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Abstract

Recent events in India have brought a fresh focus on the appropriate regulatory stance towards micro-finance. In this paper, we review facts and recent experience about Indian microfinance. We analyse the puzzles of financial regulation in this field from first principles, and argue that the mainstream mechanisms of consumer protection and micro-prudential regulation need to be modified owing to joint-liability groups. From this perspective, we suggest regulatory strategies that need to be adopted for dealing with micro-credit and financial distribution that focuses on the poor. This analysis and conceptual framework also helps analyse the two policy responses till date, the Malegam report and the draft Microfinance Bill, 2011.

Keywords: Micro-finance, micro-credit, joint-liability-groups, India, consumer protection, regulation.

JEL Code: G20, G21, G28

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Contents

1 Introduction

Financial services for the poor has long been a goal for public policy in India. Poor households face very high consumption volatility, and access to an array of financial services – ranging from safekeeping of money and payments to credit and risk management – can substantially increase welfare by reducing consumption volatility. For many decades, policy makers emphasised a series of interventions into banking, ranging from bank nationalisation to directed credit, in an attempt to increase financial inclusion. These efforts yielded poor results. In the recent decade, an important financial innovation – joint liability groups (JLG) – created a pathway to giving loans to poor people without collateral. While JLG credit was invented by non-profits, it was successfully scaled up by for-profit firms, who were able to build large-scale distribution in some parts of India, and connect poor households to bank financing.

The rapid growth of this industry was punctuated by two crises in Andhra Pradesh, in 2005 and 2010. In both cases, the difficulties were rooted in problems of consumer protection of the borrower. A variety of political economy considerations, such as competition by for-profit Micro-Finance Institutions (MFIs) against state government Self-Help Group (SHG) programs, may have played a role in translating these problems into full fledged crises. In 2010, the Andhra Pradesh (AP) government essentially stopped new loans by MFIs and encouraged all existing borrowers to default.

Given the size and prominence of Andhra Pradesh in the portfolios of MFIs, the comprehensive collapse of repayment by households in AP was a serious blow. Apprehensive about rising credit risk, banks stopped lending to *all* MFIs in India, without regard to the actual risk that an individual MFI faced. Through this, all MFIs faced a funding constraint. Crisis transmission took place, through the aegis of banks, from a decision of the AP government to MFIs all over India.

On one hand, MFIs have a substantial potential to make a difference to financial inclusion, and have proven themselves by delivering financial services to income deciles that were ignored by banks. At the same time, the two crises demand careful policy analysis. At this juncture, it is important to analyse the appropriate role of the State in this field. All financial regulation falls under three categories: consumer protection, micro-prudential regulation and systemic risk. It is useful to analyse the problems of micro-finance and how the three elements of financial regulation may have a role.

In this analysis, it is useful to demarcate two interfaces of the MFI. On one hand, MFIs deal with households, extending them credit, and potentially going on to engage with households in a more complete array of financial products. This interaction involves concerns about consumer protection. On the other hand, MFIs deal with the formal financial system, for the purpose of obtaining wholesale financing. This interaction involves concerns about micro-prudential regulation and potentially systemic risk.

Mainstream thinking on consumer protection in finance has been based on an individual as the consumer. Micro-finance is unique in the role of the group. This induces new problems of consumer protection. Careful analysis and specification is required, of the rights of borrowers vis-a-vis the MFI, the rights of the group against the MFI and the rights of the individual against the group.

From the viewpoint of the formal financial system, lending to the MFI involves some unique problems. Homogeneity of the group in a JLG may induce correlated risk. Groups could mobilise themselves into political actions and thus induce political risk. These reasons require a unique perspective on the credit risk faced when lending to MFIs.

This analysis suggests five elements of a policy response. First, there is a need for an emphasis on consumer protection for the borrower vis-a-vis the JLG and vis-a-vis the MFI. Second, credit analysis by MFIs requires credit information about groups. Third, lending to MFIs requires disclosure by the MFI about characteristics of loans, borrowers and groups. Fourth, MFIs need to diversify away from the emphasis on banks as the source of financing. Finally, policy reforms are required through which state governments are less able to close down an industry as was seen in the second AP crisis.

This framework helps us analyse the two elements of the response of policy makers : the Malegam report (2011) and the draft Micro-Finance Bill. After the AP Crisis of 2010, the Malegam (2011) report has been adopted as the defacto framework for regulation of the NBFC MFIs. The more comprehensive (Ministry of Finance, 2011) has been tabled in Parliament in May 2012. However, key elements of these two policy responses require a rethink in the light of the analysis described above.

