REGULATIONS ON MICROFINANCE

SYNTHESIS OF IMPORTANT DICUSSIONS ON MICRO FINANCE REGULATIONS

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Solution Exchange for the Microfinance Community Consolidated Reply

FOR COMMENTS: Micro Finance Institutions (Development and Regulation) Bill - 2011

Compiled by Navin Anand, Resource Person and Monika Khanna, Research Associate
Issue Date: 01 September 2011

From Jyoti Vij, Federation of Indian Chambers of Commerce and Industry (FICCI), New Delhi

Posted 25 July 2011

I work with Federation of Indian Chambers of Commerce and Industry (FICCI). FICCI works closely with the government on policy issues, enhancing efficiency, competitiveness and expanding business opportunities for industry through a range of specialized services and global linkages. It has formed a Financial Inclusion Committee for speeding the financial inclusion of the marginalized.

Ministry of Finance, Government of India has formulated **Draft - Micro Finance Institutions (Development and Regulation) Bill, 2011** that lays out the rules and regulations concerning India's microfinance sector. Draft Bill, aims to protect the clients, and gives Reserve Bank of India total jurisdiction and control to regulate and oversee the working of the entire microfinance industry. The draft Bill was released by the Ministry on 6 July 2011 to seek necessary public opinion before finalizing it. The Bill intends to bring significant changes to India's MFI sector landscape.

Some of the key highlights of the draft Bill under the proposed legislation are as follows:

- *MFIs would be brought under the purview of the RBI and would have to register with RBI before starting business. It will also allow any existing MFI to apply for registration within three months of the law coming into effect. Moreover, Reserve Bank will be able to place caps on margins and interest rates and set repayment schedules*
- *Beyond credit, the draft Bill mentions "thrift"—savings taking—as well as remittances and insurance as legitimate activities of microfinance institutions.*
- *The bill has proposed that any entity, except banks, which provides microfinance services, would be treated as a micro finance institution (MFI) and come under the RBI's regulatory oversight.*
- *Bill also envisages a Microfinance Development Fund to be constituted by RBI to provide loans, refinance, grants, seed capital or any other financial assistance to any MFI and to which all government grants received and fees payable for this sector will go. The Bill will also empower RBI to ask MFIs to cease their activities if warranted upon inspection of the accounts. It will also be able to cancel registration granted to the MFI*
- *Enactment of this bill would reduce the ability of State Governments to impose their own rules on micro-lenders*

Various chapters included in the Bill are – Microfinance Development Council; State Advisory Councils; Registration of Microfinance Institutions; Reserve, accounts, Audit and Returns; Functions and Powers of Reserve Bank; Constitution of Microfinance Development Fund; Redressal Mechanism and Offences and Penalties.

To read the **full draft**, please visit: ftp://ftp.solutionexchange.net.in/public/mf/cr/res22071101.pdf

The Ministry of Finance has invited comments on the proposed draft until 7 August 2011. To take things forward in a more concerted manner, FICCI, under the aegis of its Financial Inclusion Committee request your valuable feedback and suggestions on the draft Bill to bring key issues to the fore of concerned policy makers.

Look forward to your support and cooperation for this endeavor towards effective policy advocacy through wide consensus building.

Responses were received, with thanks, from

1. **N.Srinivasan, Independent Consultant, Pune**
2. **Ramesh S Arunachalam, Rural and MSME Practitioner, Chennai (Response 1; Response 2)**
3. **G K Agrawal, Rural Development Microfinance Consultant, Mumbai**
4. **K Sukumaran, NationalInstitute of Securities Markets, Mumbai**
5. **Sreedhar Nair, Initiative for Social and Economic Transformation (InSET), New Delhi**
6. **Savita Shankar, National University of Singapore, Singapore**
7. **Rajesh K Verma, Vananchal Gramin Bank, Jharkhand**
8. **K. C. Malick, Bharat Integrated Social Welfare Agency (BISWA), Orissa**
9. **Veerashekharappa, Institute for Social and Economic Change, Bangalore (Response 1; Response 2)**
10. **N.Jeyaseelan, Hand in Hand, Tamil Nadu**
11. **MBS Reddy, APMAS, Hyderabad**
12. **Arpita Choudhary, PATH, New Delhi**
13. **Ritesh Dwivedi, Amity School of Rural Management, Amity University, Uttar Pradesh**
14. **Ajit Kumar Maity, Village Welfare Society, Kolkata**
15. **Subhransu Tripathy, Entrepreneurship Development Institute of India, Gandhinagar, Gujarat**
16. **Kiran Kulkarni, Institute of Rural Credit and Entrepreneurship Development (IRCED), Sangli, Maharashtra**
17. **Anil Kumar Sukumaran, Development Consultant, London, United Kingdom**
18. **M. A. Ali, Grameen Financial Services Private Limited, Bangalore**
19. **Vineet Rai, Intellecap, Mumbai**
20. **Resham Singh, Punjab Gramin Bank, Punjab**
21. **M H Prasadu, Centre for Bhartiya Management Development, Nagpur**
22. **Smita Premchander, Sampark, Bangalore**
23. **M Rajshekhar, University of Sussex, Brighton, United Kingdom** *

**Offline Contribution*

Summary of Responses
Responses in Full

Summary of Responses

In order to fast track financial inclusion and provide protection to the poor customers seeking MF services, members felt that streamlining regulations is the need of the hour. Members appreciated the participatory approach adopted by the Ministry of Finance by inviting the suggestions of the stakeholders on the draft Microfinance Institutions (Development and Regulation) Bill – 2011. Members felt that Bill is comprehensive as it considers Malegam Committee recommendations and also causes of Andhra Pradesh crisis. It also incorporates all measures to improve customer protection such as grievance redressal procedures, mandatory enrollment to credit bureaus and enforcement of code of conduct.

Members enumerated following positive features of the draft Bill that will lead to more balanced and healthier development of the microfinance sector-

- **Single Regulator for MFIs:** All the Microfinance institutions irrespective of legal entity and level will come under the ambit of a single regulator – Reserve Banks of India; Every MFI, new or existing, will have to register under RBI. The bill also provides flexibility to RBI to apply different measures and delegate the powers to regulate the MF sector.
- **Broadening Scope of MF services**: Any MFI can now take up one or multiple MF services such as credit, savings, remittance, insurance, pension and other services.
- **Recognizing different models:** RBI will recognize both group as well as individual MF models keeping in view the agenda of inclusion of vulnerable and most disadvantaged
- **Creation of Microfinance Development Fund** - Financial support to MFIs will be provided in the form of refinance, loans, grants, seed capital and other financial services
- **Creation of Ombudsmen –** A quasi judicial structure will function for grievance redressal
- **Keeping MFIs out of Money lenders Acts** – All MFIs registered with RBI will be out of the ambit of Money Lending Laws of States

Some of the specific suggestions of the members on the Bill:

Microfinance Development Council (MFDC)

- Representation of members from the MFIs representing different geographical regions
- MFDC has to be entrusted with the role of regulating and supervising MFIs
- In addition to the other roles mentioned in the bill, the council could perform the functions that 'Board of Supervision' performs in respect of Banks
- Linkages between the National Council and State Councils is required so that there is significant role in between them and state councils are participating in some manner with the National council
- To have the genuine complaints, MFDC has to define as to who all can complaint

State Advisory Council (SAC)

- Besides the existing members as suggested in the Bill, representation of members from the microfinance institutions implementing various models of MF (SHG and JLG)
- Representation of women representative on the pattern of composition of Microfinance Development Council
- SAC to oversee the development of microfinance in the state in terms of coverage of underserved areas
- Developing the mechanisms for monitoring and evaluating the State Councils by the Central Committee

Legal Entity, Minimum Net Owned Funds, Rating and Coverage

- **Not compelling SIMFIs to convert into companies:** There will be two categories of microfinance institutions – MFIs and Systemically Important Micro Finance institutions (SIMFIs). The compulsion of converting all SIMFIs into companies may not be encouraging for NGO-MFIs as many of them would like to continue working on their core themes and issues in addition to Microfinance
- **Minimum cap of Net owned funds** - Increasing the minimum Net Owned Fund cap from existing 5 Lakhs to 25 Lakhs, so that only interested institutions register with RBI. There can also be fixation of differential net owned fund cap based on the geographic coverage of the MFIs.
- **Annual Percentage Rate (APR):** While specifying the maximum limit of Annual Percentage Rate (APR) charged by MFIs to the clients the RBI should also specify the maximum APR which the banks could charge to MFIs. The same has to be revised from time to time by RBI so that requisite APR margin is maintained to meet the operating and other costs of MFIs
- **Uniform Code of Conduct:** Instead of code of conduct by any Self Regulatory organization of Microfinance there could be a uniform code to be followed by all MFIs irrespective of their constitution on the lines of Fair Practices Code of RBI to NBFCs, for effective client protection practices.
- **Inspections:** On the issue of inspections to be made by the Reserve Bank of India, clarity is required – whether the inspection of books of accounts or records by the inspecting authority will be within the ambit of RBI or outside it.
- **Social Rating:** Bill should provide for compulsory responsible finance rating of MFIs – A combination of financial and social rating. MFIs showing greater social returns to be rewarded with incentives by the regulator
- **Coverage of banks and cooperatives under the bill:** Banks and particular type of Cooperative Societies that are taking deposits only from their members are kept out of the purview of the bill, though they are also undertaking microfinance activities. The point of excluding a particular type of cooperatives is not clear in the bill. For protecting the customers, there is a need to extend the scope and cover all type of financial cooperatives.

Constitution of Micro Finance Development Fund

- There is a need to define the size of the Microfinance Development Fund and the financing of the microfinance sector. The fund should be able to take care of the financial requirements of the Microfinance Institutions. The bill should give clarity whether the MF development fund can be used to give guarantee to commercial banks to lend to the MFIs.

Offences and Penalties

- The bill proposes a maximum penalty of Rs.5 lakhs. There is a need to raise the maximum penalty and relate the same with the nature of violation of law or regulatory advice and possibly made proportional to the size of MFIs.

Delegation of Powers

- On the issue of delegation of powers to National Bank, there is a need to clearly spell the nature of delegation and the class of MFIs being governed by it

Some other suggestions for strengthening the MF Bill as offered by the members were:

- Scope of Annual Percentage Rate (APR), to be fixed for interest rates and processing fee charged by the MFIs, other charges like insurance premium are not the income as they are associated with the additional services rendered by the MFI.

- Since there is a mention of collection of thrift in the draft, there is a need to mention the types of MFIs eligible to offer this facility and the mandatory prerequisites for the same. Issuance of operational guidelines for savings products will be useful.
- Stipulate a ceiling in financial terms both for individual and group microfinance services (keeping in view the inflationary trends) to keep the focus on providing services for the poor
- RBI to monitor the **governance** in MFIs by prescribing compulsory independent directors certified by the professional bodies
- Allocation of funds for **quality Human Resource** building initiatives and systems development (MIS and Risk management at MFIs level), which will improve the long term outlook for the sector
- **Review** the regulations framed for the sector half yearly. For this, regional committee comprising the practitioners and persons from Microfinance sector needs to be formed as the issues faced by many MFIs are region specific

Finally, members concluded that there is a need to formulate mechanisms to insulate the small borrowers from the uncertainties and irregularities. Also it was suggested the bill to be regulating rather than controlling. Members hoped that the robust MF Bill will ultimately help the country to achieve financial inclusion.

Responses in Full

N.Srinivasan, Independent Consultant, Pune

The bill is a critical piece for vulnerable people served by microfinance or hoping to be served by microfinance. The bill has tried to take in to account most problems currently encountered in the sector. Customer protection has prominently figured in the draft. One hopes that competitive legislation and one-upmanship among states to - who is the better protector of microfinance customers does not weaken this effort.

For a more detailed commentary on the bill please see:
http://microfinance.cgap.org/2011/07/24/india%e2%80%99s-microfinance-bill-answers-most-questions/#more-2293

Ramesh S Arunachalam, Rural and MSME Practitioner, Chennai *(response 1)*

The essence of regulation is to prevent failures of various kinds (I am quoting Mr Joseph Stiglitz) and therefore, just because a bill is proposed, we cannot and should not accept it straight away. We need to learn lessons from past micro-finance crisis and see in the context of past lessons and crisis whether indeed the bill will ensure orderly growth of micro-finance in India and whether it can guarantee real consumer protection on the ground. This is critical to ensure that we do not have a mere paper bill but rather one that is actually implemented on the ground!

Here are a few articles that I have written on the subject and while the bill is very welcome and the Union Ministry of Finance must be congratulated for making the effort, the structure of the bill and specific arrangements are equally important and must be known transparently before the bill is passed by Parliament. We cannot leave the specifics for a later date

- **Learning from experience: The key to drafting a good microfinance bill for India -** http://www.moneylife.in/article/learning-from-experience-the-key-to-drafting-a-good-microfinance-bill-for-india/18164.html

There are critical lessons from the crises we have suffered over the past two decades that the authorities will do well to learn from, as they plan the course ahead for the microfinance sector

- **Increasing frauds, internal lapses at MFIs: Need to strengthen supervisory arrangements to protect the poor-** http://www.moneylife.in/article/increasing-frauds-internal-lapses-at-mfis-need-to-strengthen-supervisory-arrangements-to-protect-the-poor/18309.html

A long list of instances of failures of microfinance institutions holds several important lessons for the RBI and the finance ministry on the regulation and supervision of the sector

- **Does a five-star board guarantee good corporate governance? -** http://www.moneylife.in/article/does-a-five-star-board-guarantee-good-corporate-governance/18239.html

Rules and regulations are not enough. They must be implemented. Sadly, recent episodes have shown that even independent directors stayed silent when rules were violated

- **Establish standards for MFI independent directors as first step to ensure good corporate governance -**http://www.moneylife.in/article/establish-standards-for-mfi-independent-directors-as-first-step-to-ensure-good-corporate-governance/18328.html

The RBI and the Union Finance Ministry must provide clear guidelines on the appointment, roles, compensation and evaluation of independent directors for microfinance companies, critical for effective and ethical operations

I will be writing more articles in the public domain to ensure that we have a well informed and objective debate and will keep posting the articles here as well

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Ramesh S Arunachalam, Rural and MSME Practitioner, Chennai *(response 2)*

The specific nature of microfinance requires local level supervision and this is a very critical issue for the proposed Microfinance as otherwise, the various provisions of the bill may not be fully implemented on the ground. I attach an article in this regard, with specific focus on consumer protection.

Local level supervision is critical to ensure consumer protection in microfinance - http://microfinance-in-india.blogspot.com/2011/07/local-level-supervision-is-critical-to.html

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G K Agrawal, Rural Development Microfinance Consultant, Mumbai

My views/comments on the Micro Finance Institutions (Development and Regulation) Bill - 2011 are furnished here under:

Micro Finance Institutions (Development and Regulation) Bill - 2011 - A Welcome Move

Micro Finance Institutions (Development and Regulation) Bill – 2011 (Draft Bill) is the most timely initiative of the GOI -MOF and will be meeting the long outstanding demand of MFIs and practitioners for a formal statutory framework for its financial activities. The Bill is to provide access to financial services for the rural and urban poor and certain disadvantaged sections of the people by promoting the growth and development of micro finance institutions as extended arms of the banks and financial institutions and for the regulation of micro finance institutions. MFIs/other entities engaged in providing micro finance services both existing and new ones, except banks and cooperative societies will be brought under the regulatory purview of the Reserve Bank of India.

The Bill provides for a new category of MFIs viz., "Systemically important micro finance institution" deploying such amount of funds for providing micro credit to such minimum number of clients as may be specified by the Reserve Bank. The Bill provides for setting up of Micro Finance Development Council, to advise the Central Government, on formulation of policies, schemes and other measures required in the interest of orderly growth and development of the micro finance sector and micro finance institutions, to promote financial inclusion. The Bill also provides for setting of State Advisory Councils for Micro Finance at the State level. The Bill bestows wide ranging powers to the RBI for registration, direction, regulating, inspection, fixing caps on margins and interest rates, setting repayment schedules, books of accounts, rating norms, capacity building, information system, etc. of MFIs. The Bill also provides for setting up of the Micro Finance Development Fund with RBI for receiving grants, donations and granting loans and other financial support for various purposes. The Bill provides for appointment of Micro Finance Ombudsmen for the purpose of redressal of grievances between clients of micro finance institutions and micro finance institutions with powers to issue directions to micro finance institutions.

The following **comments /observations** are made on various select provisions of the Bill, which may be taken into account by GoI MOF while finalizing the Bill.

Clause 2(f) of the Bill defines "micro finance institution" as an entity (irrespective of its organizational form), which provides micro finance services in the form and manner as may be prescribed but does not include among others banks and cooperative societies. Self Help Groups which are informal groups but constitute a significant portion of MFI lending and mf lending by cooperatives should also form part of Micro finance institutions for the regulatory purposes.

Clause 2(g) of the Bill defines Micro Finance services. It should also stipulate a ceiling in financial terms both for individual and group micro finance services so that focus on micro finance services, mainly for poor, is not lost.

Clause 8(2) of the Bill providing for composition of State Advisory Councils for Micro Finance at the State level should also include a women representative on the pattern of composition of Micro Finance Development Council (clause 4(g))

Clause 26(1) of the Bill provides for the Reserve Bank causing inspection to be made of books of account or any other record of any micro finance institution, by an inspecting authority approved by it. It is not clear whether such an inspecting authority will be within the ambit of the RBI or outside.

Also, under Clause 38 (1) of the Bill, the RBI may, with the previous approval of the Central Government, delegate any of its powers conferred to it under the Act to the NABARD in respect of any micro finance institution or a class of micro finance institutions generally.

At present, the National Bank for Agriculture and Rural Development (NABARD) conducts statutory inspection of State Cooperative Banks, District Central Cooperative Banks, and Regional Rural Banks on behalf of RBI under the Banking Regulation Act, 1949. Otherwise, also, NABARD is well conversant with the functioning of MFIs and their operations, as being pioneer of promoting Self Help Groups linked with banks and otherwise, which constitute a significant portion of MFI lending. If NABARD is envisaged to be designated as inspecting authority for MFIs, and/or delegated certain powers of RBI under the Act, it has to be ensured that its interests in promotion, development, capacity building, financial support by way of finance, refinance, bulk lending, equity support etc., to

SHGs, NGOs and MFIs engaged in m f lending do not come in conflict with regulatory/inspection/delegated functions under the Act. . Since RBI will be the policy making body for MFIs, it will be more appropriate if it conducts itself, in the initial years at least, inspection of MFIs and exercises powers under the Act, to get a pulse of MFI issues, problems, constraints and their practices especially in so far as they relate to poor to strike a balance between commercial and social lending compulsions of MFIs.

Clause 2(P) of the Bill provides for "thrift" i.e., any money collected other than in the form of current account or demand deposits, by a micro finance institution from members of self-help groups or any other group of individuals by whatever name called, who are availing financial services provided by such micro finance institution. Since MFIs will have their own limitations of expertise of managing such thrifts collected and as such thrifts will not be covered by the Deposit Insurance Corporation Act and by the statutory cash reserve/liquidity requirements, as applicable to banks, it may be advisable that such thrifts are collected as agents/Business Correspondents of banks and not otherwise.

K Sukumaran, National Institute of Securities Markets, Mumbai

Referring to the query by Ms. Jyoti Vij, I am glad to furnish my views, in seriatim, to the issues raised

Need for Regulation: It is glad that the regulatory body in the banking and financial services sector has decided to bring the microfinance sector under the ambit of regulatory framework, thus meeting the long pending demand of the sector. The reason for not regulating this important segment of the financial sector as pointed out by the representatives of the regulatory authority on several occasions was the experience of over regulating the financial sector in the past. Why Indian financial sector is so strong and stable today is as a result of the regulatory practices followed since 1969. The foundation laid out by a strong regulatory regime allowed the financial system to respond to the reform measures and succeed. Hence the move to bring the microfinance sector under regulation would definitely contribute to the orderly growth of the microfinance sector and serve the needs of millions of disadvantaged in India.

Savings, Insurance and Remittance: The proposed legislation should take into consideration savings as a financial service and hence this product should be allowed to be launched by the institutions in the sector. The experience gained by the members in Self Help Groups in India would definitely give a boost for the clients of the microfinance institutions to undergo the process. Proper checks and balances are to be put in on the process of managing the savings function in a microfinance institution. Prudential guidelines can be framed by the regulatory authority and MFIs should comply with the same so that the savings function in a microfinance institution can be managed effectively. Regarding micro insurance, this activity can be undertaken by an MFI as an add on one, i.e., acting as an agent of an insurance company, subject to the guidelines issued by Insurance and Regulatory Development Authority. Remittances need not come in the beginning as an activity of an MFI as there are various instruments at present to make the payment mechanism work for the poor.

Institutions coming under the regulatory framework: Any entity providing microfinance services other than banks are treated as MFIs and coming under the regulatory framework. Presently the definition of a Microfinance Institution (MFIs) is very broad as any activity of savings, credit, insurance etc. undertaken by an agency directly or indirectly benefitting the poor are considered as an MFI. Hence an institution should be defined as an MFI only when these agencies provide credit directly to the target clients. Technical service providers, wholesalers, banking correspondents/facilitators etc. should be left out of the ambit of this definition.

Management of MEDF, Supervisory roles etc.: The existing Microfinance Equity and Development Fund managed by NABARD should be continued and let NABARD be the fund manager of this initiative. NABARD can continue the development functions and the new regulatory authority can anchor the regulatory role. Mixing the development functions and regulatory/supervisory functions would lead to conflict of interest. The regulatory authority should be empowered to inspect the books of accounts on periodic intervals and impose necessary penalty as per the guidelines issued by the authority. Ombudsman type of quasi judicial structure can definitely find solutions to the client grievances.

Role of State Government: The power of state government over the affairs of an MFI should be dispensed with once the regulatory authority comes in force. MFIs should be regulated by a national authority on all aspects of its functioning. Once the institutions comply with the regulatory requirements and start functioning, they would be inducted as member of the State Level Bankers Committee (SLBC) and the state government can liaise/coordinate with these institutions just like what is done at present by the state government machineries with the SLBC members. The Lead Bank Scheme in India is restructured few years back, and in the new regime, MFIs can also play a vital role in the financial education/counseling role

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Sreedhar Nair, Initiative for Social and Economic Transformation (InSET), New Delhi

Further to the query on Micro Finance Institutions (Development and Regulation) Bill – 2011, please see below my views:

- It is good that the Government is bringing in some regulations in the Microfinance sector, the lack of which has resulted in some NBFCs and other commercially-motivated organizations taking undue advantage of the loopholes and making benefits only for themselves, and not for whom such finances have been intended to.

- We should recommend to the Government to provide separate banking finances for micro finance sector alone including framing of separate banking rules for microfinance industry, taking into account the poverty level, and also why reduction in poverty level has not reached the planned level;

- No commercial organizations, other than self help groups, cooperative societies, NGOs with seven years experience or such other social venture, should be allowed to work in microfinance sector, as others' entry would spoil the scene again as seen by us with the entry of some NBFCs in the sector.

- All the microfinance organizations should be evaluated by external agencies every year for their general conduct, benefits being provided to the members, fiscal prudence and management, capacity to integrate with the community and the members, social projects financed or undertaken, number of beneficiaries availing the finance etc.

- A separate training body should be set up to train the people working in the micro finance sector.

Savita Shankar, National University of Singapore, Singapore

In response to the query, I would like to share a newspaper column by Prof Mukul Asher and myself on the draft microfinance Bill, which summarizes our views. The article appeared in DNA on 19 July 2011

Why the Microfinance Bill is a good move

The new draft microfinance Bill, on the finance ministry's website, has a number of positive features which augur well for a geographically more balanced and healthier development of the sector.
First, despite having 71 million borrowers and accounting for about Rs45,000 crore in loans outstanding, the microfinance sector does not have a regulatory structure that encompasses all the participants. The microfinance Bill will address this limitation by including all the participants, except the cooperatives, on a nation-wide basis.

Second, by specifically providing regulation of the microfinance institutions (MFIs), the Bill recognises that further development and geographical spread of the microfinance sector requires operations of the MFIs are not equated with money lending. The microfinance Bill will thus constrain states, such as Andhra Pradesh, using outdated money lending Acts, to regulate the MFIs.

Third, the Bill could help broaden the scope of services provided by microfinance sector as it defines microfinance to include microcredit, savings products, remittances, pensions, insurance and others. It recognises use of group and individual models.

The conditions under which savings products may be offered have not been delineated. Currently, only MFIs that are incorporated as cooperatives or local area banks can offer such products. It is, hence, important that operational guidelines for savings products be provided, with sufficient safeguards.

Fourth, the Bill calls for registration of all MFIs with the Reserve Bank of India (RBI) within a period of three months of it becoming Act. It mandates a minimum net worth of Rs 5 lakh for the MFIs, whether this limit is appropriate for deposit taking functions merits a re-think. NBFCs already registered with the RBI are also required to register themselves specifically as MFIs.

Registration can be expected to bring greater accountability to sector participants and will help build a more comprehensive database concerning various aspects. For databases to be useful, data mining capabilities, and analytically rigorous policy-oriented research will need to be encouraged. In particular, costs and benefits of administering and complying with the provisions of the microfinance Bill and of delivering microfinance services need to be analysed and results incorporated in regulatory and operational practices.

Fifth, the Bill requires MFIs, having an asset size higher than a specified value, to convert themselves into companies. Though most of the large MFIs are registered as NBFCs, the regulatory requirement to do so may help ensure greater transparency as disclosure requirements for firms are more stringent.

Sixth, the Bill mandates the creation of a reserve fund and annual audit of MFI accounts. Other than the minimum net worth of MFIs, the Bill avoids definitions of numerical limits, which is prudent as these would need periodic revision.

There are additional areas which merit further examination as the Bill progresses through the parliamentary process. Given the low net worth threshold prescribed for registration of MFIs, the process of registration and regulation of MFIs may stretch the regulatory capacity of RBI. Establishing a special division for microfinance regulation, with requisite expertise, merits consideration.

Though the Bill provides for delegation of powers by the RBI to Nabard, such a delegation of responsibilities is not desirable, as Nabard an active participant in the sector, should not be a part of regulatory process.

The Bill proposes Microfinance Development Councils (MDCs) at the Central level and at State levels with advisory roles. At the Central level, representation from government, Nabard, Sidbi and NHB and from the microfinance sector is envisaged. Care should, however, be taken to include representatives from different microfinance models.

Representatives of members of self help groups (SHGs) and MFIs and researchers should also be included. It may also be desirable to ensure representation from microfinance organisations operating in rural, urban and semi-urban areas, taking due cognizance of the rapid urbanisation.
At the state level, representation should cover government and private microfinance programmes and the councils should have chairperson with relevant expertise and independence. The Bill proposes that MDCs could advice on policies and measures relating to use of technology, establishing of credit bureaus and working of grievance redressal mechanisms.

It may be useful to specifically include improvement of financial literacy and financial education of microfinance members as a priority area for MDCs to address. The costs of setting up and operating the MCDs should be carefully analysed, and this should be made public. Transparency and accountability guidelines for the operations of the MCDs should be so structured asto facilitate such an analysis.

The Bill gives powers to the RBI to provide directives on various matters relating to the sector, including effective interest rates on loans and caps on profit margins. These have also been enumerated earlier in the RBI's circular on priority sector eligibility for microfinance activities.
A number of sector participants have pointed out the practical difficulties in measurement and maintenance of profit margins as these tend to fluctuate over time with changes in cost of funds and changes in the number and maturity of MFI branches.

Other important powers given to the RBI are powers to direct MFIs to become members of credit bureaus, to observe codes of conduct formulated by recognised self regulatory organisations and to follow specific norms for corporate governance and client protection have important implications.

These requirements could be useful in building sector wide credit bureaus, giving more teeth to voluntary codes of conduct developed by the sector and improving governance practices in the sector.

Refinements and expeditious passage of the microfinance Bill could help enhance confidence in the sector, which has seen considerable erosion recently.

This could have positive implications for access to greater and long term funding from commercial and social enterprise oriented sources. Such access could enable MFIs to invest in technology and increase the scale of operations, helping to reduce transaction costs, and to expand geographical coverage. It could also facilitate options of micro-finance members to access other financial institutions.

The success of the microfinance Bill will be ultimately judged by its contribution to the national objective of financial inclusion in the country, and in terms of quantity and quality of services provided by the sector at affordable economic costs.

Rajesh K Verma, Vananchal Gramin Bank, Jharkhand

As I understand the regulation of the microfinance industry has long been overdue. The recovery measures and the application of the interest on the lending needed correction and therefore the bill is a welcome step.

As far as the collection of the deposits in the name of thrift is concerned it should be insured and the payment guaranteed alike that of the Deposit Insurance and Credit Guarantee Corporation (DICGC) in the case of banks. The MFI before getting registration should be checked for the soundness and strength through premeditated tests.

The only plus point that the MFI has in comparison with the financial institutions working in the rural areas viz. the post offices, the co-operative banks, the RRBs is its freedom of schedules and innovative operating techniques, I presume that, it should not be disturbed to realize its benefit to the fullest extent for the beneficiaries.

With the help of SHGs the MFIs can create miracles in the field of financial inclusion and spread banking activities into the remotest corners.

K. C. Malick, Bharat Integrated Social Welfare Agency (BISWA), Orissa

The extracted portions of the draft bill on which comments are placed are underlined with comments written by its side.

- Clause 3 MICRO FINANCE DEVELOPMENT COUNCIL: There is no representation from MFIs in the council and experience in rural credit cannot qualify as representation of MFIs. There should be representation of members from the MFIs representing different regions of the country. The selection of MFI for the council should be based on certain listed criterion based on its nature of operations, micro finance products at disposal and client strength.

- Clause 5 (iii) the working of grievance redressal mechanisms and suggest modifications of the systems to protect the interest of clients of micro finance services of the Micro Finance Development Council: The Council should define as to who should be the plaintiff, so that only genuine complaints are entertained and supported.

- Clause 8 (2) of the Bill providing for composition of State Advisory Councils for Micro Finance at the State level: Should ensure that the selection of the MFI representative should not be arbitrary rather the representative could be the largest MFI of the state in terms of the beneficiary base and the portfolio held in the state. This would ensure that the regional contexts and issues are better understood and represented in the council.

- There has to be a mechanism, where the state councils are evaluated and monitored by the Central committee.

- Clause 10 to 14 of the Bill which talks about eligibility of an institution for carrying out microfinance services : As the draft Bill provides for RBI as the overall regulator along with the Councils at National as well as State level to administer the functions of the MFIs, the conversion of all MFIs/ NGOs involved in micro credit program will be discouraging. NGO-MFIs have existed with a motive of social development and have additional programs which are philanthropic in nature, therefore conversion to Company's Act will be a natural death for such organizations.

- Clause 17 RESERVE, ACCOUNTS, AUDIT AND RETURNS (3) The Reserve Bank may, in the public interest or in the interest of clients of any micro finance institution direct any micro finance institution or any class of micro finance institutions to invest the whole or part of such reserve fund in such unencumbered securities, as it may, by regulations specify: This should be within legal jurisdiction and based on the evidences provided by the 2 parties (MFIs and the Clients, or between two MFIs).

- 24, 2, RBI's Power to issue directions to micro finance institution (f) specify the locations where financial assistance may be sanctioned and disbursed by micro finance institutions: The disbursements are based on the demand from the communities and the funds available with the MFI. RBI can suggest to MFIs on the location but cannot provide directions.

- Clause 26(1) of the Bill provides for the Reserve Bank causing inspection to be made of books of account or any other record of any micro finance institution, by an inspecting authority approved by it. It is not clear whether such an inspecting authority will be within the ambit of the RBI or outside.

- Micro finance should not be restricted to any of the forms of credit. It should go with the demand of the poor client for fulfillment of the urgent need of it.

- Micro finance in itself should be a priority sector and its sub products like agriculture, business, livestock, etc should not be the delimitations. There has to adequate scope for loan products pertaining to development of rural household level infrastructure and asset like toilets, water connection, low cost housing.

Veerashekharappa, Institute for Social and Economic Change, Bangalore *(response 1)*

It is alright to frame all the rules and regulations subject to a condition that the lending will not go bad. If it goes bad then, what is the solution?

I feel there is a need to have a mechanism to insulate the smallest borrowers from the uncertainties of our system due to so many unforeseen circumstances for which the borrower is no way responsible but resulting in failed repayment. This perennial problem of our economy needs to be looked into seriously as the problem of recovery was the bane of our current situations in the micro finance sector.

