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Abstract

Recent events in India have brought a fresh focus upon the problem of regulation in the field of micro-finance. This paper delineates the three distinct aspects where government needs to play a role. The first is to protect the rights of the micro-borrower, the consumer of micro-financial services. The second is that of prudential oversight of risk-taking by firms operating in micro-finance, since this could have systemic implications. The third is a developmental role, emphasising scale-up of the micro-finance industry where the key issues are diversification of access to funds, innovations indistribution and product structure, and the use of new technologies such as credit bureaus and the UID. Each of these roles need to be placed in an existing or a new regulatory agency. There is a case forcreating a new regulatory agency which unifies the consumer protection function across all financial products.

Keywords:

financial services distribution, consumer protection, credit bureaus, securitisation

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Recent events in India have brought a fresh focus upon the problem of regulation in the field of micro-finance. This paper delineates the three distinct aspects where government needs to play a role. The first is to protect the rights of the micro-borrower, the consumer of micro-financial services. The second is that of prudential oversight of risk-taking by firms operating in micro-finance, since this could have systemic implications. The third is a developmental role, emphasising scale-up of the micro-finance industry where the key issues are diversification of access to funds, innovations in distribution and product structure, and the use of new technologies such as credit bureaus and the UID. Each of these roles need to be placed in an existing or a new regulatory agency. There is a case for creating a new regulatory agency which unifies the consumer protection function across all financial products.

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Contents

1 Introduction

In recent times, the global micro-finance industry has faced a crisis because of the heads-on clash between their original goal of poverty alleviation and the profit-maximisation goals of formal financial firms that have brought about a scale-up of the micro-finance business. In India, this crisis is compounded because these firms appear to maximise profits while simultaneously borrowing funds at Priority Sector Lending rates which have been set very low in order to benefit the poor micro-borrower.

However, this is just one factor that caused the recent liquidity crisis in Indian micro-finance. In the state of Andhra Pradesh, micro-finance institutions have been accused of lending practices that adversely affected the lives of the poor borrower, to the extent that they have been driven to suicide. This has led to government intervention with an ordinance that effectively stopped collection of micro-debt and prohibited any new micro-loans in the state. The more systemic outcome from this was the lending-freeze by the banks to the micro-finance sector, not just in the state but all across India.

The current stalemate puts into the forefront the importance and urgency of getting policy for the micro-finance sector right. It is important to ensure that the policy is not so much on the specifics of the business of micro-credit, but rather on the principles that will ensure sustained growth of the industry to achieve full financial inclusion in India. This requires focus on the overarching *mandate* for micro-finance regulation.

An examination of the current complaints against micro-finance industry practices identifies three problems: a) mis-selling of micro-credit products, b) usurious interest rates, and c) coercive debt collection practices. From the perspective of financial regulation, these issues pertain to the distribution of credit services by the MFI to the borrower. This is very different from the issue of prudential regulation of micro-finance that have been proposed as the solutions for the Indian micro-finance crisis.

Moreover, if the policy debate is to focus on achieving financial inclusion through the growth of the micro-finance industry, it must address the issue of facilitating a stable flow of funds for micro-credit transactions. For instance, it is important to ensure that a crisis in one state,does not lead to a national liquidity crisis for micro-finance activities all across the country.

Thus, policy must focus on improving the linkages of the firms with their customers by strengthening the rights of the micro-finance customer, and simultaneously, of strengthening the linkages of the firms with various funding agencies. Collective experience from financial regulation suggests the following broad focus:

1. Protect the rights of the micro-finance consumer with a primary focus on ensuring quality of financial services distribution.
2. Monitor and supervise the level of disclosure by micro-finance firms to ensure transparency about the risks in the micro-credit portfolios. This would assist funding agencies make informed decisions.
3. Promote the development of the sector by innovations in
   (a) Linkages between customer and MFI, creating an enabling framework where all types of financial services can reach those who are not financially included.
   (b) Linkages between funding agency and MFI, creating an enabling framework for all types of formal financial firms to fund micro-finance activities, not just banks.

In this paper, we examine how policy can address each of the above, in the short term to resolve the multiple crises in the micro-finance sector, and in the longer term, to address the more fundamental issue of facilitating growth that does not run afoul of the political economy of doing business with the poor.

In the short-term, mechanisms need to be put in place to deal with the crisis of trust and liquidity that the MFI industry is currently facing. Two key actions are to set up information flows of the MFI portfolios to credit bureaus, and to put in place securitisation as the main funding channel between MFIs and the formal financial sector rather than direct access between the two. The sourcing of customer information to the credit bureau can have multiple positive ramifications if it is also linked with the government's UID project.

In the long-term, policy should lead to a regulator for the distribution of all financial services. Such a regulator would fit in the existing landscape of Indian financial sector regulation more efficiently than a dedicated regulator for MFI. The focus of such a regulator would include micro-finance as part of financial service that today distributes financial products that are already regulated, but not available to the poor both because they lack access to the formal payments system and suffer a lack of awareness of such products.

While both the short-term and the long-term actions can be rapidly institutionalised, it is a problem to operationalise it within the industry. The very heterogeniety of micro-finance firms that enables the growth of the sector into areas where the banking sector does not enter, poses a problem when it comes to ensuring industry-wide standards for the disclosure required in the interface with the credit bureaus, or with the securitisation process.

An *oversight body for micro-finance* needs to be set up which is entrusted with the task of monitoring and supervising micro-finance firms so that they adhere to a pace needed to achieve the required standardisation of process, within a required time frame. The oversight body can also be the enabler through which a focus can be developed for the micro-borrowers to access existing framework for consumer protection, such as the National Consumer Dispute Redressal Commission. This oversight body should have an explicit term after which its responsibilities will be relinquished to the financial services distribution regulator when it comes into being.

Given the operational nature of this body, it should be constituted with members from the financial sector regulators whose products are likely to be distributed by the micro-finance firms such as RBI, SEBI, IRDA and PFRDA. Given the focus on micro-credit, it should also have representation from some of the state governments. The creation of the financial services distribution regulator should be the onus of the Ministry of Finance.

The paper is organised as follows: Section 2 presents an overview of the micro-finance sector in India with a focus on the policy influences in micro-finance development. In particular, we briefly discuss priority sector lending (PSL) and the role of the Andhra Pradesh government in this section. Section 3 examines the role of policy and the principles of financial sector regulation. A possible mandate for micro-finance regulation is discussed in section 4. In section 5, we discuss implementation isssues related to delivering on the mandate. A time line of actions required is charted out in section 6. Section 7 concludes.

2 Micro-finance in India

There are two models in India that link the formal financial sector with lending to low-income households that cannot afford collateral. The first is the bank-led SHG model, promoted by the State through commercial banks, which lends to groups of 10 to 20 women called the Self-Help Groups (SHGs). The other model is that of micro-finance institutions (MFIs) which are private sector entities lending to small groups similar to the SHGs. Both are based on the joint-liability-group (JLG) method.

Table 1 How households borrow, 2009-10

Centre for Monitoring Indian Economy (CMIE) runs a system named Consumer Pyramids, which is a household survey database with a panel of 140,000 households measured every quarter. Information about borrowing by these households in the four quarters of fiscal year 2009-10 is reported in this table.
The last column in the table shows the fraction of households, in each income group, who have borrowing. This varies from a fifth of the richest to a bit less than half of the poorest. The role of banks peaks at 22.8% of households with households with mean annual income of Rs.479,000. It steadily peters away when dealing with lower incomes, down to 3.1% for the poorest. SHG and MFIs have come to play an important role starting from average annual income of Rs.148,000 (6%) with a maximal role of 7.7% at a mean annual income of Rs.49,000.
Sources: Household income data is from `http://goo.gl/g0ke0` and sources of borrowing data from `http://goo.gl/yPX6U`

Category	HH count (%)	Annual income (Rs. '000)	Source of borrowing				
			Friends Family	Money lender	SHG / MFI	Bank	Any
Rich - I	0.3	1367	0.4	0.2	0.1	18.0	20.1
Rich - II	0.6	834	3.3	2.8	0.6	16.8	20.1
High middle income - I	5.6	479	9.9	8.6	2.1	22.8	30.9
High middle income - II	8.8	292	10.4	8.2	1.9	20.0	32.7
High middle income - III	9.5	209	11.8	7.8	2.3	14.2	32.2
Middle income - I	16.3	148	16.5	10.2	4.1	12.9	36.5
Middle income - II	10.2	108	20.9	13.1	6.0	10.4	40.4
Low middle income - I	22.4	77	21.5	14.6	7.0	7.3	42.1
Low middle income - II	19.3	49	24.7	14.3	7.7	5.2	42.6
Poor - I	5.2	31	29.5	14.1	7.0	4.6	46.1
Poor - II	1.8	19	30.0	13.3	6.7	3.1	44.9
Overall	100.0		20.6	12.6	5.8	9.3	39.9

Data on financial access across Indian households is relatively weak. However, existing sources strongly suggest that different models are required to reach credit access to different income segments. Table 1 shows that banks are the primary source of loans among the rich. MFI/SHG lending is found amongst the lower middle class and the poor.