The remainder of this paper is organised as follows. First, Section 2 establishes the economic context, with the role of the micro-finance industry in the goal of financial inclusion in India (Section 2.1), and what went wrong in the Andhra Pradesh crisis (Section 2.2). Section 3 analyses micro-finance from first principles of financial regulation, and lays out a set of functions for the

State in micro-finance, spanning both the conventional thinking about financial regulation worldwide (which is, however, not mainstream in India) and the unique features of micro-finance which justify a modification of these standard approaches. Section 4 suggests a way forward with the primary focus on providing regulation for consumer protection for credit under the joint-liability group structure (Section 4.1.1) and for distribution of other financial services (Section 4.1.2). Section 4.2 looks at the two main pillars of the government response to the Andhra Pradesh crisis. Finally, Section 5 discusses the implications of this work and areas for further research.

2 Micro-finance in India: A Review

Worldwide, lending to households has traditionally been based on three technologies – (a) Lending based on collateral that can be possessed under situations of default; (b) Lending based on a stable income stream; (c) Lending based on prospects of a business. In high income countries, a fourth technology has come to dominate loans to individuals: risk assessment by lenders using credit scoring models, backed by credit bureaus which track defaults and give households a strong incentive to repay loans. This technology has yet to play a significant role in India.

Poor households pose unique challenges to all four techniques of lending:

1. These households typically lack collateral or proof of repayment that formal-sector lenders such as the banks will accept. Even if they do have collateral, possession and recovery from this collateral pose difficulties.
2. They have high income volatility, which makes it difficult to adhere to regular payments. This is exacerbated by the high cost they face to access the payment systems.
3. They use borrowed funds for both enterprise financing as well as for consumption smoothing.
4. Lacking identity information, and given the low presence of credit bureaus in the country, modern techniques based on credit scoring models and credit bureaus cannot be utilised.

Until recently, these challenges posed hard-constraints to the stated public policy stance on promoting financial inclusion i.e. moving away from reliance on the local money-lender, towards loans from banks. In the last decade, the field of micro-finance has evolved an innovative structure of credit contracts, where the joint-liability group replaced the traditional dependence on collateral.

In India, the first changes came in the 1980s when banks and NGO-MFIs used the joint-liability group (JLG) model to overcome the challenge of lending to households that did not have credible collateral. They lent to groups of women based on their ability to first collectively accumulate savings of some size in a bank account. The most successful of these have been the bank-led Self-Help Group (SHG) model. Once the collective ability to save was demonstrated, banks were willing to lend to such groups, even though no single individual in the group had what was traditionally accepted as collateral.

Two decades later, private sector MFIs scaled up lending based on the joint-liability group model using innovations in the business model (Thorat, 2007). This was done by employing and training field credit officers who became a network of physical links between the lending firm and the poor household. The lending was still made to a group, but the loans were disbursed without a demonstration of the capacity to save, thereby resulting in a less onerous credit process for the end customer or borrower. The network of field officers bypassed the need to make repayments into the formal financial sector which is a significant cost to the poorer and financially excluded households. This enabled a rapid growth in both number of customers as well as outstanding credit that was significantly higher than that in either the SHG or the formal financial sector (Srinivasan, 2010; NABARD, 2010).

2.1 What went right: the role of JLG lending in financial inclusion

How has this translated at the level of credit access of households? Table 1 reports the results of a household sample in the period of the year 2009-2010, before the AP crisis. The survey is conducted over a sample of 125,000 households at the district level, all across the country. The statistics show (a) what fraction of households in a given income category borrow, and (b) the source of their borrowing.

Around 40 percent of the households in the sample have outstanding borrowings, compared to 45 percent in the case of the poorest households that have outstanding loans. These borrowings are recorded as being friends and family, money-lender, SHG/MFIs, or banks. The role of banks peaks at 22.8%

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 125,000 households measured every quarter. Information about borrowing by these households in the 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/gOkeO` and sources of borrowing data from `http://goo.gl/yPX6U`

Category	HH	Annual	Source of borrowing				
	count (%)	income (Rs. '000)	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

of the households that have a mean annual income of Rs.479,000. However, banks cater less and less as a source of borrowing for households with lower incomes, coming down to 3.1% for the poorest. For these low-income households, 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. This is higher than the 5.2% of the households that have loans outstanding to banks at the same income level.