The problem of uncertainty has to be sorted out by an affordable insurance mechanism which will protect the lender as well as relieve the borrowers from harassment. All other issues are controllable and devised conveniently and in acceptable manner suitable for both the parties.

N.Jeyaseelan, Hand in Hand, Tamil Nadu

I would like to give my comments on the draft MFI Bill 2011.

Positive features:

- RBI as regulator
- Covers all legal forms
- Provides for formation of MF Development Council
- MF Ombudsmen
- Need for MFIs to keep a reserve fund.

Suggestions:

- RBI has been given wide powers to regulate the sector by prescribing a number of guidelines on various operational aspects of MFIs including margin cap and prudential norms.

- Bill should specify that RBI should create an enabling ecosystem by providing proactive policy framework, at the same time encouraging innovations among MFIs.

- Bill must specify that MF Development fund may be used to give guarantees to commercial banks to lend to MFIs (Like what foreign banks offer Stand By letter of credit, which is used as Guarantee instrument or Like how Central bank of Pakistan gives guarantee (60%) to Banks to lend to MFIs.

- Bill may specify to RBI to monitor the governance in MFIs by prescribing compulsory Independent Directors (30% of board seats), who are certified by Professional bodies like IBA or IIBF having practical knowledge on MF.

- Bill may specify the Capital requirements (Not as Rs.5 lakhs as provided in the bill) for:

MFIs depending upon their Operational level, as being practiced by Central Bank in Nigeria.
If the MFIs operate in National level (Multi state-more than 3): Rs.5 crores
If the MFIs operate in a region (More than one, upto 3)- 1 crores
If the MFI operates in a single state: 25 lakhs
If the MFI operates in a single district: Rs.10 lakhs

- Bill should provide for advocacy program through MF Development Council to build the reputation of the sector by periodically organizing training programs to Parliamentarians and Legislative members of the State Assembly and Media persons and should facilitate sharing of information from MFIs, so as to ensure transparency in operations.

- Bill should provide for compulsory Responsible finance rating of MFIs (combining both Financial and social rating) and should approve the agencies, which are involved in MF sector. MFIs showing greater social returns should be rewarded with incentives by the regulator.

- Bill should ensure allocation of funds for quality Human resource building initiatives and systems development (MIS and Risk management at MFIs level), which will improve the long term outlook for the sector.

- Bill should come out with policies for social and economic sanctions against the willful defaulting borrowers in the credit bureau data base. If the name included as willful defaulter in a MF credit bureau, then that person should not have access to Mobile phone/ LPG / EB / Water in his name or in spouse name, this will force the defaulter to honor the commitments.

MBS Reddy, APMAS, Hyderabad

Regulations are always benefiting to fulfill the objective, which we all dreamed. In the beginning the MFIs have helped in reaching out to the unreached, financial weaker section of the society that needed credit for daily routine requirement. However in the later stages there was shift in the mission and focus was shifted from helping the poor to expand the share in the market.

At present the situation is very critical. Banks, neither nationalized nor private have managed to reach to all the poor. So the poor are suffering from both sides and once again they are moving towards private money lenders. In this regard, all of us expect the regulations to be framed in a way to answer - who will monitor the programme, who are the regulators and the possible role of government authorities

Moreover, I feel that there is a need to bring in the perspectives of the weak and poor. One of the solutions is to promote member owned, member managed institution as no remote controls, can help the poor. The formal financial agencies should give sufficient credit access at nominal interest rates for these institutions. There is a need to ensure that the institutions must disclose their financial status every quarter to their members and promote decentralized, democratic functioning in the institutions.

Arpita Choudhary, PATH, New Delhi

Though I need to go through the whole draft, but my idea is accountability of regulatory authority as well. There must be a portal of regulatory authority or link in current portal, which publish quarterly review of MFIs, their credibility status, detail of grants received by MFI, the output produced by MFI in return of the grant received, reason from RBI to ask MFIs to cease their activities and cancellation of registration granted to the MFI etc. for swift and transparent move

Provision of online registration and document submission should be mandatory before submission of hard copies to avoid any kind of favoritism.

Ritesh Dwivedi, Amity School of Rural Management, Amity University, Uttar Pradesh

I am writing my views in the following sequence.

RBI should play its own role and that should not be diluted with any other agency. It is mentioned in the Bill that NABARD will be holding some important role; it is welcoming but the apex regulator's role should always be with RBI, where every stakeholder can submit its request. Special division for microfinance should be there at RBI level so that its growth can achieve its original path and grassroots level beneficiary can get speedy and heal regulation, with requisite expertise, merits consideration.

The Bill mentions about the reserve fund and annual audit of MFI accounts which is quiet necessary for the sound financial health of service providers.

Representation of both streams of services such as self help groups (SHGs) model as well as MFI model should be there at state and central council. Representation at state level is necessary for good governance at service providers' level and mandate and powers of the council should be very clear so that the sector can witness healthy environment.

RBI's powers regarding credit interest rates and limiting the profit margins are very crucial and these should be implemented in true letter and spirit. Timely review of these provisions is also mandatory.

Self regulation is always necessary for any sector; likewise microfinance service providers should also come forward and present their own framework for regulation, which should be considered positively.

Microfinance has established its importance among all the stakeholders and it should never be defamed otherwise mobilizing people's faith will be very tough. Keeping this in mind, rating system should also be there which will promote healthy rivalry as well as demote the malpractices of certain service providers.

Coordination among Banks, NGOs and MFIs (registered as NBFCs) should also be taken care of because at grassroots level common SHG members suffer heavily on this account. There should be comprehensive roadmap for the capacity building of all stakeholders specifically the village beneficiary.

Microfinance development fund should manage effectively towards innovative promotion of products and services which have been designed to solve acute problems of farmers.

Ajit Kumar Maity, Village Welfare Society, Kolkata

My comments on Micro Finance Institutions (Development and Regulation) Bill – 2011 are:

Chapter II - Composition of Council

Clause 4 (g) not more than 6 persons………

Here at least two persons from MF industry associations in which one from not for profit entity and the other from for profit entity to be nominated.

Chapter III State Advisory Councils

Clause 2 (c): One member representing micro finance sector………….

Here my suggestion is two members, one from not for profit and other from for profit entity through MF industry associations be nominated at the state level.

Clause 2(p): Collection of thrift…………..

My comment on it is that the poor women want to save. In nineties and early twenties when most of the MFIs are small and not converted to NBFC, they all used to accept thrift from the members as it was their demand and efficiently managed by the MFIs, no single complaint was raised from any members in any corner of the country. MFIs are giving loan to members with a minimum of ten thousand rupees whereas her thrift may not exceed even one fourth the loan amount. And no MFIs will fly by night like chit fund organizations because the loan outstanding in that particular area is enough times more that the accumulated thrift in that particular area. So I do not find any reason of soaring for the collection of thrift. It also give leverages for higher loan size and this will reduce multiple lending drastically. When the thrift becomes a handsome amount, they can invest in their own business or invest for her future requirements. As they are getting a platform for parking thrift in the MFIs, then there is very less possibility for them to be cheated by chit fund organizations.

In Bangladesh or in North American countries, all MFIs are collecting thrifts and I have not heard any incidence of cheating by any MFIs. So there must be the provisions for thrift, otherwise the objective of microfinance will not be fulfilled.

Subhransu Tripathy, Entrepreneurship Development Institute of India, Gandhinagar, Gujarat

Micro finance services are spread across various sectors/sections of the society. The need and purpose of micro financial services could be more a kind of informal finance with minimal exploitation or without exploitation. Moreover, it has a social dimension and it is collateral free. So it is very difficult to develop a Micro Finance Institutions (Development and Regulation) Bill - 2011, which can address the institutional problems of Microfinance sector as a whole.

The present draft bill has considered the broad areas and how far it will be useful in a practical sense is very difficult to predict. Keeping the size of operation (area covered, clients, financial portfolio, etc.) of a MFI there should be a decentralized approach or a Multi-Agency approach. The clients are predominantly rural/urban poor, illiterate and who can not access formal financial sources and awareness level is very low. RBI's involvement in such situation will provide legal validity to MFIs for becoming more rule based rather than care based. Creating Credit bureau and ombudsman, etc. for

MF sector is highly impracticable at the present juncture as vast mass of Microfinance clients are not even aware of basics of finance.

Bill should be regulating rather than controlling. Autonomy of MFIs needs to be ensured. But, we are very poor in differentiating regulation and control. Regulations are converted into control mechanisms. MFIs depending upon the size of operation could be given options to register with RBI, NABARD or can work under BC/BF models. Involvement of Panchayat and social audit system could be there. Linking MFIs with poverty alleviation programmes particularly NRLM is useful. When. Interest subsidies or loan subsidies comes into picture under various anti-poverty schemes and agricultural loans, banks are selected. Why MFIs can not be involved in such cases, if RBI is becoming nodal for registering MFIs.

Kiran Kulkarni, Institute of Rural Credit and Entrepreneurship Development (IRCED), Sangli, Maharashtra

IRCED is working in Micro Finance field for last 5 years in Maharashtra. We are working as NGO -MFI and extending micro finance services along with livelihood promotion, housing and health for the empowerment of women. We are very much affected by AP problem once in 2008 and now in 2010 - 11. Micro finance is a very powerful tool for the economic and social empowerment of women but many people used it for gaining profits. For sustainability of the organization, reasonable profits are ok, but at the same time it should actually eradicate the poverty of the poor people.

In this connection livelihood promotion has important role. Looking after poor people's development is another concern. Here RBI has constraints, it can regulate the MFI but it cannot look after the development and hence organizations like NABARD have important role to play.

NGOs are already working with NABARD. Many of them are working on SHG/JLG linkage programme. These agencies can get registered with NABARD. NABARD officers are present in almost every district of India, but that is not the case with RBI. These officers can smell the working of MFIs and get reports as and when required.

Anil Kumar Sukumaran, Development Consultant, London, United Kingdom

Human being are known to make the simple things complicated. And, Law, Systems and Regulations can work only when we have a reciprocative community. Microfinance came into existance keeping the poor people in picture. However, it seems the policy makers are keen to strengthen the MF neglecting the community. We have a number of Commercial Banks and NBFCs who have plunged into mF sector with a greed to make money. The obvious reason is lucrative interest rate: normally maximum 10% p.a interest (at individual level) can be earned in fixed deposits while mF interest starts at 24% per month (at group level). This explain the merger of several commercial banks including ICICI, SIDBI, IDBI in microfinance sector.

But the interesting facts is:

- None of the NBFCs or commercial banks have come-up with replicable solution for the grassroot problems – these Organisations developed very good softwares, provided overseas travel opportunities for few villagers, however, the larger mass is neglected.
- Party/National/caste Politics has a direct influence in mF. Because (1)Vote banks – mF groups/ Federation is an easy platform to address larger communities; (2) there is heavy donor funding; and (3) politicians are among the wealthy who are keen to secure and gain additional interest from their deposits.

- A cost-benefit analysis will show that mF is not creating enough livelihood opportunities for the poor in EAG states. The bottle-necks have not been addressed.
- In a community of 2000 there may be 400 households; say 8-10 MF groups. While processing second bank linkage (18-24 months): we need to question - how many groups have gained additional skills to take-up new/viable economic activities; whether the groups internal borrowing is showing sound transformation from consumption credit to investment.
- In the absence of entreprenuership in backward areas, how many organisations tried to pick members from different groups in a community/locality and promote a viable economic activities. In the absence of gain/profit from such invetsment, the organisations are compelling the members to pay from their pockets and thus aggravating poverty.

There is a need that our policy makers look into the simple questions to address the complex mF operations. The startling realites are:

- Poor are exploited in the name of mF as poverty remains where it was (baseline indicator). An investigative research will prove the growth of mF donors, Banks.
- Poor are being subjected to coersion in the name of mF. First, by compelling them to borrow loan, later – by forcing them to repay, even if the business is not lucrative. It will end up in depression, suicide, migration, broken family, etc.
- Finally, mF is an off-shoot of cooperative movement which is based on the coordinated cooperation of the community members which may be neighbourhood, affinity, solidarity based. But what makes them failure is sheer importance of finance/money over the human relations.

Three decade of mF operation is more than enough to understand the realities. If we are still repeating our mistakes, then something wrong with our mission/vision.

Veerashekharappa, Institute for Social and Economic Change, Bangalore *(response 2)*

In fact after implementation of financial reforms the credit to vulnerable sections have been declined from the formal banking sector, which has been published by national agencies. This has happened post reforms, as the objective of the bank is to attain efficiency and profitability. The profitability makes them park funds where they have assured returns with higher margins. This has indirectly contributed to expand of micro finance activities. However, the expansion has led to unhealthy competition and the later part everybody knows .

Now questions is how to regaulate the Microfiinance Sector. I feel that the regulations framed for the sector to be reviewed every half yearly and changes needs to be made. For this, RBI can constitute regional committees consisting of practitioners and persons involved in the filed of micro finance. This type of advisory at the regional level is need for a couple of years, as the problems of MFIs are regional specific.

Moreoover, I feel that currently there is inefficiency in providing saving products to the poor in marketplace. In fact widespread desire to save by the poor has not translated into effective demand for savings in the financial services. One can critically look at the saving programmes under micro finance programmes, do they actually help poor save more, or wheter they force individual to transfer money from other sources into these products. Dos such product empower women by giving them access to savings that is safe from others in their household? I feel there is no friendly savings developed for the poor.

M. A. Ali, Grameen Financial Services Private Limited, Bangalore

My views on the bill are:

Areas requiring attention

Page	Section	Comments
2	2.(a)	APR-Definition The APR has been defined as “aggregate rate consisting of interest, processing fees, service charges and any other charges or fees charged by the micro finance institution on any financial assistance granted to any client”. The APR should contain only the interest rate and processing fee charged by MFIs. Other charges like insurance premium etc, if any levied by MFIs are not their income since they are associated with the additional services rendered.
3	2.(f)	**Purview** Banks and Co-operatives are excluded from the purview of the bill though they are also undertaking microfinance activities. This should be appropriately addressed in the bill.
3	2.(g)	**Scope of Microfinance** It is mentioned that micro-credit, thrift, remittance, pension and insurance services can be provided by MFIs. Does it mean SI-MFIs can offer saving products to their clients? If so, it is a welcome measure which facilitates MFIs to have access to cheap funds. Hence the Bill to mention the type of MFIs eligible to offer thrift facility and the mandatory pre-requisites. Further the task of insuring depositor protection needs to be incorporated in the bill.
3	2.(g).(1)	**Microcredit Definition** The present micro-credit limit of Rs. 50,000 has remained unchanged since a long time. RBI may be authorized to define the microcredit and lending limit periodically keeping in view the inflation.
7	8.(2)	**Constitution of State Advisory Council** There should be at least two members in the council from the microfinance institutions. These members should preferably be from the MFIs representing different models of microfinance (SHG, JLG etc.).
7	8.(3)	**Functions of State Advisory Council** The state advisory council should also oversee the development of microfinance in the state in terms of area of coverage of underserved areas etc.

9	12.(1).(c)	**Net owned Funds limit** The minimum cap of net owned funds should be stipulated as Rs. 25 lakhs as it will prevent mushrooming of large number of MFIs and would encourage only the interested and capable organizations. It would also facilitate better regulatory supervision.
18	24.(2).(e)	**APR specification** While specifying the maximum limit of APR charged by MFIs to the clients the RBI should also specify the maximum APR which the banks could charge to MFIs. The same should be revised from time to time by RBI so that requisite APR margin is maintained to meet the operating and other costs of MFIs. This may be imbedded in the bill.
18	24.(2).(h)	**Common Code of Conduct** The Bill to specify the code of conduct to be uniformly followed by all MFIs irrespective of their constitution on the lines of Fair Practices Code of RBI to NBFCs, for effective client protection practices. This will help in having common code of conduct for all categories of MFIs instead of adopting CoCs of various voluntary organizations like MFIN, Sa-Dhan etc.
23	30.(1)	**Microfinance Development Fund** The size of the fund and the financing microfinance sector needs to be well defined. The size of the fund need to be substantial to take care of the financial requirement of MFIs
29	38.(1)	**Delegation to NABARD** The RBI, with the previous approval of the Government, may delegate any of its Powers with respect to any class of MFIs to NABARD. It indicates that NGO-MFIs may be governed by NABARD till they become SI-MFIs. However the nature of delegation, class of MFIs needs etc. to be clearly spelt out in the Bill. Also a consideration should be done whether NABARD should be given the role of regulator of MFIs given its active participation in SHG promotion.

Vineet Rai, Intellecap, Mumbai

I had written a note on Microfinance bill for CGAP blog, you may find it useful

India's Microfinance Bill Offers a Mixed Bag to Investors

India's Ministry of Finance released the much awaited draft microfinance bill which is to be introduced in the country's parliament shortly. This post is the next in a short series of commentary on the bill by a variety of experts from the region on what the bill means for India and the global microfinance industry.

The draft Indian Microfinance Institutions (Development and Regulation) Bill 2011 has been made available by the Central Government for comments. The bill has been under preparation for a long time and in its last avatar left out the for-profit Microfinance Institutions (MFIs) outside its ambit completely. However, in its new avatar, the bill appears to be a comprehensive piece of legislation that wants to resolve the long standing challenges that the microfinance sector has faced.

The change in the thinking of the government in terms of introducing the comprehensive microfinance bill to replace the old one and emphasizing the supremacy of the regulator, the Reserve Bank of India (RBI) is a consequence of the events in Andhra Pradesh where the State Government has introduced a State level Act to regulate MFIs. It thus is best if we look at the Bill from that perspective and comment on its ability to answer the key challenges it had identified to resolve.

My reading is that there were three key issues that the government was grappling with and it wants to use the bill to address them comprehensively. These are:

- To establish the supremacy of RBI as the key regulator for the Microfinance Sector and to resolve all political and regulatory ambiguity. The action of the Andhra Pradesh Government in bringing about the State level act that crippled the microfinance movement was a key trigger and the bill is an attempt to resolve the issue of multiplicity of regulation in microfinance.
- Acknowledge that poor, needy, and underserved clients in the microfinance domain need extra protection and hence introduce measures that would make sure that the client is protected.
- Microfinance as a business must have limits to profitability and while scale is important, the investors must not make disproportionate profits.

Without going into a debate on the merits of these assumptions I think it would be worthwhile to see if the bill does address some of the concerns or challenges.

One Regulator

The Microfinance Bill seems to say enough to clearly dissuade state governments to try and replicate the Andhra Pradesh bill. It clearly lays down the rights of RBI as a regulator and clearly treats microfinance as an extension of the banking sector. The bill makes a mention of thrift, remittances, pension, insurance and other services to clearly indicate a departure in treating microfinance as credit alone business and through this it is clearly making a distinction between microfinance industry and money lenders.

The Bill goes a step further to address any confusion that may arise due to multiplicity of regulation by asking every institution involved in microfinance to register with RBI under the act even if they are already registered with RBI as an NBFC. The Bill has not only tried to address concerns expressed by states but has created provision for them to participate through the State Advisory Council and provide inputs to the regulator.

Verdict: The bill's constitutional validity can be challenged by the State Government and the State of Andhra Pradesh has indicated that it may approach the Supreme Court against it. But it appears that there is enough content and pith in the proposed bill for it to be able to withstand its constitutional validity over the issues of State vs. Central list and jurisdiction issues. The strong push to demonstrate microfinance as an extension of banking activity also makes a strong case for this being a centrally administered legislation.

As an Investor: Investors dislike ambiguity and what has happened in Andhra Pradesh is an investor's worst nightmare. In the current situation, absolute clarity is the only thing that would bring back investor interest in microfinance and for that to happen the absolute support of Central Government and clear supremacy of RBI as the single regulator are of utmost importance. The bill in that sense is possibly correcting an anomaly and hence is a step in the right direction.

The big concern that the bill brings to the mind of the investor is the rights it has given to RBI to approve, merger, demerger, change in capital structure that may mean that exits would become a bigger challenge. In the absence of definition of ownership and control one may need clarification if investment or sale of equity by financial investors would need RBI approval.

Client Protection

Client is 'God' goes the maxim and in case of microfinance surely the State and Central Government do believe so. One of the key reasons for the current crisis in Indian microfinance is the stated belief of the Andhra Pradesh Government that the clients are not being treated properly.
The bill has tried to address client needs by introducing obligations and putting in place extensive monitoring and reporting requirements.

Verdict: The bill has tried to put in place a grievance redressal mechanism to make sure clients grievances are addressed. Additionally the bill gives RBI the power to recognize the Code of Conduct for MFIs through a self regulatory organization and a client protection code, provisions of which would be good guidance for what MFIs can and cannot do which are steps in the right direction. The presence of Central and State advisory committees would ensure that there are enough eyes on the implementation of these codes as well and penal provisions put in place may act as deterrent for those who do not adhere to these provisions.

Investor Point of View: As an investor with a conscience, protecting the client who is vulnerable is a very desirable step. However in trying to implement these client protection mechanisms on the ground, cost implications have not been taken into account. While the bill is silent on the income of the borrower as a criterion for deciding his eligibility for loan, RBI guidelines inadvertently, in my view, actually penalize clients instead of protecting them by imposing restrictions on the income of the client to receive microfinance loan. As an investor in microfinance, I see this penal provision for the well performing clients as a serious flaw.

Ironically, on one hand microfinance is being questioned to prove its usability in bringing about a change in the income of the poor, while the law drafted ensures that in case it does bring about a change in his income, the client may not be eligible for future loans. This would lead one to question the very viability of the business which is compelled to lose its well performing clients!

Microfinance as a business must have limits to profitability and while scale is important the investors must not make disproportionate profits.

The Bill has retained two key recommendations of the Malegam committee on capping the interest rate and putting in place margin caps. These provisions have been put in place to make sure that microfinance institutions do not profiteer from the poor.

Verdict: For a country that has otherwise decided to move from regulation to de-regulation, this is a retrogressive step. However one may want to agree with the regulator and the formulators of the bill that such provisions are needed to protect the interest of the poor who are not in a position to negotiate a better deal for themselves. The only question I have is, whether the drafters of this the bill analysed if the profitable and large MFIs are within these caps and if not, how far outside these caps they are?

Closer looks at the numbers of large MFIs clearly indicate that the competition and pressure to scale have pushed them to move into these thresholds already and in that sense are compliant to these terms. The question one is left wondering is if the steps were really needed and has the bill and associated guidelines have removed the incentives for these companies to bring down these rates further?

Investor Point of View: The margin cap and interest rate caps are blessings in disguise in some sense. The introduction of such steps while being retrogressive, have scared away short term, opportunistic investors from the sector making it easier for long term investors to find good deals at a reasonable price. However, on the flip side, these moves have given to the MFI, a reason not to push these rates down further because there is an artificial limit already set in place as the benchmark for performance. Margin cap similarly has clearly done away with incentives for the microfinance institutions to rework their cost structures and use technology to bring down their costs once they have reached a certain benchmark. It seems that inadvertently, the bill has put in place incentives and penal provision that are not aligned to other provisions of the bill namely better technology penetration and bringing down the interest rates.

Finally, I am yet to find a magical microfinance entrepreneur who can successfully operate a business that has a fixed interest and margin cap, in an inflationary economy like India where interest rates are increasing every day.

Final comments

As an investor in the sector, who took the risk of investing in microfinance as early as 2005, I must say that the bill has features that may mitigate the risks of reappearance of the 2010 October crisis. However, I remain disappointed by the failure of the bill or RBI to address the consequence of the meltdown that is being faced by the sector. Neither the bill nor Reserve Bank of India has shown any alacrity in recognizing the significance of current challenges to the microfinance industry nor have they tried to address the destruction of MFIs in Andhra Pradesh, some of whom have provided services to people for years and has attracted investments from across the globe.

However, it does try to answer questions for investors who want to move into the sector now and hence it may not be inappropriate to term the new bill a mixed bag.

Resham Singh, Punjab Gramin Bank, Punjab

The Bill will support both forward and backward linkage for the members of self help groups. In my opinion the savings of the groups is the base of adopting the journey from poverty to wealth. The group should be considered as a permanent institution and let the members may come and go. It should not be considered defunct in case of removal or entering of the members, even below 10 members. The overdraft bank limit is suggested 10 times of saving or 90 percent of the total project costs that too without asking any collateral security. The capital subsidy should be treated as capital for capacity building and should not be allowed to be distributed amongst the members and should be treated as recycling of funds and as an investment.

Linkage by banks should be capacity based. It has already been suggested to charge 6 to 7 % rate of interest by the Banks. The role of RRBs should be confined to promote SHGs under the provision of this Bill. The Gramin banks have forgotten to combat poverty and are playing the similar roles of commercial banks. The committee members should be nominated from institutions having down to earth experience in promotion of self help groups. As far as the insurance concept is concerned the amount should be paid to the company by debiting the loan account of the members.

M H Prasadu, Centre for Bhartiya Management Development, Nagpur

Since some months or few days, micro finance is facing number of challenges from different segments due to different reasons. Some of the present problems in MF sector and corrective measures as per my view are given below:

- Multiple loans to one member
- Non-productive and consumption loans to members
- Multi organizational and multiple loans to one member
- Target oriented and forceful growth
- Lack of correct HR policies
- Funders are forcing the MFIs through pumping of funds
- One man show
- Non-professional attitude
- Non-customer based policies / products
- Un-necessary and un-wanted competition between MFIs
- Not linking the best borrowers with the banks for more funds to their business entities for cheapest interest rates
- Higher the loan amount – higher the risk to MFI
- Big amounts for entrepreneurs only
- Weekly recovery for all cases not suitable and why not fort-nightly / monthly (but with utmost care)
- Interest rate to the member should be 10% flat
- Surplus for MFI is alright but profit oriented is not good (greedy for profit is worst)
- Proper insurance coverage to the members (with correct premium and product and covering their actual needs)
- Proper and exact area surveys by the MFIs to start their program
- Funders should ask about the HR and operational plans, facts and projections along with financial reports
- Staffing methodology, recruitment, orientation, training, pay-package, PF, ESI and other benefits to staff and those benefits should be added in the projections
- From one funder to one MFI, maximum loan fund should not exceed Rs.150 crores or Rs. 75 crores outstanding in one financial year.
- 2 monitors / officers should be appointed for one MFI (as per the above point) and if MFI operations are in more than one state, then one officer per one state (appointed by the bank /FI / funder)
- Representation on governing board / active role (vigilance) in HR issues through its officers / monitors
- Fixing a cap on interest rates for the members by the MFI
- Cap on funding to the MFIs, which are working in the same area / are conflicting with each other
- Much importance to the ratings is not that much good
- One central board should be constituted by all of the funders (banks, donors, government) to lend to the MFIs. It can prevent the funding agencies not to go for beyond the investments in one MFIs
- Whatever may be the legal structure of any MFI, its operations should be limited to 10 districts (in a state) or 2 crore population
- Funding institutions better to appoint experienced personnel from MF sector. 1 person per 3 MFIs or Rs.100 crores outstanding to deal with the monitors. Rs. 350 crores is the maximum amount for a state, which is having <=20 districts / 5 crores populations by a bank/FA
- Every MF funding institute / investment agency must convene yearly
- MFIs meet to share their experiences and to solve their problems
- Bop services / products - as credit+ diversification

Smita Premchander, Sampark, Bangalore

It is good that the MF Bill is being debated better this time, compared to the last. And it is important that we highlight the provisions that remain in, despite much advice given to the Ministry the last time the Bill was drafted.

These relate to the safety of women's savings. If MFIs are constituted with a capital of Rs. 5 lakhs, then it will provide easy access to moneylenders as well as small NGOs, who have no standing as good deposit taking institutions, and women's money will be at tremendous risk. This provision must definitely be deleted, and deposit taking organizations be subjected to normal banking and non-banking institutions' laws.

I am attaching an article that outlines the issue, which was published in Economic Times: http://economictimes.indiatimes.com/opinion/guest-writer/mfi-bill-concerns-remain/articleshow/9243006.cms

I hope FICCI can influence the Ministry to safeguard poor women's small savings.

M Rajshekhar, University of Sussex, Brighton, United Kingdom *

I wrote an article for The Economic Times on – **Microfinance Bill: Shouldn't MFI Come Under State Law?**

Microfinance practitioners insist their embattled industry should not be regulated by state governments. State governments, they say, do not know how to regulate financial organizations. Keeping microfinance institutions (MFI) under the purview of the state government, they add, will leave micro lenders vulnerable to political pressures.

It is a set of arguments that has been accepted by an expert committee that wrote the draft microfinance Bill. The draft Bill, put up by the finance ministry, promises to override state laws.

It also proposes that state advisory councils be set up to, among other things, monitor MFIs' field-level conduct and give a feedback to the central government. Further, it says that if the RBI feels an MFI's actions are hurting clients, it can issue orders to stop the functioning of the organization.

It is not clear, however, if these measures can protect the MFIs' poor and vulnerable borrowers. For instance, while the draft Bill gives sweeping powers to the RBI, it is far from clear if the apex bank has the capacity to supervise and monitor MFIs. Says microfinance expert Ramesh Arunachalam, "During 2008-10, the five largest MFIs - SKS, Spandana, Share, Basix and Asmitha - added a gross loan portfolio of
78.55 crore per month."

The department of non-bank supervision, he says, should supervise every NBFC that has a loan portfolio of over 100 crore. However, despite each of these five MFIs adding almost 78% of that threshold value every month, their growth went unscrutinised, resulting in the collective default Andhra Pradesh saw last year.

Similarly, while the draft Bill empowers the RBI to derecognize an MFI that violates borrower rights, this provision of punitive action was available to the RBI even as a regulator of NBFCs. But it was never used even when the reports of suicides among MFI borrowers and corporate misgovernance began trickling in.

One reason for this relative inaction is that microfinance is still a small piece of the country's financial system. Last year, just before the Andhra Pradesh Ordinance was promulgated, the industry stood at just 27,000 crore. Today, it stands at about 15,000 crore - a minuscule portfolio when compared to the banks. And the RBI seems to be allotting proportionately limited mindspace to the industry.

Further, the work of micro lending and collecting is done - in multiple, small transactions - in bastis and villages. These are not transactions the RBI is geared to track.

What about the state advisory councils that the Bill proposes? Can they safeguard the interests of the borrowers? No. These are problematic as well. Take their composition: two nominees from the state(s) covered by the council, one nominee from the convener bank of the state-level bankers' committee, one representative of the MFIs operating in the state(s) and one member nominated by the RBI. Who is speaking on behalf of the borrowers?

Further, it is not clear how these councils will track events in the field. The borrowers are poor. Some of them will live in isolated hamlets. It is unfair to expect them to travel to the state capital (or the adjoining state's capital) for registering their grievances.

This is also an architecture that fails to spell out how investigations will be carried out, nor is it clear how swiftly corrective steps can be taken under this structure.

The Bill also says that the "Reserve Bank may, with the previous approval of the central government delegate, any of its powers conferred under this Act to the National Bank in respect of any microfinance institution or a class of microfinance institutions".
This might be Nabard. Which is another problematic suggestion. Its self-help group programme competes with MFIs.

According to IIM professor M S Sriram, "The current problems of MFIs have not occurred on account of their registration, capital structure or governance structure. They are on account of practices at the client end."

The state government is the only institution with both the investigative and grievance-redressal mechanisms in place at the local level. Yet, it has no role. Remember, even the state advisory councils relay their comments to the Centre, not the state government.

What is needed is a system where the RBI lays down prudential norms for the sector. But the state governments should have a role in monitoring the industry's conduct with its borrowers.

Many thanks to all who contributed to this consultation!

If you have further information to share on this topic, please send it to Solution Exchange for the Microfinance Community in India at se-mf@solutionexchange-un.net.in with the subject heading "Re: [se-mf] FOR COMMENTS: Micro Finance Institutions (Development and Regulation) Bill - 2011. Additional Reply."

Solution Exchange for the Microfinance Community Discussion Summary

A National Regulatory Framework for Microfinance Sector

Compiled by Navin Anand, Resource Person and Monika Khanna, Research Associate
Issue Date: 29 December 2010

From Ramesh S Arunachalam, Independent Micro-Finance Practitioner, Chennai

Posted 27 October 2010

I am independent microfinance practitioner, analyst and researcher and I am interested in knowing the views of the community with regard to a (legitimacy providing) national regulatory framework for microfinance in India.

