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Client protection in microfinance companies in India

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Abstract

Objectives: This paper examines what microfinance companies are doing to protect their clients –mostly women belonging to weaker sections -from mis-selling, over indebtedness and unfair practices.
Methods/Statistical analysis: The study is based on annual reports produced by 49 microfinance institutions belong to Microfinance Institution Network (MFIN) an interview of 355 microfinance in Alwar, Rajasthan was conducted in 2015 and 2017. Focus group discussions were the main tool used to solicit views of microfinance clients.
Findings: The client grievance redressal mechanism available to microfinance clients is skewed in favor of the microfinance providers, who are members of MFIN. The Reserve Bank of India has recognized MFIN as the Special Regulatory Organization (SRO) to resolve all client complaints at its own level. Till now not a single adverse decision has been made by the Enforcement Committee of MFIN against any of its members for violating Code of Conduct or Fair Practices Code, which protects clients against lenders abuse. Unless RBI independently monitors the client grievance redressal work of MFIN, there is little hope that clients will receive justice which is without any reproach.
Application/Improvements: Microfinance clients should have recourse to third party dispute resolution, including Banking Ombudsman appointed by the RBI. Keywords: 5-6 words, Drawn from title, Word representing the work.
Keywords: Microfinance, consumer protection, grievance redressal.

1. Introduction

The risk of political interference and irrational behavior of borrowers make credit markets fragile. Policy makers and regulators do institute measures to counter over-indebtedness and usurious practices.

Fixing ceiling on maximum permissible chargeable interest rate is a widely applied tool. Other soft approaches include educating the borrowers through financial literacy compulsory disclosures of terms and conditions in loan contracts, and transparency in loan collection processes have been advocated. Apprehensions over growing indebtedness beyond the repaying capacity of borrowers, have exercised public opinion in Latin America, South Asia and South Africa.

The knowledge about best way to extend protection to microfinance clients is very scattered. The commercialization of microfinance have given rise the microfinance experience has conclusively shown that poor women honor their loan repayment commitments.

The growing commercialization accompanied by push for larger average loans is disrupting more conservative practices of compulsory customer training before loan disbursement.

Along with larger sized loans, clients are being offered a bundle of products including insurance, pension, and remittances increasing the chances of mis-selling. Some fear that unscrupulous lenders might exploit vulnerabilities of poor borrowers, leading to their debt trap.

Moral arguments demand for judicious government intervention in favor of clients because due to information and power asymmetries, service providers have the upper hand over the clients. Illiterate, first time borrowers are unfamiliar with the formalities of microfinance institutions which puts them in great disadvantage to negotiate well with the loan officers.

In such situation, there is real danger of mis-selling, and over borrowing which can hurt both the borrower and the lending institution.

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2. Materials and methods

This paper first considers the traditional case of client protection in India. It examines whether the regulations need to be supplemented with financial literacy in microfinance borrowers.

The main focus in this paper is non-banking financial companies (NBFC) permitted by the Reserve Bank of India to carry out microfinance operations. These NBFC microfinance institutions (MFIs) have 80% of the microfinance market share [1].

3. Research methodology

Financial literacy is a feature of well-designed financial regulations. Behavioral research indicate that availability of right amount information have considerable influence in the choices clients make and curb instinct of over borrowing [2] Product features and contract forms can be designed to gently persuade clients away from over-borrowing without explicitly commanding to do so [3]. Among the measures they suggest is a "cooling off" period between loan sanction and disbursement which allows plenty of time for reflection and annulling the contract, if so desired. Clients often get confused when they are presented with an array of alternative. If the alternatives are disclosed in a standardized and simplified manner, there is greater likelihood of better evaluation of the risks and benefits of various propositions that are made. These research findings highlight the importance of raising awareness of the clients on what to look out while choosing a financial product. Standardized disclosures in vernacular languages can reduce information asymmetries regarding financial products and services. There is evidence that individuals do not fully comprehend interest rates [4]. Where the clientele lack understanding of basic concepts of savings and borrowing, (which may be due to lack of prior exposure or illiteracy) financial literacy can bridge the information asymmetry between borrowers and microfinance lenders [5].Along with financial literacy, regulations for adoption and implementation of fair practices code by the lenders are useful.