MFIs have thus established a significant presence in the space of household lending and have come to occupy a place in the credit industry between the formal sector banking channel and the informal sector money-lenders.[1] The MFI sector has thus made remarkable inroads in the field of lending to the poor, in just a few years, compared with the field of banking policy which has attempted to be in this field for over 50 years.

These developments have largely taken place in the last decade. While MFIs are drawn from a medley of organisational forms, including non-profit organisations (NGOs, Trusts) and for-profit firms, it is the for-profit firms that have dominated this growth in credit off-take of recent years (Srinivasan, 2010). These developments reflect important institutional innovations in Indian finance (Thorat, 2007).

On the funding side, MFIs cannot raise money through deposits from the public. Originally, funding came from concessional aid and continues to largely come from banks under their Priority Sector Lending (PSL) targets.[2] The scaling up of the industry, and its ability to make a difference to the economy on a meaningful scale, is now critically about its ability to grow well beyond charitable motivations, and shift to sustainable for-profit business models.

[1] Kaladhar (1997); Nair (2001); Basu and Srivastava (2005); Chakrabarti (2005); Chakrabarti and Ravi (2011) provide details about the structure and evolution of the micro-finance industry in India.

[2] Under Priority Sector Lending rules, banks are required 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. The RBI master circular of 2004 with details on the PSL can be found in (RBI, 2004).

2.2 What went wrong: Micro-finance crises in Andhra Pradesh

Lending to the poor has been a subject of intense interest to politicians in India, as is revealed in an array of government intervention in issues such as bank nationalisation (Cole, 2009), directed credit, loan waivers (Kanz, 2011), etc. The micro-finance industry enjoyed the benefits of access to priority sector lending (PSL) resources because politicians care about lending to the poor. Conversely, MFIs faced political interference after accusations that their actions were harming the poor.

2.2.1 Backdrop

These complexities led to two crises in Andhra Pradesh (AP) in recent years. Historically, AP was one of the first states where policy makers emphasised micro-credit through bank-led Self-Help Groups (SHG) (Datta and Mahajan, 2003). This created awareness about JLG loans in the population, which set the stage for rapid growth of for-profit MFIs in the state. The largest[3] registered Non-Banking-Finance-Company-MFIs (NBFC-MFIs) are headquartered in AP. While the private firms in AP benefited from the awareness among customers and prospective employees, that was induced by the involvement of the State, they also faced turf wars when the government saw households favouring the new private providers over its own programs (Intellecap, 2010).

2.2.2 Crisis I: 2005

The first confrontation between the government and the MFI industry (called the *Krishna crisis*) took place in 2005.[4] 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 of usurious interest rates and forceful loan recovery practices (Shylendra, 2006). The state government and the micro-finance industry agreed to modifications including a better code of conduct when dealing with consumers, as well as the

[3]Largest by size of portfolio and consumer reach.

[4]The phrase 'Krishna crisis' was used since the crisis 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.

first proposal of the Micro Financial Sector (Development and Regulation) Bill.[5]

2.2.3 Crisis II: 2010

By and large, it appears that MFIs did not deliver on what was promised. Many observers came to feel that the growth of some MFIs was accomplished by the use of sharp practices in taking away consumers from bank-led SHG programs. At the same time, some criticisms of MFIs were widely accepted in an information vacuum. As an example, many policy makers have expressed concerns about multiple borrowing from MFIs; however there is little evidence of this (Johnson and Meka, 2010). Similarly, the fact that borrowing per poor household in AP is three times higher than the Indian average is widely treated as evidence of over-indebtedness, while it could alternatively be interpreted as reflecting the credit constraints faced by poor people in the remainder of India.

Another source of discomfort were claims that MFIs charged high interest rates to their micro-borrowers. In India, the criticism has been especially harsh since MFIs have been able to borrow from banks at reduced Priority Sector Lending (PSL) rates that are intended to deliver subsidised bank loans to the poor. This discomfort reached a climax with the IPO of one of the largest NBFCs in AP, called SKS Microfinance, which was valued at Rs.80 billion[6] the time of listing. For many policy makers, it was self-evident that earning profits and valuations from serving the poor was wrong.

This backdrop of rapid growth and high discomfort was the setting for the second crisis in October 2010. Unlike in 2005, the response of the AP government was an Ordinance in October 2010, which became law in December 2010. The new law effectively stopped collections on existing loans and prohibited any new micro-credit origination in the state (State government of Andhra Pradesh, 2010) by intervening in the business processes of the microfinance firms.[7]

[5] This Bill has remained pending in Parliament from 2007. In 2011, an updated version was posted on the Ministry of Finance website for comments.