As microfinance moves to a large scale roll out stage, it becomes imperative to establish fair rules for conducting micro finance. An analysis of the microfinance regulatory situation in India reveals multiple mechanisms for regulation of various entities engaged in the microfinance space. At one end, NGOs, Trusts and other not-for-profit institutions functioning as financial intermediaries are out of the purview of any direct supervision by the financial regulatory mechanism. On the other hand, some MFIs focused on fast growth and high profits seem to be going off track – especially with regard to good governance and ethical practices of business.

Experts and senior practitioners like Mr Al Fernandez, Mr Ramakrisha, Prof Sriram, Prof R Srinivasan, Mr Vijay Mahajan, Ms Shashi, Rajagopalan, Journalist M Rajsekhar, Dr Thorat, Dr N R Narayana Murthy and many others have given their views on the present crisis in microfinance. (Details available at: ftp://ftp.solutionexchange.net.in/public/mf/cr/res26101001.doc; Size: 52 KB). Some of the key areas of concern relate to: *over-indebtedness; private investors looking for quick growth, high profits, high cost and its impact; multiple loans; investors putting pressure for returns; corporate misgovernance and lending irregularities including coercive repayment techniques and harsh repayment schedules etc.*

Hence, in context of safeguarding interest of customers at one level and giving functional clarity to MFIs/MFOs on the other, it seems necessary to have clear National Regulatory Framework for Micro-finance in India. This is becomes even more essential, when one considers the recent ordinance passed by the Andhra Pradesh Government. As quoted in many newspapers, banks appear to have halted disbursements of sanctioned and approved loans to MFIs. Further, it has been reported that the despite the Hon Court's interim relief, MFIs are still finding it very difficult to lend and/or recover their dues.

In fact, in 2005, Dr Thorat (Former Chairperson, NABARD) and I, in a paper (Available here, please see pages 26 – 36 and other pages) presented at the NABARD high level policy conference at New Delhi, had forewarned that the burgeoning growth of micro-finance could result in a number of not-so-desirable practices being adopted. We had therefore argued for a single (super) regulator to provide the much needed legitimacy to the Indian micro-finance industry as well as help prevent some of the very (unfortunate) events that are occurring today..

Therefore, given the present crisis and urgent need for a regulatory framework of Micro-finance, I would like members to highlight their views on **regulation and supervision** of Micro-finance in India and provide some answers to the following specific questions:

Need of a Regulatory body

- Is further regulation of micro-finance necessary? If yes, what kind of institutions should be regulated? And who should be the regulatory body and why?
- What about the idea of self-regulation? Will it work? What are members opinions on these issues in the light of their own experiences with self-regulation (codes of conduct by Sa-Dhan and MFIN) in India?

Regulatory Framework

- Do we need a national regulatory framework for micro-finance encompassing all types of MFIs? What aspects (prudential, non-prudential etc) should be focused in the framework? Should the framework have any non-negotiable in terms of specific things to be done by the regulated bodies?
- What kind of supervisory mechanisms (On-site, off site, third party etc) are envisaged? What checks and balances would be required for the proposed framework to be effectively implemented on the ground?

Capacities Required

- What capacities would be required to effectively implement such a regulatory framework?

Besides the need for a National Regulatory Framework from micro-finance, I also feel that we need to ensure that MFIs adopt good **Corporate Governance Practices**, if they are to be viewed positively. I would also request members to provide their suggestions regarding this:

- How to enable MFIs get to implement in practice good corporate governance in full earnest?

Dr N R Narayana Murthy defines good Corporate Governance as: 'Corporate governance, to me, is about maximizing shareholder value legally, ethically and on a sustainable basis, while ensuring fairness to every stakeholder - the company's customers, employees, investors, vendor-partners, the government of the land and the community.'

Based on the responses received from the members, I would like to compile these responses as a paper and share it with the RBI Sub-Committee that is looking into current crisis in micro-finance, especially in the backdrop of the AP ordinance for MFIs.

Responses were received, with thanks, from

24. **Aparajita Agrawal, Intellectual Capital Advisory Services (Intellecap), Mumbai**
25. **Ritesh Dwivedi, Amity School of Rural Management, Amity University, Noida**
26. **Malay Dewanji, Liberal Association for Movement of People (LAMP), Kolkata**
27. **Umesh Chandra Gaur, Confederation of Community Based Organizations of India, Delhi**

28. Subrata Sarkar, Kalyani, West Bengal
29. Subhash Chatterjee, AXIS Bank Limited, Mumbai
30. Srinivas, Independent Consultant, Hyderabad
31. Sreedharan Nair, Initiative for Social & Economic Transformation (InSET), New Delhi
32. Smita Premchander, Sampark, Bangalore
33. Ravi Chandra, Bihar Development Trust, Patna
34. Ramesh S Arunachalam, Independent Micro-Finance Practitioner, Chennai (Response 1; Response2; Response 3; Response 4; Response 5; Response 6)
35. K. Rajendran, Research Scholar, Chennai
36. Radhika Jha, Independent Consultant/ Researcher, New York, USA
37. Jaipal Singh, Centre for microFinance, Jaipur
38. George E. Thomas, Mumbai
39. G. Bhaskara Rao, Enable – APMAS, Hyderabad (Response 1; Response 2)
40. Badri Nath Tiwari, Grameen Development Services (GDS), Ajmer, Rajasthan
41. Arabinda Mitra, Ghoragacha Swanirvar Samiti, Kalyani, West Bengal
42. A P Fernandez, MYRADA, Bangalore (Response 1; Response 2)
43. Toms K. Thomas, Mutual Assistance Resource Group (MARG), Trichur, Kerala
44. T Vanitha, BASIX, Andhra Pradesh
45. R. Ramachandran, Association for Development through Integration and Cooperation (AICOP), Cuddalore, Tamil Nadu
46. Savita Shankar, Lee Kuan Yew School of Public Policy, National University of Singapore, Singapore
47. Harish Chotani, Resource Consultant - Microfinance and Livelihoods Promotion, Gurgaon
48. N. Jeyaseelan, Hand in Hand, Chennai
49. Navin Anand, United Nations Development Programme, New Delhi

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Summary of Responses
Related Resources
Responses in Full

Summary of Responses

In the present microfinance scenario, members showed their concern about some of the key problems emerged due to the mission drift in MF sector. These problems include over-indebtedness, private investors looking for quick growth and high returns, high costs for clients, multiple lending, improper governance, harsh repayment schedules and coercive repayment techniques used by some of the MF service providers. Keeping in view client's interests at one level and giving functional clarity to a variety of MF service providers for successful and ethical implementation of microfinance activities, a good regulatory framework is a prerequisite.

Referring to the present crisis in the MF sector, members expressed that 'mere access' is not the only objective but other critical factors mutually perceived between the service providers and clients are also to be taken into account such as up scaling, affordability and sustainability.

Diversities in the MF Scenario and Appropriate Regulatory Framework

A high level of diversity is seen in the microfinance sector in context of - range of MF organizations having different legal forms, variation in MF products and services and extent of mF operations, variety of regulatory bodies, type and level of intermediation of MFIs, economic and social status of the target population and geographic spread of poor. Members envisaged that the MF regulatory framework can be developed considering all these complexities of the sector that can address the information asymmetries, encourage healthy competition and protect the interests of all the stakeholders. Members find it a right time to introduce a regulatory mechanism through regulatory bodies like RBI, NABARD, Securities and Exchange Board of India (SEBI), IRDA and a variety of other regulatory bodies.

Scanning of present regulatory scenario reveals that different kinds of banks such as commercial banks, RRBs, Cooperatives Banks, local area banks and other private banks are covered under Banking Regulation Act and also RBI/NABARD regulations related to microfinance. The Non-Banking Finance Companies (NBFCs) engaged in microfinance are being regulated by RBI whereas the NGOs, Trusts and other not-for-profit institutions functioning as financial intermediaries are out of the purview of the direct supervision of the RBI. The scenario of financial cooperatives is more complex as these institutions are being regulated by Registrar of cooperative societies and also by NABARD/RBI. This situation demands for a regulatory framework that can encompass different types of MF service providers.

Design Problem

Analyzing the present crisis in the microfinance sector, members identified MF Project Designs as one of the important factors responsible for the present crisis in MF sector. They find some links between the funding models or capital generation arrangements and the present crisis of the MF sector. The funding models differ from each other in context of sharing of risks by different stakeholders and also form of financial support like bulk loans, grants, quasi equity, equity capital and loan guarantee funds received by the MFIs. Hence, this provides logic for the coverage of investments in the regulatory frame work.

On regulatory framework, member suggested the following -

- **National Framework -** A well defined MF regulatory framework at the macro or national level applicable for all types of MF service providers (NBFCs, Section – 25 companies, Public Listed, Trusts, Societies, and Cooperatives etc.)
- **Single Regulator at the National Level** - All MFIs can be regulated by one regulator while complying with the Acts in which they are registered.
- **Primary and Secondary Regulators -** Different legal entities can continue to be regulated by one or more primary regulators depending upon their registration and portfolio of activities. Secondary regulator can watch the activities at the macro level in specific context of microfinance operations. This forms two boundaries for microfinance institutions in terms of regulations.
- **Individual Service providers** - Individuals functioning as service providers such as Business Correspondents /Business facilitators and Money lenders may also be taken up under the ambit of MF regulatory framework.
- **Regulations for those opting for mobile phone banking –** MFIs providing remittances services and using mobile phone banking are to be regulated by appropriate regulatory bodies in addition to RBI.
- **Monitoring of MF activities –** The regulatory framework needs to incorporate provisions for monitoring of MF activities at the grassroots level.
- **No dilution of banking standards –** Banking standards need not to be diluted so as to save poor clients, especially illiterate women who require financial literacy
- **Supervisory Mechanisms** – A combination of different supervisory mechanism (On-site, off site, third party etc.). and checks and balances are required for effective implementation of the regulatory framework
- **New Regulatory authority** – Since there has been no consensus on a particular regulatory body for MF, Government shall form a new Regulatory authority with officials taken from RBI, NABARD, SIDBI and also from Market

- **Coverage of Regulation up to Investors' Level:** The investment made by a variety of investors in MF also needs to be covered under the regulatory framework

Regulatory Body

While members recommended for establishing a single regulatory body at a national level, they also suggested the following to be taken up by the regulatory body –

- Conducting periodical audit of all the MFIs by the regulatory body
- Periodic Rotation of the officials of the regulatory body and keeping officials up to five
- Making registration mandatory for all the MFIs/MFOs based on MF mapping so as to minimize the incidence of overlapping and cross financing
- Ensuring strict adherence to KYC norms by MFIs followed by ensuring code of conducts
- Using macro level controls and ensuring long-term financial solvency

Regulations for Urban Micro financing

Referring back to the recommendation of the Task Force (1999) for including Urban SHGs under NABARD - SHG Bank Linkage programme, members expressed the need of focused MF initiatives in urban areas and a policy framework with flexible norms for including heterogeneous groups.

Micro Finance Interest Rates

In context of interest rates, members mentioned about the total cost of delivering financial services to the low income people includes transaction/financial costs at three levels – Institutions, intermediaries and at client level. This delivery cost varies across the models. Besides models, there are factors like economies of scale, life cycle stage, fixed and variable costs, products strategy, type and efficiency channel partners/intermediaries and competitive strategy which affect the rate of interest charged by the MFIs. Mentioning about the Andhra Pradesh crisis, members strongly recommended for a study covering issues like interest rates being charged by the MFIs, implications of adopting 'full cost recovery from clients' and benefits of opting for 'partial cost recovery from clients plus subsidies' model. A rational decision by the Government on the regulating the interest rates has become essential at this juncture.

Self Regulation

Expressing their doubts about the applicability of self-regulations in MF sector, members expressed that self regulation requires very high ethical framework and ability to control the temptation of earning quick buck. It is only possible when the institutions involved are committed to upliftment of the poor. A frame work for self-regulation can be developed to advocate measures like assessing the debt capacity of the borrowers, overseeing the utilization of loans etc.

Capacities Required

Members highlighted about the importance of "Human Element" in MF sector and recommended for engaging focused resources by service providers. Capacities in the relevant fields of micro finance i.e., Micro Finance Principles and Theory, economics, sociology, human rights, leadership development and marketing etc. would be required to effectively implement the new regulatory framework. The regulators must have the technical capabilities to assess and evaluate MFI practices and control systems.

Savings Mobilization

The present regulations restrict a variety of MFIs including NGO-MFIs for taking savings from the public. The regulators perspective of not permitting numerous small institutions to mobilize savings has been to give protection to poor. RBI has introduced Business Correspondent (BC) model so that through banks, adequate safety to the deposits of poor is provided. Recently, RBI has also allowed BCs to appoint sub-agents thereby addressing financial inclusion agenda.

Savings mobilization by CBMFIs and other MFIs from their clients would reduce the cost of capital to a significant extent and it will influence the change in the interest rates in a positive way. There are regulations for the type of organizations that can collect savings. Small savers need more, not less protection. Besides strengthening the regulations for permitting collection of savings, members also suggested for transformation of NGOs or creation of sister organizations so as to undertake savings activity, legally. Similarly, NBFCs comply with RBI norms and get the requisite approvals to start getting savings and deposits. Members were not in favor of diluting norms related to collecting savings.

Suggestions for Tackling the Microfinance crisis

- **Short Term Measures** – Identify shared Clients and JLGs with Multiple loans; engage with stakeholders to deal with clients having multiple loans; ensure regular MF business for clients not having multiple loans; create a uniform practical code of conduct for MFIs; integrate credit bureau with CIBIL.
- **Long term Measures –** Create Single regulatory regime; enable regulators to perform crucial roles of legitimizing microfinance; regulate and supervise MF through appropriate prudential and non-prudential regulations, protect MF consumers and MFIs (provide Literacy/ education to MF Clients on consumer rights, undertake actions on complaints of clients through ombudsman, protect MFIs from state level usury interest ordinances, if required); and give special emphasis on MFI governance.

Overall, members analyzed the existing regulatory situation and recommended for a comprehensive MF regulatory framework that can cover all MF service providers including BCs/BFs as well as money lenders. Members envisaged an environment of Ethical Microfinance Services (EMS) wherein the interests of the 'Service Providers' (SP), and the 'Service Users' (SU) can be balanced and protected.

Related Resources

Recommended Documentation

Indian Microfinance Crisis of 2010 -Turf War or a Battle of Intentions (*from Aparajita Agrawal, Intellectual Capital Advisory Services (Intellecap), Mumbai)*
Paper; Intellecap; October 2010
Available at ftp://ftp.solutionexchange.net.in/public/mf/cr/res27101001.pdf (PDF; Size: 101 KB)

> *Analyzes crisis in AP, revisits fundamentals of business, and questions the effectiveness of radical approaches to multiple bottom-line business by the State and the media*

Microfinance Developments: Let Good Economies and Sound Regulation be Good Politics (*from Savita Shankar, Lee Kuan Yew School of Public Policy, National University of Singapore, Singapore)*
Article; by Savita Shankar and Mukul G Asher; DNA; 24 November 2010
Available at http://epaper.dnaindia.com/newsview.aspx?eddate=11/24/2010&pageno=10&edition=9&prntid=129512&bxid=30696276&pgno=10

> *Highlights that Microfinance sector needs decisive policy direction from the Government to restore the confidence of stakeholder*

From Monika Khanna, Research Associate

Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance
Focus Note; Consultative Group to Assist the Poor (CGAP); November 2010

Available at http://www.cgap.org/gm/document-1.9.48945/FN67.pdf (PDF; Size:277 KB)

Note provides background and context on the situation, which raises important questions about the evolution of microfinance markets more broadly

The Andhra Pradesh Crisis: Three Dress Rehearsals and Then the Full Drama
Note; by Graham A.N. Wright and Manoj K. Sharma; *MicroSave*; December 2010
Available at http://www.microfinancegateway.org/gm/document-1.1.8919/IFN_55_The_Andhra_Pradesh_Crisis.pdf (PDF; Size: 44.7 KB)

Examines the build up to the Andhra crisis, future prospects for Indian MF, implications of interest rate caps and lessons that should be learned by the mf sector worldwide

Recommended Organizations and Programmes

From Malay Dewanji, Liberal Association for Movement of People (LAMP), Kolkata

National Bank for Agriculture and Rural Development (NABARD), Mumbai
Plot No. C-24, "G" Block, Bandra-Kurla Complex, P. B. No 8121, Bandra (E), Mumbai - 400051; Tel.: 91-22-2653 9244; Fax: 91-22-2652-8141; nabmcid@vsnl.com; http://www.nabard.org/

Apex institution providing loan funds for microfinance services in the form of revolving fund assistance to NGO-MFIs, SHG Federations and NGOs to lend to SHGs

Reserve Bank of India (RBI), Mumbai
Rural Planning and Credit Department, Central Office Building, 13th Floor, Mumbai 400001;
Tel.: 91-22- 22610261; Fax: 91-22- 22658276;
http://www.rbi.org.in/scripts/AboutUsDisplay.aspx?pg=Depts.htm#RPCD

Rural Planning and Credit Department of RBI formulates policies relating to rural credit and monitors timely and adequate flow of credit

Sa Dhan, New Delhi
12 & 13, 2nd Floor, MPTCD Building, Special Institutional Area, Shaheed Jeet Singh Marg, New Delhi-110067; Tel: 91-11-47174400 ;
Fax: 91-11-47174405; info@sa-dhan.org; http://www.sa-dhan.net/Default.aspx

A forum for organisations and individuals engaged in the field of community development finance to meet, share and exchange their experiences, expertise and resources

Khadi and Village Industries Commission (KVIC), Maharashtra
"Gramodaya", 3, Irla Road, Vile Parle (West), Mumbai 400056; Tel: 91-22-26714320-22/4325/6323/2324/3527-29/1073/3675; Fax: 91-22-26711003;
dit@kvic.gov.in; http://www.kvic.org.in/v4/homepage.asp

KVIC is charged with the planning, promotion, organisation and implementation of programs for the development of Khadi and other village industries in the rural areas

From Srinivas, Independent Consultant, Hyderabad

Insurance Regulatory and Development Authority (IRDA), Hyderabad
3rd Floor, Parisrama Bhavanam, Basheerbagh, Hyderabad – 500004, Andhra Pradesh; Tel: 91-040-66820964/789768; Fax: 91-040-66823334; http://www.irdaindia.org/

Insurance regulatory body set up to protect the interests of the policyholders and to regulate, promote and ensure orderly growth of the insurance industry

Pension Fund Regulatory and Development Authority, New Delhi

First Floor, ICADR Building, Plot No. 6, Vasant Kunj Institutional Area, Phase - II, New Delhi - 110070; Tel: 91-11-26897948/49; Fax: 91-11-26897938;
kamal.chaudhry@pfrda.org.in; http://pfrda.org.in/index.asp

Acts as a regulator for the pension sector with the mandate of development and regulation of pension sector in India

Telecom Regulatory Authority of India (TRAI), New Delhi
Mahanagar Doorsanchar Bhawan, (next to Zakir Hussain College) Jawaharlal Nehru Marg (Old Minto Road) New Delhi – 110002; Tel: 91-11-2321 1934, 2323 3466, 2322 0534, 2321 3223, trai@del2.vsnl.net.in, trai@trai.gov.in; http://www.trai.gov.in/

TRAI aims to ensure fair and transparent policy environment, which facilitates fair competition in the telecom sector and protects the interests of consumers

Securities and Exchange Board of India (SEBI), Mumbai
Plot No. C4-A,'G' Block, Bandra Kurla Complex, Bandra (East), Mumbai 400051 Maharashtra; Tel: 91-22-26449000/40459000; Fax: 91-22-26449016-20/40459016-20;
sebi@sebi.gov.in; http://www.sebi.gov.in/

Autonomous body, drafts regulations, conducts investigation and enforcement action and passes rulings and orders in its judicial capacity

Small Industries Development Bank of India, Lucknow *(from N. Jeyaseelan, Hand in Hand, Chennai)*
SIDBI Tower, 15, Ashok Marg, Lucknow - 226001 Uttar Pradesh; Tel: 91 -522-2288547; sfmc@sidbi.in; http://www.sidbi.in/Micro/index.htm

SIDBI Foundation for Micro Credit (SFMC) provides bulk loans and technical support to MFIs

Society for Elimination of Rural Poverty (SERP), Hyderabad *(from G. Bhaskara Rao, Enable – APMAS, Hyderabad; response1)*

4th Floor, Hermitage Office Complex, Huda Building, Hill Fort Road, Nampally, Hyderabad – 500004; Tel: 91-40-23298981; Fax: 91-40 -23211848; http://www.serp.ap.gov.in/SHG/

A microfinance programme supported by the State Government of Andhra Pradesh which promotes SHGs with an emphasis on capacity building

Credit Information Bureau (India) Limited, Mumbai *(from Radhika Jha, Independent Consultant/Researcher, New York, USA)*

Hoechst House, 6th Floor, 193 Backbay Reclamation, Nariman Point, Mumbai 400021; Tel: 91 -22 6638 4600; Fax: 91 -22 6638 4666; info@cibil.com; http://www.cibil.com/

Provides comprehensive credit information by collecting, collating and disseminating to both commercial and consumer borrowers and to a closed user group of member

Recommended Portals and Information Bases

Candid Unheard Voice of Indian Microfinance *(from Ramesh Arunachalam)*
Blog; Contact Mr; Ramesh S Arunachalam; Independent Micro-Finance Practitioner; rarunachalam@hotmail.com

Blog focuses on the issues emerging in the microfinance sector ranging from Andhra Pradesh Microfinance Crisis, governance, transparency and regulatory issues in MF sector

Related Consolidated Replies

Draft Document on Regulation and Development of Microfinance Sector, from Ratnesh, UNDP - India, New Delhi (For Comments). Microfinance Community - Solution Exchange - India,
Issued 31 March 2010. Available at ftp://ftp.solutionexchange.net.in/public/mf/cr/cr-se-mf-22021001.pdf (PDF, 249 KB)

Seeks comments and suggestions of the stakeholders on the draft document on Regulation and Development of MF Sector proposed by NABARD and Ministry of Finance

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Responses in Full

Aparajita Agrawal, Intellectual Capital Advisory Services (Intellecap), Mumbai

Intellecap, the social investment advisory firm based in India, has drafted a white paper in response to the ongoing microfinance crisis in India. The paper analyzes the buildup to the crisis in Andhra Pradesh, attempts to revisit some fundamentals of the business, and questions the effectiveness of radical approaches to multiple bottom-line businesses by the Government and the media. To read the paper, please visit: ftp://ftp.solutionexchange.net.in/public/mf/cr/res27101001.pdf. I hope you will find the paper to be thought-provoking and informative.

Ritesh Dwivedi, Amity School of Rural Management, Amity University, Noida

I think this is the most important discussion as it is relating with the problems of crores of poor people. Today Microfinance has become quite popular with some private investors but they don't know the ethical foundations of this sector. This is the root cause of present crisis. It has been reported in different newspapers that excessive interest rates are being charged by few Microfinance Institutions which has caused serious damage to the already weak financial health of poor people. This situation has resulted in some serious introspection for all stakeholders of this sector and as well as reflected a strong need of a Regulatory body.

I do propose that a separate legislation on whole Microfinance activities (saving, credit, remittances, lease etc.) covering all important issues, dos and don'ts should be passed by parliament. Sector has become so vast that a regulatory body is a must. In the present condition, I don't think self regulation will work. There are so many MFIs which are working honestly and serving to the poor but again some money-minded and market driven MFIs are vitiating the atmosphere as they are focusing only on profit maximization.

There should be clear and strict investment norms regarding investor's experience on poverty eradication, capital limits, return time limits, interest limits for clients. Monitoring of these norms should be always on-site and only by third party.

Malay Dewanji, Liberal Association for Movement of People (LAMP), Kolkata

I would like to highlight my views on regulation and supervision of Micro-finance in India. Through this response I will try to provide specific answers to the questions raised in the discussion:

Need of a Regulatory body

I feel that regulation of micro-finance is necessary. NABARD should be the regulatory body of all the non-profit making NGOs/CBOs only, working in the micro finance as a means of development of the poor. As NABARD has been working for the development of the poor for many years and supporting Self-Help Groups throughout India, they with the participation of RBI, Ministry of Finance and Ministry of Rural Development and prominent NGOs should be the regulatory body.

Reserve Bank of India should regulate the NBFCs. Many NBFCs have been claiming to come under the proposed Micro Finance Bill meant only for NGOs/CBOs, and their argument is that they are also working for the poor in the field of micro finance.

In this case, we can compare the situation, regarding the operations of small and micro industries in India. There are many NGOs working in the Khadi and small industries sector throughout India that are governed by the Societies Act and affiliated and regulated by the Khadi and Village Industries Commission (KVIC) and all the State Khadi and Village Industries Boards. All these Khadi and Village industries organizations have been making businesses and surpluses, as they are not profit-motivating organizations, but they are not making profits and therefore, not paying any dividends to their members. At the same time, there are many profit-making companies, who are registered under the Companies Act and doing businesses in the micro and small industries sector, and they are regulated by the Companies Board.

The same principles are to be followed in the Micro Finance sector too. The undersigned is associated with both the NGOs and NBFCs, who have been actively working in the field of Micro Finance, and from the dual experiences the above suggestions are given for regulating and supervising the Micro Finance sector.

Finally, it should be mentioned here that all the big NBFCs must not be allowed to get the same kind of benefits like the NGOs/CBOs. Moreover, most NBFCs are directly or indirectly regulated and governed by the foreign capital and therefore, they should not be equally treated with the development NGOs, otherwise, injustices will be done on the development NGOs of India.

The idea of self-regulation sounds good, but it will not work. In the light of our own experiences, self-regulation does not work in our country. In fact, codes of conduct finalized by Sa-Dhan and MFIN are not followed by many of their members in India.

Regulatory Framework

No, we do not need one national regulatory framework for micro-finance encompassing all types of MFIs. We have already mentioned our opinions in this regard, at the above. In our opinion, there should be two different types of regulatory bodies (NABARD for NGOs and RBI for NBFCs) for two different categories of organizations, these aspects (prudential, non-prudential etc) should be focused according to the organizational ownership and framework.

There should be combination of different supervisory mechanisms (On-site, off site, third party etc). Checks and balances by the different regulatory bodies and the beneficiaries would be required for the proposed framework for effective implementation on the ground.

Capacities Required

Capacities in the relevant fields of micro finance i.e., economics, sociology, human rights, leadership development and marketing etc would be required to effectively implement such a regulatory framework. There must be a balance of work-orientation and people-orientation in operations of regulatory framework.

Regarding your opinion about the need to ensure good Corporate Governance Practices, by the MFIs, we opine that NBFCs only must adopt it, if they are to be viewed positively. The reason is : you have mentioned the idea of Dr. N R Narayana Murthy, who defines good Corporate Governance as: 'Corporate governance, to me, is about *maximizing shareholder value legally, ethically and on a sustainable basis*, while ensuring fairness to every stakeholder - the company's customers, employees, investors, vendor-partners, the government of the land and the community.' From this write-up, it is very clear that "Shareholders of the Companies i.e., NBFCs should get highest priority" and in our opinion, Good Governance of the NGOs, means maximizing SHG members value legally, ethically and on a sustainable basis and thus community comes first.

Finally, I should mention here that our efforts should be focused on serving the community rather than the interest of few individual businessmen.

Umesh Chandra Gaur, Confederation of Community Based Organizations of India, Delhi

Microfinance is defined as a provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve their living standards. A series of policy measures of the Government of India have facilitated intensification and deepening of microfinance. These initiatives include - nationalization of commercial banking sector in 1969, setting-up of Regional Rural Banks (RRBs) in 1975, reforms of financial sector (since 1991), implementation of pro-poor schemes/programmes through credit delivery system etc. Similarly, Reserve Bank of India (RBI) (the Central Bank of the Country) has also taken up a number of initiatives for expansion of rural bank branches, priority sector lending and financial inclusion. All these initiatives by the Government of India and RBI have positive bearing on microfinance development. In the last two decades, a variety of MFIs have expanded their outreach through SHGs, Joint Liability Groups (JLGs) and individuals. These MFIs have also made innovative experiments in providing microfinance services at the doorsteps of the poor.

For successful implementation of microfinance activities, a good regulatory framework is a prerequisite. In context of the same, I would like to suggest the following -

- First of all, we have to make people aware about microfinance services so that they can take advantage of various programmes and projects of microfinance. Hence, focus on financial literacy is the step towards financial inclusion.
- NGOs/CBOs/SHGs are playing important role in implementation of microfinance schemes and programmes. They can organize seminars and knowledge melas at the local level to create awareness about microfinance. Media can also play a good role in spreading awareness about microfinance.

Regarding Regulatory framework, I want to recommend that the regulations in microfinance should be focused towards –

- Bringing orderly, holistic and integrated development of microfinance sector
- Enlarging and facilitating financial inclusion of the poor and disadvantaged
- Protecting the interests of the small savers and depositors
- Eliminating the scope of exploitation of the vulnerable and disadvantaged clients
- Facilitating universal and easy access of credit, thrift and other financial services to the women and disadvantaged

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Subrata Sarkar, Kalyani, West Bengal

I really appreciate the Solution Exchange MF Community's timely effort to put the captioned topic for the e-discussion. Here I have the following feedback on the MF regulation in India:

- It would be wise to keep the option for savings mobilization for the CBMFI, MFI from their clients, which would reduce the cost of capital to a significant extent. Moreover exclusion of Savings component some cases causes a huge drop out in the borrowers, especially for the SHGs/CBMFI transformed in to MFI. This option might minimize the issue of" usurious interest rate" to a great extent, as I opine.

- In most of the cases, we are concerned for rural SHGs only and their Credit linkage through Banks. What about the Urban Bank linkage? Many thought provoking discussion were there in the past in this regard, but frankly speaking no such serous attempts have been made to bring the urban SHGs in the financial inclusion framework, except the co-operatives. I still remember that during 1999 Task Force recommendation, strong suggestions were there to include the Urban SHGs under NABARD SBLP (especially in the peri urban areas). Although some commercial Banks have taken some effort for extending the credit support to Urban SHGs, but still it is very sporadic. Some broad based policy framework needs to be evolved for the Urban SHG credit linage (Bank), based on developing the flexible norms for the urban heterogeneous groups.
- Registration of MFI/MFOs is must under a regulator, but a judicious balance needs to maintained between the small thrift and credit groups and the NBFC (because some times we say that as they are already been regulated by RBI why then to include them again). Registration of Small Thrift and Credit Groups/CBMFIs should not only to be registered but all MFI players should be considered for this case otherwise the conducive environment would not be there, as it is happening in some States.
- Registration of MFIs under the regulator should be based on MF mapping (location, client's loan portfolio) in order to minimize the incidence of overlapping, cross financing and cross financing. Although there is one school of thought that perfect completion reduces the rate of interest, may be true, but unless managed effectively it may lead MF in to a macro mess, as it has happened in some cases.
- Strict adherence to KYC norms followed by ensuring code of conducts for recovery needs to taken in to consideration in view of creating an enabling environment of MF. Moreover, synergy between different MF service delivery models must be evolved to ensure the provision of financial services by maintaining quality, accountability and relevance of the same.

Subhash Chatterjee, AXIS Bank Limited, Mumbai

The inputs have been great and would certainly help in formulation of a central level framework which would help all the concerned agencies to act and produce positive results.

A few of the points which I would like to comments on are as under:

Regulatory Body: A formation of a national regulatory body seems imperative to oversee that all the activities carried out under Microfinance, does bring out the desired outcomes. The body may be formed with officials from RBI, NABARD and MFIN or any other such Institution. As the activities are varied, the representatives should be well versed in all aspects of Microfinance and of course with the basic requirement i.e. a samaritan's heart. No government official other than mentioned above should be included in the body as otherwise it would influence the functioning or effect the desired outputs.

The body should be able to carry out periodical audit of all the MFIs based on the norms formed by them. Audits may be carried out by audit firms/people deployed by the body (ex -bankers/retired personnel who have worked/have experience in such activities.

The officials of the body should be rotated on a term, acceptable to all stake holders.

The body would approve/disapprove, the entry of any institution based on their capabilities, resources available, infrastructure, human resources, knowledge and of course the basic requirement i.e. to improve/wholesome development of the rural people, by their actions.

The number of officials in the regulatory body should not be more than five, to arrive at agreement than at disagreement.

Self Regulation: I don't think that in the present scenario we are ready for self regulation, it would not succeed as there are many institutions which would like to come in the Micro Finance just to earn profits. It is only possible when the Institutions involved are committed to upliftment of the poor/rural masses.

