

“Microfinance Sector in India - Developing a supportive policy and regulatory framework and environment - Position and Perspectives” - Abstract of the Paper

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1. Microfinance Sector in India

Indian scenario - Microfinance Service Providers - Formal and Informal Institutions - Apex Development Financial Institutions and Banks - MFIs of various legal forms - spectacular growth of SHG-Bank Linkage Programme and its predominant position in microfinance-Rapid growth of MFIs and changing landscape - Successes and areas of concern.

2. Microfinance Regulation in India - Experience

Formal banking structure - regulatory arrangements and experience - Regulation of For Profit registered companies/NBFCs - experience

3. Regulatory Approaches/Initiatives in MFI Sector - International - Learnings

Why regulation? The general objectives and guiding principles - Prudential and Non-prudential - Prudential norms applied generally to MFIs, Differences from conventional banking regulation - Protection of thrift/depositors and beyond - building inclusive financial services, adherence to sound performance standards [Portfolio management, MIS, internal checks and control, Self-Regulation, Governance, etc.], Client/consumer education, removal of restrictions for access/leveraging funds, disclosures and transparency in functioning, Common Reporting, Prompt Corrective Action, giving credibility to MFIs, creating conducive policy environment for financial discipline - Regulation in a broader context and vision - a framework tailored to national circumstances - expected ST and LT outcome/benefits.

4. Proposed statutory framework for microfinance services – Position & Perspectives

Broad philosophy, objectives, features, scope and provisions of the Draft Microfinance (Development and Regulation) Bill 2007 - Regulation + role envisaged for the Regulator - Role expectations for policy formulation, standard settings, ensuring codes of conduct and fair practices, data- building, customers' education, capacity-building, studies and documentation, grievance redressal, coordination, etc.

Suggested Approaches towards regulation of MFIs-avoiding over-regulation, Public Awareness building - Supportive Sector/Institution building interventions

On-going Preparations - Future road map and long term perspectives for orderly growth of the MF sector - integration with mainstream financial system.

5. International Cooperation and Exchanges – Possibilities

International Cooperation and Exchanges in regulation and supervision - Global efforts in micro-credit/microfinance development should cover/focus on regulatory best practices for furtherance of the Sector - Mutual understanding and cooperation for development of regulatory, supervisory and development architecture, tools and methods, rating norms, disclosure standards, risk management, Inspection Manual/Guidelines, Training modules, Off-site Surveillance System (OSS), computerisation and MIS, Development of Social Performance Management.

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Microfinance Sector in India - Developing a supportive Policy and Regulatory Framework and Environment - Position and Perspectives

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1. Microfinance Sector in India

Microfinance is defined as provision of thrift, credit and financial services and products of very small amount to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improving their living standards (Small amount is conceived upto Indian Rupees Rs.50,000/- for the present). Microfinance per se has been century old phenomenon in India with emergence of cooperative banking in the beginning of 20th century. There have been policy initiatives, institutional thrust and efforts on the part of policy makers, development institutions and implementing agencies for furtherance of microfinance services over the years in the context of vast socially disadvantaged and financially excluded population. A series of policy measures were taken by the Govt. of India in the financial sector, which have facilitated intensification and deepening of microfinance. These included nationalisation of commercial banking sector in 1969, setting-up of Regional Rural Banks (RRBs) in 1975, reforms of financial sector (since 1991), implementation of pro-poor schemes/programmes through credit delivery system, etc. Similarly, Reserve Bank of India's (RBI) (the Central Bank of the Country) initiatives in terms of focus on expansion of rural branches of banks, priority sector norms, financial inclusion, etc., had positive bearing on microfinance development. The priority sector norms envisaged that 40% of Net Bank Credit should be directed towards the identified sectors/activities of which 18% for agriculture, 10% for weaker sections, etc. With over 6,00,000 villages and 74% of poor people living in rural areas, microfinance continued to be the major challenge for rural credit. Thus, the formal financial sector which consists of about 36000 rural and semi-urban branches of Commercial banks, 14000 branches of RRBs, 13,000 branches of Cooperative Banks and over a hundred thousands of rural Cooperative Societies have been engaged in rural credit and the bulk of their loan accounts are small size loans within the purview of microfinance. National Bank for Agriculture and Rural Development (NABARD) was set-up by an Act of Parliament in 1982 for pursuing the mandate of 'integrated rural development' through triple major functions- financial, developmental and supervisory. It also played catalytical role in the microfinance development.