[6] `http://microfinance.cgap.org/2010/08/11/sks-ipo-success-and-excess/`

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

2.2.4 Crisis transmission outside Andhra Pradesh

In contrast to the 2005-06 crisis, which was limited to AP, the 2010 event had an adverse impact upon MFIs nationwide. The AP state government intervention was accompanied by mass default on outstanding loans to MFIs in AP. The asset class that had been consistently performing with recovery rates of 98.5 percent dropped drastically to loan recoveries of 0 percent immediately after the action of the state government.

This has been a massive setback to the long and slow process through which households gain familiarity with the rhythm of borrowing and repaying. In the remainder of India, recovery rates continued to be very high, with values such as 98.5 and 99 percent. The action of the AP government only damaged repayment within AP.

However, AP occupied a prominent position in the balance sheet of MFIs. Roughly 40 per cent of the overall loans outstanding by MFIs came from AP. These firms thus suffered from a negative shock of roughly 40 per cent of their balance sheet size. Banks chose to respond to this situation by stopping the flow of all loans to all MFIs. Given the domination of banks in the sources of MFI financing, this decision by Indian banks implied that the AP shock was transmitted to MFIs and their borrowers nationwide.

This shock has led to the demise of a large number of MFIs, particularly the smaller ones. The firms that have survived the crisis have tended to be the larger firms, particularly those with access to foreign equity capital (inter-mediated through private equity funds). In a reminder of the unintended consequences that follow from many government interventions, the large MFIs who had been accused of bad bad practices in AP have *gained* from the bankruptcy of myriad small competitors nationwide.

3 The role of the State in micro-finance

We now turn from this factual treatment of Indian micro-finance to a conceptual understanding of what the State needs to do in this field. This requires clarity about the market failures in micro-finance and the appropriate regulatory instruments for dealing with these.

3.1 The role of regulation in finance

For laws, agencies and the private sector to operate in an optimal fashion, it is important to fully articulate the conceptual framework under which government intervention is applied. This requires clearly answering four key questions:

1. What is the market failure? What would go wrong with pure *laissez faire*?
2. What are the interventions through which the market failure will be addressed?
3. How does this understanding of market failures and required interventions translate into law, and into the day-to-day engagement of financial regulatory agencies with the industry?
4. How will supervision be done, so that the 40,000 foot perspective of the law and regulations will actually get enforced on the ground?

The allegations made against the micro-finance industry in the AP crisis involve problems relate to mis-selling, usurious interest rates and unfair debt collection practices. It can be argued that the resolution of such problems should have been left to forces of competition in the market. But this requires that consumers are alike and rational, and that they have access to all information about services and the service providers (Zingales, 2009).

All across the world, there is now an appreciation that unregulated finance leads to suboptimal outcomes, and that one of the three pillars of financial regulation must be consumer protection (Campbell *et al.*, 2011). In the field of micro-finance, the problems of consumer skills are acute. The poor require complex products, but would often find it difficult to understand complex products.

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 consumer. In micro-finance, these assumptions about the consumer's ability to differentiate between competing products and services can be exacerbated by the lack of financial awareness and literacy amongst the poor micro-borrowers.

Thus, it is unlikely that the resolution of the problems of the micro-finance sector can be achieved solely through the market forces of competition. The sector has suffered a loss of confidence in the public view, and a key role that regulation plays is to bolster and restore trust (Zingales, 2009). In the field of financial regulation, a three-part classification is useful:

Consumer protection where the focus is to protect the rights and interests of the consumer of financial products and services. This focuses on the interfaces between financial firms and households.

Micro-prudential regulation where the focus is to monitor and reduce the probability of failure of individual financial firms, so as to avoid the adverse impact upon consumers.

Systemic risk which aims to curtail the risk that the financial system as a whole collapses.

This three-part framework is useful for analysing problems and proposed interventions in the field of micro-finance, as it is for all parts of finance.

3.2 Regulatory targets in the MFI business

The Indian MFI is in the business of being a *credit provider* with obligations on two fronts: the consumer on one end (which we call the *MFI-consumer linkage*) and the formal financial sector on the other end (the *MFI-funding linkage*) from whom the MFI obtains resources.

These two linkages impose two different sets of obligations on the MFI. In the case of the MFI-funding linkage, there is a broad range of possible firms/entities that fund MFIs. These include donors (with gifts) to banks and other financial firms (with loans) to private equity firms and the public equity market (with equity). All these are sophisticated financial participants. There is no difficulty with consumer protection, in order to protect the interests of these sources of funds. The only role of regulation lies in ensuring high quality and truthful disclosures by MFIs to their shareholders and lenders.