Accessibility to third-party recourse mechanisms to redress client grievances is a means to secure economic justice. If a client is not satisfied with the way her complaint was handled by the lender, or the outcome of her complaint, she should have avenues for raising her grievance to an independent ombudsman. Financial literacy, together with fair practices code and legal recourse for dispute resolution between borrowers and lenders have proved its merit in microfinance markets such as Cambodia, Peru, and Bangladesh. Indeed, there is evidence that disclosure requirements aid growth of competitive markets and eventual lowering of interest rates.

4. Microfinance client protection in India

The Preamble of India's Constitution promises to secure for all its citizens justice, liberty, and equality. The thoughts enshrined in the Preamble find practical expression in many financial laws and administrative practices. For example, the Reserve Bank of India (RBI) designed a policy of Priority Sector Lending making it mandatory for all banks, both domestic and foreign; to have at least 40 per cent of their net bank credit (NBC) delivered to targeted social groups and economic sectors.

Such target segments include: agriculture, micro-enterprises, weaker sections, and scheduled castes and scheduled tribes. The Consumer Protection Act, 1986 is a central piece of legislation which grants all consumers "... the right to have information about the quality, potency, quantity, purity, price, and standard of goods or services."

The CPA applies to the provision of all financial services and products. Under this law, Consumer Courts have been established at national, State and District level. One major flaw of this law has been its reliance on a compensatory, rather than a punitive punishment to set an example to future offenders.

The small compensation awards have not deterred repeated wrong doing by more powerful service providers. As a result, the consumer courts have not provided much relief to rural consumers looking for expeditious, inexpensive adjudication.

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District court decisions are often challenged in higher courts, leading to time consuming and expensive proceedings. Client awareness is essential to curb unfair practices of trade.

Unfortunately, due to lack of administrative will, enforcement of consumer protection laws has remained weak in India. Some old laws also provide additional protection. The Contract Act of 1872 lays down the conditions in which acceptance by one part of an offer by another party forms a contract and if necessary, can be legally enforced. This Act lays down the remedies available to any aggrieved party if other party fails to honor the agreement entered between the two parties. Likewise, the Sale of Goods Act of 1930 act uphold the rights of buyers of goods if goods purchased fail to meet the expressed or implied conditions and warranties.

The RBI currently has no mechanism to deal with complaints of from NBFC-MFI clients. The Banking Ombudsman Scheme 2006 promulgated by RBI only deals with client complaints related to services provided by any of the banks, not NBFC-MFIs. Clients can directly lodge their complaints to the Banking Ombudsman. The Ombudsman can issue awards, which is binding on the banks, unless set aside by appeal to higher courts. Further, the RBI's Customer Service Department works in coordination with both the Banking Ombudsmen and the Banking Codes and Standards Bureau of India (BCSBI) including review meetings with Grievance Redressal Officers of banks. There is no such mechanism for reviews or consultation between RBI and microfinance SROs. In response to alleged suicides by microfinance borrowers in Andhra Pradesh, in October 2010, the State government promulgated the Microfinance Institutions (Regulation of Money Lending) Ordinance.

The restrictions placed on the operations of microfinance institutions virtually brought to halt all lending and repayment collections by MFIs in the State, and triggered mass defaults in few pockets in neighboring states. It was feared that other States would follow suit to protect microfinance borrowers. To dissolve the crisis, RBI issued new directions to regulate MFIs. All MFI Board of Directors were charged to formulate and monitor Fair Practices Code [6], [7], [8]. Further guidelines defined income criteria for clients in urban and rural areas, maximum loan they can avail from two MFIs, usage of loans for income, generation, margin cap, and the frequency of loan repayment [7]. All microloans were to be disbursed without to any borrower with a household annual income not exceeding ₹60,000 in rural areas and double that amount in urban and semi-urban areas on the condition that the total indebtedness of the household does not exceed ₹ 50,000 [9]. The Loan Card from the borrower would clearly reflect in vernacular language the annual rate of interest charged, repayments made, and balance due. With effect from 1st of April, 2014 the margin caps for large MFIs having loan portfolio exceeding ₹ 100 crore has been fixed at 10% and 12% for smaller MFIs. As a result, MFIs annual interest rates were capped at 10-12 percentage points above their own borrowing costs, leaving most charging 23-26%. In order to curb multiple lending, all MFIs had to compulsorily use credit information of the borrowers stored with credit bureaus. The use of Aadhaar card and other forms of identity stored in the credit bureau considerably reduced the danger of multiple lending to borrowers.RBI accorded Self-Regulatory Organization (SRO) status in June 2014 to Microfinance Institution Network (MFIN), and later in March 2015, to Sa-Dhan. Both MFIN and Sa-Dhan are industry association of microfinance institutions.