1.2. Despite the phenomenal expansion of the organised banking system and continued thrust on pro-poor policies and schemes till 80's, a large segment of the poor continued to remain excluded from the banking system. The traditional misconception about the banking with poor that they cannot save, not credit-worthy and cannot manage business enterprise, prevailed supreme during the period .

Moreover, there were serious aberrations affecting timely and adequate credit delivery to the poor through conventional lending procedure, system and schemes. The impact of poverty alleviation programmes was diluted because of poor targeting, mismatch between borrowers' capabilities and purpose of loans, lack of linkage with other support system, leakages at various levels, lack of voluntary participation on account of directed credit, inadequacy of loan and consequent substandard asset creation. NABARD initiated search for alternative policy, systems, procedures, savings and loan products, other complementary services and new delivery mechanism that would fulfill the requirements of the poor and disadvantaged.

1.3. The Self-Help Groups (SHGs) - Bank Linkage Programme (SHG-BLP) was conceptualised and launched by NABARD in 1992 as a pilot with 500 SHGs combining the mutual strength of formal credit institutions and informal agencies (SHGs). The linkage concept involves forming small, cohesive and participative groups of the poor, encouraging them to pool their savings regularly and using the pooled savings to make small interest-bearing loans to members and in the process, learning the nuances of financial discipline. The SHGs first get saving linked with banks and with banks gaining confidence with the group dynamics and their internal lending processes, provide credit in proportion to the savings. The success of programme exploded all myths regarding the Banking with Poor. Recognising its potential innovation for providing access to microfinance in a cost-effective, hassle-free and timely manner to the poor, the programme was mainstreamed in 1996. The programme was made part of priority sector and normal lending business of the banks. With the policy support of Reserve Bank of India, continued multi-pronged promotional efforts and leadership of NABARD, participation of all other stakeholders - Self Help Promoting Institution (SHPI), financing banks, Govt. etc., the SHG-BLP continues to flourish. The programme has become a national movement with more than 6.12 million SHGs having been saving-linked with savings of Rs.54456.20 million and more than 4.24 million SHGs credit linked with loan outstanding of Rs.226808.5 million as on 31 March 2009. It is the largest microfinance programme in the world in terms of outreach covering nearly 86 million households, largest financial inclusion programme in India. SHGs have become the common vehicle of development process, converging all development and livelihood programmes. The programme has transformed the rural financial institutions and their approaches to microfinance delivery to the poor, led to emergence of large number of SHPIs, Federations, Business Facilitators and above all, ushered socio-economic empowerment of the poor, particularly women. The massive growth of the programme has brought to the fore several new issues and challenges e.g., ensuring balanced distribution of SHGs across the regions, micro-enterprise promotion for matured SHGs/members, sustenance of quality of SHGs, etc.

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1.4. On the other hand, MFIs of different legal forms have made rapid strides and expanded their outreach through SHGs, Joint Liability Groups (JLGs) and individuals by way of providing them doorstep financial services. Under SHG-Bank Linkage Programme, apart from banks financing SHGs directly, they have financed MFIs for on-lending to SHGs and other small borrowers. As on 31 March, 2009, 1915 MFIs had loan outstanding of Rs.50091 million under this route. Besides, the MFIs have pursued aggressive expansion mode. Notwithstanding their growth in business portfolio, outreach and financial services, the issues and challenges of multiple financing, over-indebtedness, weak governance/internal checks and control system, high interest rates, lack of transparency of operations, etc., have surfaced, in the MFI front.

1.5. Notwithstanding the above growth story of SHG-Bank Linkage Programme and MFIs, there is huge unmet demand of financial services for the poor. As per the World Bank's estimates on global poverty, India has 456 million poor people of which about 42% of total population, 1.15 billion living below the revised International Poverty Line (IPL) of USD 1.25 (INR 50) per day. As per the National Sample Survey Organisation (NSSO) Survey (59th Round) Report, 51.4% of farmers households are financially excluded from the formal/informal sources. Of the total farmers households, only 27% access to formal sources of credit and one-third of this group also borrows from non-formal sources. In this context, the microfinance sector offers tremendous scope for growth. There are expectations from the new generation of customers, besides small farmers, marginal farmers, oral lessees, tribals, dryland farmers, rural women, etc., for their unique needs for financial services.

2. MFIs - Various Legal Forms

In response to inadequacies of the banking system in terms of outreach to bottom of pyramid on the one hand and the exploitative practices of village money lenders in relation to their customers, trapping them in an ever moving vicious circle of poverty, paved the way for creation of people-based voluntary organisations which started to focus on or diversify to microcredit.