However, the situation is very different in the linkage between the MFI and consumers. There are three roles that the MFI can play in the domain of the MFI-consumer linkage, which helps define their obligations to the consumer:

1. That of a credit provider with the business processes to assess credit risk of non-collateralised retail consumers, along with the processes to disburse and collect payments cost-effectively to this consumer base.

2. That of a distributor of other financial products, and

3. That of an agency that promotes awareness about financial services.

These roles help define the following obligations on the MFI: (a) Truth and transparency in the distribution of financial services, (b) Adherence to fair collection practices, (c) Ensuring that the consumer is aware of all the alternatives before they make their choice.

3.3 The unique policy puzzles of micro-credit

In this section, we examine the market failures in the field of micro-finance, which induce unique policy puzzles when compared with the well understood issues of mainstream finance.

3.3.1 Unique consumer protection issues with credit recovery

Regulation can be readily visualised when there is a clear demarcation between those who have the rights and those who have the obligations. In standard financial contracts such as fixed deposits or insurance, the consumer has the rights while the service provider has the obligation.

In the case of credit, the consumer (borrower) has the obligations and the service provider (the lender) has the rights. However, the borrower does have some rights, including being presented contracts that have clarity about the terms under which the loan is made, what the definition of default is, and what their liabilities are if there is default.

The world over, legislation defines the rights of the borrower. Regulation then defines a code of conduct and practices under which debt collection can be undertaken, and how recovery can be done when the borrower defaults.

This becomes more complicated when credit is given through a JLG structure. Numerous studies have demonstrated the complexity of the joint-liability contract and the impact it has on group-member behaviour (Besley and Coate, 1995; Ghatak, 1999; Gangopadhyay *et al.*, 2005; Bhole and Ogden, 2010; Baland *et al.*, 2011). In the AP crisis for example, one of the allegations was coercive debt recovery practices. However, given that the first recourse to good credit performance was at the level of the group, the application of coercion might have been by the group leaders or other group members rather than the credit officer of the MFI. The code of conduct, therefore, needs to account for more than just the link between the service provider (the MFI as the lender) and the consumer (the borrower who is an individual in a JLG). There are two more links to account for, which are:

1. The link between the member of the JLG and the JLG itself, and
2. The link between the MFI and the other members of the JLG, when one member defaults.

To the extent that the loan is being made based on the strength of the credit quality of the group, there needs to be legal clarity on what are the rights of the lender and the obligations of the JLG when a member of the group defaults. For instance, if other group members have assets, then can those be vulnerable for possession if a group member defaults? In the case of an individual member default, does the credit information bureau mark down the credit quality of just the member, or also of the members of the JLG through which the loan was obtained?

The other concern for regulation that is unique when the JLG is involved is the link between the member and other members of the JLG. Group leaders or other members of the JLG have far greater access to the borrower member than the MFI does. This is part of the strength of the JLG that enables the comfort about credit performance from the individual. This however, becomes a concern for consumer protection. The group could more efficiently inflict damage in the process of debt collection or debt recovery than the MFI or their employees. The consumer protection mandate of the regulation must, therefore, have provision for grievance redressal for the individual borrower against the MFI as well as the JLG or specific members of the JLG through which they obtained the loan.

In summary, financial regulation applied to MFIs that is motivated by consumer protection[8] needs to explicitly include protection at several levels:

1. The rights of the borrower against the MFI,
2. The rights of the JLG against the MFI, *and*
3. The rights of the individual borrower against the JLG, either individual members like the group leader, or as a whole.

[8] These issues apply equally for all JLG lending, regardless of the organisational structure through which the lending takes place.

3.3.2 Unique micro-prudential regulation issues about MFIs

MFIs lend to households, and present no risk to households if they fail. Hence, regulators do not need to worry about the failure of an MFI from the consumer protection perspective. There is, however, a concern about the implications of lending to MFIs for the financial firms which lend to MFIs. This, in turn, requires careful analysis of the mechanisms of failure of the MFI.

The credit risk associated with lending to a JLG differs in important ways from that associated with lending to an individual, for two reasons:

- The first issue relates to correlated defaults associated with homogeneous credit quality. It can be argued that there will always be a higher degree of homogeneity when lending to members in a group – whether the members are from the same cultural background, physical location, risk preferences, political preference etc. The commonality of these factors in a group can lead to correlated changes in the level of default, as was seen in the case of willful defaults among micro-borrowers of the same community in the Kolar district in 2007. These defaults occurred simultaneously in all the MFIs that were operating in this district at the time.