Indian public policy on financial inclusion has put an enormous effort into banking, including policy interventions such as public ownership, fiscal resources, regulatory and policy focus, etc. These interventions were motivated by the claim that through these interventions, banks would reach out to the poor. As emphasised by the Raghuram Rajan report, the evidence shows that this desired outcome has not been achieved despite the steadfast application of this set of policies for over 50 years.

MFI/SHG is a small and new group of firms which have taken root in only some states. The government has only played a small role here (e.g. the absence of public ownership). Yet, MFI/SHG has come to play a bigger role than banks for the poor. This suggests that there are some valuable institutional innovations in the field of MFI/SHG (Thorat, 2007).

2.1 A quick look at Indian micro-finance

There has been a lot written about the structure and the growth of the micro-finance industry in India (Kaladhar, 1997; Nair, 2001; Basu and Srivastava, 2005; Chakrabarti, 2005). A lot about this industry mirrors the development of the global micro-finance sector (Arun and Hulme, 2008b). The studies highlight that:

- There are mainly four different types of legal structures of the Indian MFI. These are the *NGO*s, *Co-operative societies*, *Section 25 companies*, and the *Non-Banking Finance Companies* (NBFCs).[1]
- NBFC-MFIs have the largest share of the loan portfolio even though they only account for about 45% of the total number of MFIs (Srinivasan, 2010).
- There has been a significant shift from NGO-MFIs to NBFC-MFIs in the scale-up period of the last five years (Gaul, 2009). Along with this, there has been a shift in the primary sources of funding from donor-led finance to bank-led finance and, more recently, equity finance.
- The MFIs have led the accelerated growth in the micro-credit business, with 18% growth in clients and 56% growth in loans over 2009 alone (Srinivasan, 2010). Notwithstanding the high growth, the size of micro-finance sector is smaller in absolute terms than the bank-led SHGs.
- This growth been accompanied by a rise in resentment against MFIs, driven by the perception that their rapid growth has been accomplished by the use of predatory practices in taking away customers from bank-led SHG programs.

  For instance, loan amounts per poor household in Andhra Pradesh (AP) are three times that in the next largest state (Srinivasan, 2010). Public opinion views this as a sign of over-indebtedness of the poor

[1] For details on the registration and licensing status of the different legal structure, please refer to (NABARD, 2010).

caused by the MFIs, even though MFIs are not the only lenders in AP, and despite studies showing that there is considerable uncertainty about multiple borrowing from MFIs (Johnson and Meka, 2010).

Put together, these observations show a sector that is growing rapidly due to the great demand for the service they provide to customers who have need of it, but are disadvantaged in access to the formal financial sector that typically delivers it. But it also shows a sector that is increasingly vulnerable to criticism from both their competition as well as from the polity, for adversely affecting the lives of the very people who choose their services. The heart of this conflict rests in differences in perception of what are the goals of micro-finance, which we will deal with in detail in the next section.

2.2 Poverty-lending or profit maximising?

A fundamental problem that the micro-finance industry faces is the discomfort that arises in public discussion with the idea of micro-finance shifting from poverty-lending to being a part of the profit-maximising financial sector. Unfortunately, this has not been accompanied by much public discussion about how the entry of the formal financial sector into the sector has made a larger set of credit choices available to poor borrowers.

Micro-finance had started with the goals of social mobilisation of marginalised communities, particularly women. As early as 1999, there was evidence that it is difficult to scale up lending to households that are just above poverty line (Morduch, 1999). Where scale-up has been achieved, it has been with the involvement of tighter links with the formal financial sector, particularly over the last decade, when focus has shifted from credit-only to all financial services. Unfortunately, post the 2008-credit crisis, the formal financial sector is accompanied by an explicit focus on maximising profits, rather than seeking good will (Arun and Hulme, 2008a).

For instance, public discomfort was high when a Mexican MFI called *Banco Compartamos* listed equity shares in 2007. At listing, the MFI was worth US$1.6 billion.[2] In India, the first MFI that listed was SKS Micro-Finance in 2010, which was reportedly worth US$358 million at listing. A recent area of discomfort has been the entry of private equity and venture capital into the sector.[3]

[2]The same MFI was seen to be charging interest rates of around 94% before its listing.

[3]For a discussion of venture capital in the Indian micro-finance sector, please refer to (Amarnani and Amarnani, 2008).

The crux of the discomfort was about MFIs that charged high interest rates to their micro-borrowers and simultaneously earned high valuations from super-sized profits. In India, the criticism has been especially harsh about MFIs being able to borrow money at Priority Sector Lending (PSL) rates at which they earn high profits, when these have been set low to encourage enterprise in low income households. (This is discussed in greater detail in Section 2.3.1.)

Suddenly, the MFIs are being equated to the traditional money-lender, reversing all the accolades that the MFIs had earlier received for having replaced the money-lender. Matters have not been helped with rising concerns about poor management, and low corporate governance among the MFIs, both in India as well as in the rest of the world (Sriram, 2010; Lascelles, 2008).

However, it cannot be denied that the profit-maximisation goals do achieve better financial inclusion. Thus, policy today struggles with the impossible conundrum of seeking a solution to retain formal financial sector presence while simultaneously keeping profits low. In a study of MFIs around the world, Cull, Demirguc-Kunt, and Morduch (2008) find that at the median NGOs charge their borrowers 25%, while the top quarter charges 37% per year. They conclude their analysis by saying that *while commercial investment is necessary to fund the continued expansion of micro-finance, institutions with strong social missions, many taking advantage of subsidies, remain best placed to reach and serve the poorest customers.*

2.3 Policy influences in Indian micro-finance development

There have been two significant factors driving the development of the micro-finance industry in India. The first has been the implementation of the government goals of financial inclusion by setting *priority sector lending targets for banks*. The second has been the role played by the *state government of Andhra Pradesh*, a state that has been centre-stage in promoting micro-credit in India.

2.3.1 Priority Sector Lending

Financial inclusion has always been a priority for India polity, particularly given the socialist disposition of the state. With the bank nationalisation of the seventies, public sector banks and other subsidies became the chosen implementers of this policy, primarily through mandated rules on priority sector lending. This requires banks to lend between 32-40% of net bank credit to specific areas (defined as priority sectors) at a rate lower than the prime lending rate of the bank. This rate is called the *priority sector lending*, or PSL, rate.[4]

Traditionally, most PSL was targeted towards the poor engaged in agricultural or allied activities. These were monitored by the National Bank for Agriculture and Rural Development (NABARD), a department of the RBI. The definition of what PSL activities entail have been steadily modified, and today include consumption loans for weaker sections, as well as micro-loans to SHGs, either directly or through any intermediary including NGOs.[5]

Since the MFI business falls under a PSL category, they can raise loans from banks at PSL rates. In addition, MFIs can deploy these funds with more flexibility than can be done under any of the bank-led efforts since they do not face the public sector constraints of the typical Indian bank. It is a combination of this operational flexibility together with their ability to raise funds at PSL rates that has enabled the MFIs to help displace the strong hold of traditional money-lenders on indebted households. The MFI growth has been so significant that Rangarajan (2008) underlined the importance of deepening the outreach of micro-finance through *both* the bank-led SHG program *and* the MFI.

However, when faced with such a boom period in lending, received wisdom in financial regulation across centuries, encourages caution on understanding and managing systemic risk. Particularly, when the boom is accompanied by a large shift from a mostly informal to a formal financial structure, it is important to ask:

1. Is the shift fundamental or merely an outcome of legal/regulatory loopholes?
2. What is the impact of the change on the users of the services?
3. What is the impact on the other participants in the sector?
4. How does it impact the systemic risks of the overall financial sector?

The last concern is particularly relevant because PSL is the outcome of a policy position, mandating the promotion of financial inclusion. Care needs

[4] The RBI master circular of 2004 with details on the PSL can be found in (RBI, 2004).

[5] The full list of activities with all modifications can be found at `http://www.rbi.org.in/scripts/FAQView.aspx?Id=8`.

to be taken to constantly measure the outcome of policy action, as well as ensuing changes that could adversely impact systemic risk.[6]

In India, concerns on all the above issues have come to the forefront twice in the last decade. Both times, the episodes were located in the state of Andhra Pradesh.

2.3.2 The role of Andhra Pradesh

Andhra Pradesh (AP) has a central role in the Indian micro-finance story. The state government in AP has dominated the effort to scale-up access to micro-credit services with a concerted program to promote bank-led SHG schemes (Datta and Mahajan, 2003). It is also here that the largest[7] registered NBFC-MFIs are headquartered. Lastly, given that the growth of the MFI has created turf wars with the bank-led SHGs that have been strongly promoted by the state itself (Intellecap, 2010), it is also the state which has proved to be the strongest source of political risk for MFIs.