Ethics: Altruism is the fundamental requirement for any individual who really wants to help others to grow. So any Corporate Governance Practices would emanate from within the Institution which would see not only financial growth of the people it serves but overall change in the outlook of the community. There could not any fixed barometer for the same. It is based on the fact that if there is a will, there is a way.

As have been rightly pointed out by one of the members, Yearly Growth should not be the only scale against which an institution should be mapped or scaled. The amount of impact it has been able to make on the community it is serving should be taken into account.

Strengthening the MFI community as whole would help to leverage their point of view not only in front of the Government but it would help to forge dialogues with Banks, donor agencies and other stakeholders. It would also be a force against such institutions which come in garb of welfare organizations just to get the profits.

Srinivas, Independent Consultant, Hyderabad

Please find below my response to the query on A National Regulatory Framework for Microfinance Sector.

Need of a Regulatory body

Is further regulation of micro-finance necessary? If yes, what kind of institutions should be regulated? And who should be the regulatory body and why?

As all the members are aware, MF is offered by variety of institutions - Banks, MF NBFCs, NGOs (Societies / Trusts) and Cooperatives. The flow of credit to these institutions, either through Banks by way of Term Loans or through other financial instruments like NCDs, ECBs or Savings, is critical for effective functioning of these institutions. Each structure has its pros and cons. In the absence of a regulation, the bigger ones become bigger and the smaller ones become smaller. By virtue of mobilizing equity, the NBFCs have advantage of growing at a scale whereas the NGOs the founding pillars of the SHG movement find it difficult to mobilize credit as they do not have reserves and surpluses, whereas the cooperatives have the advantage of mobilizing the savings. Income Tax rules also vary with each structure. A regulation is therefore required:

- To bring a legitimacy to the work done by all the legal structures
- Barriers for growth to be kept on par for all legal structures
- Encourage flow of credit to all the legal structures, probably a policy may be derived wherein out of the total exposure of a bank to the microfinance sector, exposure to each legal structure and each institution may be limited (Currently NBFCs attract higher exposures in view of the favorable legislation, equity contribution etc.). It makes the life of a banker easy to sanction a Rs.200 crore or 300 or Rs.500 crore to one institution rather than a number of sanctions for the similar amounts (This does not mean that the banks should not sanction that amount to the institutions). I think we should draw some line. Probably assigning higher risk weightage if the sanctions cross above the prescribed limit or removing them from Priority Sector Lending etc. may be thought of. The objective is that there should be orderly growth of the sector. After all, financial inclusion does not mean that we exclude the institutions that have originally highlighted

this issue. I think we should have an inclusive policy. We should protect all the legal structures, if we see the value in the services that these legal structures provide.

Who should be the regulator? Can we think of having an independent microfinance regulatory authority (mFRA) drawing expertise from RBI, SEBI, IRDA, TRAI and PFRDA.

- What about the idea of self-regulation? Will it work? What are members opinions on these issues in the light of their own experiences with self-regulation (codes of conduct by Sa-Dhan and MFIN) in India?

I don't think self regulation will work there is nothing which is self regulatory. Every body has some external regulation without which there will be uneven growth. Even a big tree which bears fruits had to be cut down if there is an uneven growth or obstructing the growth of other trees which bear different kind of fruits. Similarly, unnecessary plants / trees need to be weeded out if they are not bearing any fruits for the benefit of the community at large or obstructing the orderly growth of the sector.

Regulatory Framework

- Do we need a national regulatory framework for micro-finance encompassing all types of MFIs? What aspects (prudential, non-prudential etc) should be focused in the framework? Should the framework have any non-negotiable in terms of specific things to be done by the regulated bodies?

I think a regulatory framework wherein the information asymmetries are addressed, the flow of credit to the institutions is encouraged, healthy competition is encouraged and at the same time protecting the interests of all the stakeholders - Government, Clients, Investors, Philanthropists may be thought of.

I think, we can take the clues from the existing regulators i.e. RBI, IRDA, PFRDA, SEBI, TRAI. The recent AP ordinance is also a good example, barring few exceptions and also with lot additions that are required. The regulation should allow a level playing field for all the legal structures.

The draft regulatory framework may be widely circulated for feedback, not just to industry leaders or industry associations, but to a large number of institutions and networks with clear cut timelines. We should bear in mind that those who respond to the mails or part of the industry networks are very few in comparison to the actual numbers present and also those who respond to the mails may not be the actual practitioners.

Besides the need for a National Regulatory Framework from micro-finance, I also feel that we need to ensure that MFIs adopt good **Corporate Governance Practices**, if they are to be viewed positively. I would also request members to provide their suggestions regarding this:

- How to enable MFIs get to implement in practice good corporate governance in full earnest?

I think one of the best way to enable MFIs to implement in practice good corporate governance in full earnest is first to define what exactly does it mean, then encourage MFIs who follow it and punish those who do not follow. Unfortunately, we have not seen in India the stricter implementation of rules and regulations. In India we have good rules but still there are many road accidents reported due to lack of strict implementation of the rules.

Sreedharan Nair, Initiative for Social & Economic Transformation (InSET), New Delhi

The query raised by Mr. Arunachalam is very relevant and timely. I have been of the view that there should be some regulatory framework to control the sporadic malpractices of certain MFIs. In fact, in the meetings of Microfinance Community, Solution Exchange held at Bhopal in 2009 and the one held in Jaipur in 2010, I have vociferously argued that there appeared to be some irrelevant growth of MFIs in the country. I also questioned the standings of certain MFIs in charging high interest rates coming to more than 36% and their methods of recovery of the loans. I also stressed that the real objective of establishing a MFI has been deliberately forgotten by certain MFIs in the name of maintaining financial sustainability, the result is incidents like SKS'. It would be timely to remember now that the MFIs are meant for helping the poor by enabling them to break the strong clutches of poverty and not to intimidate them in the name of maintaining profitability to have sustainability for the organizations. I do agree with the fact that to have sustainability, any organization should earn some profit but it does not also mean that organizations have to cut the throat of poor and the disadvantaged. Hence, it is now become essential that the Government come forth with a proper set up to help the poor with cheaper loans so that they are able to enjoy the benefits of financial inclusiveness.

As long as some organizations are allowed to frame their own law and practice it without being asked to be answerable for their misadventure or extremism in financial matters the incidents that happened in states like Andhra Pradesh are bound to repeat elsewhere in the country. Hence establishment of a regulatory framework in the Microfinance sector has become drastically essential.

Smita Premchander, Sampark, Bangalore

Thanks to Ramesh for initiating this very useful discussion. Do we need a regulatory framework for microfinance sector? The answer depends on an evaluation of the framework that exists. As far as regulation is concerned, Banks, Cooperatives, NGOs and NBFCs all are regulated.

What are MFIs?

Microfinance can be provided, according to Indian law, by any of these above organisations. They can all extend credit.

Can they all take savings deposits? Only the former two can. There are regulations for the type of organizations who can collect savings. These are to protect the savers. Small savers need more, not less protection. I believe that the standards here should not be diluted. If NGOs want to collect savings, let them transform and/ or start sister organisations, as many have done in the past decade. There is no harm in that. If NBFCs want to take savings, let them comply with RBI norms and get the requisite approvals. I am not in favor of diluting norms for collecting savings. The strict regulations for banks is the one single factor that saved India from the financial crisis in 2008, we need to appreciate that and safeguard the safeguards! The Reserve Bank of India is often made out to be a villain, all regulators face this, I am sure, and RBI has faced it well, it has not diluted norms, at least not yet.

Similarly, NGOs should not be permitted to offer insurance. Nor should they be permitted to do remittance transfers. These are operations for which financial organisations are created. Let them do it. If we are concerned about these banking organisations not reaching the poor, then let us exert the pressure for them to do so, as RBI does, through moves towards financial inclusion. The other option is to create more banking organisations whose mandate is to reach the poor. Let the donors who want to create this outreach support real banks to come up. Why do they want to put in less money than is needed? Why can't we see donors creating women's banks? Why do we want to dilute norms?

In the name of a 'new regulatory framework' for microfinance, what is often demanded is a dilution of banking standards. Let us first have a debate on what standards are we willing to stand by. There may be a few gaps, we can fix them. If there is no reason to dilute standards, then there is no rationale for new types of organisations. Then the current regulatory framework is fine. But no separate regulations are needed for microfinance than for any other size of financial services. Those who are poor, particularly women who may be illiterate, they deserve high banking standards to be upheld in this country. They need financial literacy, financial inclusion, and they need banks with positive attitudes towards lending to them.

Lets get more donor funded full fledged banks, that meet current banking standards, and not talk of different standards for microfinance sector. The recent developments show that MFIs do not, in fact, deserve any such treatment.

Ravi Chandra, Bihar Development Trust, Patna

I am co-founder of microfinance and livelihood institution named Bihar Development Trust in Bihar. We are a small MFI with portfolio of 1.6 crore with 3000 active borrowers. We have cumulatively disbursed Rs. 450 lakhs to 5000 borrowers till date in three years. I found the query of Mr. Arunachalam very appropriate and timely.

Need of a Regulatory body

Regulation of MFIs is very necessary. In fact, small players like us feel more need of it for legitimacy purpose rather than any other. Self Regulation requires very high ethical framework and ability to control the temptation of earning quick buck. I think the self regulation has failed. The operations people in MFIs are forced to grow fast ignoring the control system and policies as incentives are biased towards growth rather than control systems. Who is asking the national MFIs to grow at 100-200% CAGR or pressing the second tier between 20-100 crore bracket to grow at such a fast and unnatural pace.

Regulatory Framework

All MFIs (NBFC, Section 25, Public Listed, Trust, Society, Coops etc) should be regulated by one regulator while complying to the acts they have been registered. My only fear is that even with the crisis, many MFIs representatives are not going to learn and may block the MF bill in parliament this winter. Some of the NBFC MFIs have distorted the healthy policy debate on MFI bill and singing the tune that we are already being registered with RBI.

Capacities Required

The regulator must have the technical capabilities to assess and evaluate MFI practices and control systems. I feel there must be a strong technical panel with people having 20-25 years of experience of Microfinance in Banks, Academics, MFIs, Donor Agencies and Multi lateral bodies. They must be adequately staffed to handle regulation of a large number of MFIs. It must have people of high repute and ethical conduct.

How to enable MFIs get to implement in practice good corporate governance in full earnest?

It is totally dependent on promoters and founders' intent and will. Any amount of guidelines and statutes may not help. There are enough guidelines in place. The founder/promoter will always found a way out if s/he wishes to. Let's pray that promoters/Founders wish to implement good governance practices and implement it within their own organisations.

We being a small MFI were worried about growing fast. The high growth of MFIs has put lot of mental pressure on small MFIs to grow fast. I believe that our decision of taking up livelihood programmes along with Micro financing has proved to be a right decision in this situation of crisis.

Ramesh S Arunachalam, Independent Micro-Finance Practitioner, Chennai *(response 1)*

Greetings and many thanks for the wonderful and highly informative postings towards the regulation query. I am writing to inform you of a recently established blog in micro-finance and you may find it useful to look at some of the posts which are relevant to the current Solution Exchange query on national regulatory framework. This is a very critical time for Indian Micro-finance and we need to work closely together to help build a vibrant micro-finance industry in India that puts CLIENTS FIRST (as Dr Robert Chambers would say) and an appropriate National regulatory framework would go a long way towards that.

The Weblinks of some of the recent posts are given below (the latest posts are at the bottom)

Indian Micro-Finance: Time for RBI to Get the (Legal) Framework Right!
http://microfinance-in-india.blogspot.com/2010/11/indian-micro-finance-time-for-rbi-to_02.html

The Andhra Pradesh Micro-Finance Crisis: Time to Clean the Stables and Start Afresh
http://microfinance-in-india.blogspot.com/2010/11/andhra-pradesh-micro-finance-crisis.html

Zero PAR Policy in Some[1] Indian MFIs: Satyagraha, Staff Pressure and Other Methods
http://microfinance-in-india.blogspot.com/2010/11/zero-par-policy-in-some1-indian-mfis.html

Multiple Loans to Shared JLGs/Clients by MFIs: How Widespread is this Phenomenon, Why Has it Happened and Is it the Major Cause of the Present AP Crisis?
http://microfinance-in-india.blogspot.com/2010/11/multiple-loans-to-shared-jlgsclients-by.html

Understanding The State of Management Information Systems (MIS) in Indian MFIs: Critical Issues For The RBI Board Sub-Committee
http://microfinance-in-india.blogspot.com/2010/11/understanding-state-of-management.html

Sa-Dhan Members (Re) Adopt The Code of Conduct in Andhra Pradesh: A Positive Step but what is the Guarantee for Implementation this time around?
http://microfinance-in-india.blogspot.com/2010/11/sa-dhan-members-re-adopt-code-of.html

Building A Transparent MIS for Micro-Finance: Key Design and Implementation Lessons from The Indian Experience
http://microfinance-in-india.blogspot.com/2010/11/building-transparent-mis-for-micro.html

Tackling the Indian Micro-Finance Crisis: Some Practical Short and Long Term Measures that RBI Could Look At Implementing
http://microfinance-in-india.blogspot.com/2010/11/tackling-indian-micro-finance-crisis.html

It is about time that MFIN starts and delivers on the Promised Self-Cleansing!
http://microfinance-in-india.blogspot.com/2010/10/it-is-about-time-that-mfin-starts-and_9513.html

Has Burgeoning Growth Caused Increasing Frauds in Indian Micro-Finance: Do the Regulators and The RBI Sub-Committee Need to Carefully Examine this Relationship?
http://microfinance-in-india.blogspot.com/2010/11/has-burgeoning-growth-caused-increasing.html

It is Easy to Confess Today but Why Did MFIs Engage in Such (Over) Lending in the First Place?
http://microfinance-in-india.blogspot.com/2010/11/it-is-easy-to-confess-today-but-why-did.html

MFIN Requests for Formulation of Comprehensive Package for Micro-Finance Sector in India...
http://microfinance-in-india.blogspot.com/search/label/Microfinance%20Associations

What is Coercion in Repayment; A Client Perspective from Indian Micro-Finance
http://microfinance-in-india.blogspot.com/2010/11/what-is-coercion-in-repayment-client.html

I also request all the members that for candid and objective views on Indian Micro-Finance, Please Visit **-** http://microfinance-in-india.blogspot.com/

K. Rajendran, Research Scholar, Chennai

It is the right time to introduce framework for the Micro finance sector. Regulations by NABARD or its guidelines are not able to watch the MFIs. MFIs are charging high interest rate without emphasizing empowerment or development of people. It is the right time to frame guidelines for micro financing and introduce a regulatory mechanism through regulatory bodies like RBI and Securities and Exchange Board of India (SEBI) so as to cover a variety of MFIs.

Radhika Jha, Independent Consultant/ Researcher, New York, USA

The micro finance (MF) sector has been witnessing a rapid expansion globally and has been extremely successful in catering to the needs of the lower income- bracket borrowers. Whenever a sector grows, so does the need to better regulate it, so that the problems and downside risks associated with its rapid growth can be surmounted. Currently, one of the biggest challenges in the way of long term sustainability of the micro finance sector is its poorly regulated and un-supervised state. The microfinance industry undoubtedly needs better supervision and regulation for the smooth functioning of micro lending operations. The big question here is which type of regulation will be more favorable to MF industry: should it be regulated by government or semi government agencies or it is better off with self regulations?

Since restrictive and formal banking type regulation as imposed by the government could stifle the growth of this sector and limit its maneuverability and competitiveness especially in such a dynamic environment of micro financing, the adoption of self-regulation seems the better option. Self-regulation means self proclaimed codes of conduct and ethics, self enforcement, and adherence to such practices instead of regulations by an outside agency. The current measures being instituted by Microfinance Institutions' network (MFIN) are important steps towards self regulatory reforms of the MF sector. Following are some suggestions for streamlining the operations of the microfinance industry.

Creation of a central database: A centralized database accessible to all lenders should be created which would allow members to share borrowers' identification details, credit records and default information. A collaboration with national credit bureaus can be helpful too if they allow microfinance industry to leverage their existing database and updating facilities. A profitable partnership with mobile phone manufacturers and service providers would allow microfinance applications to run on mobile phones allowing field level workers to access and update this database timely. This would definitely make the process of credit checking, verification, lending and repayment smooth, fast and very effective.

Standardization of Practices: Standardization of the practices of microfinance would be very helpful in bringing uniformity in the business operations of the microfinance institutions. The various practices of micro lending regarding the financial assessment of the borrowers, interest rates charged, loan disbursement, and repayment operations should be standardized so as to make the procedures more transparent and uniform. This would also promote the best business practices among multiple micro finance lenders. Other supporting industries such as information technology shall be able to develop IT applications and related processes profitably if they can serve the whole industry uniformly rather than a few individual players.

Encouragement to all micro lenders to become organized members of MF industry: All the micro finance providers would be encouraged to become registered members of national organizations like MFIN and other organized networks if they clearly see the advantage. An educational program should be developed by MFIN to educate the members of micro finance community about the benefits of abiding by the self regulations and adopting the uniform practices. Other benefits should be full support and platform for its grievances, lobbying at all fronts and helping to bring down the cost of operations by profitably partnering with other service providers such as IT industry etc. Other benefits are no brainers as all members would benefit in cutting the default losses if they share the defaulters' data among themselves. Together they can influence government to enact laws healthy for their operations. All this would encourage healthy competitions among good lenders and weed out the bad ones to save the industry from getting bad image and publicity.

Major areas in need for Self Regulation

The major focus of self regulatory measures could be in the following areas:

Financial assessment of Potential Borrowers: The MF institutions should assess the debt capacity of the borrower by proper guidelines as suggested by code of practices. Such a practice would even help the borrowers to avoid getting into bigger debt issues and avoid the recent repayment crisis resulting in suicides by some borrowers in India.

Lending for productive purposes: The lending institutions should also ensure that the loans given for productive purposes are utilized for the productive purpose only and not for consumption purpose. This would also avoid repayment problems as the productive loans would help in generating money for the borrower.

Reasonable Rates of Interest: Micro finance institutions have been known to charge very high rates of interest. Codes of ethics and conduct regarding imposing the cap on interest rates charged from the borrowers, is highly desirable. The MFIN has been taking corrective measures to reduce the interest rates in the sector and would be beneficial to the whole community if respected by all the members.

Administration of the outstanding Loans: Emphasis should be on effective management of the outstanding loans & loan servicing costs as well as on the timely disbursement of the loans. Proper monitoring of lending practices should help identifying the flash areas early on. This would also enhance the profitability of MF industry.

Recovery operations: The micro finance institutions need proper guidelines on the recovery norms to ensure the smooth and effective recovery operations and avoid the recent incidents of coercion in recovery of loans.

Financial Sustainability of the MF Institutions: The regulatory code of conduct should also include measures for assessing the financial sustainability of the lender institutions i.e. the capacity of a MF institution to manage its costs against the revenue earned and its sustainability during the crisis period.

Refinancing: Regulation and measures regarding the refinancing of microfinance loans would help in keeping the current loan rates in sync with that charged by banking institutions to higher credits thus curbing the predatory practices in micro lending and keeping the healthy competitions among micro finance institutions. This would also allow the borrowers to access better rates via refinancing as their financial situation improves resulting in credit cure. These practices need to be borrowed from residential mortgage industry. The overall effect would be the expanding the credit operations of the microfinance institutions.

Conclusion: The birth and the growth of the micro finance industry has been a major breakthrough in serving the financial needs of the poor people across the globe. To protect the positive image of Microfinance sector as the savior of the needy and un-served poor, the micro finance institutions need to create some mechanism of self regulatory reforms and abide by those regulations to ensure the long term sustainability of the industry.

Jaipal Singh, Centre for microFinance, Jaipur

It is very timely discussion and interesting too. Hope it will also be useful.

Many friends have put their valuable ideas and I am sure the discussion is at least contributing towards educating all of us on the 'technical subject' like Regulation. I also have been thinking about it and wish to share my thoughts.

I feel that before deciding about the regulations for MF sector, it would be good to look at existing regulatory bodies like RBI, SEBI, TRAI, IRDA and others. How effective they have been to protect the interests of clients and what are the existing gaps. If these regulators are effective then how come there are still such large scale financial exclusion, how come 2G spectrum is sold at 10% of its market value, how come Harshad Mehta could play with 'intelligent investors'?. And we should remember that clients whom these regulators are protecting are largely literate and middle class people who can make noise and demand their rights.

Who is asking for the regulation of MF sector? Is it the investors in MFIs, or the MFIs themselves or the clients? I do not think MFIs are interested that someone should regulate them. In fact no one likes to be regulated. If they are willing to be regulated, it is only because they want the permission to mobilize public deposits. Clients want only protection from harassment from the staff of MFIs.

In my opinion there are four issues that need to be dealt with (through regulation or no regulation)

1. Rate of interest charged by MFIs - now do we expect that the interest rate can be regulated? When the demand is so much and so urgent, and banks have largely failed to provide credit to poor, they will take loan at whatever cost they can afford. Almost every state has their own 'Money lenders Regulation Act' but it is hardly enforced. Considering the vastness of country, it is

not possible to regulate it by a single national agency. In my view, state governments should gear up to enforce the money lenders act and they should make necessary changes in the act if needed.

2. Governance of MFIs- Every MFIs is already registered under some Act or other. All these Acts have necessary provisions to keep errant MFIs in check. So the need is again 'effective enforcement' of existing regulation.
3. Behavior of MFI staff – there is a civil procedure code, criminal procedure core and Indian penal code. If a bike rider without helmet can be booked, why can't a MFI staff abusing poor women be booked and put behind bars. What will a regulator do on this? Have they stopped recovery agents of so many private banks?
4. If MFIs are to be permitted to collect savings from clients or public then there will be need to ensure that the public money is safe and is invested in secure and safe place. For that RBI is already in place.

In my opinion, there is a need to safeguard poor clients of some MFIs. There are large numbers of MFIs who are working with good motive and with zeal to help poor. They should be protected from the regulator. The MFIs that are charging usurious rates, giving exorbitant returns to investors (at the cost of poor) and their owners are accumulating wealth, in any case are on the wrong side of laws. Existing rules can punish them if there is administrative and political will. I am afraid that by having a regulation, we may give such rogue MFIs a safe passage of escape. Many of these MFIs are saying that they are already regulated by one or other regulator.

I would suggest that in every state there should be an office of 'ombudsman' where complaints about MFIs can be taken and the ombudsman also takes suo moto action against errant MFIs. Also in RBI, Companies Registrar Office and in Home Department of every state, there can be a special cell/ or a nodal person to deal with such MFIs where problem emerges.

George E. Thomas, Mumbai

Article I. The world has seen enough of principle-based-regulation over the last decade and how lax rules/ lax implementation have shaken the mighty US market and created ripples the world over. We should not forget why the financial sector needs regulation!!

Article II. To keep all players healthy enough to perform their contractual obligations, regulators have to use macro level controls and ensure long-term financial solvency.
Products need to be standardized to help customers in evaluating players' promises of performance. This is important in the context of micro-finance and micro-insurance because the target population cannot easily evaluate the products.

There is an inbuilt opportunity for fraud and financial speculation when large amounts of public money are pooled up in a few hands for long periods. While entrepreneurs have to be adventurous for their own existence, excessive adventurism and speculative dealings are checked by regulators by insisting on prudential investment norms, transparent balance sheets, audit of accounts etc. Unregulated competition can weaken both the players and the system; players can be constantly reaching for other players' throats and finding ways of punching one another below the belt. Regulators prescribe common norms for valuation of assets, grievance handling systems, codes of ethics etc. to prevent such situations.

The two ultimate objectives related to microfinance are – the market grows and develops so that the society gets the desired benefits; and all the stakeholders get their due rewards for investing their money, time and efforts and also taking the risk as entrepreneurs.

Once the importance of these fundamentals is appreciated by the stakeholders, many other aspects of the discussion become only matters of detail and implementation issues.

G. Bhaskara Rao, Enable – APMAS, Hyderabad *(response 1)*

I complement Ramesh and the MF community for initiating this timely discussion. Now I am responding specifically on AP - MFI Ordinance. I may send more comprehensive response on all aspects of regulatory framework later on.

Andhra Pradesh has been the pioneer in both models of microfinance, i.e. SHG – banking model and commercial microfinance model. With issuing of an Ordinance to control the activities of MFIs in the state, AP became pioneer to initiate the much needed debate on various aspect of microfinance. I personally believe that any administrative controls on development activities would result in many costs to the society. The best way to control the MFIs is through competition. SHG – banking emerged as a wonderful model for effective financial inclusion. SHG – banking could have been a credible competitor for MFIs. But due to variety of reasons, it could not take off in many states and is facing number of challenges, wherever, it reached certain maturity. This is high time to introspect by all stakeholders in SHG – banking. As the present Ordinance was issued for AP, I have described briefly the current AP situation and some suggestions for the Ordinance in the following paragraphs.

The Government should work on completion rather than command and controls

Andhra Pradesh is known as the pioneer and hub of MFIs and SHG movement. With this Ordinance, AP also became the pioneer in MFI regulation and much needed discussion about various aspects of microfinance in India, including the alternative channels for microfinance, especially the SHG – banking. The purpose of this note is to raise certain questions for the debate on the subject and put the Ordinance in a perspective. The AP Ordinance does not address the real issues - (1) high interest rates, and (2) SHG women's compulsions for going to MFIs.

High interest rates

It is well known fact that MFIs are charging effective interest rate in the range of 30% to 40%. MFIs, which claim that they are working for poverty alleviation and for the poor, should explain, in which enterprises the borrower can earn 40% to 50% margins to repay their loans, without jeopardizing their financial well being. In the Ordinance, there is no cap on the interest. Perhaps it is beyond the jurisdiction of the State government. However, it did mentioned not to charge any hidden charges. Of course, as in all Government orders, there are some exemptions. The MFIs could add all their hidden charges to their rate of interest. The Ordinance has no provisions to prevent such practice. One potential benefit of having one interest rate, without any riders, is that it would enable the borrowers to know, what they are doing. The Ordinance could also insist for quoting the diminishing interest rate instead of quoting the flat interest rate, which is very common practice in MFIs. It, again, may enlighten the borrowers about the gravity of their borrowing from MFIs. The Ordinance did not touch this problem. However, the Ordinance has restriction that total interest amount should not exceed the principal amount. As almost all major MFIs collect their loan in fixed 52 weekly installments, the interest amount may not exceed the principal amount in normal cases. However, collection of loan in fixed 52 weekly installments, irrespective of loan size and purpose, itself might cause severe pressure. Loan repayment terms should be based on loan size and purpose.

SHG women's compulsions for going to MFIs

It is really surprising to any person, who is monitoring the progress of SHG – banking in AP that SHG members (of SERP & MEPMA) are going in large numbers for MFI loans. As per the macro data provided by NABARD, AP is far head of other states in SHG banking. In 2008 – 09, SHGs in AP got about 45% of total credit disbursed to SHGs (over Rs.12,250 cr.) by all banks in the country. Further, as per SERP reports, SHGs in AP are getting more loans and amount than reported by

NABARD. e.g. As per SERP progress reports SERP SHGs alone got over Rs.6,684 cr. credit from the banks in 2008 - 09 vis-à-vis Rs.5,509 cr. reported by NABARD for the entire state.

Further SHG federations in the state have about Rs.1,500 cr. corpus for lending to SHGs/ members. SHGs have about Rs.2,500 cr. of their own savings. But SHG members are still going for MFI loans at very high rate of interest. It implies that present available funds are quite inadequate compare to the needs of SHG members. Apart from this basic factor, there are many other factors aggravating the funds availability to the members. These include:

- To meet target pressures, the banks and field staff of promoting agencies (SEPP & MEPMA) are going for new loans for SHGs, well before complete repayment of old loans. They recover the balance of old loans from new loan amount. In this way the actual available funds for SHGs/ members are quite low compare to the reported macro data. Further, some banks are forcing SHGs/ members to purchase some insurance or other, every time a new loan is sanctioned. In facts some banks are directly deducting the insurance premium from the loan amounts. Some banks are also forcing the members to make a part of loan as fixed deposit. Because of these practices, the actual loan amount reaching the SHG/ members is substantially lower than sanctioned loan amount. Further, some banks, mostly RRBs, are not allowing the withdrawal of loan amount for 2 to 4 months, may be due to shortage of funds. However the fact is that credit – deposit ratio in the state is well over 100%. In RRBs, it is even higher, thanks to thriving SHG lending.

- In many federations, the primary members/ Board members are not able to manage their microfinance operations. They are heavily dependent on project staff to manage their microfinance. As there is little control by, and, involvement of, primary members in management of their microfinance, there are so many mismanagements and misappropriations. There are also issues of repayment.

- Though SHGs were started on the principle of 'saving first', over the years, the SHGs, effectively became credit management groups. There is no regular rotation of internal funds. Whoever, most probably the leaders borrowed first and are just repaying the interest part regularly. In some instance, even the interest is not being repaid. In overwhelming majority of SHGs, members do not know - what is their saving amount, where their savings are, etc. There is no return on members' savings. As a result members are just saving minimum amount regularly. There are no voluntary savings. Many SHGs return the savings to their members periodically. Some banks are forcefully impounding the SHG savings.

- Despite above described problems, SHG banking in AP is a resoundingly successful story, worth emulation in all other states. Members have been getting loans year after year without fail. This assured source of credit encouraged the members to invest higher amounts on their lives and livelihoods e.g. SHG members have admitted their children in quality/ high cost educational institutions. Many members have acquired assets like tractors, tempos, autos, bore well, land, housing, etc on credit. They need larger cash inflows (including credit) to meet their enhanced cash outflows. Last year, due to rumors of loan waivers, there was marked decline in repayment rates. It in turn resulted in low bank credit to SHGs. SHG members are forced to borrow from MFIs to meet their enhanced cash outflows.

Apart from above described cash flow related problems, there are many non-financial issues compelling the SHG members for going to MFIs. As per the available evidence, some of advantages perceived by members in MFI linking vis-à-vis AP/ SERP SHG model are described below.

Parameters	MFI model	AP/ SERP SHG model
Meetings and time required	No meetings and no thrift are required to get loans	In SHGs, SERP has imposed weekly meeting and notional thrift rate of Rs.10 to Rs.20 per week. The field staff used to recommend bank loans only to those SHGs, which opted for weekly meetings. SHG members are being used for all kinds of works like watershed, NREG, distribution of pensions, agriculture products procurement, NTFP trade, etc. and all kinds of meeting like celebrations of state functions, visits of ministers, higher officials, foreign delegates, VIPs, etc.
Loan processing	Simple	Complicated, lengthy and needs a number of person days
Quality of service	Door delivery of loan amount and recovery of loan installments. What SHG/ members need is the clarity about their loan amount and timeliness	SHGs, even in AP/ SERP have many uncertainties about their bank loans. These are: • Completion of documentation required professional support. There is an uncertainty about the availability of that support. • Bank loan amount and timeliness are not certain. • SHGs have to pay some money to many stakeholders every time to get their loan
Loan installments	Weekly	Though majority of SHGs in the state have weekly meeting, they have monthly installments. Some members, who have daily cash flow, want to repay their loans in very small and more frequent installments.
Savings	No saving is required	SERP has weekly nominal thrift rates. SHGs have to pay additional amounts for weekly book keeping. There are no internal controls and checks and balances to protect members' savings. There are no interest payment on members' savings
Ownership over people's institutions	No institutions to own	Though there is a network of about a million SHGs and federations, the sense of ownership is conspicuously missing on the part of primary members. The institutions from SHGs to district level federations are by and large externally driven institutions. A small proportion of leaders are also driving the institutions without real internal democracy.

Without addressing the above mentioned crucial issues, the Ordinance proposes to put restrictions on the functioning of MFIs and borrowers. Like most of the administrative control measures, this Ordinance may result in throwing out the baby with the bath water. The Government should focus on competition or strengthening of alternative channels to overcome the monopolistic and exploitative practices of MFIs. However, any democratic Government can not be a mute spectator to the exploitation of the poor and vulnerable sections. It is laudable that the Government has acted promptly to the problem. But given limitations of the State Government, the Ordinance has several limitations. At the same time, the Ordinance does not look fair and practical. Compliance of various provisions of the Ordinance may result in a steep increase in the cost of operations of MFIs, which may further add to the burden of borrowers. Some of shortcomings and possible suggestions are discussed below.