  MFIs have modified their business models to reduce this concentration risk. However, not all factors of homogeneity can be directly observed. The databases required to analyse these issues – at the group level and not just at the individual level – are not available at present. Credit bureaus today collect repayment history at the level of *individuals* and not groups. Complex dynamics can arise from the interplay between multiple individuals and multiple groups. If there are different groups (perhaps across different MFIs) who share some similar members, it is possible that a default of a member or a set of members can generate default across different groups. This, in turn, may adversely impact the default experience across MFIs, depending upon the contractual implications of member default and JLG default to the MFI.

- The second path through which the JLG structure of lending could enhance the systemic risk for the MFI industry is because a group could be an easier channel for obtaining political interference. On one hand, the JLG can engender better credit behaviour from their members, but on the flip side, JLGs can lead to political mobilisation that hampers a sound credit culture.

These arguments suggest that the regulation of the credit business that is implemented using the joint liability group structure does involve different considerations. These unique features influence our thinking about the three pillars of financial regulation, namely consumer protection, micro-prudential regulation and systemic risk.

4 The way forward

4.1 What should financial regulation do?

Given this background, what should financial regulation for the micro-finance industry do so as to support the robust growth of the industry? Our analysis suggests the following issues are most important:

1. Protecting the rights of the micro-finance consumer as a member of a *joint-liability group*, with a focus on ensuring quality of financial services distribution.
2. Enhancing credit information to go beyond tracking of individuals to the tracking of groups.
3. Improving the information available to the financial firms that lend to MFIs.

   This requires transparency about the characteristics of micro-credit portfolios, both at the level of the individual borrower and the related group exposure. This would assist better decision making by the financial firms who give debt and equity to MFIs.
4. Improving credit access for MFIs, with diversification beyond the narrow focus on banks as a source of credit. This involves solving policy problems in the fields of securitisation and capital controls.
5. Reducing political risk at the state level.

Since the primary factor driving the crises described in Section 2.2 were concerns about protecting the rights of the consumer of micro-financial services, we focus on consumer protection regulation in the following sections.

4.1.1 Consumer protection regulation for micro-credit

While the international discourse recognises consumer protection as the central motivation for financial regulation, mainstream Indian laws and regulations in the field of finance are largely silent on consumer protection. A recent government committee report (Committee on Investor Awareness and

Protection, 2010) has brought consumer protection to the attention of policy makers, and in coming years, this may be expected to substantially influence the direction of financial law.

As has been argued above, within the field of consumer protection for personal borrowing, there are unique problems with micro-credit based on JLGs where joint liability for repayment of debt is used instead of collateral. Joint-liability contracts involve concerns regarding enforcement, ex-post repayment incentives, and risk taking by group members. Fresh thinking is required at three levels in Indian financial policy: (a) To build a new set of financial laws which lay down consumer protection as the major function of financial regulation; (b) Within this, to build a consistent framework for consumer protection when there is borrowing by individuals across an array of lenders; (c) Within this, to build a regulatory strategy that responds to the unique problems of micro-credit.

Contracts need to be drawn for member borrowers while explicitly acknowledging their participation as a group. The rights and obligations of each group member vis-a-vis the MFI, and vis-a-vis one another, has to be made explicit. The impact of defaults on future group-borrowings and on credit-histories of the other group members needs to be monitored. Protection from malpractices by the MFI, as well as from the pressures of internal group members, ought to be covered under the rubric of consumer protection.

In the short term, given the absence of financial laws that focus on consumer protection in general and household borrowing in particular, there may be a case for rapidly finding solutions to the problems presented by micro-credit and JLG alone. A Micro-credit Authority of India (MCAI) could be setup (Sahoo *et al.*, 2012). The MCAI would set up details on registration, licensing and governance of micro-credit entities. Further, the MCAI would be entrusted with the task of developing consumer protection guidelines to guard against the possibility of a repeat of the 2010 AP crisis. The MCAI would also take on the task of setting disclosure norms for the micro-credit and micro-finance firms about their portfolios, and to innovate in mechanisms to facilitate flow of funds to the sector.

However, regulation will always face limitations on ensuring that the rights of the individual borrower is protected in the JLG lending model because the credit process takes place through the group. The MCAI can monitor and supervise the credit practices of the MFI, but cannot effectively reach into the relationship between groups and their members.