The Government is encouraging industry association to self-regulate its business. The responsibility of SRO covers addressing client grievance, dispute resolution among members, promoting best practices through training, and capacity development of members, and maintaining constant surveillance to check any deviations from the common Code of Conduct adopted by the two SROs. Considering that currently the microfinance sector is spread over thirty states and has about 2.5 million clients, 98% of whom are women belonging to low income households, MFIN and Sa-Dhan have been entrusted a huge responsibility to protect clients against the wrong doing by lenders. MFIN has taken a number of initiatives in line with the various directives of RBI to NBFC-MFIs and also the best practices advocated by the Smart Campaign, a global effort to recognize clients as the driving force of the industry. The Campaign holds that the implementation of its' Client Protection Principles would foster client centric good practices, stricter due diligence and reduction of financial risks. Some of the key initiatives under self-regulation are mentioned below:

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1. Responsible lending

To build investor confidence, MFIN has joined the Responsible Finance Forum (RFF) set up by the Small Industries Development Bank of India (SIDBI). The Forum has all major banks and financial institutions as its members. This peer forum advocates for the need to develop a robust client protection framework, share views on the emerging issues in the microfinance sector, and generate knowledge through commissioned studies to spot check client protection practices in the field.

2. Code of conduct

MFIN together with Sa-Dhan, have developed a comprehensive Code of Conduct (CoC) which has found acceptance by MFIs and their lending banks. The COC has detailed guidelines on client protection, interest rate disclosures, maintenance of data privacy and financial literacy and mechanism for redressing grievances. The Enforcement Committee of MFIN has been put in place formal processes for investigating CoC and regulatory violations, and reporting on it to Board of Directors of MFIN. Till date, 62 MFIs have undergone COC Assessment conducted by external consulting agencies and 26 others by Sa-Dhan. The assessments found MFIs in broad conformity of the COC. Several of the MFIs have also been assessed against the Smart Campaign principles of client protect and social performance management.

3. Transparency and disclosure

The COC requires clear communication to clients on interest rate, processing fee and insurance charges etc. Generally, such information is printed on the loan cards/passbook held by the clients. Some MFIs make it point to verbally explain the terms and conditions of the products in detail. Likewise, the procedure for grievance redressal is prominently displayed on office notice board. MFIN members also report on client complaints received and disposed to the concerned authorities, RBI, lending banks, shareholders, and industry associations.

4. Governance

Table 1. Best Practices in Microfinance Client Protection

Stage in Cycle	Misuse	Best Practices
Before Sale	Inaccurate or misleading communication on effective interest rate on loan, processing charges and penalties. Inappropriate sales techniques.Kickback requests.	To state interest rate on a declining balance basis. Ban use of threats to clients. Strengthen vigilance and monitoring.
At time of sale/ disbursement of loan	Misleading language in contract. Push for loans without reference to borrowers' absorptive capacity. Use of penalties and hidden charges. False documentation of client's identity or other particulars.	Easy to understand, and properly drafted contracts with full disclosure of all charges and terms. Standardized due diligence of borrowers' capacity to pay. Built-in options for cancellation of loan by either party during the period between sanction of loan and its disbursement.Disbursement in front of family members and other group members.
After Sale	Issuing false or incorrect receipts. Use of coercion or abusive behaviour in recovery of dues.Sharing of borrower information with another entity.	Issue proper and on time receipts for all payments and disbursements. Punish staff using coercion in collection of dues. Resolve disputes with clients amicably. Maintain privacy of client information.

Improved corporate governance practices among MFIs are helping client protection. SIDBI and global investors have pushed hard for better governance. The inclusion of independent board members with professional background in financial services has positively contributed to better credit rating and positive COCA assessments. The RBI expects the lending institutions to create mechanisms for redressal of grievances of clients [7]. Here 'Grievances' includes all matters relating to loans, third party products such as insurance or pension, and inter- personal relations arising between the client, and the staff of MFI.

The objective of the grievance resolution mechanism is to provide clients with a user friendly, low cost, administratively efficient option for settlement of individual grievances. The NBFC-MFIs have also created a mechanism for redressal at intra-industry level. Clients may refer their grievances first to the concerned MFI. There is a dedicated Grievance Redressal Officer in each of the MFI supervises this function. If the client does not receive any response within reasonable period of time, or not satisfied with the outcome, the grievance can be escalated to the MFIN.