Existing Provisions	Suggestions
Appointment of PD of SERP and MEPMA as implementing authority at district level	PDs of SERP/ MEPMA have stakes. Appointment of them as controlling authority over their rivals is not justifiable. Further appointment of district level registering authorities is too cumbersome to comply. An Independent Authority may be created at state level to implement the Ordinance/ regulations over microfinance. The Authority may be empowered to review the restrictive practices of banks, SERP, MEPM and other stakeholders.
Restrictions on multiple loans and membership in multiple institutions	These are the strategies adopted by the poor to get minimum/ sufficient financial and other services. Without addressing the supply side bottle necks, as discussed above, restrictions on borrowers only add to their woes.
Prior approval from the Registering Authority for lending to members, who have active loans	This is cumbersome process, may fillip corruption. MFIs may force the borrowers to get those permissions.
Freezing of lending and recovery until MFIs get registered with district/ town authorities	Freezing of recovery may lead to the collapse of the MFIs in the state. Therefore, recovery may be allowed. If registration is not done within stipulated period, they may be prosecuted
Exhibiting of interest rates	The Ordinance must have provision to exhibit the diminishing rate of interest instead flat rate which is widely prevalent in the sector and potential to mislead the borrowers
Covers only SERP and MEPMA SHG members	It should cover all borrowers of MFIs

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G. Bhaskara Rao, Enable – APMAS, Hyderabad *(response 2)*

I totally agree with Smita that the regulatory frame should not be diluted for microfinance. Since the MFIs operate in the monopolistic conditions and deal with illiterate and gullible clients, the regulation should be more stringent. Such regulation should also be made applicable to banks and other financial institutions, which resort to restrictive practices (as mentioned in my previous posting) with their rural/ microfinance clients.

We should understand why our mainstream financial institutions are not able to reach majority of Indian people and provide MF services. According to me, there are two basic reasons -

- Banks are forced or compelled to cross subsidize their rural/ microfinance operations. Instead banks should be allowed to charge interest rate sufficient to cover their actual economic cost including average profit margin they get in other operations/ areas. I believe, those interest rates may not be so high, no where close to current MFI rates. Further the Government could subsidize the interest rate, as practiced in SHG – banking in AP, linking it to disciplined repayment. If the Government is providing subsidies worth lakhs of crores to oil marketing companies to keep down oil prices and fertilizer companies to keep down the fertilizer prices, why not subsidize the rural interest rates? Affordable credit is far more crucial to the poor to tie over lean periods and emergencies without jeopardizing their future. It will also fillip their economic activities.

We all know that rural credit, (be it cooperatives, be it loan waivers), became a victim of political manipulations and power games. Instead of loan waiver, farmers could have been helped through 'direct cash transfer'. Hopefully that the governments and politicians, in the future, will resist from measures which may result in larger social costs in the long run.

Badri Nath Tiwari, Grameen Development Services (GDS), Ajmer, Rajasthan

As we know that only small percentage from poor families are able to reach banks for their requirements related to microfinance services. But I am not sure that if our mainstream financial institutions will charge more rate of interest then delivery system will improve. I think, first of all we have to understand why banks are not proactive in financing the poor.

The procedures, formalities and accessibility norms of the banks are not in favor of poor. The product designs also need to be customized to the requirements of the poor. I agree that subsidies from Government should be given to Banks for micro finance services provided to the poor. The support from government will help banks to reduce the burden of operational cost. The investors in MFIs look for high returns on their equity at minimum risk.

I think that some sort of national regulation for MFIs should be there. The mainstream financial institutions are required to be liberal in the case of poor in order to make them Bankable. If we analyze the data of Non-Performing Assets (NPA) of any bank branch we will find that the maximum amount is blocked by the non-poor families. I suggest that the bankers should be more accountable to make the poor bankable and RBI should put a cap related to interest being charged by banks or MFIs.

Arabinda Mitra, Ghoragacha Swanirvar Samiti, Kalyani, West Bengal

MFIs are commonly run by NGOs or private bodies. Many of them have the permission of RBI for operating lending, deposit, savings operations, while others are doing business without RBI's permission. RBI stipulates certain norms for lending/depositing business. Many MFIs avoid those norms by applying various tricks. There should be some sound network to oversee the activities of MFs. I would like to mention that MFIs are not pro-poor rather they are friendly to middle class people who are having capacity to repay loans. In many cases they also serve the poor but after safeguarding their own interest. The reason of their presence is because banks or governmental institutions are not able to serve the poor in time.

Recently, I visited Chalaberia, North 24-parganas which is under MEPA program. I met several rural entrepreneurs in Chalaberia, who are engaged in pottery business. Those entrepreneurs often take loans from various MFIs paying high interest rates. When I asked them why they are not keeping touch with banks, they answered that it is easy and simple to take loans from MFIs. They can avail loan at right moment and of what ever amount they require. Our Banks are not competitive. They must be accessible to rural poor in time of need. I hope, if Banks become aggressive in their operation then MFIs will also reduce their rate of interest. I feel that stringent regulations will limit the access to funds available for the poor.

I am not against regulatory framework, but would like to stress more on the functioning of rural financial institutions.

A P Fernandez, MYRADA, Bangalore *(response 1)*

As a response to the query, I would like to share my article on the subject of Microfinance Regulations -

Is Micro Finance leading to a Macro Mess - the AP Ordinance

Micro finance started in 1966-67 with the Integrated Agricultural development Program and was adopted in several Govt. sponsored programs during the 80s and 90s culminating in the SGSY which amalgamated several of them. If several of these programs did not deliver as expected, the reasons were related to inadequate support services – especially in animal husbandry and agriculture , inadequate investment to support scaling up through aggregation, grading, adding value and marketing – AMUL being a major exception, corruption and poor targeting. Yet micro finance continued. The title of this article really refers to micro finance driven by pressures resulting from venture capitalists and other private investors which is characterized by quick growth, high profits, high cost (interest and remunerations especially for senior staff), IPOs and quick exits. This model is promoted aggressively by International Financial Organizations and is now rooted in India with the tacit support- so far - of financial authorities. I shall refer to this group as the Neo NBFCs involved in micro finance since they share a great deal with the neo liberals and International Organizations which promote their strategy. These Neo-NBFCs have become the dominant micro finance model between 2000 and 2010.

The justification for this Neo-NBFC model are primarily these: a) it is sustainable; b) it encourages self help; it is based on the neo liberal principle that the poor should lift themselves up by their bootstraps and by inference Govt. should keep at a distance; c) it has reached the hitherto excluded sector where the official financial institutions have not penetrated and do not show any signs of doing so due to increasing corporate pressures arising from amalgamations, core banking, shortage of staff at the Branch level and a focus on a single bottom line namely profit (there are no champions of the SHG-Bank Linkage model at high levels); this reason is the main one behind the hands off approach with regard to Neo NBFCs of some sections in Government at the National level; the flip side of this is that official financial institutions have quietly shifted their social responsibilities to the Neo-NBFCs; this is the prevailing sentiment especially at the lower levels; d) it attracts private capital- private capital directly or indirectly amounting to Rs. 2000 crore has flowed into the Neo-liberal sector ;this may be only 15%-20% of the total investment a large part coming from Commercial Banks but the influence of private investors on the Boards of these Neo NBFCs is far greater than that of the banks; and of late e) the share market supports the one Neo - NBFC that is listed and as long as this support continues, the investors also will do so.

High interest costs are justified because micro loans have high transaction costs and high risks. The best talent is required, hence high remunerations need to be paid which makes the Neo-liberal model a high cost one which the borrower finally has to bear. We are told that high interest costs can be reduced through technology and scale. All this sounds good - the right mix- especially since these Institutions were projected at least in the initial years as the real strategy for poverty alleviation. But suddenly the picture is becoming clouded due to several reasons which the media has highlighted.

The AP Ordinance, which is the Government's reaction to the changing scenario, refers only to the SHGs. In fact the Neo-NBFCs do not lend to SHGs; forming and training SHGs is too slow and requires up front investment in the form of grants or long term loans. They have instead formed Joint Liability Groups (JLGs) which experience has shown are neither joint or mutually liable or groups. Several policy makers in Government have supported the JLGs in preference to the SHGs since, the evidence shows, the JLGs are by far the quickest and cheapest way of disbursing credit. The SHGs require investment in institutional capacity building - which NABARD has supported since 1992; but it takes time - at least 6-10 months during which savings are promoted and internal lending starts before the Banks advance a loan. But today the name SHGs is a veil used by the neo NBFCs that covers (and justifies) many animals. In the long run however, the SHG model together with the SHG Bank Linkage is more sustainable especially for the borrowers.

To explain this a little further, we need to briefly trace the history and the concept of what a real SHG is. This history has been buried under media coverage promoting the fast growing Neo-NBFC model. Between 1984-1986 Myrada (an NGO) worked with the primary Cooperative Societies as the base institution. It realized that far from fostering the interest of all, the benefits went to a few powerful families including the President, Secretary and a few others. They borrowed at the official rates (6%-8%) and on lent to others at rates ranging from 30% to 40%. The poor were dependent on the powerful for jobs, immediate loans etc. Myrada encouraged them to challenge this situation., They broke away and formed small groups - the members were self selected; we later realized that the groups were based on affinity among the members. Affinity in turn was based on relations of trust and mutual support which existed before we entered. This was later called social capital and was the strength of people on which Myrada built. After several rounds of discussions they decided to return the loans they had taken from the Cooperative to their respective group. Myrada encouraged them to meet weekly; each member contributed to the agenda which comprised issues related to health, domestic problems, need for credit etc. They were encouraged to save and Myrada staff kept records of meetings and accounts. When they wanted money, they were encouraged to take loans from their savings which meanwhile had been deposited in a local Bank. These groups were the real cooperatives. Myrada approached NABARD in 1986 with a request to support this complimentary/alternate model.

NABARD provided Myrada with a grant of Rs 1 million in 1987 to train the groups how to meet, to participate, to analyze the society around them, to arrive at a consensus – it was called institutional capacity building (ICB). After several studies NABARD and Myrada came up with three recommendations for policy change to support the groups. The first policy decision was to allow Banks to lend to unregistered groups – this was based on the survey conducted by Myrada of its groups. They assured Myrada that they would function like registered groups but did not want to be registered – the reason? They feared harassment by petty government officials. Policy change in this area was difficult since the legal departments strongly supported lending only to registered groups. It was Dr Rangarajan, as Governor of the RBI, who in 1992 decided to accept this. He said: “let Banks lend to unregistered groups”. By this one stroke he liberated the SHGs.

The AP Ordinance completely overturns this historic decision. It requires all SHGs to be registered. However this is the result of the confusion cause by neo NBFCs between the JLGs and SHGs. I fully agree that the quality of the SHGs has declined due to Government’s policy of achieving time bound targets to form and disburse funds to SHGs. The pressure to lend fast together with the total failure to provide ICB has caused this deterioration in SHG quality. The SGSY allotted Rs 10,000 for ICB but it was never used for training a group. The solution is to invest in ICB, not to register SHGs in order to control them and impose standardized norms; after all the Cooperatives are registered; this has not improved their governance. The AP Ordinance primarily intends to control alleged excesses that have emerged in some of the Neo NBFC management; but it will throw the baby out with the bath water and in this case the wrong baby.

The second policy decision was to allow Banks to give one loan to the group allowing the group to decide whether and how to lend to its members. This was easier to push through in official circles. It reduced transaction costs - this encouraged the Banks. NABARD and Myrada welcomed this because it promoted the SHGs members skills and confidence. This was accomplished because the group was free to discuss and decide on individual loans. The dialectic of this discussion together with the ICB training increased their confidence to talk and gradually their skills to lobby for their rights and entitlements without resulting in open conflict with the power structure. However, it is necessary that the members of SHGs self select themselves on the basis of affinity. Unfortunately this policy of one loan to the group has been forgotten. Loans are given to individuals who happen to be in groups.

The Neo NBFCs do not advance one loan to the group; they advance individual loans and claim that the members are jointly responsible even though they are not inked by affinity. In most cases they are selected by the NBFCs often from various existing SHGs; further no ICB has been given – because this is time consuming and costly. Government policy to give different subsidies to SCs, STs and Minorities has further divided several genuine SHGs which comprise all these communities and undermined social capital which still prevails in Bharat.

The third policy decision was to lend without physical collateral; the affinity and training was considered adequate. This did not meet with much opposition. These three policy decisions have not been taken anywhere in the world. Due to them the SHG-Bank Linkage which was launched in 1992 by NABARD and nurtured by it thereafter progressed.

The need for supervision

Any financial institution especially the private ones using public funds from Banks need to be supervised. Concerned individuals have set up an apex organisation called MFIN - a self regulating initiative. But MFIN at most can black list those Neo NBFCs which do not fall in line with accepted norms relating to multiple lending resulting in large amounts which drive the client into deeper debt, to transparency in reports and acceptable behavior in ensuring repayments.

As long as the share market supports the Neo NBFC, MFIN can do little to enforce norms though they may have all subscribed to them. The RBI is the next possible institution that can play a supervisory role. But do the Neo NBFCs want to morph into Banks? They originally lobbied for this on the grounds that credit would become cheaper but of late they are silent. Is this because they are hesitant to have officials on their Board or to be subject to RBI supervision? The RBIs position on this matter is ambivalent. The Govt. of AP has come in perhaps as the supervisor of last resort with the ordinance; but experience has shown that Government intervention especially in the financial sector has had negative consequences all around- including a fillip to corruption - in spite of the good intentions of senior officials.

What can one suggest? All three perhaps have a role to play. MFIN can collect, aggregate and analyze data but it must also be free to meet the borrowers and verify reports. One sees no reason (apart from the costs in terms of time and personnel) why RBI cannot ensure that larger NBFCs in the micro finance sector conform to all requirements required of Banks. The State Government could intervene but not through the District Authority that the Ordinance proposes but through a fast track court (which the 0rdinance also proposes). The approach taken by NREGS to appoint Ombudsman at District levels could be an approach to adopt.

The AP Ordinance does not touch on interest rates. Flat - declining- effective interest rates are terms floating around. Each Neo NBFC interprets these differently. Yet flat rates of 26% are common among them. Official Financial Institutions hesitate to set a limit since they are apprehensive about being branded as supporters of non sustainable models or because it is difficult, they say, to monitor. But to be honest, if the clients are in the poor category can they really invest and manage businesses which earn a return of at least 80% to 100% if flat rates of 26% are to be paid. Are there any takers from the private organized sector for loans over 15%. Not for Profit MFIs with a low cost model have broken even and earned adequate surpluses at interest rates of 16% - 17% declining; why cannot the Neo NBFCs do the same?

A subsidized model not just for credit but also for creating wealth through up scaling, value addition etc., is required for inclusion in growth not just into the financial sector which is largely reduced to opening no frills accounts in Banks. Among the neo NBFCs and their institutional supporters, self help ideology has been interpreted to mean that the poor must pull themselves up by their bootstraps without any subsidized support. The burden is entirely on them. This model needs to be seriously questioned. Another emerging model in Vietnam which this author had the privilege of visiting is decried as non sustainable since it is heavily subsidized by the State. Vietnam based its approach on promoting financial institutions to cater to the credit needs at household level for better inputs, appropriate mechanization as well as at the secondary level directed at creating value through small scale processing, storage and packaging - these were small scale enterprises. These institutions were owned by the people or in partnership with government and they were low cost (no high salaries etc). Interest rates hovered around 13% declining. The impact has been a fall in poverty. It is not necessary to subsidize the cost of the assets but surely subsidized investment is required to provide the skills to manage then and for adequate support services for the asset to realize its potential for income generation. Subsidized credit is required to lower the risk to the borrower not to reduce the cost of asset.

Toms K. Thomas, Mutual Assistance Resource Group (MARG), Trichur, Kerala

I should congratulate Mr. Arunachalam for posting this important query to the community. As Microfinance is one of my interest areas and, I have been associated with a number of MFIs, I would like to share my views on the issues raised by Mr. Arunachalam.

In principle, Microfinance is the provision of a variety of financial services to low income families or solidarity lending groups including consumers and self employed people who traditionally lack access to formal banking related financial services. Microfinance covers not just credit as some perceive, but also the affordable appropriate financial services for the poor/low income families. Microfinance also keeps the belief that provision of financial services to the poor is the best way to address the issue of poverty. An analysis of micro finance history in India suggests that it had three major phases –

Phase	Period	Theory	Mission	Institutions
I	1980's	Profit. No Subsidy. High Interest. Individual Lending.	Credit to the Financially Excluded, Emergency Cash. Exploitation of Financial Need.	Private Money Lenders, Chit Funds.
II	Early 1990's	Profit + Social Transformation+ Trickle Down+ Subsidized Credit, Commercial Interest, Bank Interest. Individual and Group Lending.	Financial Inclusion. Cheap and affordable credit to the poor, Enterprise Development, Poverty Reduction.	SHGs, Commercial Banks, NABARD, Credit Linked Poverty Reduction Schemes like IRDP, DWCRA.
III	Mid 1990's & 2000's	FOR PROFIT, NBFC. Alternative Banking (New Breed as an alternative to Private Money Lender and Commercial Banks)	Mission Unknown! For Profit? Financial Inclusion? Poverty Reduction?	SHG, Grameen Bank Model, Micro Finance Institutions.

Need of a Regulatory body

Is further regulation of microfinance necessary? If yes, what kind of institutions should be regulated? And who should be the regulatory body and why?

Regulation is not an adequate solution for the present crises since regulation alone can not solve the present problems with in the Microfinance sector. Some questions connected to this argument are;

- What need to be regulated?
- Who should regulate? Is it RBI/NABARD or a newly formed independent entity?
- Do we have a competent entity to regulate the micro finance sector?
- Do we need to initiate a new competent entity?
- Can we call Micro Finance a Non Banking Financial Activity?
- If no, then what is the feasibility of NBFC framework for MFIs?

A Framework for Regulation

It is important to say that all the finance delivery channels are presently regulated in one way or the other. Both NBFC and NGO-MFI are somewhat regulated in one way or the other. Instead of regulation, I strongly feel that there is a need to sensitize MFIs about the principle of micro lending and its relevance in financial inclusion and national development, as an alternative bank. The question also remains unanswered that whether micro finance is a pure commercial business activity or a Social Enterprise / Social Business. What is Micro Lending all about? Is it a part of the requirement for Equity? These questions need to be answered before talking about regulation. Probably there is a need for a Reform in the sector since the sector some how is loosing its original mission and vision.

Regulation Levels

a) **Regulation at Investor Level:** Is this also a matter for consideration under MF regulation? Since financial inflow is important therefore the investment made by a variety of investors in MF also needs to be regulated and there should be a framework for investment which will adhere to the broader Micro Finance goals of the Country.

b) **Who should regulate?** NABARD was made as a regulator of MFIs in the former Micro Finance Bill. But I think there should be an independent agency under RBI that should regulate the MF Sector. A lead MFI needs to be identified on a rotating basis under the regulator who will monitor the adherence of regulations. Do we need a different legal frame work as such different from NBFC? Can MF be categorized under non banking activity?

Is MF Movement in indian context an effort to eliminate Money lenders? Do we need to think of stregthening the actors like private money lenders who are still a close to heart casuality lender for the poor.

Where is the Money Lender? Are we saying that the regulatory frame work should bring in all rural lending / financial activity like private money lending, savings and credit cooperatives, Chit Fund etc. under a common legal and regulatory framework? Are they also needed to be brought under the broader micro finance sector?

What about the idea of self-regulation? Will it work? What are members' opinions on these issues in the light of their own experiences with self-regulation (codes of conduct by Sa-Dhan and MFIs) in India?

Self Regulation – What? It is important to develop a frame work for Self-regulation. Organization like Sa Dhan could play a vital role in formulating a national framework provided Sa Dhan undertakes a role of an independent policy formulating organization. Self regulation at what levels as a financial retailer? What about the banker or the investor? What investors or the donors look for is also important since MFIs sustainability depends on provision of finance on a sustainable basis. Is there a need to develop a funding framework for MFIs?

Do we need a national regulatory framework for micro-finance encompassing all types of MFIs? What aspects (prudential, non-prudential etc) should be focused in the framework? Should the framework have any non-negotiable in terms of specific things to be done by the regulated bodies?

Yes. This might solve many of the present problems. The framework should include;

- Interest Base – there is a need for rating the MFIs Operations with regard to the location and clients. This will be a little different from the present rating mechanisms. PAR and the repayment should not be the sole determinant of MFIs success. Other social and economic indicators need to be brought in. We cannot blindly blame MFIs for being some times strict (or harsh) on repayment since it is insisted on them by the rating agencies which play an important role in raising funds (Investment). So an investment framework needs to be developed with in the goal of Micro Finance in the country frame work.

What Could Be The Base Of Interest Rate? How to Reduce It?

- Categorizing of Operational area – Rural, Urban and Semi Urban. Since the operational cost is different for different areas, an area rating might help in suggesting a feasible interest rate.
- Lead MFI: In each of the district, an MFI could be selected as a lead MFI. They should control other small MFIs in the district. If there is none, a Rural Bank could be authorized to act as a lead MFI.
- Packaging and Innovation: Packaging of Micro finance products could be a mechanism to reduce cost of operations. Introducing innovative delivery channels will also be useful. I think in packaging the operational mix, organizations like Hope Foundation in Palakkad (Kerala) is worth studying.
- Joint Operations: Is it possible? This is another method to reduce cost.
- Cost of Transformation, Rating and Training: NGO-NBFC Transformation is an expensive activity. Organizations like Sadhan should think of technical support to MFIs in this at a reduced cost. This cost also is ultimately transferred to the clients. Is NBFC is the appropriate legal framework for MFI?
- What is the role of SHG Federation? What is their stake? Could they be a reliable economic delivery channel for MFIs where cost could be considerably reduced? How to build the capacity of SHGs federation?

What kind of supervisory mechanisms (On-site, off site, third party etc) are envisaged? What checks and balances would be required for the proposed framework to be effectively implemented on the ground?

The supervisory mechanisms needs to be developed at following three levels –

- Client level
- Provider level
- Investor level

Different mechanisms required to be developed at these three levels.

Capacities Required

What capacities would be required to effectively implement such a regulatory framework?
Capacities required may include:

- Knowledge of Micro Finance Principles and Theory
- Efficient network and data support with regard to the MF clients
- Decentralized regulatory framework
- A Common Channeling of Funding
- A Lead MFI at the district level

Besides the need for a National Regulatory Framework for micro-finance, I also feel that we need to ensure that MFIs adopt good Corporate Governance Practices. I would also request members to provide their suggestions regarding this. Since I do not see MFIs operations from a pure corporate angle, the sector is in needs of good governance rather than corporate governance along with promoting the best financial practices. We all know that corporate governance is not the same as Good Governance. There is dearth of documentation on Best Practices in Rural Finance / Microfinance.

Some Final Observations

Another question regarding regulation is that whether regulating the MFIs is sufficient? What about other channels like Money Lenders? What about the interest rates with in the commercial regulated banking framework? A car loan is easier and less expensive (8%) compared to education loan (12%). We need to sensitize the big brothers the role of banks in national development. Are the so called Regulated Banks, regulated enough? Are they transparent? I can give you my own story of a housing loan which I availed a few years back. I borrowed home loan on flexible interest rates. Bank is now providing new loans at 8% while I am paying over 9% interest on my loan. Although, any increase in interest however is immediately affected.

Emergence of MFIs suggests the over all failure of formal banking system across the globe in larger inclusion. It is unethical to bluntly blame MFIs in the name of regulation since government is more or less unclear on how to regulate. It is important to note here that MFIs and private banks together made banking more or less accessible to the poor. Within a high risk lending framework the micro finance sector is doing its best.

Finally if no MFI, do we have an alternative banking channel ready with us? Is our formal banking system capable (or committed) to provide access to finance to all? It is definite that Micro Finance sector require innovation where packaging of different subsidiary / complementary products is explored to reduce the operational cost.

Ramesh S Arunachalam, Independent Micro-Finance Practitioner, Chennai *(response 2)*

You may find this of special interest. Some proposals towards incentives as part of the regulatory framework in India: Never Waste a Crisis - Use It to Get Micro-Finance in India Back on Track: Some Proposals for Incentives As Part of A National Regulatory Framework: http://microfinance-in-india.blogspot.com/2010/11/never-waste-crisis-use-it-to-get-micro.html

You may also be interested in looking at:

The Key to Getting Micro-Finance in India Back on Track Lies with Establishing the Right Incentives for Various Stakeholders...Part II, Client Perspective:
http://microfinance-in-india.blogspot.com/2010/11/key-to-getting-micro-finance-in-india_21.html

Expectations Rise as the Hon Finance Minister of India, Shri Pranab Mukherjee, Waits for The Report of RBI Board Sub-Committee on Micro-Finance:
http://microfinance-in-india.blogspot.com/2010/11/expectations-rise-as-hon-finance.html

The Key to Getting Micro-Finance in India Back on Track Lies with Establishing the Right Incentives for Various Stakeholders...Part I: http://microfinance-in-india.blogspot.com/2010/11/key-to-getting-micro-finance-in-india.html

The Zahera Bhee Case Study: http://microfinance-in-india.blogspot.com/2010/11/can-we-bring-back-ayeshas-ammy.html

Effective Interest Rates in Andhra Pradesh: Results from an April 2010 Study: http://microfinance-in-india.blogspot.com/2010/11/effective-interest-rates-in-andhra.html

Analysis of APMAS April 2010 Study on Effective Interest Rates: Further Evidence For Multiple Borrowing in Andhra Pradesh: http://microfinance-in-india.blogspot.com/2010/11/analysis-of-apmas-april-2010-study-on.html

APMAS Study in Nellore District Indicates Significant Borrowings by (Default) SHGs From MFIs: http://microfinance-in-india.blogspot.com/2010/11/apmas-study-in-nellore-district.html

MFIs May Seem to Have Lost the Battle But They SURELY Can Still Win the War!: http://microfinance-in-india.blogspot.com/2010/11/mfis-may-seem-to-have-lost-battle-but.html

Evaluating MFI Internal Control Systems: Some Strategies for Regulators and Supervisors: http://microfinance-in-india.blogspot.com/2010/11/evaluating-mfi-internal-control-systems.html

Strengthening Internal Controls During Turbulent Times: What Should MFIs and Regulators Do?: http://microfinance-in-india.blogspot.com/2010/11/strengthening-internal-controls-during.html

What is Coercion in Repayment; A Client Perspective from Indian Micro-Finance: http://microfinance-in-india.blogspot.com/2010/11/what-is-coercion-in-repayment-client.html

Thanks again for your valuable replies and please do offer some comments on the proposed (suggested) incentives.

T Vanitha, BASIX, Andhra Pradesh

I agree with Mr. Jaipal, now a days every body is asking about MFI regulation, already MFIs have self regulation (created MFIN) and serving according to that mission. However, in MFIN also few companies are working for only their profit, not for the service. Because of these companies others are facing so many problems at the ground level. Especially AP Ordinance is a very big issue for the sector. As per the ordinance there is a lot of emphasis on the Government's interference in day to day transactions of the MFIs. This in return will effect the smooth functioning of the MFIs as they will not be able to serve their customers.

Moreover, because of this MFI staffs are facing lot of problems in villages and our staff is also demotivated. Nearly 25,000 people are working in this sector and no body is thinking about their lives and livelihoods. Even media (paper and electronic) is reporting the negative side of the microfinance, despite its benefits and lot of positive work.

R. Ramachandran, Association for Development through Integration and Cooperation (AICOP), Cuddalore, Tamil Nadu

I am a founder and secretary of a small NGO. With available resources our organization is working in two blocks in Tamil Nadu under Mahalir Thittam having more than 2000 SHGs. But now days many MFIs are entering in to lending the women without keeping in mind the requirements of the loans in the area. Because of such methods we are suffering in linkages with banks. Earlier the groups that were linked with the banks have started taking loans from the MFIs as well. This has disturbed the activities of the organizations that had 10-20 years of field work in development activities. While looking at the aspects of regulating the MFIs we should also look towards the need that MFIs while expanding their work should not disturb the existing NGOs.

Savita Shankar, Lee Kuan Yew School of Public Policy, National University of Singapore, Singapore

Further to the query on National Framework for Microfinance Sector, I would like to share an article on the recent developments in Indian microfinance. To read the article, please visit: http://epaper.dnaindia.com/newsview.aspx?eddate=11/24/2010&pageno=10&edition=9&prntid=129512&bxid=30696276&pgno=10

Ramesh S Arunachalam, Independent Micro-Finance Practitioner, Chennai *(response 3)*

Many thanks for the very useful suggestions and analysis. I would be grateful if the community members look at the aspect of governance and regulation specifically and send in some replies. Thanks and the following may be of interest to you in this regard.

The Governance of Risk Management in MFIs: Lessons from The Andhra Pradesh and Indian Experience
http://microfinance-in-india.blogspot.com/2010/11/governance-of-risk-management-in-mfis.html

The Governance of Remuneration in Indian MFIs: Lessons from The Indian Experience
http://microfinance-in-india.blogspot.com/2010/11/governance-of-remuneration-in-indian.html

Who Are The 'Rogue MFIs' That Have Supposedly Caused The Andhra Pradesh Micro-Finance Crisis? http://microfinance-in-india.blogspot.com/2010/11/who-are-rogue-mfis-that-have-supposedly.html

The Emergency (Liquidity Bailout) Fund for The Indian Micro-Finance Industry: A Great Chance for The RBI to Take CONTROL!!!
http://microfinance-in-india.blogspot.com/2010/11/emergency-liquidity-bailout-fund-for.html

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Harish Chotani, Resource Consultant - Microfinance and Livelihoods Promotion, Gurgaon

The roots of microfinance and poverty are connected whilst the stem of both is "Human Element". It's the compound of social and economic deprivation that needs attention of various stakeholders from the government, private and non government sectors to employ focused resources that must be 'outcome and impact' oriented focusing on the poverty. On this accord, it becomes even more demanding upon MFIs (NBFC, NGOs and others) to provide products and services with conscious mind that is 'catalysing in uprooting poverty among its cliental. This conscious mind among the providers of microfinance services must ensure that '**mere access'** is not the only objective but other critical factors mutually perceived between the service providers and clients are also taken into account such as '**affordability and sustainability' by clients** i.e. ability to pay back and still allow growth in business/household assets for safety nets, are part of the service spectrum.

Although ongoing discussion on 'National Regulatory Framework', is indeed pertinent for ensuring standards, controls and perceived seriousness to allow regulated growth in the microfinance sector. The need for this is long over due as so many countries including our neighbours from the Central Asian region have already gone ahead with the legislation. Hope the recent revelations happened in Andhra Pradesh will prompt our government to take quick and prudent steps rather than limiting these discussions over the media.

In the back drop of the growth and immense experiences that the microfinance sector has demonstrated, we must very seriously take into account the demand and supply as well as critical elements emerging from the SWOT spectrum, so that the final version of the regulatory measures are not just limiting to reporting statements with enormous transactions, but is based on the core of microfinance for the poor which is unique to regular commercial based financing. It is also pertinent to note that there are various forms of MFIs e.g. NGOs, NBFC, Cooperatives specific to urban and rural, Federations driven by SHGs membership, Credit Unions etc. However, the following principles may also be essential for objective regulation:

1. Statutory Accountability is regular and comprehensive that leads to transparency and good governance;

2. Regulate the outreach in terms of geographical growth, financial deepening, regularity of services, other qualitative aspects including seeking clients' feedback so that to service delivery is well balanced on the demand and supply elements and is not mere an ambition to grow in scale (number of clients, branches, across states, sum of portfolio etc;

3. The trends emerging out of the regulatory practices are also interwoven to policy reviews, structural adjustments and financial resources mobilisation including venture capital funds, resources allocations, and interfacing with the larger poverty agenda.

4. Finally, the above three principles enable establish **Ethical Microfinance Services (EMS)** where the interests of the **'Service Providers' (SP)**, and the **'Service Users' (SU)** are balancing the demand and supply with poverty focus rather than mere scale focus.