As the market for micro-finance develops, and better credit processes fall into place, there may well be a move away from group-lending towards individual lending supported by the Unique ID, credit histories and collateral checks. This would mirror the developments of personal loans that has been seen worldwide. When that happens, and micro-credit diverges from the JLG structure, the mainstream approach in consumer protection towards personal loans would be adequate, and the special treatment of micro-credit would no longer be required.

4.1.2 Consumer protection regulation for financial distribution

While regulation of advice is absent today, some effort has already been made at proposing a legislative framework that will provide for the regulation of financial advice (Sahoo and Sane, 2011). Distribution of financial products falls under the purview of the various product regulators i.e. IRDA for insurance, PFRDA for pensions, RBI for banking and SEBI for capital markets. Micro-finance entities already have to seek approval from the various product regulators to sell their products.

In the long term, the goal of financial policy that aims at consumer protection should be two-fold: an explicit recognition of credit products as one amongst a portfolio of financial products which include equity, insurance, pensions and savings, and an explicit recognition of the role of distribution and advice of financial products and services as a significant cause of malpractice in this sector. Micro-finance should eventually be subsumed under these.

4.2 Review of existing policy responses

Two key efforts in proposing a framework for the Indian micro-finance industry after the 2010 AP legislation was passed are the Malegam (2011) report and the Micro-finance (Development & Regulation) Bill, 2011 (Ministry of Finance, 2011). However, both these efforts focus heavily on micro-prudential norms and corporate governance issues for the MFI. We analyse these efforts from the conceptual framework of the previous sections.

4.2.1 The Malegam Committee Report

The Malegam Committee Report (Malegam, 2011) was initiated by the Reserve Bank of India (RBI). The RBI, being the regulator of both the NBFCs and the banks, had a two-fold interest in this issue since several MFIs with large exposure to the Andhra Pradesh defaults were structured as NBFCs, and their collapse would affect bank portfolios since banks were the largest source of funding to the NBFCs.

The Malegam Committee report has consequently narrowly focused on the question of the NBFC-MFI. It starts with a definition of the NBFC-MFI and lay down conditions related to net-worth and assets that it had to satisfy as a NBFC-MFI. The report requires NBFC-MFIs to maintain a capital-adequacy ratio and provisions for loan losses. NBFC-MFIs are also required to follow certain corporate governance norms.

A key gap in these recommendations is that they apply only to NBFCs, which are only 45% of MFIs by number (Srinivasan, 2010). Another problem is the focus on the *prudential* aspects of MFI business. Even if all of these rules were in place before October 2010, they could not have protected the small consumer from the alleged malpractices of MFIs. 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 micro-credit as a whole.

The approach of the report to consumer protection has been to prescribe conditions on who can be consumers of MFI and the manner in which MFIs can lend. The report goes on to stipulate rules on a) the purpose for which MFIs can disburse loans (i.e. 75% of the loans may be disbursed only for *productive purposes*), b) pricing of loans and the quantities and rates that can be charged (a margin cap of 26% which is the difference between the amount charged to the borrower and the cost of funds to the MFI), c) location where sanctioning and disbursement of loans can take place, and d) the individuals who can be consumers (an individual cannot be a member of more than two groups and has to have annual household income of less than Rs.50000).

These initiatives do not add up to a comprehensive approach to consumer protection. These conditions severely limit who can be consumers of micro-finance and leads to a restrictive definition of financial exclusion – the very problem that MFIs were successful in solving – while not necessarily ensuring better credit processes. The report does mention setting up of a credit information bureau and an Ombudsman. The responsibility of arbitration, however, is left to the manager of a lead-bank in each district which may not provide adequate protection against malpractice.

4.2.2 The Micro-finance (Development & Regulation) Bill, 2011

The Micro Finance Institutions (Development & Regulation) Bill, 2011, (the Bill) has been drafted with the objective to provide a regulatory structure for the micro-finance industry. In a nutshell, the Bill views micro finance institutions as 'extended arms of banks and financial services'. However, rather than drawing upon existing regulation in these areas, it proposes to: (a) Create advisory councils to guide the development of the industry, (b) Place registration and micro-prudential functions upon the RBI and (c) Create a new redressal mechanism for handling consumer grievances.

A careful legal analysis of this Bill reveals certain areas of concern. The first is about the clarity of objectives. Regulation is not an end; it is the means to an end. Until the problem is clearly stated, the rationale underlying the bill will not be clear to the judiciary and to the regulated industry. In addition, the lack of clarity about market failures that motivate government intervention tends to obscure the process through which law is drafted.

