Additionally, on a ₹40,000 loan repayable monthly over two years, the difference in per month EMI of a loan at 24 per cent and other at 20 per cent is less than ₹50. Comparison with other lending rates to a similar segment shows that microfinance rates are the lowest. Thus, while REs should have a robust pricing policy, exclusive focus on headline rate and ignoring other factors will make the sector unviable.

While there are other challenges requiring policy action like a suitable guarantee fund, allowing MFIs some scope for diversification and equity support for small MFIs will be in order.

But the future actionables are not a one-way street; the RBI-regulated entities and MFIN, as self-regulatory organisation, also have a role to address policy concerns on over-lending and fair practices.

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