Along the sphere of the regulatory framework and mechanisms, the emerging trends in the microfinance sector also take us to a number of hard core and soft core factors for micro review with **"Full Conscious Spirit"** than egoistic belief of **"All is well".** As we all know that the first rule of any game is **'Ethical Engagement' (EE)**. One essential question to put it upfront in this case would be: **Has the poverty been impacted along the enormous scale up that the microfinance sector has experienced especially in the last one decade**? i.e. to critically review the intrinsic relationships between and among the aspects such as:

- **Upscale** - Number of clients, portfolio valuing Crores of rupees, Number of branches in relation to outcome and impact achieved at clients and households level;
- **Accessibility** based on the poverty spectrum i.e. rural, urban, vulnerable, poor;
- **Affordability-** financial elements in terms of opportunities to get return on investments through viable livelihoods; and
- **Sustainability** of clients' financial and non financial health is as important as quality of portfolio for MFIs (in the present context former is nearly non entity)

Unless the above are appropriately balanced with specific focus on the 'Poverty Lending Service Delivery' the MFI may have achieved operational and financial sustainability, usual regulatory prudence may have also been complied with when enacted, but the vision and mission of microfinance would remain unaccomplished. As we all know that formal financial institutions given the mandate of delivering products and services, some directly and others through the MFIs, are periodically regulated, but we are still experiencing the core gaps of scale and outreach, financial deepening, outcome and impact issues etc. Surely, we do not want similar regulation for the MFIs that becomes statutory event only.

I would like to share with you a short story of a moneylender and his client. A money lender offered to his client two options- (i) he will pardon his loan if he (client) marry his daughter with him (moneylender), (ii) if not, he has to pay the loan as per schedule. To decide this, the money lender also offered a so called democratic process which was to pick up one of the two stones from a bag. One of the stone was black that attached to option one (daughter marry and loan waiver) and the white stone attached to option two. Daughter was asked to pick up one of the two stones. Whilst picking up the stones, the moneylender had picked both the stones in black, but the daughter had noticed the cunning trick. However, she decided to go along with the preposition and picked one stone but purposely tumbled and fell on the ground and opened her palm to let the stone mingle with other stones on the ground. So, she asked the moneylender to decide the deal based on the second stone which was black and option one prevailed. So, she saved her own life as well as of his father's debt.

The moral of the story is that we need to ensure that service providing is well regulated and ethical; and that the user of the services are "adequately literate".

N. Jeyaseelan, Hand in Hand, Chennai

I would like to share the following with regard to the MF regulations.

- Only one regulator for the sector: MFIs of all legal forms (societies, trusts, co-operatives, Section 25 Company and NBFC) be brought under one Regulator for Microfinance.

- Formation of regulatory authority: The MFI practitioners are not able to come to a consensus on who should be the regulator either RBI or NABARD. The earlier bill suggested NABARD as the regulator and NBFCs were kept outside its purview. Hence, the Government shall form a new Regulatory authority with officials taken from RBI, NABARD, SIDBI and also from Market. The Regulator should be made as a full professional body.

- Governance of Regulatory authority: The board should have majority independent Directors apart from nominee directors from RBI, NABARD and SIDBI.

- Registration of MFIs: As the NABARD is having its District Development Manager (DDM) office at every district and the DDM are well aware of the SHGs and NGOs, the Bill shall mention NABARD DDM's office as local authority for registration of MFIs.

- Risk based supervision may be put in place. Those offering credit only will be under lesser supervision. But, those offering credit and savings will be required to undergo more prudential norms.

- Regulatory capital: The draft bill prescribed a limit of Rs.5 lakh so as to give space to smaller MFOs. But, as mobilizing thrift is a risky one, higher net owned funds may be prescribed as follows.

For MFOs doing only mf services other than thrift- Rs. 5 lakhs
For MFOs doing any mf services including thrift service-Rs.25 lakhs.

- Governance: The Regulator should bring out guidance on Constitution of board of MFIs. Board of MFIs should have varied expertise ranging from Banking, Finance, HR, Legal, Strategy, gender, community development. Adding Nominee directors from financial institutions should be made as compulsory.

- Credit Bureau: Right now, credit bureau access is open only to MFIN members, which are NBFCs. The Government and IFC shall invest on a common Credit Bureau that will take care of the entire sector including the small NGO MFIs. Credit bureau with the participation of just big players will not serve the real purpose. Banks also should share their data on SHG direct linkage to CB

- Redressal mechanism: The draft mentions that if deemed necessary, MFDC may appoint MF ombudsman. It should be changed so as to appoint MF ombudsman to every state level, as the problems that will come to ombudsman will be diverse from regional context.

- The regulator should impose the interest rate ceiling. But, the cap should be based on the average cost of funds, cost of operations of a typical MFI in a specific regional context. Two set of rates may be prescribed i.e. one for MFIs below 3 years and another one rate (slightly lower than the first one) for the MFIs of 3 years and above.

- District and State level Steering Committees: The regulator shall provide for formation of district level and state level committees. In district level, all NGOs operating in the district will be the members in the Steering committee, where bankers and Government officials also will be coming. The meetings will be monthly. The forum will discuss the problems and will take up the disciplinary cases regarding the MFIs violating the code of ethics.

State level forums will have selected NGO-MFIs, Bankers and Government officials meeting once in 3 months and will address policy issues.

- Regulator will come out with a Code of Conduct for MFIs.

The above suggestions, if taken into account in the bill, will enable the sector to overcome the challenges.

Ramesh S Arunachalam, Independent Micro-Finance Practitioner, Chennai *(response 4)*

Thanks for all of your responses and also addressing the Governance issue. I look forward to more responses on the same. You may be interested in looking at this:

Outsourcing and The Use of Agents in Indian Micro-Finance and Regulatory Implications: http://microfinance-in-india.blogspot.com/2010/12/outsourcing-and-use-of-agents-in-indian.html

The Role of Independent Directors in Enhancing Corporate Governance in Indian MFIs: Specific Issues That Need To Be Examined By The RBI Board Sub-Committee: http://microfinance-in-india.blogspot.com/2010/11/role-of-independent-directors-in.html

Why Did Several Top Indian MFIs Grow Very Rapidly During April 2007 to March 2009: 4 Scenarios for Hypothesis Testing By The Reserve Bank Of India Board Sub-Committee on Micro-Finance!: http://microfinance-in-india.blogspot.com/2010/11/why-did-several-top-indian-mfis-grow.html

Improving The Governance of Compensation in MFIs: Four Practical Strategies Based On The Indian Experience:
http://microfinance-in-india.blogspot.com/2010/11/improving-governance-of-compensation-in.html

The Proposed Credit Bureau for Micro-Finance in India: A Great Idea But Let It Not Be Baptism by Fire!: http://microfinance-in-india.blogspot.com/2010/11/proposed-credit-bureau-for-micro.html

The Governance of Risk Management in MFIs: Lessons from The Andhra Pradesh and Indian Experience: http://microfinance-in-india.blogspot.com/2010/11/governance-of-risk-management-in-mfis.html

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Ramesh S Arunachalam, Independent Micro-Finance Practitioner, Chennai *(response 5)*

Many thanks for the wonderful and highly informative responses on the regulation query.

I have compiled some lessons for regulation from the current crisis and this may be of interest and use to you all.

Views, Issues and Initial Lessons on The Regulatory Front From The 2010 Andhra Pradesh and Indian Micro-Finance Crisis:
http://microfinance-in-india.blogspot.com/2010/12/views-issues-and-initial-lessons-on.html

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Ramesh S Arunachalam, Independent Micro-Finance Practitioner, Chennai *(response 6)*

The issue of interest has always been a debatable one and I think that policy needs to look at several issues before deciding on what interest rates are appropriate.

I would be grateful if community members respond to the interest rate issue from a regulatory perspective and please look at the following as well

Understanding Micro-Finance Interest Rates: Some Fundamental Issues For The RBI Sub-Committee to Consider...: http://microfinance-in-india.blogspot.com/2010/12/understanding-micro-finance-interest.html

There is also the issue of some level of regulatory failure in every crisis and you may be interested in looking at this as well.

Learning From Crisis Situations: A Comparative Analysis of 2010 Indian Micro-Finance Crisis With Two Past Crisis Situations...:
http://microfinance-in-india.blogspot.com/2010/12/learning-from-crisis-situations.html

Views, Issues and Initial Lessons on The Regulatory Front From The 2010 Andhra Pradesh and Indian Micro-Finance Crisis:
http://microfinance-in-india.blogspot.com/2010/12/views-issues-and-initial-lessons-on.html

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A P Fernandez, MYRADA, Bangalore *(response 2)*

The focus of concern during the recent past has been on the risk to MFI-NBFCs. Several articles have appeared on the need for MFIs to give priority to risk assessment and management, to insurance, to provide for political risk and to securitize their portfolios, but very little has appeared on the risk borne by the clients - until the reported suicides brought their risk squarely into the political domain. This note focuses on the risk borne by clients.

But first I would like to make my position clear and distinguish between two groups: The **first group consists of the poor who need credit plus other opportunities for livelihood activities to survive**. These activities largely include a mix of dryland agriculture, farm and plantation labour, small trading, animal husbandry, cottage industries and collection of forest produce. My position is that the poor need some extra investment in order to go beyond survival and enter into the growth trajectory. These opportunities are provided by all round growth in the area due to investment by private or public sector and by NGOs to reduce risk and increase productivity in agriculture related livelihoods, to provide health, education, infrastructure and industry etc. This extra investment also has to take the shape of institutional support- like the SHGs at the base which provides the poor with the space to set their agenda to support their livelihood strategy which comprises several activities, as well as with the skills, confidence and linkages to use the opportunities provide by all round growth and to neutralize oppressive power relations arising from local power structures and gender. This extra support cannot be given as a short term credit at commercial rates where repayments are fixed by outsiders. It requires a degree of subsidy not of the assets but of the services required to support the livelihood strategies of the poor and for institutional capacity building (ICB) so that the SHGs function as genuine participative and membership institutions. This requires a long term perspective.

I do not think the business model of the MFI NBFCs which is driven by venture/private capital, quick disbursements, weekly repayments, high profits and remunerations for senior staff, a focus on valuations and IPOs and a quick exit in appropriate for this group. It increases their risk, often beyond a level that they cannot bear. The SHGs and the SHG-Bank Linkage Model (as it was originally conceived) is to me the appropriate strategy for this group. The affinity among the members provides the pressure for recovery and their savings provides the space to adjust repayments when a member has a genuine problem with cash flow. In Myrada's experience, interest rates from groups to members also fall from 20-24% to stabilize between 12 % to 14%.

The second group is not poor; their livelihood strategy largely includes non farm activities; but they cannot grow to meet their aspirations without access to credit even at market rates. They cannot get this credit from banks because they do not have land records or fixed assets like houses to provide security and no credit history. They do not have the confidence and skills required to negotiate with banks if they need credit for activities in the non-farm sector and do not have access to working capital from official financial institutions. Unlike in the agricultural sector, there are a few Government sponsored schemes which are really working that support this group. They rely on private credit from relatives, friends and finally moneylenders –all at differing interest rates. Of course borrowing from relatives involves an obligation to lend them when their need arises. The business model of MFIs can meet the needs of this group provided profit is not maximized at which level there is little difference between them and the moneylenders. In maintaining a balance, good governance of the MFI can play a greater role than regulation; but evidence indicates that good governance is in short supply. The major problem is that MFIs will need security to back their loans to this group. The MFIs and the borrowers do not have the time or resources to invest in forming SHGs where internal pressures to manage and repay loans operate. The JLGs will not function for long if one member fails to repay. The security will have to take the shape of assets. Most of the families in this group have some gold which they pledge against loans. This is why those Financial Institutions dealing in gold loans are growing so fast.

The words "marginalized" and "excluded" in this paper include both groups the poor and the not poor who have no access to credit from the official system. Of course there is a group that does not fall clearly into either of these categories but in a way has features of both. We will leave this group out for the moment.

This distinction between the two groups is relevant to the current debate due to the following: Over the past few years the MFI NBFC model was held up as the most effective in promoting rapid financial inclusion of the marginalized. Both groups mentioned above were included in this term. The current crisis shifted the focus to the SHG approach and the SHG-Bank Program. Some say that this is the only approach. To me it is the appropriate strategy to address the hurdles that are in the way of the poor to be full included into growth (not just into the financial system). The SHG model has features which do not make it an effective model for fast disbursement of credit. It is not appropriate for this second group which needs credit. The hurdles in the way of the second group do not arise from lack of confidence of skills or linkages; they arise from lack of infrastructure water roads and power, from a corrupt government service delivery system and from lack of working capital. The MFI loans to this group are used both for investing in income generating activities as well as to purchase consumer items including gold. The temptation to borrow in excess of their capacity to repay is strong, especially when there is sales pressure from several MFIs who come to their doorstep.

Others say that both models (MFIs and SHGs) as well s the third - the moneylender are appropriate without making this distinction between the groups This is a “chairman’s approach”. They are appropriate but to respective groups.

Let us now revert to the risk for borrowers - primarily borrowers in the first group of the poor but also in the second group where the borrowers have succumbed to the temptation to borrow from several MFIs - multiple borrowings. They are locked into a cycle of regular repayment. Together this excess borrowing and cycle of repayment also increases their risk considerably especially when their cash flow is interrupted.

Risk and the official policy promoting inclusion: Inclusion of the poor (the first group) into the formal financial system of the country involves considerable risks and costs on their part. The SHG model was an attempt to lower this risk and costs for the poor by providing an intermediary institution which the poor managed. Profits to the Banks were low; they were satisfied since the program was categorized under the priority sector and repayments far exceeded those under previous programs like IRDP. **But the MFI/NBFCs have not included the marginalized into the country’s financial system as they claim. They have in fact included them directly into the international financial system which is not only inappropriate as a first step but raises the level of risk that clients have to bear**. The international financial system is driven by venture and private capital whose DNA is characterized by high profits, high cost (interest, salaries and commissions), IPOs, quick exits and frequent and regular repayments on the part of the borrower. These are the features of the MFI/NBFC business model. This raises the level of risk to both categories of clients considerably.

Between 2003-2008 integration of the country’s trade and financial sectors with the world economy grew steeply and quickly. The main concern of the RBI during this period was to **manage** this integration. The RBI cautioned that it should go slow; words like “calibration”, “a road map”, “step by step “were used. Alongside, initiatives were taken to strength the country’s institutions before this integration was speeded up in order that they could cope. The RRBs were consolidated, efforts to revive the Cooperatives rural and urban were taken, a Working Group was set up and a plan drawn up for restructuring long term lending institutions for agriculture. The pressure from other Government sources in the country however was to move faster with this integration on the belief (mistaken, I think) that the impressive growth rates achieved were almost exclusively due to opening up of the trade and financial sectors to the world economy. The RBI’s step by step approach gave time for the country’s financial and trade institutions to cope with the pressures of integration.

Unfortunately the RBI did not take the same approach with regard to the MFI-NBFC’s in their rapid growth on the grounds that it was urgent to integrate the poor into the international financial sector. The RBI took actions- but they related to plans for extending financial services into the interior (Business Correspondents and Facilitators and use of technology), removal of caps on interest rates (Banks could charge commercially viable rates for priority sector loans below Rs. 2 lac) etc. The RBIs focus was on pushing the official financial system further into the interior on one hand and, on the other, a “hands off” approach as far as the MFI-NBFCs were concerned, encouraging them at most to “self regulate”. “Soft regulation” of MFIs was the policy that gained ground, because it was assumed the MFIs are local, community based organizations which they are not. This lack of regulation/direction increased the risk of the marginalized that were “included” by the MFIs.

The induction of venture and private capital into the MFIs in a major way during the past three years is primarily responsible for raising the level of risk to clients. Venture/private capital seeks to maximize profit and to do it quickly. Their mission is to take high risks and they expect to be rewarded with high and quick profits. The investors argue that since they do not use debt, they should not be regulated. None of them in the US has asked to be bailed out. This makes good sense.

But by including the marginalized into this sector the pressures created by these features (high risk /high reward) are passed on to the client which raises the level of their risk. Multiple borrowing is resorted to as a first step out of this situation but this cannot last and there comes a stage when the client can no longer bear it. The SHG Bank Linkage program was brought under the priority sector to encourage the banks to promote the flow of credit to the poor, but the SHGs provided a safety net. Once Banks lent directly to MFIs they ended up pushing money and going along uncritically with the culture and practice of the MFIs which used Bank's finance to include the clients more deeply into their neo liberal model. The Banks were only concerned with the level of repayment which was good and which gave them the leverage that their performance in the priority sector provided. As long as the repayments were good, the MFIs were encouraged without any attempt at regulation.

Risk and focus on speed to 'include' by disbursing credit (and by implication to include). Speed to disburse is the dominant feature both of the neo liberal model of the MFIs and also of the SHG model after it was adopted by the Government as part of its official strategy to mitigate poverty, fortunately high profits and remunerations were not part of the Government's strategy. The SHG Bank Linkage Model grew slowly till 2000 and with adequate investment in building the institutional capacity of the SHGs before Banks loans were extended. When it became part of Govt. policy in 2000, pressure was exerted by dedicated Government officers at the District to grow fast and achieve targets. As a result, the quality of SHGs declined and so did their performance in mobilizing savings, in deciding on loans (equal distribution became common), managing repayments (NPAs increased) and in building a supporting environment for a livelihood strategy. SHGs were formed to achieve targets, with the wives of the Panchayat president and secretary dominating proceedings; they borrowed from Banks and lent outside at higher rates; other members did not benefit while repayments to banks was good. Official reports focused only on disbursements; corrective measures were taken to balance the spread in areas where growth was slow but no investment was made to add value or to support increases in productivity and diversification. No priority was given to form SHGs on the basis of affinity where the poor members were identified in public and then had the freedom to form SHG by self selecting their members. Very few SHGs were provided with institutional capacity building so that all members participated in decision making. All this took time; the Government was in a hurry to disburse and include.

The SHG is not a good model for speedy disbursement of credit; but it is a good model for lowering the risks of the borrowers as well as the lenders. The SHGs have savings which they use to cushion irregular cash flows; they are able to adjust to urgent and unexpected situations, yet Myrada's analysis of its SHGs shows that their common fund increases year on year. The MFIs do not work with SHGs as forming and nurturing them takes at least 3-6 months before loans can be extended. This is too slow. They claim that they work with Joint Liability Groups. If the members are jointly liable, why does the staff of the MFI have to exert pressure on clients for repayments? One MFI when asked which groups it was working with came up with a new one "SHG-JLG"; it had promoted 20,000 in one year! Speed is the order of the day and the message from the Govt. supports a faster level of integration in both systems – national and international.

The impact of the focus on speed on the MFIs operations is logical. The velocity of money plays a major role in generating profits. So they insist on weekly repayments. This increases the borrowers risk and vulnerability to local power groups. Incomes from agriculture are lumpy not weekly; incomes from animal husbandry are usually monthly. Clients are forced into activities earning daily like labour or shops or into a pattern of multiple borrowing where they have space to borrow from one and repay to another. In fact my experience is that both multiple borrowers and MFIs who are lending to the same individual are happy to continue. The former use multiple borrowing as a safety net and the latter finds that it keeps the velocity of disbursements and repayment high. One practice that contributes to this is that borrowers hardly ever repay the entire loan before their loans are topped up. However if their source of income collapses, if their borrowings are largely used for consumption

(as is the case with MFI loans since the clients cannot find investment opportunities to absorb the credit flow) and if the pressure to maintain the schedules of repayment continue as before, the pressure can become unbearable.

Risk and Interest rates: High interest rates are justified, the MFIs argue, because the risk of lending to small borrowers is high, the cost of delivery at the doorstep is high and finally the rates are far less than those of the private moneylenders. But high interest rate to the poor in the first group increases their risk. More significantly, the claim that there is high risk involved does not seem to fit the over-all picture which shows high profitability. The State of the Sector report 2010 (N. Srinivasan) indicates that out of 60 MFIs which reported on profitability, six had ROAs over 7%; thirty five had ROAs over 2%. In contrast the public sector banks in 2009 had average ROAs of 0.6% with the best being 1.6%, while the best private bank had ROAs of 2%. The yield on portfolio confirms this picture; in the case of 23 MFIs it was above 30 %(the highest being 41.29%). Further the report says that the assumption that economies of scale will result in drop of interest rates resulting in lower yields was not confirmed. Obviously the DNA drove the MFI to maximize profits and competition did not decrease rates as it was expected to.

The poor are boxed in a high interest rate regime. Yet the MFIs did not agree to reduce their interest rates even when it was clear that the risks had become unbearable, On the contrary their spokesperson said:" The basic fact is that providing credit is expensive, difficult and risky. If MFIs have to be sustainable, society will have to get accustomed to the interest rate". (The Week Nov 14,2010 pg 24)

As a result the largest MFI recorded a 116% jump in net profit at Rs. 81 crore in the second quarter ending Sept 2010 as against the corresponding period last year. No one questions that profits should be made, but the level of profit required to meet all costs, cover risks and expand operations is different from the level of profit required to meet all these costs plus attract venture and private capital, pay salaries and commissions higher than the remunerations of the CEO/MDs of the largest private banks. Valuations not values seem to drive the sector. While this again can be justified, it does not seem to be an appropriate business model for the poor where values are required to guide the governance of these institutions. The MFIs can provide credit to the non-poor but regulation by the RBI is required; self-regulation was tried in 2005 but no one bothered to comply.

And the major question - What should be the interest rate? The figure of 24% is floating around in official circles. The problem is that the effective interest rates of MFIs are far from clear. There appears to be a difference of 5% to 10% between the rates as provided by the MFI and the rates that emerge from an analysis of the books of the clients. Professionals in this field say that the MFIs do not know how to calculate effective interest rates. No wonder one representative remarked that the MFI made profits by accident. The management of add-ons like insurance also adds to the credibility deficit. MFIs argue that the cost of credit form banks is high and that they should be allowed to mobilize public deposits if interest rates are capped. Interviews with clients show clearly that they do not have an idea of what they actually pay over and above the capital. They are satisfied if credit keeps coming preferably through the practice of "topping up". In fact interviews with those clients who had succumbed to the temptation of multiple borrowings showed clearly that they wanted to borrow from several MFIs to maintain a cash flow which coped with repayments as well as their expenditure. Multiple borrowings and topping up serve the same purpose as far as they are concerned. In turn this increases their risk substantially.

To get some guidance about interest rates let us go to the SHGs. We find that interest rates of SHGs in Myrada stabilize after two years or so between 12% and 14%, which is about 3% to 4% above cost of credit from Banks. Non for profit MFIs which do not pay high salaries but adequate to attract experience and capital from Banks manage to make a surplus at interest rates between 17% to 19% where the average cost of credit is around 9% -10% and annual growth rates are 40% to 50%. For

Profit MFIs should be able to manage their affairs and attract capital (not venture capital and high valuations) by charging effective rates ranging from 15% to 17% above the average cost of credit. This would put interest rates for the For Profit MFIs in the range of 24% to 29%. At present they are charging about 20% to 30% above the average cost of credit. Commissions on add ons like insurance need to be biased in favor of the client and not to maximize profit of the MFIs.

To conclude: The poor in the SHGs manage with interest rates of 12% -14% and they have managed with interest rates higher than these in the initial period till they built up their groups common fund. They can therefore cope with interest rates of around 17% which Not for Profit MFIs are levying. The risk involved in manageable; the cushion provided by the SHG will help them to tide over urgent needs. The not poor in the second group can cope with higher interest rates levied by For Profit MFIs but the rates should not exceed 30%.

Competition among MFIs has not had an effect on reducing rates, neither has self regulation. The bottom line is that interest rates, commissions, salaries, profits have to be regulated by the Board. It has to come from good and value based governance which seems to be in short supply. The decision by the Board to go in for an IPO will surely force management to focus on the coming quarterly figures as the logic of the financial markets dictates it should. This will further integrate (include) the marginalized into the free market system of which the share market is perhaps the best expression of high risk and profits. This will in turn increase the risks of the clients who are particularly vulnerable.

The exorbitant hike in airline fares attracted quick reaction from government- first to reduce the fares and later to ensure that they are transparent. This case is similar to the one related to the interest rates because the reasons put forward by both the parties are similar. The result in the case of the airline fares is that fares have been reduced. But airlines tried their best to avoid transparency in exhibiting the real fares. In fact the first attempt was so confusing that one had to be in the travel industry to unravel them. Ditto for interest rates. Why is the Government hesitating to regulate interest rates? Years ago I was asked by senior official whether the liberalization policy would affect the poor. My answer was that the poor have survived in a liberal economy – their wages rise and fall on demand and supply, they pay above market interest rates; they are not subsidized. Those around are the table may have difficulty in adjusting. If Govt. can move so swiftly in the case of airline fares, why the delay in the case of interest rates – both to set a ceiling as well as to ensure transparency?

Are MFIs really better than moneylenders? To begin with in neither of these groups is the effective interest rate transparent. The objective of moneylenders is to ensure repayment of interest not of the capital and they are flexible as regards the amount of repayment. But they can adopt this approach since they have long term relationships with the client and no software to conform to which requires standardization in repayments.

In the late 80s I asked a group of village people in Bidadi to select symbols to describe their sources of credit. First they pointed out to a large boulder –"that" they said, "is the bank; we cannot move it". Next they placed a small boulder in the middle with some pieces of newspaper beneath. "This" they said is the Cooperative; the paper is the money we have to pay for a loan". Third they placed a twig of parthenium. (Popularly called congress grass); "once this comes in the field we cannot remove it". Then I asked "In which do you have the greatest trust". Without hesitation they pointed to the twig of parthenium. (A Year later they add a flower to symbolize their SHG). The moneylender lives among them or closes by and is involved in several other activities in the life of the village. In the MFI the speed involved in dealing with borrowers fails to build sufficient trust and understanding between the two – this is where the moneylender scores over the MFI. One MFI staff has to cover several borrowers who are usually asked to come to one place at a fixed time. The time for the next group to meet is fixed. It is very much like a private bus which has to stop at fixed times and for as short as possible over the route. If the staffs delay, another MFI will reach the group and secure their dues just as the private buses have to rush in order to keep ahead of the competition. If the borrowers are late they are fined in many cases; trust is not built in this business model.

Once again our experience with SHGs as well as with MFIs indicates that the interest rates operating in SHG model is the most appropriate for the poor, while the interest rates operating in the For Profit MFIs is appropriate for the not poor but who are in need of credit. In keeping interest rates within limits, the governance of MFIs has a greater role to play than any regulation since it involves other costs related to salaries, commissions as well as over all institutional values.

Navin Anand, United Nations Development Programme, New Delhi

Many thanks for your valuable contributions on the issue of MF regulations. Following are my views on the MF regulatory framework-

Complexity of the MF Environment in context of Regulations

The microfinance milieu in context of regulations looks complex today due to the diversities in context of the MF organizations, their legal entities, variation in MF products and services Microfinance institutions, different variety of regulatory bodies, diversity of target population in terms of their economic and social status as well as geographic locations and level and extent of mF operations etc.

In such a complex environment, it is definitely difficult to come out with a single regulation that can cover all the microfinance service providers. Hence in such a situation, it is pertinent to have a regulatory framework that simply specifies the boundaries of different regulatory bodies and relevance as well as importance of compliance to different regulator by the service providers of the microfinance Sector.

An analysis of the regulatory scenario for MF reveals the fact that the commercial banks, Regional Rural Banks, Cooperatives Banks, local area banks and other private banks, are covered under Banking Regulation Act and also RBI's regulations related to microfinance. The National Bank for Agriculture and Rural Development (NABARD) supervises and regulates the banks working in rural areas and also play a key role as promoter and wholesale financer for banks and MFIs.

The Non-Banking Finance Companies (NBFCs) engaged in microfinance are being regulated by RBI whereas the NGOs, Trusts and other not-for-profit institutions functioning as financial intermediaries are out of the purview of the direct supervision of the RBI. The scenario of rural as well as urban financial cooperatives is more complex as these institutions are being regulated by registrar of cooperative societies and also by NABARD/RBI. Since the status of regulations and cooperative Acts are varying in different states the provisions in the Acts are not similar in all the states. Within a state the provisions depends on the Act in which the financial cooperative is registered.

Primary and Secondary Regulators or no Regulators/Self Regulators

Keeping in view the above mentioned scenario we need a MF regulatory framework which can answer the question – How a particular microfinance institutions/ service provider will be regulated/monitored.

In context of the above, the first option could be that different legal entities can be continue to be regulated by a primary regulator i.e. cooperatives are being regulated by the Registrar cooperative societies who regulates under the ambit of relevant cooperative Societies Act.

A secondary regulator could be common to all the legal entities who can watch the activities at the macro level in specific context of microfinance operations. In this way there will two boundaries of the microfinance sector in terms of regulations.

The decisions regarding the fact that whether any MF institution is to be regulated by Primary regulator or primary as well as secondary regulator or it will be self regulated will depend on various parameters. The extend of regulations will depend on the following factors –

- Formal and informal characteristics of the organization
- Legal entity of the origination
- Product and Services provided by the organizations (It can be one or combination of product and services i.e. savings, credit, Insurance, Remittance/ transfer of money, micro leasing, Micro pensions. The portfolio of activity will play a decisive role related to regulations applicable for an organization. Similar legal entities will be regulated differently if one is taking savings activities and other takes up insurance)
- Delivery mechanism adopted by the organizations (Organizations doing mobile phone banking will be regulated in a different way compared to other organizations)
- Direct financial intermediation or indirect intermediation (i.e. The regulations applicable for the organizations working as Business correspondent and business facilitator will be different from the NBFC or a bank or a pure MFI)

In addition to the organizations, there will be individuals functioning as service providers of microfinance such as Business Correspondents /Business facilitators and money lenders who will also come under the ambit of MF regulations. Hence the Regulatory framework and Mf regulations need to consider individual service providers in the regulatory frame.

The regulations for savings has due importance in the present scenario of microfinance. The present regulations restrict a variety of MFIs including NGO-MFIs for taking savings from the public. The regulators perspective of not permitting numerous small institutions to mobilize savings has been to give protection to poor. RBI has introduced Business Correspondent (BC) model so that through banks, adequate safety to the deposits of poor is provided. Recently, RBI has allowed BCs to appoint sub-agents thereby addressing financial inclusion agenda. The regulations in context of NGOs and other MFs functioning as BCs will be very different compared to those who are collecting money directly from the public and utilizing the same for undertaking other activities.

Remittances services have become important for the MFIs dealing with migrant labour and people living in remote areas. This demands a clear regulation related to the technologies and mechanisms for it. RBI's clear guidelines facilitate MFIs to accelerate mobile banking activity for faster financial inclusion. Here regulations will depend on the type of institution taking up mobile phone banking.

Design Problem

Besides products and services which are related to the delivery of MF services, mechanisms for generating capital and funds is also required to be regulated. It is important due to the reason that it affects the implementation mechanism and norms of the providing MF services. Ultimately it is a project implementation cycle. If an MFI generates capital from the funders or individual investors then the MFI is accountable to the fund providers at one side and on the other the beneficiaries or clients.

There have been various funding models or capital generation arrangements such as a 'Debt funding model', 'Partnership Model', funding arrangements used by apex Government institutions. Besides this, there are funding models based on socially motivated venture capitalists and the fund generation model adopted by community based MFIs including financial cooperatives. These models differ from each other in context of sharing of risks by the funding institutions, form of financial support like bulk loans, grants, quasi equity, equity capital and loan guarantee funds. Regulations are required for the mechanisms adopted by the different MFIs and the commitment assured to the funding agencies or capital providers (organizations as well as individuals).

In the nutshell, we need a well defined standard MF regulatory framework at the macro or national level whereas at the state level the regulations will vary as per the situation as well as different Acts applicable in the particular states. Cooperative and money lending are state subjects so there can not be single regulation related to MF in all the states.

Central and State Governments can play vital role in standardizing the MF regulations in the country which has become important in context of saving poor clients who ultimately need microfinance services and on the same hand also needs protection.

Many thanks to all who contributed to this discussion!

If you have further information to share on this topic, please send it to Solution Exchange for the Microfinance Community in India at se-mf@solutionexchange-un.net.in with the subject heading "Re: [se-mf] DISCUSSION: A National Regulatory Framework for Microfinance Sector. Additional Reply."

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Solution Exchange for the Microfinance Community Consolidated Reply

Query: Malegam Committee Report on Microfinance - Advice

Compiled by Navin Anand, Resource Person and Monika Khanna, Research Associate

Issue Date: 23 March 2011

From Ramesh S Arunachalam, Independent Microfinance Practitioner, Chennai

Posted 25 January 2011

I am independent microfinance practitioner, analyst and researcher. In October 2010, Reserve Bank of India formed a sub committee under the chairmanship of Shri. Y H Malegam to address the issues and concerns in the MFI Sector.

The sub committee reviewed the prevalent practices of MFIs in regard to interest rates, lending and recovery practices, scope of regulation of NBFCs, applicability of money lending legislation of the States, ways of enhancing transparency disclosure, conditions under which loans to MFIs can be classified as priority sector lending and recommend a grievance redressal machinery for ensuring adherence to the regulations. The report of the committee was released on 19 January 2011. To read the full report, please visit: http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/YHMR190111.pdf (PDF, 262 KB).