The Bill envisages deposit-taking by MFIs. However, it implies that these same fixed deposits would be then lent out to micro-borrowers who could be the depositors themselves. This would mean that the savings of the poor would be lend out to risky credit products. Great care needs to be exercised here, particularly given the problems which have been experienced in India with cooperative banks and deposit-taking NBFCs. Even if it were felt that MFIs should become banks, the appropriate legal apparatus for this should be within the Banking Regulation Act, and not a new parallel legislation.

The Bill envisages the field of micro-finance as interacting with an array of government bodies: the Central Government, RBI, NABARD, the Micro Finance Development Councils and the State Advisory Councils. The resulting scenario will involve friction between multiple government agencies, through overlapping jurisdictions. This will inevitably lead to a loss of accountability since nobody is clearly responsible for a well defined outcome.

The Bill envisages a fiscal function: a tax (in the form of a reserve fund) which is imposed upon the industry, which is to be earmarked for the purpose of funding MFIs in the industry. This is a questionable idea at many levels. Efficiency demands raising resources through income tax and the GST; levying charges on an industry should be avoided. In addition, it is not clear that the government can play a useful role as a venture capitalist or as a lender to this industry.

The Bill has not provided a measure of the cost that will be faced by the government (or RBI and the other agencies in their regulatory capacity) in performing the tasks envisaged in the Bill. Such calculations would help improve the ability of the Ministry of Finance and the Parliament in assessing the benefits versus the costs of enacting the legislation.

The draft Bill leaves many concerns on issues of rule of law (Roy *et al.*, 2011). The Bill makes any violation to be a criminal offence. At the same time, consumers are visualised as having no recourse to civil or criminal courts without the permission of the RBI. There is no skilled judicial appeals mechanism (such as the Securities Appellate Tribunal) where orders can be appealed.

5 Conclusion

Many decades of government interventions into finance gave little progress on delivering credit to the poor. In a short time, the combination of an innovative contractual structure (the JLG) coupled with the for-profit MFI (that connected micro-credit to the formal financial system) has made a significant difference to access to credit. While MFIs are criticised for usurious interest rates and coercive credit recovery, we need to remember that households *choose* to borrow from MFIs as a way of avoiding even higher interest rates, and the possibility of even more coercive recovery methods, from moneylenders.

All financial regulation falls under the three issues of consumer protection, micro-prudential regulation and systemic risk. Prudential regulation is a relatively minor concern: at worst, if micro-prudential regulation fails, the sophisticated financial firms that lend to MFIs will suffer unexpected losses. Similarly, until micro-lending exceeds 5 to 10 per cent of GDP, there is little possibility of systemic risk emanating from the field. Hence, the main problem in the field of micro-finance is that of consumer protection, which has been the main focus of this article.

If regulation seeks to strengthen the rights of the MFI-consumer, then it must take into consideration the effect of group-lending while understanding market failures in sales practices or debt recovery practices. In micro-credit, the contract that the MFI signs with an individual involves a two-tier obligation: the first is of the MFI with the individual. However, the second is with the joint liability group itself – without which the individual cannot become a consumer of the MFI. Regulation ought to consider the rights of the customer against the MFI, the rights of the JLG against the MFI as well as the rights of the individual member against other members of the JLG.

At present, MFIs are primarily focused on lending. Looking to the future, the MFI business model has a network of employees through which other financial services such as deposits, insurance and pensions can be delivered to the same poor household that consumes credit services today. At this time, the issues faced in consumer protection and advice will broaden out, beyond the difficulties seen today.

Lastly, in order to ensure consistency and avoid regulatory arbitrage, regulation needs to be consistent across the activity of credit provision, regardless of the entity that does the activity. There is little merit in creating a separate regulatory authority for governing micro-credit as opposed to consumer credit. More generally, there is little merit for creating regulation of distribution of financial services like pensions and insurance which could be fruitfully deployed along the same network that the MFI uses to disburse credit to the poorer households. Thus, a larger effort is required to put the financial regulatory architecture in India on a sound footing, wherein which the field of micro-finance needs to be placed correctly.

In the long run, the implementation of identity infrastructure coupled with credit bureaus will fundamentally modify incentives of the borrower. This will make it possible to lend to individuals based on credit scoring and credit bureaus. The innovation of the JLG will then become less important. In that future, the issues faced today with JLG-oriented mechanisms for lending to the poor will subside. Policy makers need to work on both tracks: To create the regulatory infrastructure that copes with the JLG-oriented realities of today, while simultaneously laying the informational foundation for a very different world of the future.

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