2.1 NGO-MFIs

The NGOs are registered as Public or Private Trusts under the Indian Trust Act, 1882 or any State enactment governing trust for public religious or charitable purposes. Many are also registered under the Societies Registration Act, 1860 or any other State enactment governing such Societies. NGO-MFIs vary significantly in their size, philosophy and approach and take-up financial intermediation to provide microfinance.

2.2 Cooperative MFIs

The Cooperative Societies registered as cooperative society or mutual benefit society or mutual aided society under any State enactment relating to such societies or any multi-State cooperative Society registered under Multi-State Cooperative Societies Act, 2002, do undertake microfinance activities.

2.3 Non-Banking Financial Companies (NBFC)

The profit-making NBFCs registered under the Companies Act, 1956 undertake microfinance activities.

Not for profit Section 25 Companies as also NGO-MFIs are not permitted to accept public deposits. The 'For Profit' NBFCs which take public deposits are regulated prudentially by the RBI.

2.4 Thus, three categories of institutions emerged in microfinance sector. Firstly, Apex Development Institutions like NABARD, Small Industries Development Bank of India (SIDBI) and Rashtriya Mahila Kosh (RMK) provided funding and promotional support to banks/MFIs. Secondly, the banks with their more than 150,000 outlets in rural India upscaled and deepened their microfinance delivery mainly through SHG-BLP. Thirdly, MFIs of the above categories introduced varieties of products and services.

Concrete and authentic data on number and nature of MFIs are not available in the absence of full-fledged and comprehensive regulatory architecture.

As per RBI Annual Report, there were 12,739 NBFCs of which 336 NBFCs had been permitted to accept public deposits. As per Sa-dhan Quick Report 2009 (umbrella organisation of MFIs), 232 MFIs had loan outstanding of Rs.11374 crore supporting 2.26 crore households. For profit organisations shared 62% of client outreach and 75% of the total business portfolio. As per the Inventorisation Survey conducted by GTZ in 13 States, 786 MFOs (3 Cooperatives, 445 MACS, 24 NBFCs, 9 Section 25 Companies, 199 Societies and 106 Trusts) had total loan outstanding of Rs.41420 million as on 31 March 2008. However, only 4% of the agencies (companies) accounted for 67% of total loan outstanding.

3. Supervision and Regulation of banks and MFIs in India

3.1 Banking Sector

The Banking Regulation (BR) Act, 1949 provides legal framework for regulation and supervision of the formal banking institutions. The financial institutions includes 80 Commercial Banks (CBs), 86 Regional Rural Banks (RRBs), 1770 Urban Cooperative Banks, 4 Development Finance Institutions

(DFIs), 12739 NBFCs, 31 State Cooperative Banks (SCBs), 370 District Central Cooperative Banks (DCCBs). In terms of the B.R. Act, together with certain provisions of RBI, Act, 1934, the RBI assumes powers to prescribe standards and liquidity, solvency and soundness of the regulated institutions so as to ensure that interests of depositors are protected. The Commercial Banks, Urban Cooperative Banks and For Profit NBFCs (registered with RBI) will be subject to supervisory and regulatory jurisdiction of RBI, while RRBs and SCBs/DCCBs will be under the supervisory jurisdiction of NABARD, without dilution of the regulatory and supervisory powers of RBI. The supervisory and regulatory policy and practices for these entities have been developed and matured over the years. While the Board of Financial Supervision (BFS) in RBI provides direction and guidance to exercise regulatory and supervisory powers, the Board of Supervision (BOS) in NABARD extends policy guidance in supervision of SCBs/DCCBs and RRBs. The Asset classification and provisioning norms, supervisory rating standards, liquidity, disclosure norms, Risk Management System, audit and accounting principles, exposure limits, codes of standards and fair practices, on-site inspection processes, Off-site Surveillance System (OSS), statutory reporting and compliance through Prompt Corrective Action (PCA) trigger points, preventive action through warning signals and punitive action through regulatory directions/penalty/prohibitions/cancellation of license, Grievance Redressal Mechanism, internal checks and control system, entry barriers, supervisory and regulatory guidelines, fit and proper criteria for Board and Directors, Corporate governance standards, Branch Licensing Norms, Financial Performance Standards, etc., have been put in place, as a matter of regulatory and supervisory architecture. CBs have been asked to comply with Basel II norms within the stipulated time-frame. The banks which provide microfinance are required to undertake those safeguards and obligations. Although, RRBs and cooperative banks have not been called upon to comply with various principles of Basel Principles of I/II supervision, specifically within any time-frame, they have been facilitated to implement/comply with various principles of supervision as enshrined by Basle Committee. NABARD has adopted CAMELSC approach (Capital, Asset Quality, Management, Earnings, Liquidity, Systems and Compliance) with regard to inspection process and supervisory rating of RRBs and Cooperative Banks. NABARD, apart from making suitable recommendations to RBI for licensing and regulatory action and providing inputs from time to time, has evolved and implemented suitable supervisory best practices pertaining to RRBs and Cooperative Banks. There has been steady progression in this direction.