The first episode (called the *Krishna crisis*) took place in 2005.[8] At this time, the NBFC-MFI model was yet nascent and had just started scaling up in AP. District authorities closed down 50 branches of two major MFIs following accusations that they were charging usurious interest rates and indulging in forced loan practices (Shylendra, 2006). The state government and the micro-finance sector negotiated a set of terms under which MFIs could get back on track with the micro-lending business in the state.[9] Once the negotiations were over, however, anecdote suggests that business growth took precedence over fulfilling the terms under which the MFIs were allowed to continue their business, and the MFIs took no further action to adhere to the terms.

The second crisis came to fore in October, 2010. In this episode also, MFIs were subject to similar allegations of poor credit interfaces with the

[6] One example of this is the link between the build up of systemic risk in the 2008 Global Credit Crisis that has been attributed to the pro-mortgage stance of the U.S. Parliament (Rajan, 2010).

[7] Largest by size of portfolio and customer reach.

[8] This was called so because it arose around issues of bad practices of lending by MFIs in the Krishna district in AP. Arunachalam (2010) is a good reference to details of this case as well as the later episode of September 2010.

[9] The terms included, among other things, definition of a better code of conduct when dealing with customers, as well as the proposal of the Micro Financial Sector (Development and Regulation) Bill. The bill has been pending in parliament since 2007.

micro-borrower, as they were in 2006. The AP government proposed an ordinance that was passed as law within two months, which effectively stopped collections on old loans and prohibited any new micro-lending business in the state (State government of Andhra Pradesh, 2010).[10]

In contrast to the 2005 crisis episode, the 2010 event had systemic consequences. The intervention of the government through the ordinance encouraged default from the borrowers. For some of the MFIs (including the large NBFC-MFIs that had a strong presence in the state), there was a significant increase in the default probabilities in their portfolio, with the rise in defaults being largely restricted to AP. What was unexpected was the reaction of the banking sector in completely cutting off liquidity to the MFIs across the country. This was irrespective of whether the MFI portfolio had any AP credit-exposure, or whether there was any observed changes in the credit quality of the non-AP exposure. This full-blown liquidity crisis for the MFIs has had far more damaging effects than the AP intervention itself.

As part of the response to prevent several MFIs shutting down from the lack of liquidity, as well as an effort to prevent other state governments from taking the same steps as AP, there has been a call to regulate the micro-finance sector. As part of this, a committee was constituted by the RBI[11] in order to put in place fresh regulations for the NBFC-MFIs, as well as to recommended practices for the whole micro-finance industry.[12]

In this paper, we attempt to understand whether (a) regulation is the only optimal policy response to the situation and (b) what form the regulation should take.

3 The role of policy

An examination of the allegations made against the micro-finance industry in the 2010 AP crisis show that the problems relate to mis-selling, usurious interest rates and unfair debt collection practices. If policy action needs to be taken to solve the problems behind the allegations, then the end goal of this action ought to be to achieve better credit practices of the sector towards

[10] Arunachalam (2010) provides a brief history of the crisis.

[11] The RBI is the regulator of the NBFCs in India.

[12] A brief overview of the recommendations of (Malegam, 2011) is provided in the Appendix.

the micro-borrower.[13]

Therefore, we first draw upon the principles of what financial sector regulation seeks to achieve, and what form of regulation should be considered in the case of MFI regulation. While doing this, we take note of what lessons were learnt about regulation from the Indian equity market developments of 1994-2000, given the analogies it has with the Indian microfinance setting.

3.1 Principles of financial sector regulation

The first port of call for problem resolution in financial markets has traditionally been the forces of competition. Economists advocate that when the market opens up to higher levels of competition, competitive forces will ensure that customer needs will be served the best. This assumes that all customers are alike and rational, and that they all have access to all information about the services and the service providers with no costs of acquiring that information (Zingales, 2009).

The recent literature on this position questions all these assumptions, particularly when applied in the area of financial products. This is because financial market competition can drive up the complexity of product type and definition with greater ease than the ease with which the customer can understand it.[15]

Zingales (2009) notes that a key role that regulation plays is to bolster *trust* in the sector. This is particularly relevant for the MFI in India, which has suffered a loss of confidence in the public view. It is evident from the crisis in the Indian micro-finance sector that the lack of transparency had crippled the ability of the MFI to deny accusations of bad debt practices.

[13] A common feature of regulation proposed to "fix" the Indian micro-finance problems is that it takes the form of prudential regulation. This emphasises a mix of capital requirements or minimum corporate governance norms on firms that provide micro-finance services. There is some emphasis on fixing a minimum rate on interest rates charged.[14]

However, our observation is that it was the larger, better capitalised firms that were charged with the allegations in the 2010 AP crisis. These firms were the better capitalised and conformed to corporate governance practices. Thus, it is not apparent that prudential regulation would solve the problems. Worse, it will likely bias against smaller entities in the sector and benefit the larger ones, which would not serve the customers well necessarily.

[15] Gabaix and Laibson (2006) show how it is optimal for a firm to "shroud" fees for goods when the market has a mixture of myopic and aware investors. In such markets, it can be shown that competitive market forces do not arrive at the lowest cost, or optimal service for the customer. The paper is also relevant in raising these issues in markets where the consumer has limited experience and awareness of the complexities of financial products.

A useful example of the tremendous benefits of increasing transparency in finance is the case of the Indian equity markets. From the the early nineties, when policy changes were targeted to improve the processes and the transparency of the equity markets, these markets grew several times over, in terms of outreach to all stakeholders. These changes were also accompanied by the creation of a statutory regulator which got an explicit legal mandate to improve use and access of equity markets in India. Lessons from this segment indicate three important guidelines for regulation:

1. What is the regulatory mandate? This includes clear identification of *what* is the economic activity which is being regulated. Within this business activity, who are the users (those who have the *rights*); who are the service providers (who have the *obligations*).

   For example, in the equities market, the business activity was that of an enabling framework for the issue and the trading of financial securities. Here, the share-holder had the rights. There was a multiple set of service providers with obligations that includes: firms issuing the shares, merchant bankers that placed the shares for purchase, financial institutions of trading, clearing and settlement – exchanges, clearing corporations, depositories, brokers that intermediate between the buying and selling share-holders, fund management firms that managed the purchases of shares on behalf of the shareholders, etc.

   In the case of the micro-finance/micro-credit industry, it is relatively simple to identify the user of the services. However, there is less clarity on the specific entities that are the service providers, ranging from the local money lenders to the NBFC-MFIs.

2. What is the legislation that would empower the regulator to carry out the mandate?

   In the case of the equities market, it was the Securities Contracts (Regulations) Act (1956) and the Securities and Exchanges Board of India, Act (1992).

   The primary law governing the micro-credit business is the *Moneylenders Act*, which the Constitution categorises as a state subject. It permits each state to set rules and regulations about lending within their borders,[16] including the choice of a rate at which the loans

[16] Various state governments have brought their own legislations and ordinances to curb the activities of moneylenders. Under this Act, each state can enact ordinances/laws to control the MFI business as well. RBI (2007) is a useful introduction to the domain of the Act and how it varies across different states in India.

can be done within the state. This would fragment the lending business across different regions, and would need to be resolved to support a national micro-credit industry.

3. Why there should be a focus on principles rather than rules while writing the Act to create the regulator?

   One of the observations from the equity markets is that a principles-based legislation gives the regulator the flexibility to accommodate and implement changes that will take place in the future, that cannot be visualised today.

   This emphasis on principles would be especially important for the micro-finance sector where (a) the manner of business is evolving, (b) the nature of business rides on heterogeneous types of participating firms, and (c) there is a strong overhang of political risk of working with the poor and the disadvantaged. Rules would have constant need of updating as the business keeps changing, and would slow the rate of growth.

4 Guidelines for regulating microfinance

The typical precedent in regulation for micro-credit is banking sector regulation, which has a focus on protecting the rights of the depositor. As a result, micro-finance regulation tends to differentiate between deposit and non-deposit taking MFIs, with a lot of the banking sector regulation applied to the deposit-taking MFIs.[17] This does not quite apply in the case of the Indian micro-credit sector, where MFIs offer credit while deposit-taking has remained a distinctly uncertain future possibility.[18]

To add to the complexity, banking regulation cannot readily translate into a framework to accommodate the heterogeneity of legal structures that the typical micro-finance sector is based on. If regulation has to be created for the micro-finance industry, it would need to be uniform across these different forms so that the industry does not get fragmented across regulatory lines.

[17] Internationally, there is some precedent for this approach. For instance, the Basel Committee on Banking Supervision has developed guidelines for prudential regulation of deposit-taking institutions in the micro-finance space (BIS, 2010b).

[18] Several recommendations for expansion of the financial inclusion agenda have made a case for the the establishment of *small-banks* which would be permitted to take deposits from the rural poor. But, so far, these have not had much traction in policy (CFSR, 2008).

Shankar and Asher (2010) offers a mandate for Indian micro-finance regulation that falls within the domain of the deposit-taking MFIs. They propose that RBI regulate deposit-taking MFIs by eventually making them *MFI banks*, along with an independent oversight board (under the purview of RBI) to regulate the non-prudential aspects of the remainder of the micro-finance business.