This report is a landmark in the history of microfinance. The committee has recommended on creating a separate category for NBFCs operating in Microfinance sector to be designated as NBFC – MFI. Besides this there are suggestions on pricing of interest, transparency in interest rates, mitigate the problems of multiple-lending, over borrowing, ghost borrowers and coercive methods of recovery. For a quick overview of the recommendations suggested in the report, please visit: http://microfinance-in-india.blogspot.com/2011/01/rbi-sub-committee-report-my-summary-of.html

With this background, I request the members of Microfinance Community to share their views on the following:

- What are the strengths of the various recommendations made in the Malegam report?
- What gaps (if any) exist in the Malegam committee report and how it can be addressed?
- Which recommendations in your opinions should be taken up by the RBI?
- If the recommendations mentioned in the report are accepted, what implementation challenges are likely to exist and how can they be overcome?

As the report is of great significance to the Indian microfinance sector, I would be grateful if members take time out and respond to this query. The contributions from the members will help the microfinance sector in developing robust regulation.

Responses were received, with thanks, from

50. **Ramesh S Arunachalam, Independent Microfinance Practitioner, Chennai (Response 1; Response2)**
51. **N.Srinivasan and Girija Srinivasan, Consultant, Pune**
52. **Resham Singh, Punjab Gramin Bank, Mohali**
53. **Savita Shankar, National University of Singapore, Singapore**
54. **Subhash C Wadhwa, Development Consultant, Mumbai**
55. **Stefan Pellech, Intellecap, Hyderabad**
56. **N. L. Narasimha Reddy and Shailey Tucker, Poverty Learning Foundation, Hyderabad**
57. **G K Agrawal, Rural Development and Microfinance Consultant, Mumbai**
58. **N.Jeyaseelan, hand in Hand, Chennai**
59. **Ajimon L., EMFIL, Thrissur, Kerala**
60. **Rahul Kumar, Mimo Finance, New Delhi**

Summary of Responses
Related Resources
Responses in Full

Summary of Responses

Finding Reserve Bank of India's initiative of appointing Malegam Committee a timely initiative, members appreciated the report as it recognizes the need of creating a national regulatory framework for MF in India and also attempts to legitimize MF as an integral part of the Indian financial sector. Overall, members felt that the mechanisms proposed by the committee such as focus on low-income customers, smaller loan volumes, interest rate caps, intermediation margin caps, limiting the fees and charges, restriction of membership in multiple groups could be effective in the short run, but their effectiveness over the long run seems uncertain.

Members endorsed the following key recommendations of the report –

- Creating a separate category for NBFCs operating in MF sector as 'NBFC – MFIs'
- Establishing a grievance redressal mechanism for ensuring adherence to the regulations – Lead Bank officer as Ombudsman
- Retention of Priority sector status to all those Banks that lend to MFIs - ensuring continued availability of funding for MFIs
- Promoting greater transparency – by prescribing rates and margin cap and also components in the pricing i.e. processing fee, interest and insurance premium
- Emphasizing on off-site and on-site supervision of NBFC-MFIs and Corporate Governance
- Exemption of NBFC-MFIs from the provisions of Money-Lending Acts - preventing the misuse of such Acts by State Governments
- Avoidance of using coercive collection practices by MFIs and emphasizing on Peer pressures and enhancing borrowers' awareness on 'repayment ethics'
- Stopping multiple lending, over lending and ghost lending through several measures including better loan origination procedures, establishment of a credit bureau etc.
- Creation of 'Social Capital Fund' to fund MFIs having focus on social performance

- Emphasizing on government funding for group promotion, capacity building and also collaboration with NRLM to promote community based MFIs

Priority Sector Lending

The committee feels that the regulatory standards will meet the objectives and, therefore, allows priority sector lending status for bank lending to MFIs. Members suggested for a specific allocation of 10 per cent of 40 per cent limit of priority sector lending of banks through revision in RBI Circular on Lending to Priority Sector.

Criteria related to lending by NBFC-MFI

Regarding capping of overall interest, margins, loan size and total loan outstanding, members expressed that the cap on loan sizes and total loan outstanding may be some what restrictive for the clients prospects related to their vertical growth in context of livelihoods.

On the specific issue of putting a cap of Rs.50,000 for annual family income, members expressed that it will be difficult to implement. Members advised to remove this artificial barrier and suggested to prescribe the ceiling at an individual member level and not at the household level as it is very difficult to determine the household income. Additionally, they also suggested that the ceiling of income may be taken into account only at entry level.

Capping of Interest Rate

Justifying the logic of fixing margin of 10-12 per cent and putting up an interest cap of 24 per cent on individual loans, members argued that poor can not be exploited by MFIs in the name of high cost of retail operations, sustainability, and financial viability. Keeping in view the interests of the poor, it is advisable that MFIs earn 'reasonable profits' and do not opt for 'profiteering'. As per the members, another dimension on the issue of capping of interest could affect the prospects for small MFIs operating in difficult terrains, as interest cap does not compensate for the higher cost of operation in remote areas. It is possible that for greater efficiencies, more short cuts will be used with regard to client acquisition and client engagement.

Analyzing the value chain of the credit business, members argued that while putting a cap on the interest to be charged from the customers, it is equally important to put a cap for the interest charged by the banks from MFIs as in some cases interest charged by banks is as high as 15 per cent. Since loans to MFIs by banks would continue to be part of the priority sector lending, there is a strong case for charging lower interest by banks from MFIs. Members also suggested for continuing with capping of the margins / return on equity and/or dividends and looking into the aspect of equity investment in MFIs and building necessary safeguards to protect clients.

Coercive Methods for Recoveries

Endorsing the recommendation of not using coercive methods for recovery, members stressed on the benefits of creating peer pressure as the key for microfinance loans with JLG/SHG approach. Additionally, MFIs need to devote little more time for awareness building on aspects of peer pressure and joint liability, before sanctioning loans. They felt that recommendation regarding non recovery by field staff at borrower residence and place of work may go against the very strong points of MFIs with door step lending and recoveries. Members do agree that visits to the work place or residence should be limited to providing MF services and regular recovery.

Number of Loans

Members believe that restricting to only two sources of loans will lead to increased dependence on informal sources therefore number of sources, loan amount and numbers of loans are to be linked to members' need and capacity to repay.

Regulations for other forms of MFIs

On regulation of MFIs, members suggested that it will be useful if committee recognizes and provides legitimacy for operation of other legal forms of MFIs including Not - For Profit and Mutual Benefit Institutions for providing microfinance services. Members also find it important for the committee/RBI to take cognizance of the agent model of micro-finance in India and address issues related to the use of agents.

Members opined that there has to be one Regulator and Supervisor for the entire MFI sector. If for any reason it is not possible for RBI to confine its supervision and regulation, an independent organization which is already inspecting /supervising Cooperative banks and RRBs on behalf of RBI, can be designated as Regulator for Non NBFC-MFIs. Alternatively, a new independent regulatory authority like SEBI, IRDA, NHB can be created to exercise control, supervision and give visionary direction to the entire MFI sector. Members also suggested for establishment of an overarching institution to act as an anchor and catalyzing force that facilitates greater access to financial services and products, addresses capacity-building needs of all stakeholders, and provides other livelihood support services.

Customer Protection

Members appreciated the coverage of customer protection aspects in the report like - control over pricing; attention to excessive debt; avoidance of consumption financing; ruling out coercive recovery practices; advising banks to play a larger role in financing and handholding of SHGs; and measures for setting up customer grievance handling procedures. Customers need to be protected not only from extortionate pricing but also from excessive debt from multiple institutions.

Limitations on joining number of groups

The limitations on number of groups that customers can join, amount of loans and number of loans, restricts the vertical growth of the members in terms of taking forward their economic enterprises and livelihood activities. Members suggested that it should be based on the needs and capacities of the borrowers. Again, imposing limits on MFIs lending may not be the solution for excessive debt as there are no means of reliably verify the level of informal debt.

Credit Bureaus seem to have been thought of as a solution for the problems of identifying multiple loans. However, credit bureaus will not be able to track loans given by SHGs and informal sources other than participating banks and MFIs. It is difficult to replace quality customer appraisal with any other substitute for determining the debt levels and loan servicing capacity.

Ceiling of Loaning per member

The committee mandates that 75 per cent of the loans by MFIs should be for income-generation. Insistence on 75 per cent of loan for income generating activities may be difficult to implement. It may force the poor to continue to go to money lender for their emergent consumption, health and social need and pay much higher interest rates. Further, by putting a cap of Rs.25,000 on the MFI loans, the Committee seeks to protect borrowers from excessive financial burdens. However, this amount is inadequate to meet the consumption and livelihoods needs. The limit of Rs.25,000 is too low to procure assets for IGAs and therefore it will result into under-financing. It will also compel the customers to avail loans from other informal sources.

Members suggested that an additional overall borrowing cap should be decided upon after examining the borrowing capacities of each household. Care should also be taken so that the borrowing cap does not impede the deepening of credit or restrict the choice of credit at the household level. The heterogeneous nature of low income groups with varying cash flow patterns necessitates multiple models of microfinance instead of a “one size fits all” solution.

Importance of Savings

Members highlighted the importance of savings by quoting the following factors –

- Collection of savings from members by regulated MFIs will reduce the cost of funds
- Savings Services will provide an avenue for financial inclusion (SHGs-banks linkage model has helped in substantial savings by poor with banks reducing the chances of defaults)
- It will be a binding force for the JLG and SHGs
- Cultivating the culture for saving and asset creation at the grass root level will help in combating the recovery problem

Commenting on the Committee's decision of not recommending for the provision of thrift and savings services by MFIs, members suggested reconsidering it, keeping all the initiatives and recommendations for safeguarding the interest of depositors.

Provisions for NBFCs –MFIs and other NBFCs

Members felt that the expectation of maintaining a minimum net worth of Rs.15 crore by the NBFC-MFIs will be difficult for the small and nascent MFIs. Therefore, it would be appropriate if the committee reconsiders this aspect for modification. Permission to other NBFCs to engage in microfinance up to a cap of 10 per cent of total assets without specific regulations will affect the business of NBFC- MFIs. While the provision is obviously intended to encourage scale in microfinance, it restricts the scope of product diversification of NBFC-MFIs.

In addition to commenting on the recommendations of the Committee, members also suggested for - establishment of a community-monitoring system to maintain community-database and periodically validate the information provided by credit bureaus; creation of a fund through the collection of a 1-2% cess from all financial service providers, including banks; utilization of existing MF development and equity fund to assist small MFIs in the form of risk capital.

Finally members suggested that the RBI, should view the Malegam Committee Report in the larger context of financial inclusion and regulation in the overall rural credit system. In the nutshell, members enumerated the recommendations that are conducive for the sector in long run and suggested modifications, keeping the larger perspective of MF regulations and development.

Related Resources

Recommended Documentation

Access to Finance in Andhra Pradesh (*from N.Srinivasan and Girija Srinivasan, Consultant, Pune)*
Report; Doug Johnson and Sushmita Meka; IFMR-Center for Microfinance; October 2010 Available at http://www.ifmr.ac.in/cmf/publications/wp/2010/CMF_Access_to_Finance_in_Andhra_Pradesh_2010.pdf (PDF; Size: 812 KB)

Study aims to understand the current state of financial access and levels of financial inclusion in rural Andhra Pradesh

Control, micromanagement will be counterproductive for microfinance sector (*from Savita Shankar, National University of Singapore, Singapore)*
Article; Mukul G Asher & Savita Shankar; Daily News and Analysis; 2 February 2010 Available at http://www.dnaindia.com/money/column_control-micromanagement-will-be-counterproductive-for-microfinance-sector_1501984

Analyzes the recommendations suggested by the Malegam Committee

From Ramesh S. Arunachalam, Independent Microfinance Practitioner, Chennai; response 2

Q&A: Y H Malegam, Chairman, Malegam Committee
Article; Abhijit Lele & Niladri Bhattacharya; Business Standard; 11 February 2011
Available at http://www.business-standard.com/india/news/qa-y-h-malegam-chairman-malegam-committee/424720/

Shares the interview of Y H Malegam, Chairman - Malegam Committee

Growth and Vulnerabilities in Microfinance
Article; Greg Chen, Stephen Rasmussen, and Xavier Reille; Consultative Group to Assist the Poor; February 2010
Available at http://www.cgap.org/gm/document-1.9.42393/FN61.pdf (PDF; Size: 1 MB)

Shares lessons from four microfinance markets: Nicaragua, Morocco, Bosnia and Herzegovina (BiH), and Pakistan

The Perfect Balancing Act with an Imperfect Outcome: Malegam Committee Recommendations on Microfinance (*from Stefan Pellech, Intellecap,Hyderabad)*
Paper; Intellecap; February 2011 Available at
http://intellecap.com/assets/89/Response_to_Malegam_Committee_Reco_Intellecap_White_Paper-February_2011.pdf (PDF; Size: 222 KB)

Paper examines the recommendations by Malegam Committee for the private sector commercial microfinance industry

Malegam Comittee Report: Voices of the People from Andhra Pradesh (*from N. L. Narasimha Reddy and Shailey Tucker, Poverty Learning Foundation, Hyderabad)*
Paper; N. L. Narasimha Reddy and Shailey Tucker; Poverty Learning Foundation; Hyderabad; February 2011 Available at ftp://ftp.solutionexchange.net.in/public/mf/cr/res25011101.pdf (PDF; Size: 61.3 KB)

Paper reflects the reality of the MFI sector in rural Andhra Pradesh and shares views of the people

Recommended Organizations and Programmes

From N.Srinivasan and Girija Srinivasan, Consultant, Pune

Reserve Bank of India (RBI), Mumbai
Rural Planning and Credit Department, Central Office Building, 13th Floor, Mumbai 400001; Tel.: 91-22-22610261; http://www.rbi.org.in/scripts/AboutUsDisplay.aspx?pg=Depts.htm#RPCD

Rural Planning and Credit Department of RBI formulates policies relating to rural credit and monitors timely and adequate flow of credit

National Rural Livelihood Mission (NLRM) - Ministry of Rural Development (MoRD), New Delhi
Krishi Bhawan, New Delhi - 110 001; Tel: 91-11-23782373, 23782327; Fax: 91-11-23385876 Email; http://www.rural.nic.in/

MoRD has decided to re-design and re-structure the on going
Swarnjayanti Gram Swarojgar Yojana (SGSY) into National Livelihood Mission (NRLM)

National Bank for Agriculture and Rural Development (NABARD), Mumbai *(Subhash C Wadhwa, Development Consultant, Mumbai)*
Plot No. C-24, "G" Block, Bandra-Kurla Complex, P. B. No 8121, Bandra (E), Mumbai - 400051; Tel.: 91-22-26539244; Fax: 91-22-26528141;
nabmcid@vsnl.com; http://www.nabard.org/roles/microfinance/index.htm

Apex institution providing loan funds for microfinance services in the form of revolving fund assistance to NGO-MFIs, SHG Federations and NGOs to lend to SHGs

From G K Agrawal, Rural Development and Microfinance Consultant, Mumbai

Insurance Regulatory and Development Authority (IRDA), Hyderabad
3rd Floor, Parisrama Bhavanam, Basheerbagh, Hyderabad – 500004, Andhra Pradesh; Tel: 91-040-66820964/789768; Fax: 91-040-66823334; http://www.irdaindia.org/

Insurance regulatory body set up to protect the interests of the policyholders and to regulate, promote and ensure orderly growth of the insurance industry

National Housing Bank, New Delhi
Core 5 - A, India Habitat Center Lodhi Road New Delhi - 110003; Tel: 011-24649032; Fax: 91 11 2464 6988 info@nhb.org.in; http://www.nhb.org.in/Financial/default.htm

Principal agency to promote housing finance institutions and formulates schemes for the purpose of mobilizing resources and extending credit for housing

Securities and Exchange Board of India (SEBI), Mumbai
Plot No. C4-A,'G' Block, Bandra Kurla Complex, Bandra (East), Mumbai 400051 Maharashtra; Tel: 91-22-26449000/40459000; Fax: 91-22-26449016-20/40459016-20;
sebi@sebi.gov.in; http://www.sebi.gov.in/

Autonomous body, drafts regulations, conducts investigation and enforcement action and passes rulings and orders in its judicial capacity

Recommended Portals and Information Bases

Candid Unheard Voice of Indian Microfinance *(from Ramesh Arunachalam)*
Blog; Contact Mr; Ramesh S Arunachalam; Independent Micro-Finance Practitioner;
r_arunachalam@hotmail.com

Blog focuses on the issues emerging in the microfinance sector ranging from Malegam Committee report on Microfinance

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Responses in Full

Ramesh S Arunachalam, Independent Microfinance Practitioner, Chennai *(response 1)*

To start the process and give a comfort zone to all members to critique the Malegam Committee Report (MCR) in an objective manner, I would like to share my brief (initial) thoughts as a small note which can be found at: **The Malegam Committee Report on Micro-Finance: What's On The Platter?:**
http://microfinance-in-india.blogspot.com/2011/01/malegam-committee-report-on-micro.html

Look forward to your views and assessments of the report and I am very grateful to members for providing their valuable feedback.

N.Srinivasan and Girija Srinivasan, Consultant, Pune

The Malegam committee deserves appreciation from all parts of the sector for doing an exhaustive analysis of the issues and proposing solutions to most of the problems. The committees report stands out for its objective assessment of the relevance of MFIs and the need for their continued existence. Seen from the background of heightened negative attention from the media and others the objectivity shown in the committee's report is bold and mature.

The three important features of the report are:

1. The MFIs need to classified separately and regulated in the context of their customers and operations and not in a general manner along with other NBFCs;
2. Customers need to be protected not only from extortionate pricing but also from excessive debt from multiple institutions;
3. While Reserve Bank has a primary role in ensuring institutional and systemic stability focused regulation of MFIs, it cannot deny customer protection issues; RBI must regulate customer related aspects so that States do not individually take up financial sector regulation.

The mechanisms proposed for reining in the sector such as focus on low-income customers, smaller loan volumes, interest rate caps, intermediation margin caps, limiting the fees and charges, restriction of membership in multiple groups could be effective in the short run, but their effectiveness over the long run seems uncertain. Some aspects of the recommendations need elaboration and some others fine-tuning. These are described later in this note.

The positive aspects of the report are its customer protection agenda that is evident in control over pricing, attention to excessive debt, avoidance of consumption financing, ruling out coercive recovery practices, advising banks to play a larger role in financing and handholding of SHGs, and measures for setting up customer grievance handling procedures. On the regulation side, the committee has taken a positive and forthright stand on the need for RBI to regulate and has offered a framework of regulation that comprises financial sector aspects, institutional stability aspects as well as customer protection aspects. An important policy view that is worth highlighting is that RBI's regulatory effort would make State Governments legislative effort redundant. There have been differing opinions by High Courts on the *locus standi* of RBI to regulate NBFCs, overriding the State's powers under money lending acts. If the Centre could decisively settle this, it would be a signal service to low income clients. The proposed supervision over industry associations is a welcome step that will provide legitimacy and teeth to the associations in monitoring and review of member MFIs operations. On the development side, the suggestions for social investment fund, government funding of group promotion and capacity building, collaboration with NRLM to make the community based movement dynamic and vibrant are positive ones. On the issue of regulation of MFIs in non-company form, Ms Sashi Rajagopalan's stand that the existing bill is neither useful nor necessary seems to be well held.

The implications and likely outcomes of implementation of the suggestions are several. The first major outcome is a likely shrinkage of the sector over the next 12 to 18 months especially for those MFIs in competitive markets with large ticket loans. In some states such as Andhra Pradesh, Tamil Nadu, Karnataka, West Bengal and in many cities and towns in other states, MFIs might have to scale down current business to comply with the limits of two loans not exceeding Rs. 25000.

Expansion will be necessarily to smaller towns and remote areas, but within reach of the existing business locations. Expansion to other states and totally new locations is not likely to be vigorous as the intermediation margins might not permit profitable forays in to new areas.

Client acquisition would be a more protracted process, pushing up costs on account of income verification of customers as also the existing debts. Operational costs are set to go up as MFIs will retool their customer acquisition processes, refine the loan products and accommodate two year loans and offer flexible repayment periods including moratorium. The design of new process and systems, change in accounting and MIS systems, training of staff and more importantly training the customers to adapt to changes will also entail higher costs and a learning curve.

Given the 10% limit on intermediation margin, the average loan size will tend to increase, but the headroom to grow will be small. The Rs 25000 cap will also limit the long term interest of MFIs in its customers.

With the increased net worth requirements, MFIs are likely to search for equity, preferably domestic and socially oriented, on account of perception of low-profitability of the sector that the recommendations of this report generate.

Customers would face a scarcity of loans for purposes such as health, education, food security and lifecycle events on account of restriction on consumption loans. Such loans being more primary would tend to drive the customers towards moneylenders with overall reduction in welfare and well-being. The other possible development will be that customers divert loans taken ostensibly for an income generating purpose towards consumption. In either case customer interests are not likely to be well served.

Some concerns of a macro nature arise from the report. The foremost is the limiting of choices of people. Empowerment is understood in many contexts as creating choices for people and enabling them to make informed choices. The limitations on number of groups that customers can join and the amount and number of loans that they can take reduce their choices and the possibility that the more enterprising among the poor realize their full potential. The denial of freedom to join more than one group seems to violate the fundamental rights afforded under the constitution to join any group or association or organization that is lawful. When non-microfinance customers do not have to limit their memberships, why those with incomes below Rs 50000 should have freedom curtailed? The decisions on their number and quantum of loans could have been left to the lender and the customer based a clear appreciation of each other’s needs and capacities with a clear understanding of the lender’s liability in mis-selling.

The second issue is that the interest rate caps and margin caps have not been accompanied by a cap on lending rates of banks to MFIs. When MFIs are expected to exhibit responsible behavior, those that lend to them should also behave responsibly. In fact the recommendations require that all stakeholder groups excepting the banks behave responsibly. Equity investors should be socially oriented, MFIs should have interest rate caps, customers should limit their choices, government should support SHG formation and capacity building and RBI should take up additional responsibility of regulating the sector. But banks with significant business interest have not been asked to do anything specific. Interest rates charged by some banks to MFIs are as high as 15% and in such a case how the interest rates could be charged at 24% to customers by MFIs, especially the smaller ones.

The third issue is that of fixing absolute limits such as Rs 50000 income, Rs 25000 loan and a 24% interest rate cap etc. These limits would prove to be deadweights in an economy where inflation and markets make last month’s values irrelevant in the current month. These numbers should be linked to an index or a base which in itself is dynamic and reset periodically in line with the economic trends.

The fourth issue is the notion that excessive debt in the hands of the customer can be curtailed through imposing limits on MFIs lending. The informal loans to customers, as revealed in the CMF study of Access to Finance in Andhra Pradesh, are many multiples of formal institution loans. Presently there are no means of reliably verifying the level of informal debt in poor households. Shifting low-income customers from money lenders to formal institutions (whether MFIs or banks) should be a priority. This would require much larger loans than Rs 25000. A rethink on what we want MFI loans to achieve for the customers is necessary.

The committee rightly expects the MFIs to provide loans to support livelihood activities. But the Rs 25000 loan limit is inconsistent with livelihood activity requirements. The most common activity of dairying will cost more than Rs 25000 for one quality animal when cost of initial feed and fodder is taken in to account. Under-financing is likely to result, compelling the customers to avail loans from other informal sources.

Credit Bureaus seem to have been thought of as a solution for the problems of identifying multiple loans. Credit bureaus will not be able to track loans given by SHGs, informal sources and institutions other than participating banks and MFIs. It is difficult to replace quality customer appraisal with any other substitute for determining the debt levels and loan servicing capacity.

Some areas that will require elaboration are;

- Since MFIs are permitted to finance to individual only through JLGs what would happen to MFIs that adopt SHGs as their customer base? Should they convert their SHGs to JLGs or they can continue with the present groups, but observing the caps and ceilings.
- NBFCs with low income group loans of 90% of loan assets are classified as NBFC-MFIs and will be subjected to specific regulation. What happens to those NBFCs that have microfinance loans of less than 10% of their portfolio? Whether in respect of their MF portfolio they would be regulated on par with NBFC-MFIs. If this is not done, institutions will be able to arbitrage on classification of institutions and deal with the same customer segment differently?
- How to determine the income level of Rs 50000 in low income families with lumpy cash flows that tend to fluctuate year to year? If customers taken on by MFIs improve their income levels above Rs 50000 whether the MFI should drop such customers (which might result in the customers sliding down in to poverty)?
- When existing customers' loan needs for continued income generation exceeds Rs 25000, whether they have shift custom to banks? What arrangements exist to ensure that the customer does not face a disruption in her livelihood activity?
- How to enforce compliance with customer acquisition norms, loan limits per customer when a good MIS that cuts across all institutions does not exist? Will it be self-monitored and reported and externally verified through random sampling periodically?
- The limitation of one group per individual is not clear. Whether they can join one SHG and one JLG or just anyone of them should be clarified. When more than two MFIs are permitted to give loans to an individual is it the expectation that she will go along with her group to the second MFI?
- The minimum net worth for NBFC MFIs is given as Rs 15 crores. On the other hand, the report recognizes smaller MFIs with assets of less than Rs 100 crores and permits an intermediation margin of 12% for the same. Rs 15 crore minimum net worth requirement and that too in tier 1 form will close options for small MFIs. It is not clear whether only bigger MFIs are favoured?

There are other issues that remain which will no doubt be raised and debated by different practitioners. There would be several suggestions to fill in gaps and fix some inconsistencies. But the committees work is a significant milestone in the development of the sector. It clearly establishes the legitimacy of the sector that was being questioned with the backing of a sovereign government. It has endorsed that microfinance institutions carry on a lawful business activity and the business needs to be regulated as such – and not as a harmful activity requiring high level of restrictions and continued policing. By recommending the continuation of priority sector label, it has upheld the social character of microfinance. Let us recognize that it is a hard task that the committee has performed under difficult circumstances in a context of extreme emotions and bad faith caused by mindless behavior of some MFIs. The recommendations in themselves will not achieve much, unless sector willingly cooperates to reform and positions itself much closer to customers than it has managed so far. The committee has provided short term relief to a sector that seemed to be in dire straits. Convert the short term relief in to a long term rehabilitation process that would ensure the longevity of the sector is the task that the sector should earnestly take up. Neither RBI nor such committees can establish the relevance of MFIs to people in the eyes of governments. MFIs can ensure their longevity only by socially oriented functioning where customers come first.

Resham Singh, Punjab Gramin Bank, Mohali

I feel that Self Help Group is a unique and systematic way of creating wealth. Timely availability of credit, technical and substantial training is required to minimize the expenditure of members of SHGs. There is a need of wise and trusted guidance. Our role could be to enhance the skills of the poor for generating income. Moreover, our role is to raise their morale, suppress the depression to save them from diseases, raise standard of living, develop better relations with members, to invest for better health and education of children, to construct houses, to free them from the yoke of money lenders and shift them from bonded labour to paid employment. Let their children go to schools in early hours.

In my opinion we should not impose conditions of ceiling of Rs 25000 per member and repayment of money by 24 months. We have formed a large number of SHGs of landless poor people, for more information on this please visit: www.Shgwealth.org.

We should allow SHG members to have full freedom of borrowing to invest in the existing ventures or let them start new ventures. I always preferred to allow overdraft limits instead of loan for recycling of funds to earn more in a short period because after every 6 months there is a new demand for investments. The land and machinery played a significant role in raising the income and standard of living. The purpose of the banks should be to serve the poor without discrimination. We should also look at the economics of the interest rates – in case the SHGs are provided credit on higher interest rates how are they going to charge less rates amongst their groups? There is a need to separately look at the interests of the SHGs, farmer's club etc.

We installed the institution of farmers club to play a role of guardian for self help groups. There is a need to have a concept of Group Insurance that can look into the disaster funds, to help in sickness, old age and at death. Federation should be established to watch the exploitation on account of high rate of interest and adverse policies. It will also help in short listing documents at the time of linkage and will create honest dealing.

Moreover there is a need to honor and reward the good SHGs for their achievements. I would like to share my views on micro credit with the members, to read more please visit: ftp://ftp.solutionexchange.net.in/public/mf/cr/res01121001.pdf (PDF; Size: 1.17 MB).

Savita Shankar, National University of Singapore, Singapore

Professor Mukul Asher and I have written an article - 'Control, micromanagement will be counterproductive for microfinance sector'. The article was published in DNA newspaper on 2 February 2011. It reflects our opinion on the Malegam Committee Report

Please see below the excerpts taken from the article.

The mindset of control and micromanagement visible in the Malegam Committee's report is likely to inhibit dynamism and innovations in the microfinance sector.

The committee, appointed by the Reserve Bank of India (RBI) "to study issues and concerns in the microfinance sector," submitted its report on January 19.

The report has justifiably elicited many critical reactions.

Given the mandate, the committee's recommendations relate to microfinance institutions (MFIs), which are non-banking financial companies (NBFCs). NBFC-MFIs account for only 34% (Rs18,300 crore) of the microfinance loans outstanding in India. Self help group-bank linkages and other institutional structures such as societies, trusts and cooperatives account for 58% and 8% of loans in India, respectively.

As the report covers only a part of the microfinance sector, additional inputs will be needed to promote uniform regulation for the entire sector. The report does make some positive contributions.

First, it makes a case for creating a separate category of NBFC-MFIs so as to enable the specialised treatment that MFIs require as compared to other NBFCs, due to the population sub-group they serve.

Second, it suggests that MFIs should be free to decide whether to collect installments on a weekly, fortnightly or monthly basis. This is in contrast to the Andhra Pradesh (AP) MFI Act which mandates only monthly repayment. Studies have indicated that for sections of low income groups, weekly repayment of loans is appropriate.

They experience difficulties in holding surplus cash, primarily due to their inability to conveniently access savings accounts. The heterogeneous nature of low income groups with varying cash flow patterns, necessitates multiple models of microfinance instead of a "one size fits all" solution.

Third, the report specifically states that NBFC-MFIs should be exempt from the provisions of Money-Lending Acts. Such an exemption will prevent the misuse of such Acts by state governments to pursue short term partisan objectives at the expense of public interest.

Fourth, continued priority sector status recommended for the microfinance sector augurs well for continued availability of funding for MFIs.
Fifth, the report points out the drawbacks in the draft Microfinance Bill and the Andhra Pradesh MFIs Act. It recognizes the conflict of interest inherent if NABARD, a sector participant, also becomes a regulator.

Finally, the report suggests standardization in quoting interest rates; mandatory participation of MFIs in credit bureaus; and introduction of corporate governance norms for MFIs. These are urgently needed if the Indian microfinance sector is to reach its potential.

However, a number of the report's suggestions also have severely negative implications both for the MFIs and their members.

To read the full article, please visit: http://www.dnaindia.com/money/column_control-micromanagement-will-be-counterproductive-for-microfinance-sector_1501984

Ramesh S Arunachalam, Independent Microfinance Practitioner, Chennai *(response* 2)

A recent interview by Mr. Yezdi Malegam indicates that consolidation of the microfinance industry may be good as it helps MFIs to grow large and reduce costs for their clients and also reduces the risks for the banks. (http://www.business-standard.com/india/news/qa-y-h-malegam-chairman-malegam-committee/424720/). There appear to be several disadvantages to consolidation of the microfinance industry in India and I would like to **humbly** put across alternative views to Mr. Malegam, The RBI Sub Committee and the RBI -

First, the Indian microfinance industry is already highly consolidated with a few large MFIs holding substantial portfolio. Further consolidation will ensure that MFIs may not reach out to hard to reach areas or lower income (poorer) clients who are most often served by smaller MFIs and NGOs.

Second, I am not sure if increasing size beyond a point actually reduces the interest rate to clients (that is my understanding) or reduces risk. Increased size, on the other hand, may pose its own challenges for the MFIs concerned:

Need for good middle management: While smaller MFIs may be able to supervise operations from the head office directly, large MFIs perhaps may need to hire several layers of a new cadre of middle management, despite presence of outreach technology. Often this cadre, would have to come from business schools and with the intense competition for such candidates from the all other industries, the salaries need to be much higher than what is paid by MFIs. And it may also be hard to train the field staff to take on this role. CGAP's paper on growth and vulnerabilities in microfinance (http://www.cgap.org/gm/document-1.9.42393/FN61.pdf) and studies of large scale microfinance defaults in Pakistan indicate that when faced a large scale default, an MFI that paid attention to its internal supervisory capacity avoided the default while other MFIs that did not suffered seriously. Needless to say, similar things have happened in India and please see the following posts (http://microfinance-in-india.blogspot.com/search/label/Microfinance%20Frauds and http://microfinance-in-india.blogspot.com/search/label/Micro-Finance%20Agents).