The grievance can be lodged verbally through a toll free call centre maintained by MFIN or in writing to the MFIN Appellate authority. The MFIN Grievance Redressal framework follows principles of fair and timely treatment of all clients, and handles their grievances in good faith without prejudice. None of the 355 microfinance clients interviewed by this author in Alwar, Rajasthan had used the free toll line number for lodging customer complaints. These clients were being served by four NBFC-MFIs. They felt their complaints would displease the loan officer, who will stop giving them new loans. None of the clients had attended any financial literacy classes. The best practices adopted by microfinance sector in India against abusive lending are presented in Table 1.

5. Discussion

The introduction of strong regulatory requirements against unscrupulous loan selling and price ceiling has profound impact on NBFC-MFIs. These relate to positioning, adoption of a service approach in satisfying clients, investment in training of staff, and branding. Positioning is the process of establishing and occupying a place in clients mind. As service firms, MFIs differentiate among themselves on the basis of interest charged on loans, or the convenience of service rendered to the clients.

Based on their personal and repeated interaction with the MFI, the clients form certain perceptions which are shared among peers and Neighbours. For a MFI, current positioning has implications on the choice of target market, and creating an image of trust among clients based on perceived superior service.

After the fall out of Andhra Pradesh crisis, several MFIs reduced their exposure in South India, and in areas where the risk of political interference was high. Many moved to underserved markets of North and Central India. With the introduction of RBI regulations, the room to Manoeuvre price of credit was hugely curtailed. Many MFIs realized that quality of service could be an important differentiator in a commodity market, particularly where clients have a choice among MFIs. The promptness in service, speed of loan processing, and convenience in payment were offered as possible differentiator. To achieve excellence in service to clients, staff needs to be properly trained and sensitized on the importance of delivery high service to all clients every time. Without monitoring and enforcement of standard operating procedures, client handling might vary great deal.

Most MFIs reoriented employee developed standard operating procedures for handling client grievances, and trained staff to understand the appropriate personality type of clients and to modify behavior accordingly. Incentives to encourage staff to adopt a client first attitude help in fine tuning behavior of client-facing staff. NBFC-MFIs have strong business processes to ensure delivery standards and monitor employee adherence through internal audit teams.

A distinct move was to build strong brand management and conduct analysis on how that brand is perceived in the market. All microfinance institutions offer credit which is a commodity. Hence, the MFIs have invested building right image of the organization, and invested on upgrading their branch offices to convey a pleasant experience to their visiting clients.

There is also emphasis on building relationship between the brand and the local opinion makers. Leading MFIs regularly conduct retreats of successful microfinance clients, organize events like International Women's Day, organize health camps, and other public relation functions. However, financial literacy classes have not taken off. Some MFIs accord very high importance in ensuring client satisfaction.

It is best to solve clients' problem on the spot, since escalation is costly both to the MFI and the client.

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The immediate rendering of service done in a competent and polite manner is often sufficient to assuage aggrieved clients. Where the staff demonstrates extra care and affection to please an aggrieved client, there is greater likelihood of customer stickiness with the MFI. As a result of RBIs regulation, client centricity in MFIs has increased. A majority of MFIs have put in place processes which help meet client needs in a superior way. As competition to retain client's heat up, MFIs are fighting hard to stamp their distinct personality and positive image on clients mind.

6. Conclusion

Balancing creditors and borrowers right is not a zero sum game. Client protection could be a way of broadening financial access which is import for the growth of the microfinance market. Not protecting the client, may actually be an excuse for political interference or stringent regulation, both of which can hamper development of microfinance. The RBI need to collect timely and accurate information on the extent of over-indebtedness faced by microfinance borrowers and monitor how SRO members are handling client grievances. Currently, RBI has no independent mechanism for collection of data on microfinance borrowers. Without reliable, independently verifiable data, RBI's policy response on client abuse may not be in sync with changing realities on the ground. RBI should consider giving microfinance clients right to directly lodge complaints with the Banking Ombudsman. The scope of Banking Ombudsman should be enlarged to cover NBFC clients as well. SROs are controlled by microfinance institutions themselves. Clients need to have recourse for third party mechanism for dispute resolution. Greater emphasis on client protection is must for the healthy growth of microfinance sector. In a democratic society, the decisions on the form of regulation, and its enforcement requires lot of collaboration between the regulator, industry association and consumer bodies.

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