A more general framework is that presented in Christen, Lyman, and Rosenberg (2003), which details guiding principles of micro-finance regulation across both the forms. The dichotomy caused by these two regulatory approaches has been the source of much confusion in the industry.[19]

Two key efforts in proposing a framework for the Indian micro-finance industry are the (Ministry of Finance, 2010) which was actually proposed by the industry after the 2005 Krishna crisis, and the Malegam (2011) report which was proposed after the 2010 AP legislation was passed. Both these focus heavily on prudential norms, and corporate governance issues. However, they fall short of a tangible effort at tackling the issues of ensuring better credit processes.[20]

We revisit the question of what should be the mandate of an MFI regulator by first identifying who an Indian MFI is, (Section 4.1) and the nature of their business (Section 4.2).

4.1 What constitutes an MFI?

Public opinion views MFIs as entities that disburse credit to low income households. When defining a regulatory mandate, however, it is important to be more specific. The most recent attempt at defining an Indian MFI comes from Malegam (2011):

> *"A company (other than a company licensed under Section 25 of the Companies Act, 1956) which provides financial services predominantly to low-income borrowers with loans of small amounts, for short-terms, on unsecured basis, mainly for income-generating activities, with repayment schedules which are more frequent than those normally stipulated by commercial banks and which further conforms to the regulations specified in that behalf."*

[19] Details on regulations in a few countries are presented in the Appendix.
[20] Details of the proposed regulations are presented in the Appendix.

This definition excludes other forms of MFIs, and defines a low-income borrower as someone with an annual income of less than Rs.50,000. However, as seen from Table 1 in Section 2, a large number of the clients of MFIs are from the income range of Rs.31,000 to Rs.77,000. This definition may exclude several borrowers for whom micro-credit is an important source of liquidity.

Another definition comes from the Micro-Finance Industry Bill, 2007, (Ministry of Finance, 2010). This defines both *eligible clients* as well as *micro-finance services*. Eligible clients are defined as members of an SHG or any other group engaged in micro-finance, and belonging to one or more of the following categories:

1. Small farmers not owning more than two hectares of agricultural land;
2. Landless cultivators of agricultural land including oral lesees, tenants or share croppers;
3. Landless and migrant labourers;
4. Artisans, micro entrepreneurs and persons engaged in small and tiny economic activities;
5. Women; and
6. Any other such category that may be prescribed.

This definition helps to distinguish between borrowers of MFIs and borrowers of banks with loan amounts comparable to those of MFI borrowers. However, the Bill appears to be focussed on micro-credit rather than micro-finance. For example, the above definition requires a woman to be a member of an SHG before she is classified as eligible. This would be restrictive if the goal was to facilitate all manner of micro-finance transactions. The Bill does extend micro-finance services to include:

1. Credit not exceeding Rs.50,000 per individual for the purpose of agriculture, small enterprise and allied activities (and Rs.150,000 for housing purpose);
2. Financial services through any agent as permitted by the RBI;
3. Life insurance, general insurance and pension services that have been approved by the authorities regulating these services;
4. Any other services specified by NABARD regulations.

In light of the policy on general financial inclusion, we think it reasonable that regulation should cover *any* entity, regardless of its legal structure, its financial services activities, and its process design whether group-based or individual-based.

4.2 Nature of the Indian MFI business

Indian MFIs are in the lending business. Unlike the traditional money lender, MFIs raise funds from other sources to lend to the customer. Unlike banks, Indian MFIs cannot raise money from fixed deposits.

Instead, their funds come from donors that are interested in the goals of poverty alleviation or from the formal financial institutions (including banks) that are interested in the goals of earning returns. This makes the Indian MFI a credit services distributor. As a distributor, the MFI has obligations both to the customer on one end (which we call the *MFI-customer linkage*) and the formal financial sector on the other end (the *MFI-funding-firm linkage*).

MFI-customer linkage Here, MFIs play three roles:

1. a distributor of financial services,
2. a collection agency, and
3. an agency that promotes education and awareness about financial services

This model holds true even for those MFIs that have expanded beyond credit services to include the sales of insurance and pensions products. The *primary* role of the MFI is as *distributor of financial services*.

The second role is a key differentiating feature from the banking sector in that the MFI pays the cost of becoming a *collection point* with the micro-borrower. In this, the MFI delivers access to the payments system for the financially excluded. Presently, the payments system lies within the monopolistic control of the banking sector. Any one who is unbanked remains out of the broader reach of payments. Until policy opens up access to the payments systems to a wider range of economic agents, the MFI will remain the rare connection between the payments system and the poor and the disadvantaged.

The last role of the MFI is they increase the awareness of the financially excluded about what services are available for savings and investment. Some of this is explicit, as in the case of the NGO-MFI. Some is implicit, as when NBFC-MFIs try to expand the product range available to their micro-credit customer.

With customer linkage, the MFI has the following obligations:

1. Truth and transparency in the distribution of financial services.

2. Adherence to fair and good collection practices.
3. Ensuring that the customer is aware of all the alternatives before they make their choice.

What complicates matters here compared to a generic financial services sector is that the customer linkage is mostly built on the JLG model, which introduces non-transparency between the MFI and the end borrower. Policy that strengthens the MFI-customer linkages must take this into account.

MFI-funding-firm linkages There is a broad set of firms/entities that fund MFIs – from donors to PE firms. All these are well equipped with the resources to evaluate what manner of aggregate risks they are lending to within the MFI portfolio. The obligation of the MFI here is to ensure full and honest disclosure about their credit portfolio.

One efficient way of reducing the cost of building links between financial firms and the heterogenous set of MFIs would be through *securitisation* of MFI credit. Securitisation could pool both multiple micro-borrowers as well as multiple MFIs. Such an effort would benefit both the MFI (who will be able to diversify away any concentration in funding sources), as well as for the funding agency (who can similarly diversify away MFI risk). [21]

Once the nature of the MFI business can be laid down in this manner, what principles ought to guide the regulatory framework for the Indian MFI become clear. With this perspective, the regulatory framework could be applied irrespective of who the micro-finance entity is, be it NBFC-MFI, NGO-MFI or the traditional money lender.

4.3 Regulatory mandate

Given this background, if we were to create a principles-based mandate to effect improvements in the MFI sector, then the mandate should focus on:

1. Protecting the rights of the micro-finance consumer, with a primary focus on ensuring quality of financial services distribution.

[21] For example, this could be implemented through special purpose vehicles (SPVs) offering securitised products based on micro-credit portfolios aggregated across different MFIs, that can be placed with the insurance and pensions companies who would be more willing to take on diversified credit risk than the risk of any single MFI.

2. Prudential monitoring and supervision at the level of disclosure by the MFIs to ensure transparency about the risks in the micro-credit portfolios. This would assist the funding agencies to make informed decisions.
3. Promoting the development of the sector by innovations in
   - Linkages between customer and MFI, wherein there should be an enabling framework so that all kinds of financial services can reach those who are not financially included.
   - Linkages between funding agency and MFI, wherein there should be an enabling framework for funding across all formal financial savings firms beyond the banking sector.

The current debate on MFI regulation focuses on credit as the financial service. However, once the distribution channels are in place, the micro-finance industry will be ripe to address a larger financial services domain.

5 Implementing policy

We start by examining the available legal structure that could be used to implement the policy issues in the regulation mandate listed above, in as short a time as possible. There is a sense of urgency here because a solution that can be rapidly implemented could help to resolve the conflicts that the micro-finance sector has been facing, since the the 2010 AP intervention.

5.1 Customer linkages: Protecting the rights of the micro-borrower

We start defining consumer protection for the micro-consumer of financial services with a caveat: the mandate of consumer protection extends to entities outside of the current MFI sector as well. It is therefore critical to explicitly acknowledge that any discussion on such regulation should be applicable to the domain of any financial service, and by any kind of a distributor.

Consumer protection, especially in the context of credit markets has resurfaced in the global financial policy debate after the financial crisis of 2008. Porteus (2009) points out that credit markets are fragile, both because they risk political meddling, and because borrowers themselves exhibit systematic vulnerabilities which compromise their decision making.

In response, international regulators focus on promoting consumer education and strengthening disclosure laws, product, contracts and processes regulations, and grievance redressal mechanisms.[22]

In India too, stronger consumer protection will go a long way to alleviate the current political risk of working with the poor. We attempt to understand what existing mechanisms are available for consumer protection in the domain of the micro-finance industry. These include: (a) existing consumer protection laws, (b) redressal mechanism, (c) recovery and bankruptcy processes and (d) education.

5.1.1 Existing legislation

Consumer protection in India falls under *The Consumer Protection Act, 1986* (CPA) and subsequent amendments. The Act provides legal recourse to consumers for complaints as defined under the Act, which focus on hazards to health and personal property and relate to the purity, price, quality, quantity etc of the goods sold.[23] If we agree that MFI is a distributor of financial services, then complaints in this domain can be covered under unfair trade practices adopted by the service provider, or prices being in excess of the prices fixed by law.