Standardization of products and procedures: Increased size puts greater focus on standardization of procedures and often the organization can get far removed from its clients, as is presently the case and as Mr. Vijay Mahajan's yatra is perhaps likely to demonstrate. Thus very large MFIs may not be able to customize products to meet clients' needs.

Listening to client needs: In banks, most employees across all levels are from graduates or post graduates and professionally qualified. Thus junior staff is able to articulate their views reasonably well to their seniors. But in an MFI there can be a huge difference in the qualifications and significant difference of power between junior staff and senior management of the MFI. Thus a junior staff at an MFI is likely to find it much harder to get his or her views across to senior management as compared to junior staff at a bank. Thus MFIs run the risk of becoming very top down organizations and head office driven as compared to banks. This could result in situations where field staff may become less sensitive to their clients in the face of too much pressure from the superiors and the head office. Something that has happened during the period April 2007 to March 2009

Build excellent MIS systems and processes: As the organization becomes large, the MFI needs to build even more complex MIS systems and establish more intricate processes. This requires more people with specialized skills in areas like IT etc. and that may add to the complexity and increase costs to the organization. I am not sure if technology is a real cost reducer, at least, from the current situation of scale reached and technologies available and operational. Besides, in most Indian MFIs, technology is still at its infancy. Please see related post on that: http://microfinance-in-india.blogspot.com/2010/11/understanding-state-of-management.html

Third creating large MFIs poses challenges for banks to supervise and monitor as well. This poses a unique set of challenges:

Monitoring a large MFI working in multiple states becomes complex: Thus even if the relationship manager of the bank were to monitor the MFI by meeting the MFI's clients in a few branches, it would just be a few clients or branches located close to MFIS head office or the relationship managers base location. Travelling to multiple MFI locations would be expensive for the bank's relationship manager and is likely to minimal. I have practically observed this over the last few years

Diffuse accountability for the MFI within the bank: Credit decisions for large MFIs tend to be larger and thus decisions on approving credit are likely to be taken up at senior management levels. Thus accountability for anything going wrong with the MFI is diffuse as multiple senior management staff are involved in the credit decision. This also puts a lower accountability on the bank's relationship manager to monitor the MFI and report any serious incidences to senior management. This is a very practical issue

MFIs bargaining power with banks makes monitoring difficult: As MFIs become large, they possess much higher bargaining power with banks making it difficult for banks to monitor them. Some promoters may misuse the power. E.g. It is reported that before the crisis some promoters of large MFIs would not meet relationship managers or in some cases even senior bank personnel. Such meetings were delegated to other managers at the MFI. The MFI promoters would only meet Managing Director of the bank. In such a situation, one can imagine the challenges posed in monitoring large MFIs. My dairy is replete with examples and situations like this. I am sorry but I am unable to share names for obvious reasons…

Too big to fail: Sometimes the organization becomes too large to fail. Its failure could have implications on the balance sheet of its lending banks. Thus the banks are forced to keep the MFI going even if they foresee problems. However in case of small MFIS, the impact due to a failure of a small MFI will be very insignificant on a bank, thus the bank can pull up a small MFIs in case it foresees problems. This is again something that we have seen in practice in the financial services industry including micro-finance

Fourth, the ability of a client to repay her loan also depends on the livelihood activities of the clients and/or their families. While some large MFIs like Basix are involved in livelihood activities with good intentions, it may not be possible and/or advisable for all large MFIs to adopt this approach for various reasons. (http://www.microfinancegateway.org/p/site/m/template.rc/1.26.9134/).

Prof. Malcolm Harper clarifies this aspect in one of his previous interviews: "The second regret is that BASIX had not focused our activities in fewer locations so that we could say look at this place not even a district, but even one block or two which had been somewhat revolutionized by our impact. There are good reasons for being all over the place, from Rajasthan to Jharkhand to Tamil Nadu, never mind our center in Andhra Pradesh. But it is expensive, time consuming, and impact-diluting to be scattered although I supported that strategy in the beginning because it is good to take microfinance to underserved places."

Thus there is considerable merit for smaller MFIs which are very local and that could potentially transform a place by offering a whole range of financial and livelihood services.

Fifth, having a wide variety of MFIs to choose from gives the clients better choice. They could work with MFIs that offer only financial services or work with other organizations that offer financial, livelihood and developmental services.

While there are strong merits for adequate capitalization of deposit taking institutions since depositors need to be protected, increasing entry barriers for entering microcredit such as increasing the capital needed for NBFCs MFIs will largely keep civil society out (which is typically more interested in a developmental and client focused agenda out of microfinance) and make it an activity for pure play commercial players. Further consolidation of MFIs also may not (therefore) necessarily bring the desired benefits to all the stakeholders involved.

Subhash C Wadhwa, Development Consultant, Mumbai

Please see below my comments on the important recommendations of the Malegam Committee on MFIs.

Andhra MFIs crisis actually was noticed in 2005-06. It was a blessing in disguise and gave opportunity to take corrective actions by MFIs as well as other stakeholders, including state and central Government, NABARD and RBI. It was expected that MFIs would revisit their objective clause and mission statements. In most cases, there is clear and explicit mention about helping the poor in coming out of poverty. MFIs were expected to review their present policies and operations as to how they are in conformity with their objectives and mission. Although some actions were taken by a few MFIs, in most cases, their operations gave impressions that more and more MFIs are becoming exploitative and profiteering institutions. The action of Andhra Pradesh state Government in issuing ordinance brought MFI operations, including, recoveries and fresh loaning to poor to almost a halt.

The action of RBI in appointing Malegam Committee was timely and essential. The Committee has tried to address most of the relevant issues/aspects connected with operations of MFIs. By and large its recommendations are going to be helpful in sound operations and regulation of MFIs. However, some of the recommendations need further clarifications and/or alteration for their effective implementation to achieve the basic objectives of MFIs. Based on my vast national and international experience in the Microfinance sector and from the angle of practicability of implementation, I am giving below my brief comments/suggestions as per the order in the summary of recommendations of the Report:

S.No.1 and 2 – Para 3.8 & 4.2 Creation of separate category of NBFC-MFI is welcome step and help in focused attention on MFI s operations.

S.No.3 –para 5.9-i How to determine annual income? Rs. 50,000 may be ok in the beginning. After 2-3 cycles, annual income may normally go up and in some cases cross Rs.50,000. At that borrower and MFI are happy with each other they may continued to be financed by MFI. Similarly, the loan amount could be less than Rs. 25,000 till first 2 or 3 cycles. Subsequently, borrowers' requirements may go up and if MFI is satisfied loans amount higher than Rs. 25,000 may also be disbursed.

Para-5.9-v. it is generally observed that initially around 50% to 70% of microfinance loans by poor are used for emergent consumption, health and social needs. Subsequently, this automatically goes down to 20% to 25% and remaining 75% to 80% is used for productive purposes. Therefore insistence on 75% of loan for income generating activities may be difficult to implement. It may force the poor to continue to go to money lender for their emergent consumption, health and social need and pay much higher interest rates.

S.No.4 Para 5.10 It needs to be clarified whether smaller MFO like NGO, Trusts, Cooperatives, Section 25 Companies, etc will continue to provide microfinance loans. The desirability of their being regulated and if so how has to be looked into.

S.No.5-para 7.11 Fixing of margin of 10-12% and interest cap of 24% is quite reasonable and crucial recommendation and should not be diluted in view of opposition by some of the MFIs. No democratic socio political system will ultimately permit charging high interest rates of 30 to 40% from poor, while industry is able to get huge loans at 10-12%. Further which Income Generating Activities (IGAs) undertaken by poor gives such high return to repay loans with 30-40% interest? At the same time MFIs need to be provided loans by banks at reasonable interest. As 80% of MFIs resources in India come from banks, RBI and GoI may ensure that interest charge by banks from MFI is also capped at around 12%. Most of the cost on appraisal, supervision and recoveries of small loans is incurred by MFIs and transaction cost of banks is very low as compared to direct loans by banks to individuals. Besides, NPAs on loans to MFIs has been negligible (recent fall in recoveries after AP crisis is an aberration). Further, the loans to MFIs by banks would continue to be part of priority sector lending. Thus, there is a strong case for charging lower interest by banks from MFIs.

S.No. 6 -para 8.7 Recommendations regarding transparency are important and MFIs need to follow them strictly. Further, MFIs should normally follow reducing balance method while charging interest from borrowers. If for the reasons of simplicity of operations any MFI charges on Flat Rate system, this fact should be clearly mentioned along with the effective interest rates as per reducing balance method. In past, some MFIs have not been transparent in this regard with the result interest rate shown at 1.5 to 2% per month or 18 to 24% per annum actually turned out to be 35 to 40% per annum.

S.No.9-para 10.5 Recommendations regarding Credit Information Bureau is welcome. The problem will be who will bear the charges? MFIs may find it difficult to bear out of their capped margins and passing on poor borrowers may not be desirable. Further, what about micro loans provided by non NBFC-MFIs, like section 25 companies, trusts, NGOs, Cooperatives, etc.?

S.No. 10- para 11.2

a) & b) Non use of coercive methods for recoveries is important and welcome. In fact with peer pressure as the key for microfinance loans with JLG/SHG approach, there should no scope for coercive methods by MFIs for recoveries. MFIs need to devote little more time for awareness building on aspects of peer pressure and joint liability before sanctioning loans.

c) The recommendation regarding non recovery by field staff at borrower residence and place of work may go against the very strong points of MFIs with door step lending and recoveries. In fact many borrowers find it very convenient when field staffs of MFI come every week/fortnight to collect instalment. Asking them to go to MFI branch to repay would be inconvenient and may lead to postponement and ultimately defaults. This recommendations need to be relooked. The above recomendations at a) and b) should be sufficient for the time being.

S.No. 19- para 19.5 the coverage advances to MFIs by banks under Priority sector lending is welcome as it help in larger flow of credit to microfinance sector. Besides advances to NBFC-MFIs, the Microfinance loans to other smaller MFOs like section 25 Company, NGOs, Trusts, etc should also qualify for priority sector lending.

S.No. 21- para 21.4 Recommendations for funding of MFIs by creating a ‘Domestic Social Fund’ is innovative and desirable in Indian context. Such funds would help to reduce the over all cost of funds of MFIs and ultimate lending rates.

Another way to reduce the cost of funds is to allow the regulated MFIs to collect savings from its borrowing members. Although Committee has opposed provision of thrift services by MFIs, there is need to reconsider this. SHGs- banks linkage model has helped in substantial savings by poor with banks. This will provide avenue for one of the important financial services under ‘Financial Inclusion’ i.e., savings by the poor. Saving has also been found as binding force for the JLG and SHG and reduces the chances of defaults. Besides, it will reduce the cost of funds of MFIs which will help them in bringing down their interest on lending. It will also stop the wrong practice adopted by some of the MFIs of collecting savings from its borrowers in the name of their mutual benefit trusts, mutually aided cooperative societies, etc used for funding MFIs. Necessary safeguards to protect the interest of depositors may be introduced.

While dealing with poor for income generation, besides availability of timely credit, there is need to provide them with training for entrepreneurship and skill for undertaking the IGAs. It may not be possible for most of the MFIs to provide such inputs out of their margins. It is therefore, suggested that some grant fund may be created with contribution from central govt, state govt, banks and Domestic Social Fund recommended by the Committee. Such training and extension support could be provided with the help of NGOs and state govt line departments. Some of MFIs have their own wings for such activities. They could also be roped in.

S. No. 24-para 24.7 As regards regulation of MFIs, normally one would have suggested the RBI as the regulator. However, looking to the large number, it would be next to impossible for a central bank to pay the desired attention to the sector. More so, when it is engaged in more important and crucial responsibility of overall monetary and financial sector reforms and supervision and regulation of one of largest banking network, inflation, etc. Further, the regulator of Microfinance sector not only requires regulation but also developmental approach while dealing with various issues credit to poor for helping them toward sustainable poverty alleviation. It is therefore suggested that as proposed under the Micro Finance (Development and Regulation) Bill2010, NABARD may be the agency responsible for development and regulation of MFIs. NABARD with active guidance and support of RBI, has done pioneering work under SHGs-banks linkage programme, which is now the largest microfinance programme in the world covering about 100 million poor. They have also started supporting MFIs for their capacity building, share capital and revolving fund. They have also been undertaking supervision of RRBs and Cooperative banks since inception. As such NABARD may be more appropriate agency for development, supervision and regulation of microfinance sector. It is understood that one of NABARD's subsidiary in Karnataka is undertaking Microfinance activities. In case NABARD is assigned the task of Regulator of MFIs, it may have to stop microfinance activities or totally delink from NABARD. Besides, representative of SIDBI-SFMC may also be taken on the Supervisory Board in view of their experience and involvement in large number of MFIs. Further, the desirability of bringing smaller MFOs also under some sort of basic supervision (may not be strict regulation) may also be examined. In any case, as recommended by the Committee, there must be close coordination and consultation between NABARD and RBI for formulation of the regulations for MFIs.

As stated earlier, SHGs-banks linkage programme has been successful and beneficial to all stakeholders under Indian conditions with largest branch network of banks. There is need to revive the emphasis on that model which not merely deals with access of credit to poor at low cost, but also leads to better income generation through convergence and overall empowerment of poor, particularly women. It is a slow and time consuming but effective process. Besides motivated bankers, it requires support of good NGOs with appropriate funding support. Therefore, we also need to supplement it by MFIs model for faster and deeper outreach to poor for covering large number of financially excluded in rural as well as urban areas.

Stefan Pellech, Intellecap, Hyderabad

Intellecap, the social investment advisory firm based in India, has drafted a white paper in response to the Malegam Committee's recommendations in India. This paper represents Intellecap's effort to examine the Committee's recommendations for the private-sector commercial microfinance industry, some questions that they raise and their impact on the industry.

To read the paper, please visit:
http://intellecap.com/assets/89/Response_to_Malegam_Committee_Reco_Intellecap_White_Paper-February_2011.pdf.

N. L. Narasimha Reddy and Shailey Tucker, Poverty Learning Foundation, Hyderabad

Poverty Learning Foundation (PLF) is a research and support services organization based in Andhra Pradesh, engages in the fields of poverty, microfinance, NRM-based livelihoods, climate change, and migration. After having conducted a study to better understand the people's views on microfinance, PLF has shared its comments and recommendations on the Malegam Committee Report with the RBI.

To read our major recommendations, please visit:
ftp://ftp.solutionexchange.net.in/public/mf/cr/res25011101.pdf

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G K Agrawal, Rural Development and Microfinance Consultant, Mumbai

My comments on the Malegam committee report are as under:

Andhra Pradesh Government harsh Ordinance on MFIs and later appointment of Malagam Committee on MFIs by RBI were consequent to the overlooking of socio-economic interests of poor for which MFIs were intended to serve. Some of the other issues were: greedy desire of profiteering, high dividend, desire to serve the equity holders with ever increasing expectations of higher financial returns, multiple lending without taking into account the repaying capacity of the poor borrowers and the use of coercive measures to jack up recovery performance and high salary of senior executives and bonus.

Considering the recommendations of the Committee having a far reaching effect, expectations of MFIs and poor, it may be a challenge as well an opportunity for the RBI to meet both ends i.e., financial inclusion and interests of poor, financial sustainability of MFIs, accountability and transparency in the operations of MFIs, regulatory and supervisory needs for MFIs, healthy growth of MFIs, etc. Also, the Committee would appear to have made its recommendations to NBFCs working as MFIs. RBI would have to take a view as to how its recommendations can be per se made applicable to NGOs/ non profit making companies, cooperatives and Section 25 companies engaged in Micro finance both for financial norms and regulation/supervision.

My specific comments on some of the important recommendations of the Malegam Committee Report, as per the order in the summary of recommendations of the Report are as under:

- S.No.1 and 2 – Para 3.8 & 4.2 and S.No.4 Para 5.10 Creation of separate category of NBFC-MFI: It is a welcome recommendation of the Committee which the MFIs were insisting also and they should be happy to get a recognition/acceptance of their contribution. However, it is to be seen as to how Non NBFC MFIs, like NGOs/ Non profit making organizations /Sec 25 companies engaged partly or otherwise in providing micro finance under the SHG - Bank Linkage programme or otherwise can be brought into fold.
- S.No.3 –para 5.9 (b) -i- For start up financing of poor, ceiling of annual income at Rs. 50000 may be considered reasonable; however, as the income level goes up due to various schemes of Central/state government, engagement in income earning activities and taking into account inflation rate, there has to be a built in provision for enhancing the ceiling on annual income of poor to be eligible for MFI loaning.
- Para-5.9(b) v. Insistence on 75% of loan for income generating activities may be an harsh and impracticable proposition as the poor has to first satisfy his consumption, social, health financial needs before taking up income generating activities. Also, any income generating activities are, to be successful, to have tie up for backward and forward linkages including capacity building of entrepreneurs. Over a period of time depending upon the local empowerment, consumption loaning can be suitably tapered down. Even otherwise, banks are financing housing loans, white goods, vehicle loans which are not per se income generating activities.
- S.No.5-para 7.11 Fixing of margin of 10-12% and interest cap of 24%: This should be considered adequate. MFIs can not be allowed to exploit Poor in the names of reaching inaccessible areas, unbanked area, high cost of retail operations, sustainability, and financial viability. There has to be clear demarcation and reasonable balance between reasonable profit earning and greedy profiteering on one side and the poors' interest. However, good working MFIs is to be ensured by

RBI with reasonable liquidity in the form of loanable funds by banks at reasonable rates of interest. There is no reason to believe otherwise as banks' lending to MFIs is reckoned to wards targets for Priority Sector lending by banks and banks should not find it difficult to meet legitimate fund requirements for loans of good working MFIs.

- S.No. 6 -para 8.6/8.7 Recommendations regarding transparency : There has to be transparency and accountability, good governance , basically in introducing pro poor lending policies, charging of interest and other charges etc. by MFIs. As a rule, MFIs should charge interest on loans on reducing balance as against flat rate of interest charged by a number of MFIs.
- S.No.9-para 10.5 Recommendations regarding Credit Information Bureau: it is a welcome recommendation. Issues of cost sharing, management, information collection relating to non NBFC MFIs are to be sorted out.
- S.No. 10- para 11.2 & b) Non use of coercive methods for recoveries - it must be strictly enforced but how? Peer pressures, borrowers' awareness of repayment ethics to be increased.
- Recommendation regarding non recovery by field staff at borrower residence and place of work: It may result in self destruction mode of MFIs in establishing personal contacts with the borrowers and also result in cost in the form of time and wage loss of the borrowers in going to the office of MFI frequently and may increase loan defaults. One should not object if field staff is deputed to disburse and recover loans at the door steps of the borrowers, without any hidden coercive agenda.
- S.No. 21- para 21.4 Recommendations for funding of MFIs by creating a 'Domestic Social Fund': Modalities for its contribution and its uses and administration, capacity building including training and awareness both of MFI staff and borrowers may have to be worked out after discussions with the stake holders but ensuring that there is no financial burden on MFIs.
- S. No. 24-para 24.7 Regulation of MFIs_ the Committee would appear to be intending that regulation and supervision of NBFC MFIs will be done by RBI as it is already regulating NBFCs otherwise. The Press Reports would suggest that GOI, MOF would appear to have shelved the idea of introducing the Bill to regulate working of MFIs because of Committee's recommendations. Considering the intricacies of micro lending and the stiff conditionality proposed by the committee, the large number of MFIs, and their wide spread operations, it will be a challenge and opportunity for RBI to take over total responsibility of regulating MFIs both NBFCs and Others such as NGOs, not profit organizations, section 25 companies. Ideally, there has to be one Regulator and Supervisor for the entire MFI sector both NBFC and others. If for any reason it is not possible for RBI to confine its supervision and regulation to NBFC MFIs, there has to the some other organization like NABARD (which was proposed in the draft Bill) and is already inspecting /supervising Cooperative banks and RRBs on behalf of RBI, to be designated as Regulator for Non NBFC MFIs ; however in that case it has to be ensured that NABARD's promotional, developmental and financing interest of Micro finance especially SHG Bank linkage and other group lending programmes do not clash and come in conflict with regulatory and supervisory obligations and responsibilities. What so ever RBI/GOI decides, the matter of regulation of MFI activities need not be delayed. One alternative can be to constitute another independent regulatory authority like SEBI, IRDA, NHB to exercise control, supervision and give visionary direction to the entire MFI sector.

MFIs should not be seen as a parallel financial inter-mediation but as a supplementary channel to the main banking channel for financial inclusion, improving access of credit and other financial services to the poor especially to unreached/under-served poor both in rural and urban/semi urban areas and bringing them in the banking fold both for their saving mobilization and meeting credit needs including consumption, income generating, housing and other micro financial services at reasonable cost treating the whole approach as social business opportunity different from purely commercial profiteering approach but maintaining financial sustainability, accountability, transparency, good governance in the MFI lending system.

N.Jeyaseelan, Hand in Hand, Chennai

I would like to share my comments on the Malegam committee recommendations. The views expressed herein below are my personal and need not represent the views of my organization to which I belong.

What are the strengths of the various recommendations made in the Malegam report?

- It enhances stakeholders confidence in the sector
- Announcement of RBI as Single regulator for NBFC –MFIs (avoiding role of state)
- Exemption from Money lenders act to NBFC MFIs (State law)
- Retention of Priority sector status to the Bank's lending to MFIs
- Creation of credit bureau for sharing credit information
- Prescription of rates and margin cap 10/12% - Transparency on pricing (interest rate and processing fee
- Thrust on SHG bank linkage
- Longer tenor for based on loan size with holiday period
- Grievances redressal mechanism -Lead Bank officer as Ombudsman
- Avoiding coercive collection practices.
- Increase in net worth of MFIs – a filter to allow entry only to those with long term interest and will lead to consolidation in the sector
- Social capital fund to fund MFIs with focus on social performance
- Creation of Credit Bureau to share credit information.

What gaps (if any) exist in the Malegam committee report and how it can be addressed?

Gap: Restrictive definition (Qualifying clauses like: viz. Loan amount ceiling: Rs.25000, clients with a household income of less than Rs.50,000) for NBFC –MFI

Solution: - Restrictive clauses to be removed

Gap: Restricting two loans only to members. Restricting to two sources will lead to increased dependence on informal sources (money lenders)

Solution: - Access to credit is their basic right. Loan (Number of loan and amount) sanction to be linked to the member's need and capacity to repay.

Gap: Income ceiling for member's household –not to exceed Rs.50,000 per annum

Solution: - The ceiling may be prescribed at an individual member level and not at the Household level, as it is very difficult to determine the household income. The ceiling of income may be taken into account only for the first time at entry level. (During repeat loan cycles, their income is bound to go up).

Gap: Sharp drop in return and profitability will affect the inflow of risk capital into the sector in the long term

Solution: - Existing MF development and equity fund should be liberally used to assist small MFIs to receive the risk capital.

Integrity, Transparency and governance should be given due thrust and eligible MFIs to be given risk capital.

Gap: Increased operational cost (as MFIs need to reorganize their operational processes and to train their staff in the new methodology)

Solution: - MFIs need to be given larger support for building their staff capacity in new processes e.g. cash flow based appraisal techniques and so on.

Gap: When MFI's lending rate is capped, bank rate to MFI is not capped.(During the recent policy review by RBI on 25th Jan, repo rates has gone up by 0.25% and subsequently most of the banks raised their lending rates by 0.5%. Now this is becoming as routine in most of the quarters).

Solution: - Even though RBI has deregulated the interest rate structure in banks, for lending to MFIs by banks, a maximum ceiling to Banks may be prescribed e.g. 12%. This will enable them to maintain their rates to the end client at 24%.

Gap: Member cannot be in more than one SHG/JLG. Then how two MFIs can lend to the member?

Solution: one member may in one SHG and another JLG (to meet the additional credit demand).

Gap: Other legal form of MFIs to come under NABARD and registration is for only those with more than 10 crore.

Solution: As NABARD is having its District Development Manager's office in all district HQs, all MFIs need to be registered with them to keep a control on them and to enforce the basic regulations.

Gap: Provision for putting financial statements of MFIs in public domain. (Like Mix market website in Local language).

Solution: Sharing the financials in public will add to credibility and protect the interests of ethical MFIs and the client's interests.

Gap: Collecting insurance premium in periods will be difficult.

Solution: - Upfront collection of only premium may be permitted.

Gap: Ceiling of interest rate at 24% with out any scope for review periodically.

Solution: Even though prescribing Interest rate cap is a barrier in the development of the sector, as the self regulation failed among the players and to protect MFIs from the other stakeholders (political risks) interest rate cap is very much essential now and the cap may be reviewed every year taking into account the inflation and other macro economic factors.

Which recommendations in your opinions should be taken up by the RBI?

- Registration with RBI and NABARD to protect from the Political risk
- Interest rate ceiling
- Loan product design -repayment period and holiday period
- Ombudsman
- Credit bureau as common for all MFIs (and not as only for MFIN members)
- Avoiding coercive collection practices
- Creation of social capital fund
- Using MF development and equity fund at optimum level

If the recommendations mentioned in the report are accepted, what implementation challenges are likely to exist and how can they be overcome?

Challenges:

- Time frame for change to new regulations w.e.f 1.4.2011 may be difficult.

Way forward:

- Time frame for each major change may be indicated. e.g. Interest rate ceiling within I Half of 2011-12 and Capital adequacy in three years time i.e. by March 2014.

Ajimon L., EMFIL, Thrissur, Kerala

I am directly involved in microfinance operations in southern part of Kerala. Now a days there is a discussions on Mr. Yezdi Melagam committee report for the improvements of microfinance industry by way of reducing the financial loss to the sangam members and giving maximum protection to the bankers and reducing the risk involved in the lending process. In our situation, most of the high portfolio holding MFI companies are not considering the ultimate aim or motto , all the microfinance companies or NGOs are targeting the poor people and their developments by way of increasing standard of living and making changes in their infrastructural nature, increasing the loan size not reduce the interest factor for poor clients , it will directly affect their repayment ability.

NGOs are concerned that it will lead to overdue in future, if we think from the bankers point of view risk factor will increase, big companies will not at all reach the real clients at door step. Due to recovery problem, we need to cultivate the culture for saving and asset creation at the grass root level to see the changes that are needed for the people living below poverty line.

Micro finance operations in Pakistan show very sorrowful things. I think that it happened due to improper criteria selection and monitoring the operations through trained people for handling the poor people and their problem solving approach. This situation might have lead to situation of default. If we have trained staff, controlling system software and proper MIS, it can sustain the microfinance operations as per our motto up to a certain level. Most important factor is that the management can take time for listening the needs of the customers then act accordingly for their improvements.

Rahul Kumar, Mimo Finance, New Delhi

I have written an article on 'Some flaws in the Malegam report' for Business Line, and it was published on 25 February 2011. I would like to share this with the members of the Microfinance Community.

The objectives of the Malegam report are to protect the microfinance borrower, promote the SHG-bank linkage programme in preference to the MFI-JLG (Joint Liability Group) programme, ensure credit supply to the MFI-JLG programme, and protect the stake of banks and FIs in the microfinance sector.

The broad objectives are diverse and finding a balanced solution is a difficult task. The Committee's observations are not without shortcomings.

BIG NBFCs BENEFIT

The committee recommends that for NBFCs to become NBFC-MFIs, 90 per cent of their total assets (excluding cash and cash equivalent) should be for microfinance activity.

On the contrary, it permits other NBFCs to engage in microfinance up to a cap of 10 per cent of total assets without specific regulation. The big NBFCs have an asset size of over Rs 10,000 crore. Ten per cent of such a size is bigger than the assets of the fifth biggest MFI in microfinance.

Big NBFCs can carry on microfinance on a scale larger than the current microfinance players without regulatory oversight. While the provision is obviously intended to encourage scale in microfinance it restricts the scope of product diversification of NBFC-MFIs.

This lack of flexibility of NBFC-MFIs, compared with the freedom of regular NBFCs, will allow them to gradually take over the market while functioning in an unfettered manner.

BORROWING LIMIT

To prevent over-borrowing, the committee restricts the individual loan size to Rs 25,000. The aggregate outstanding loans of a borrower are restricted to Rs 25,000. The tenure of the loan is aligned with the borrower's cash flow.

The committee mandates that 75 per cent of the loans by MFIs should be for income-generation purposes, and leaves the repayment frequency (weekly/fortnightly/ monthly) to the choice of the borrower.

However, the limit of Rs 25,000 is too low to procure income-generating assets, or to protect the borrower from negative market or environmental shocks. In effect, the recommendation may drive borrowers to borrow from informal sources.

The committee does not clearly define the scope of loans for income-generating purposes.

On the repayment frequency, the committee's suggestions contrast with the JLG model, in which group decision prevails over that of the individual to ensure joint liability of repayment.

INTEREST RATE CAP

The third objective targets the growth of MFI-JLG programme because the factors driving the growth are found to be unjust.

The Committee recommends an interest rate cap to curb the growth. The interest rate cap is 24 per cent, subject to the net interest margin cap (difference between the amount charged to the borrower and the cost of funds to the MFI).

The net interest margin cap is 10 per cent for the larger MFIs (loan portfolio exceeding Rs 100 crore) and 12 per cent for the smaller MFIs (loan portfolio up to Rs 100 crore).

The margin cap applies at an aggregate level for the MFIs. The committee arrived at a normative cost structure to prescribe the margin cap with an overall interest cap.

The interest cap does not compensate for the higher cost of operation in remote areas. The committee's view to restrict scope of securitisation for NBFC-MFIs will burden traditional sources of debt and equity funds. The committee allows only corporates with a minimum net worth of Rs. 15 crore to become NBFC-MFIs. The suggestion is intended to induce economies of scale and better monitoring and control.

CAPITAL ADEQUACY

To protect the stake of banks and FIs, the committee recommends provisioning norms and capital adequacy norms. NBFC-MFI is required to maintain an aggregate provision for loan losses, which is the higher of 1 per cent of the outstanding portfolio or 50 per cent of the aggregate loan installments which are overdue between 90 to 180 days and 100 per cent of the aggregate loan installments which are overdue beyond 180 days.

The capital adequacy ratio is 15 per cent and all of the net owned funds should be in the form of Tier I Capital.

The provision is inconsistent with RBI Master Circular on Capital Adequacy. The de-recognition of the Tier II capital and other instruments of Tier I capital will prevent the broad basing of the capital structure of NBFC-MFI.

PRIORITY LENDING

The committee feels that the regulatory standards will meet the objectives and, therefore, allows priority sector lending status for bank lending to MFI.

However, the committee fails to give specific direction to precipitate bank lending. A specific allocation of 10 per cent of 40 per cent limit of priority sector lending of banks through revision in RBI Circular on Lending to Priority Sector is realistic.

On the funding source for NBFC-MFIs, the committee emphasizes setting up a "Domestic Social Capital Fund" for "Social Investors". The idea has limited relevance without clear guidelines for the fund to operate. Specific invitation to banks and government institutions to participate in the fund may ensure its success.

The recommendations may be seen as a useful framework of guidelines to regulate NBFC-MFI, but one that needs to be strengthened to facilitate the growth of microfinance.

Many thanks to all who contributed to this query!

If you have further information to share on this topic, please send it to Solution Exchange for the Microfinance Community in India at se-mf@solutionexchange-un.net.in with the subject heading "Re: [se-mf] Query: Malegam Committee Report on Microfinance - Advice. Additional Reply."

Poverty

Microfinance Community

Vision of Microfinance Community

The Microfinance Community is working to provide solutions to the day-to-day challenges faced in providing microfinance services to the poor, thereby helping attain the Government of India's poverty reduction targets

Focus Areas

- Strategies for building an inclusive and equitable financial sector
- Financial Sustainability versus outreach – balancing commercial sustainability with availability of microfinance services to the poor
- Creating an enabling environment for promoting an inclusive financial sector
- Delivery mechanisms- different approaches and models of delivering financial services, and their advantages and limitations
- Product innovations and diversification of financial services
- Microfinance and Sustainable livelihoods
- Microfinance and crisis management – to smooth out income fluctuations during crisis
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