More directly, the *Usurious Loans Act, 1918* (ULA) has provisions related to interest rates charged by lenders in the unorganized sector. These may not necessarily apply to the rates charged by the MFI, given that it is widely-acknowledged that the costs of providing micro-finance services tend to be far higher than in the formal financial sector (Rangarajan, 2008). Also, forcing interest rates downwards can have a negative impact on the business and drive MFIs out of the lending market (Christen, Lyman, and Rosenberg, 2003). Any disagreement about the credit contract can be contested in the Indian civil courts, as long as the contracts are clear and are well understood by both parties to the transaction.

[22] For example, South Africa established the "National Credit Regulator" to carry out education, research, policy development, registration of industry participants, investigation of complaints, and ensuring enforcement of the National Credit Act. `http://www.ncr.org.za/` Australia has also announced a program of "National Credit Reform" (of the Commonwealth of Australia, 2010).

[23] For more details refer to `http://ncdrc.nic.in/`

If there is a place for supervisory checks, it would be to ensure that the terms of the loans were not *mis-represented* to the small borrower by over-zealous employees of the MFIs.[24] For example, MFIs have often been accused of presenting opaque loan terms, charging various processing and monitoring fees. Where policy could help is to mandate clarity about the exact contract between borrowers and lenders when micro-credit products are sold. This could be done by mandating simplicity of terms that must be presented in any credit contract written with the micro-borrower.

5.1.2 Redressal mechanism

The CPA specifies a redressal mechanism under which quasi-judicial bodies have been set up to hear and quickly resolve disputes under the National Consumer Disputes Redressal Commission (NCDRC).[25] These have been set up at the National level (NCDRC), State level ("State Consumer Disputes Redressal Forum") and down to the level of the district ("District Forums"). They have been in place since 1988, and have heard more than 3.5 million cases since then, with around 2.9 million cases heard at the District Forums. These offer a redressal mechanism for more rapid contract dispute resolution compared with the civil courts.

If micro-credit is covered under the CPA, then these forums can be extended to provide the micro-borrower a redressal forum. Another suggestion provided has been to use Lok Adalats and Nyaya Panchayats as dispute resolution mechanisms (RBI, 2007).

5.1.3 Recovery and bankruptcy

The CPA does not completely resolve the issue of *unfair debt collection practices*. Debt collection goes deeper than consumer rights since it also has to take into account lenders' rights. There are three related issues:

Over-indebtedness owing to multiple lending As long as the lender is aware of the level of indebtedness of the borrower and can factor that

[24]This has often been reported to be a problem in financial services distribution in India, where the latest problem that arose was in the distribution of Unit-Linked-Insurance-Products by *agents* of large insurance companies and the terms of the contract was not made clear to the buyers of these products. For example see `http://www.livemint.com/2010/09/14224420/You8217ve-been-missold-a-p.html` and `http://www.livemint.com/2010/07/20202034/Recall-the-Ulip-product-Compe.html`.

[25]http://ncdrc.nic.in/

into the credit pricing model, there cannot be an argument over the mere act of borrowing from multiple lenders.[26]

Fair practices for debt collection Debt collection has been an issue in international markets.[27] Unscrupulous debt collection practices, have been a persistent issue observed in earlier instances in India, banks credit card recovery process being one example (Singh, 2010). In response the RBI issued a circular on credit recovery processes for banks (RBI, 2008). Amongst other things, the circular requires the establishment of a code of conduct for sales agents and the need to clearly demonstrate the fees and charges related to the credit transaction.[28]

In micro-credit, a troublesome aspect of the joint-liability-group (JLG) lending is that the group itself exerts tremendous pressure on the member to repay the loan. To the extent that individuals voluntarily choose to be a part of this method, the contract between the individual and the group will have to outline the rights and responsibilities of group members, which can then be held as evidence in courts.[29]

Bankruptcy procedure for the micro-borrower Bankruptcy procedures are typically discussed in the context of corporate distress and involve frameworks on efficient liquidation of the assets of the business. CFSR (2008) also discussed effective bankruptcy procedures at the small and medium enterprise level, but not at the level of a micro-borrower.

While a voluntary code of conduct by the association of MFIs allows for collateral in the form of land titles for loans of Rs.25,000 and more (Sa-dhan, 2007), it is difficult to conceive of the seizure of the land/belongings of the borrower at default.

Chapter 12 of the bankruptcy code in the USA is designed to deal with micro-loans of specific types,[30] which could be a template for

[26]Once credit bureaus are set up, as mentioned further in Section 5.2, credit histories can be used to address this problem.

[27] The Fair Debt Collection Practices Act (FDCPA) in the US, The Office of Fair Trading (OFT) in the UK have put in place measures to promote fair debt collection.

[28]This includes quoting the Annualized Percentage Rate (APR) among other terms and conditions related to the product.

[29]An example of optimal joint liability contracts is the research by (Gangopadhyay, Ghatak, and Lensink, 2005), who work with the impact of the difference between the total joint liability and total individual liability in deriving optimal contracts.

[30]This code deals with financial distress of family farmers, fisherman along with those who have regular annual income as opposed to wage income. It has provisions that allow

bankruptcy procedures for micro-credit contracts in India, while taking into account conditions specific to India as well.

5.1.4 Consumer education

A lot of these mechanisms are rendered useless if the consumers either do not have information about them, or do not feel empowered to avail of them. A huge effort needs to go into educating the borrower community about their rights within the MFI-small-borrower contract, and their recourse under default. This issue has also featured in the discussions on MFI regulation (Shankar and Asher, 2009) and needs to be emphasized in every discourse on the subject.

5.1.5 Regulating financial distribution

As the sector develops, it is very likely that MFIs will expand into selling other products such as micro-insurance and micro-pensions.[31] Even though most of the discussion on regulation in India has limited itself to the credit-delivering MFIs (Malegam, 2011), it is myopic to not include the distribution of other financial products in the mandate.

A problem is that MFIs are not the sole distributors of financial products. Mutual funds, insurance companies, pension funds, all deal with several distribution channels for their products. Thus, a regulator dedicated to the micro-finance product distribution will run into regulatory overlaps with the regulators of the core financial products such as pensions, insurance, banking, etc.

Instead of putting in place a dedicated MFI regulator, an alternative would be to put in place a *financial services distribution* regulator, which could start as a regulator for micro-finance products, but could be scaled up to

small farmers to repay debts in installments of over three to five years and is apparently more streamlined and less expensive than procedures that deal with bankruptcies of firms. `http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter12.aspx`

[31] For example, the NPS-Lite scheme of the Pension Fund Regulatory and Development Authority (PFRDA) allows for "aggregators" to sell the scheme to poor income households, and has several requirements for registration of these aggregators. Several other initiatives for promoting pensions by private sector entities such as the Invest India Micro Pension Services (IIMPS), Sheperd India, Dhan Foundation are also underway.

cover the distribution of any product, to any customer.[32]

5.2 Funding linkages: increase transparency

A critical requirement for the MFI sector is to increase transparency of the reach and depth of the MFI portfolios. Transparency has been documented to have many tangible and intangible effects on a financial market, all of them positive.[33]

How credit bureaus can help?

One way that this is dealt with in the formal financial credit sector is set up a credit information bureau (CIB) for credit-borrowers. It is well-known that CIBs deliver several benefits:

- At the simplest, a CIB can leverage economies of scale of information management that can reduce the cost of data management for each MFI.
- Currently, a significant bottleneck in the process of acquiring credit is establishing information about a micro-borrower. This is critical both for the operational efficiency of the MFI as well as to satisfy KYC norms of a funding agency in the formal financial sector. This ability to discern the quality of credit for any customer would help the MFI offer lower rates to those with better credit history. A CIB along the lines of CIBIL[34] (or perhaps CIBIL itself) would have a tremendous influence on the quality of the micro-credit sector in India.

[32] Regulation of financial services distribution is a relatively recent phenomenon even in the global financial sector services. An example is the "Australian Securities Investment Commission" (ASIC), which is entrusted with the responsibility of assisting and protecting retail investors and consumers in the financial economy. This involves licensing and regulating people and businesses engaged in consumer credit, superannuation, managed funds, shares and company securities, derivatives and insurance. http://www.asic.gov.au

[33] A clear example of this is the case of the Indian equity market from pre-reforms in 1995 to post-reforms. The industry shifted from a opaque sector where shareholders had very little trust of any of the intermediaries, to one which is one of the most transparent industries by world standards. This has led to a tremendous shift in the use of equity by both firms as well as shareholders to manage their wealth (Thomas, 2005).

[34] Credit Information Bureau of India, Ltd., which is the credit bureau where all banks have to submit credit history of both corporate and individual credit clients as mandated by the RBI.

- For the Indian MFI, such information along with a Unique ID[35] could help resolve the criticism of MFI loans leading to over-indebtedness of the micro-customer. The UID process is well underway, and MFIs or designated credit bureau could act as the registration agency micro-finance customers.

- A credit bureau (or set of bureaus) could play the same role as the role of the trade repository in the context of OTC markets (BIS, 2010a), by becoming an third party repository about customer information, and (for a fee) play the role of an *information aggregator* on behalf of a monitoring and supervisory agency on three counts:
  1. Aggregation of portfolio information of an MFI, in terms of number of accounts, number of unique accounts, total size of portfolio.
  2. A commonly cited problem with the coverage of the MFI sector has always been poor quality of data reported, particularly for the smaller MFIs. Here, a third party aggregator could become a more credible source of information about the overall state of the industry. This can be particularly useful to validate or refute a position about the quality of their business when allegations are made against the MFI or the industry. This could help mitigate the political risk problem in part.
  3. The credit bureau can become the point of information about MFI credit quality for any agency that wishes to evaluate the credit risk of the portfolio. These could be market intermediaries like a credit rating agency that will have to offer a rating when the MFI wants to participate in a *securitised* product or raise a bond in the securities markets. Or it could be used directly by the funding agency themselves.
  4. An intangible outcome would be that the coverage of an MFIs portfolio in a credit bureau could be used as a signal of the quality of the process of the MFI in managing and controlling their distribution network of rural customers and clients.

Policy

A remarkable features about this solution is that it can be rapidly implemented, given the development of the required financial legislation and institutions in India today.

- There are currently four credit bureau companies that have been licensed[36]

[35] Universal IDentity, which is a system of giving each person in India a unique number that is index to the person's name, age, address and biometric information. `http://www.uidai.gov.in`

[36] `http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/EPR1718RCIC.pdf`

and are operational – CIBIL[37], Equifax Credit Information Services Ltd., Experien Credit Information Company of India, Ltd., and Highmark Credit Information Services Pvt. Ltd.

One or multiple of these can be selected as the information repository for the micro-borrower information in an auction.[38]

- In order to facilitate a more rapid resolution of the liquidity crisis in the MFI sector, information collected at the first stage of collecting credit information from the various MFIs should be kept relatively simple. As the industry gets comfortable with the CIB process, credit information can cover a greater level of complexity, particularly if it is considered necessary for understanding the systemic risk of the micro-credit portfolio.
- A caution on the extent of information collection is also warranted in keeping with protecting the rights of the micro-borrower. Those who have access to better resources have the wherewithal to protect themselves, while there is little concern for the general rights of the poor. Their rights to privacy of information must not be violated.

With the access to technology available today, MFI participation in a CIB is not as onerous as it might have been five years ago, even for the small NGO-MFI. Particularly if it was balanced with the benefits accruing to improved transparency which would go a long way to alleviate a lot of distrust that has built up in the popular discussion about the MFIs and their practices today as mentioned in Zingales (2009).

5.3 Funding linkages: securitisation

The most critical flaw in the development of the Indian micro-finance sector is its dependence on *funding from banks.* This concentration of funding was recorded before (Gaul, 2009; Srinivasan, 2010) but the translation into a key driver of liquidity risk was clearly demonstrated in the AP 2010 crisis.

Skewed impact of liquidity crisis

Typically, liquidity risk for a financial institution in the lending business is caused with a perceived rise in the default rates of the borrowers, or because

[37] CIBIL has been operational as the CIB for the banking sector.

[38] The CIB could be selected based on lowest record maintenance fee offered.

problems are revealed in the corporate accounts that had been kept hidden by bad corporate practices on disclosure.

Neither was the case for the Indian MFI. There was no rise in the default rates of the MFI portfolios. Even when the AP government imposed the restrictions of the State government of Andhra Pradesh (2010), and there was a significant increase in the default rates of the AP MFI portfolios, the rest of the country showed default rates that were the same as before the AP ordinance.[39] However, the flow of funds from the banking sector did not reflect any nuances to MFIs with higher or lower exposure to micro-credit in AP. There was *no* bank lending to any MFI.

This resulted in an absolute crisis of liquidity to the micro-lending sector, a status that continued for the several months upto the time of the writing of this report (March 2011). But that was not the only deleterious effect on the micro-finance sector. In this liquidity crisis, it is the smaller MFI that faced a larger negative impact.

Anecdotal evidence suggests that some of these are at the forefront of taking the micro-credit business to places that have not been financially included either by the formal financial sector or the larger NBFC-MFIs. Their role in financial inclusion is disproportionately important with respect to their size if the objective of universal financial inclusion is to be met for India. Yet, these are the firms that are being removed by the liquidity crisis, when it is clear that their role cannot be played by the larger MFIs.

Given these skewed effects, the liquidity crisis is as important an issue for policy on micro-finance to deal with as much as needing to deal with the political risk of state intervention.

[39] Earlier rates of non-default were set at around 97-99%. During the initial period of the AP-led MFI crisis, some reported non-default rates of around 10%. Since the portfolio was not all invested in AP credit, this would mean a drop in repayment to the tune of the drop in repayment rate weighted by the size of the lending in AP.

For example, if an MFI had 50% of the credit portfolio lent to AP, and the remaining 50% to surrounding states where micro-borrowers continued to repay as usual, the portfolio non-default would have gone from 97% to 49%. Thus, a true assessement of the risk of the sector would require knowledge of how much was invested in the politically-sensitivised AP clientele. Reports at that time reported that even in AP, the increase in default was not as uniform as policy and media made it out to be. `http://ifmrblog.com/2010/12/02/ifmr-capital-recent-data-on-microfinance/`

How securitisation can help?

On the positive side, there as solutions from finance that can be more readily applied to solve the liquidity crisis compared with political risk of dealing with the poor, which is using *securitisation* as a means of financing for MFIs. The world over, funding sources for the credit business comes from a range of financial institutions (FIs) – insurance companies, pension companies and mutual funds. Such FIs can take on the risk in the MFI credit portfolio compared to banks that have far more stringent investment restrictions because of the deposit-taking services that are their core business.

Ideally, Indian MFIs ought to access funding from these FIs as well. A combination of reasons ensure that banks dominate the MFI-funding channel:

1. Banks are rewarded for fulfilling PSL targets; other financial institutions have no such compulsions.
2. It is difficult to assess credit risk in the micro-finance sector in India today, which acts as a barrier to funding.

The second is a key problem to funding MFIs, not just in India, but all over the world. MFI risk assessment needs to be done at two levels: (a) assessment of the aggregate credit risk over a portfolio of non-collateralised loans to micro-borrowers where any information about the individual is difficult to obtain, let alone the credit history of these individuals. (b) The credit risk of the MFIs themselves.

This is important to emphasise: known credit risk research is based on the idea that end borrower directly access the creditor. In the case of the MFI problem, the MFI is critical as the disbursement and collection agent. The repayment probability is then a combination of the borrowers ability to repay with the MFIs ability to collect the repayment back into the formal financial system. Default could take place either as the borrowers inability to repay, or the MFIs ability to collect, or both. This increases the information requirement for the FI investment into an MFI portfolio to two levels: first, the credit risk of the end micro-borrower, and second, the collection risk at the MFI.

Given better sources of data about the individuals and their credit history, which has been proposed in Section 5.2 as the first step of development, it is feasible to make an assessement on the first part. The second part which is less understood, is the credit risk of the MFI themselves.

One way to solve the issue of assessing MFI-risk is to diversify it away. This can be done through a securitisation framework where *MFI-securitised products* includes not just loans across multiple borrowers, but also across multiple MFIs.

Anecdotal evidence suggests that the current practice of securitisation mostly involves banks taking on the laon portfolio of a single MFI onto their own books for PSL targets. They achieve the diversification of credit risk at the end borrower, but not at the level of the MFI. More damaging is evidence that these portfolio acquisitions are bunched towards the last quarter of the financial year where the focus is to satisfy PSL targets rather than full and proper due diligence on the credit quality of the portfolio.

Thus, even for the existing banks, adoption of micro-credit exposure through securitised portfolios with diversification across MFIs would be a more robust channel of MFI funding compared to current industry practice. Such securitised portfolios [40] have started finding a market in India, with the first being placed by *IFMR Capital*[41] in January 2010.

Policy

Policy for securitisation is still in the process of development, and involves:

1. Facilitating legislation for creating new securities that will address robust and stable funding for loans to micro-borrowers.
2. Clarity on accounting norms for these securities at the FI portfolios.
3. Clarity on bankruptcy norms of these securities.

In the general context, Indian legislation on securities rests with the Securities and Contract Regulations Act, 1956 (SCRA) which has already been modified in 2007 to allow for securitisation (Legislative Department, Ministry of Law and Justice, 2007). The bankruptcy code, specified in the Securitisation And Reconstruction Of Financial Assets And Enforcement Of Security Interest Act, 2002 (SARFESI) has already made provisions related to securitisation. These along with international guidelines in this context should be studied and adapted to the small-loans context.[42]

[40] `http://www.reuters.com/article/2010/01/18/idUS116143+18-Jan-2010+PRN20100118`

[41] IFMR Capital is `http://ifmrtrust.in/capital/`

[42] Schwarcz (2011) present a legal framework for commercial micro-finance.

However, if policy aims to open the funding channel from the formal financial sector beyond just the banking sector, it must also address the issue of how other financial sector institutions like mutual funds, insurance companies and pension funds can fund micro-finance.[43] In particular, policy needs to revist issues on investment guidelines at these firms that could well be a bottleneck to their participation in this critical sector.

5.4 Is an MFI regulator inevitable?

The previous section identified that the real underlying concern to be resolved for the micro-finance industry to make progress is customer protection for the micro-borrower, with tangible proof that systems have been put in place all over the country, that these borrowers can reliably use. Furthermore, the micro-finance industry will need to evolve out of a pure credit services role to a larger range of financial products. The role of the MFI would then largely be that of a distributor of products that are already mandated by existing financial regulators. Where there remains a lacuna in monitoring and supervision is with regards to the *quality of distribution* of these products and services.

From the standard three-point mandate structure of financial structure regulators, it would appear more appropriate to institute a *regulator for financial services distribution* and not a *regulator for the micro-finance institutions* which is currently being assumed as the only solution to fix the problems of the Indian MFI. From the perspective of regulation of financial services, the rights would be with the purchaser of a financial service, and the obligations – of correct presentation of product features and related financial advice – would be on the provider of the financial service.

A focus on developing such a regulator for financial product and services distribution would result in a more efficient financial system than the development of an MFI regulator, which does not have such a clearly outlined mandate. Worse, given the existing structure of the Indian financial regulatory structure, an MFI regulator would inevitably have overlaps with other financial regulators.

[43] This includes the recent draft guidelines of the RBI on *Securitisation Transactions by NBFCs*, which essentially does not permit securitisation products on MFI portfolios by bounds on product design parameters of maturity and holding periods. `http://rbidocs.rbi.org.in/rdocs/Content/PDFs/SETNBF030610.pdf`

6 A way forward

The above discussion suggests actions that policy can take so as to resolve some of the issues driving the liquidity crisis in the micro-finance industry. These policy actions will also have repurcussions on how growth in this sector can be fostered over the longer horizon while ensuring that the same problems that caused the recent political and funding have a lower likelihood of recurrance.

We divide the policy actions into three different time-frames: what needs to be done in the *short-term*, in the *medium-term* and in the *long-term*.

6.1 Short term: three-six months

The immediate target of policy ought to be to free the micro-finance industry from the grips of the liquidity crunch that it is currently in. Since the latest crisis has been triggered by a lack of trust in the MFI sector, one action the industry can take immediately is to increase transparency.

In the next three to six months, the following ought to be implemented:

1. Institute an *oversight body*, for a limited period of two years, that will be entrusted with the responsibility of carrying through the policy actions below. Since the current issues of micro-finance deal mostly with micro-credit, this oversight body could be placed within the RBI. However, the body must have the participation of other financial sector regulators, including pensions, insurance and securities markets, and other critical political stakeholders such as state governments that have a large micro-credit industry.

   This body should also be responsible for communicating the proposed and achieved reforms on a regular basis to state governments such as AP to revive the trust in the micro-finance industry.

2. Run a process to select one or two CIBs to collect MFI credit information data.

3. The CIB can be used to collate and disseminate credit information pertaining to any set of borrowers.[44]

[44] These can include both commercial and consumer borrowers, to a closed user group of members, which includes banks, NBFCs, credit card companies and other financial institutions. `http://www.cibil.com/overviewin.htm`

4. Incentivise MFIs to submit information about the borrower and the loan to the credit bureau, such that 50 percent of the portfolios should be in the CIB in six months.

   One such could be policy to link the coverage of the MFI customer profile with facilitating funding to the MFI (by the Oversight body). For instance, if the MFI can submit valid information[45] upto 50 percent of their credit portfolio to the licensed credit bureau, this should be taken as a demonstration of the MFI intention to improve business processes. Policy should enable such MFIs to find relatively easier access to funding since this could mean better MFI processes than imposing capital requirements or corporate disclosures.

5. This push for transparency can continue to be a measure of good performance on the part of the MFI. In the first phase, the measure can be the rate at which the credit information database is populated. Once it is covered to the tune of 100 percent, the continuing measure can be the tightness of the gap between the actual credit portfolio and that recorded by the credit bureau at a regular frequency. The more transparent the MFI, the better should be their chances at raising stable sources of funds.

6. Use securitisation to broaden the possible sources of funds to MFIs. This will enable alternative participating financial institutions such as pension, insurance, and mutual funds to invest in the sector.

   This ought to involve a re-visit of existing securitisation rules that needs to incorporate the structure of the MFI credit portfolios which tend to have very different maturity (*very short-term*) and risk (*non-collateralised*) profiles compared to what the typical securitised products to the banks, which diversifies across end-borrower risk, but takes on MFI risk.

7. The process of registration and licensing of MFIs should proceed as it stands today.

   RBI should continue to be in-charge of developing prudential norms, and corporate governance guidelines for the NBFCs. The RBI should also co-ordinate with state governments to determine if the Money-lenders Acts in various states apply to the NBFCs, and resolve the

[45] While populating the credit information data-banks can be a relatively simple task, there must be checks and balances put in place to validate the data as well. This could be done by the period "random sampling" of the credit information in the database of each micro-finance entity, where the frequency could be higher, the larger the entity.

issue of competing legislations.

8. Malegam (2011) suggests that the money lending Acts should not apply to the NBFC-MFIs, which would cause a fragmentation of the micro-finance sector between those that do business covered under the Acts and those that are not. We agree with the broad spirit of the recommendation in that state governments ought not to have the power to intervene in the business process of an MFI, particularly those that have a reach beyond that of the state itself. We would broaden the suggestion to apply to any formally registered MFI that satisfies a certain set of criteria on corporate governance and size.[46]

6.2 Medium term: in 12 months

Within the next six months to a year, the above recommendations should proceed to the next level of development:

1. A framework should be put into place that combines provisions under the various relevant acts and operationalizes the process of consumers being able to seek redressal against malpractices committed by MFIs should be put in place.
2. There should be enough clarity about the nature of the contracts and appropriate definitions of what constitutes mis-selling, and coercive collection practices.
3. Bankruptcy procedures in the case of micro-lending should also be well-defined and incorporated in the legislation.
4. A concern about using the existing CPA machinery is the perceived inability of the small borrower to bear the legal expenses to take the MFI to court. Another concern involves the power dynamics in the lender-small borrower relationship. There are two approaches to solving this problem:
   (a) Court proceedings can be established at the panchayat level so that borrowers do not have to spend resources on going to district level courts.
   (b) Specific representatives of the legal system can be appointed who visit the villages on a regular basis to hear grievances against the MFIs.

[46]Our suggestion is to apply to any MFI which has a portfolio that contains more than 50,000 customers whose account information is fully registered and validated with a designated credit bureau.

Care should be taken to ensure that the legal representative is not an employee or stakeholder in the broader lending apparatus.

This machinery should be operationalized within the next one year.

5. The credit-bureau should have covered at least 90% of the industry.

   Individual MFIs should be asked to report the standard information set designed in the short-term to this oversight body. The body should have the legal power to demand compliance from delinquent MFIs.

6. There should be at least two securitised products that have found market acceptances with the mutual fund industry and the insurance companies.

6.3 Long term: 2-3 years

The long term goal of policy should be two-fold: protection of consumers from malpractices in the distribution of financial products and services, and an explicit recognition of credit products as one amongst a portfolio of financial products which include equity, insurance, pensions and savings.

- Today, the financial sector in India has regulators for all products except credit. There is a case to be made for bringing *all* credit products under a single *regulator for credit.*

  This will require resolution of Center vs. State legislation as money-lending is a state subject in India. It will also require focus on protecting *creditor rights*, as unlike other financial products, in the case of credit, the customer i.e. the borrower also has an obligation to the lender.

  India does not have strong bankruptcy laws, and strengthening regulation on this front will be the key task ahead of the credit regulator.

- Product regulation is typically focused on appropriate product design and prudential regulation of the product provider. The focus on *distribution* is missing. This lacuna should be addressed by establishing a regulator who would be focused solely on distribution regulation.

  The regulator would oversee how products are distributed and information is communicated. The financial services regulator would derive powers from a new *Financial Services Distribution Act* to deal with the various products being sold in the financial market.

7 Conclusion

Financial inclusion is an important element through which the welfare of the poor can be improved. In addition, some poor people use borrowing in order to embark on entrepreneurship, and thus extricate themselves from poverty.

The traditional strategy in India of improving financial inclusion – of emphasising government interventions in banking – has not delivered results despite over 50 years of sustained effort. In contrast, in a short time, the micro-finance industry has delivered remarkable results. There are, hence, some important innovations that these new firms have to offer in improving financial inclusion.

The complaints against MFIs in India revolves around issues of predatory lending and unfair debt collection practices. Additional problems include high interest rates charged on, and mis-selling of, micro credit products.

Any policy action, such as regulation, should therefore concentrate first on the protection of the *borrower* from the *distribution* practices of the MFIs, rather than focus on prudential regulation, which has been the focus of most of the discussion in India.

Regulation also has an important role to play in facilitating funds flow to the MFI lending business. Policy needs to facilitate information sharing both between FIs and MFIs, and between MFIs themselves, about borrower quality, so that decisions are made on a base of trust that is not vulnerable to the vagaries of public opinion or of political economy.

Policy measures should be implemented on a time-line to facilitate robust and stable growth of the industry that promises to deliver a scalable financial solution to poverty alleviation. The time line has three parts:

Short term

Mechanisms need to be put in place to deal with the crisis of trust and liquidity that the MFI industry is currently facing. Two key actions are to set up information flows of the MFI portfolios to credit bureaus, and to put in place securitisation as the main funding channel between MFIs and the formal financial sector rather than direct access between the two. An *oversight body for micro-finance* set up within the RBI for a term of two years to take on the responsibility of resolving the liquidity crisis, by facilitating these processes.

Medium term

The oversight body for micro-finance should be entrusted with the responsibility of ensuring continuity of MFI transparency and monitoring sources of funding. There should simultaneously be a move towards strengthening consumer protection and other laws that empower the micro-borrower.

Long term

Finally, policy should act to establish a full-fledged regulator for the distribution of all financial services including micro-finance. This would complete the existing landscape of financial regulation more efficiently than a dedicated regulator for MFI.

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A International experience on micro-finance regulation

Bangladesh

Bangladesh set up the Micro-credit Regulatory Authority (MRA) in 2006 to explicitly regulate the micro-finance sector. The goals of the MRA are outlined as follows

1. To formulate as well as implementing the policies to ensure good governance and transparent financial systems of MFIs.
2. To conduct in-depth research on critical micro-finance issues and provide policy inputs to the government consistent with the national strategy for poverty eradication.
3. To provide training of NGO-MFIs and linking them with the broader financial market to facilitate sustainable resources and efficient management.
4. To assist the government to build up an inclusive financial market for economic development of the country.
5. To identify the priority issues of micro-finance sector for policy guidance and dissemination of information to attain the MRAs social responsibility.

The MRA has the explicit authority to license the MFIs, and supervise them. The MRA requires organisations to seek registration with the MRA after having obtained registration as an NGO under the Societies Registration Act 1860; The Trust Act 1882; The Voluntary Social Welfare Agencies (Registration and Control) Ordinance, 1961 (Ordinance No. XLVI of 1961); or The Companies Act, 1994 (Act XVIII of 1994). The MRA also lays down rules for the governance of MFIs, their rights and responsibilities, operational requirements and other areas.

Source: `http://www.mra.gov.bd/`

Bolivia

The MFI industry in Bolivia is fragmented: several organisations compete in this space and are regulated by different entities. Private Financial Funds

(FFPs) and commercial banks are corporations while Open Savings & Loan Coops (CACs) are typically limited liability companies. These organizations come under the purview of Law on Banks and Financial Entities (1993), Central Bank of Bolivia Law (1995), Property & Popular Credit Law (1998), Law for Normative Strengthening & Financial Supervision (2001), and the Solidary Bond Law (2002).

All of the institutions have to satisfy minimum capital requirements, and provide documents related to economic and financial studies, proof of staff suitability and financial information. They are also subject to ongoing regulatory requirements related to ownership, corporate governance, permissible activities etc. They are also required to follow risk management guidelines and operate under interest rate restrictions.

Source: Staschen (2003) & Meagher, Campos, Christen, Druschel, Gallardo, and Martowijoyo (2006).

Ethiopia

Ethiopia has a separate legislation for micro-finance institutions known as the Micro Financing Institutions Proclamation (No. 40/1996) and various Directives. The licensing, regulatory and supervisory authority however, is the Central Bank.

Micro financing business is defined as an activity of extending credit, in cash or in kind, to peasant farmers or urban small entrepreneurs, the loan size is limited to US$600 and the loan term to 2 years. The MFIs are allowed to provide savings and time deposits along with disbursing credit.

There are minimum capital requirements and MFIs are required to re-register if they mobilize savings greater than US$120,000. MFIs are also subject to several other regulations regarding ownership, corporate governance, reporting requirements etc.

Source: Staschen (2003)

Ghana

Regulation in Ghana separates deposit taking organisations from the non-deposit taking ones. Those allowed to take deposits must function as a commercial bank, rural bank or a NBFI. Those that disburse credit function as a NBFI Credit Union or a NGO-MFI. The former are regulated by the Banking Law 2004 and the Companies Code 1963, while the latter are regulated by Business Rules - Financial Institutions (Non Bank) Law 1993; Cooperative Societies Decree 1968; Law on Trusts and Companies Code 1963.

Apart from NGO-MFIs, the rest of the organizations have to adhere to minimum capital requirements, and capital adequacy ratios and reserves. All of them are subject to some disclosure and reporting requirements.

Meagher, Campos, Christen, Druschel, Gallardo, and Martowijoyo (2006)

South Africa

South Africa has specific legislation for all kinds of lending, called the Usury Act Exemption Notice 713 of 1999 (Usury Act of 1968). The Act prescribes restrictions on the interest rate that can be charged and also requires MFIs to register themselves with the Micro-Finance Regulatory Council (MFRC). The MFRC monitors compliance with its rules and can inspect and deregister lenders. Recently, South Africa passed the National Credit Act (2005) and Regulations (2006) with an explicit mandate to protect customers against predatory lending and abuse.

MFIs do not have a minimum capital requirement, and can assume any legal form (NGOs, banks, trusts, co-operatives). The MFRC requires lenders to keep records of all loans, and to submit the loan data to a national loans register. Lenders are required to check credit history with the register, before extending credit. The MFRC also has a grievance redressal function wherein consumers can lodge complaints against lenders.

Source: Staschen (2003) & NCR (2007)

B Proposed regulations: 2006, 2011

Proposed regulations, 2006

Ministry of Finance (2010) admitted micro-finance services to include *microcredit* (not exceeding Rs.50,000 and for productive purposes), generic financial services through any RBI-approved entity, as well as *life and general insurance, pension services* that had been approved by regulators of such products. The bill therefore visualised the MFI distributing only already regulated products by which it had made a distinction between *product regulation* and *distribution regulation*.

However, the bill then branched off into specifying a regulator with powers for MFIs that *offered thrift services*. Thus, the regulation appear to fragment between MFIs that offered general financial services (non-deposit taking MFIs) compared to those that offered *thrift services* (deposit-taking MFIs). For such MFIs, the bill appeared to propose a specific regulator with whom these MFIs would register which was the NABARD. The powers of the MFI regulator included the power to accept registrations (which were over and above the firms' existing registration), cancel registrations, prescribe capital adequacy and accounting norms. In addition, NABARD would have the powers to penalise the said deposit-taking MFI for any perceived violation with the only recourse to appeal for the MFI restricted to the Central Government.

The bill further dichotomised the prudential and the development role of the regulator between the NABARD and the *Microfinance Development Council*. Thus, as pointed out by Ramji and Taishi (2008) the Bill does not resolve the issue of a single framework across all forms of MFIs. The paper and others (Shankar and Asher, 2009) also raise concerns about NABARD's ability to be the regulator as it is also the administrator of the Micro finance Development and Equity Fund, and therefore in the midst of a potential conflict of interest as both promoter and regulator.

However, the key gap between the mandate laid out and the (Ministry of Finance, 2010) was an explicit clarity on how to regulate *service provision*, particularly since parts of the bill showed a focus on *micro-finance services* and their delivery. While the bill has a clause to create Ombudsmen as part of the redressal mechanism for the micro-borrower, there is too little clarity on defining mis-selling, usurious interest rates or multiple lending in any of the provisions.

Proposed regulations, 2011

It is a comment on the changed structure of the industry that the proposed set of regulations that followed five years later were much more narrowly focused on the question of the NBFC-MFI. The Malegam Committee had the mandate to offer an operational focus on prudential regulation of NBFC-MFIs, and more of a recommendatory focus on operational parameters for the micro-finance industry as a whole.

Accordingly it starts with a definition of the NBFC-MFI and the conditions related to net-worth and assets that it had to satisfy to continue being a NBFC-MFI. The main recommendations are as follows (Malegam, 2011)

1. Corporate governance norms to be followed by MFIs
2. Solvency conditions which required MFIs to maintain provision for loan losses and maintain a capital-adequacy ratio.
3. A margin cap which provides a cap on the difference between the amount charged to the borrower and the cost of funds to the MFI.
4. Stringent rules on the pricing of loans, and the kinds and quantities of rates that could be charged by the MFI
5. Strict rules on multiple-lending. NBFC-MFIs are forbidden from lending to an individual who are members of two or more JLGs, and each member being allowed to borrow from only two MFIs.
6. All sanctioning and disbursement of loans to be done only at a central location and more than one individual to be involved in this function.
7. Establishing of a credit bureau
8. Establishing a code of conduct and grievance redressal proposal by the MFI, publishing of a client protection code by the regulator.
9. Continued priority-sector lending status to MFIs that followed the regulations

A key gap in these recommendations is that they apply only to NBFCs, and focus on the *prudential* aspects of a MFI business. There is very little said about issues of customer protection, or about developing the micro-finance industry as a whole. The recommendations also seem to worry more about ensuring that bank-lending under PSL targets is done smoothly, and less about providing an enabling framework for the MFI sector as a whole. More importantly, they focus on the business operations of the MFI, instead of broad principles of regulation.