3.2 Regulation of MFIs

NBFCs have played significant role in the Indian Financial Sector in providing outreach to the small clients. With the objective of integrating NBFCs with the financial mainstream, the RBI brought them under its regulatory arm by way of amendment of RBI Act, 1934 in 1996. This paved the way for mandatory registration of companies undertaking financial services with the RBI, compulsory credit

rating of deposit taking NBFCs and their compliance to prudential norms. As per Section 45-IA of the BR Act, no NBFC can commence or carry on the business without obtaining certificate of registration from the RBI and having Net Owned Funds (NOF) (Share holders' equity + internally generated reserves) of Rs.20 million. All NBFCs have to comply with the provisions of Companies Act relating to Board of Directors, Share Capital, Management Structure, audit, maintenance and publication of books of accounts and general conduct, etc., in addition to the requirements of RBI. Important prudential norms to be complied include Capital Adequacy Ratio (CAR) based on the risk weight of assets (15%), income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, disclosures in balance sheet, ceiling on concentration of credit/investment, etc. Not less than 15% of their deposits should be invested in specified securities and approved securities (Govt. Securities and Bonds Guaranteed by Govt.) NBFC are required to notify RBI of their intention to open branches. However, only the NBFCs taking public deposits have to comply with prudential norms on CAR, ceiling on concentration of credit/investment/quantum of deposits, etc. Thus, RBI is empowered to give rigorous policy prescriptions and regulatory directions to NBFCs having requisite NOF and accepting public deposits.

However, by loan volumes, 77% of the MFI Sector is under RBI's direct regulation; but 75% of the MFIs are functioning outside regulation. The prudentially unregulated entities are MACS, Trusts, Registered Societies which are having a small client base and limited volumes of business.

4. Regulatory Approaches and Initiative and in MFI Sector - International Experience - Learnings

4.1 Advantages of Regulation

Although the regulation of MFI Sector has been of recent origin, the regulation per se of banking sector is established, well documented and evaluated over the years. The following are accepted as attended advantages and benefits of regulation and supervision of banks/MFIs:

- i. Protects the interest of the depositors;
- ii. Put in place prudential norms, standards and practices;
- iii. Provides sufficient information about the true risks faced by the banks/MFIs;
- iv. Promoters systemic stability and thereby sustains public confidence in the banks/MFIs;
- v. Prevents a bank's/MFI's failure/potential dangers through timely interventions;
- vi. Penalises the violations, misconducts, non-compliance to the norms of behaviour;
- vii. Provides invaluable advisory inputs for problem-solving and overall improvement of the banks/MFIs;
- viii. Promoters safe, strong and sound banking/MF system and effective banking/MF policy and
- ix. Promotes and enhances orderly economic growth and development.

4.2 Genesis, Trends and Practices of Regulation - International Perspectives

During the 1990's, many countries started to supervise and regulate the nascent microfinance sector. The earliest initiatives to bring microfinance under formal regulation and supervision were undertaken in Latin America. Around the world, microfinance has been on the agenda of policy makers, regulators and supervisors. Over 50 countries have implemented or are considering specific arrangements for regulation and supervision of microfinance either as a separate new law or as amendments to the existing legal and regulatory framework. In certain countries, Central Bank has assumed the supervisory and regulatory role, while in others separate authority (existing authorities or newly created authority/networks) has been empowered and delegated powers of regulation/supervision. In some countries Self-Regulatory Organisations (SRO) have been tried, particularly for non-prudential regulation. The principles define regulation as set of statutory rules that apply to MFIs while supervision is the process of implementing and enforcing compliance with these rules. A clear distinction between prudential and non-prudential regulation is also established. Prudential regulation mandates capital adequacy requirements, loan loss provisioning, financial solvency, etc., for protecting the depositors. Non-prudential regulation covers enabling aspects like business operation, performance monitoring, credit information services, transparent reporting and disclosure, codes of fair practices and system, consumer protection, fraud prevention, etc. There has been differences in the extent and application of regulations - some have extended prudential to only deposit-taking MFIs. In recognition of uniqueness of MFIs and small, mostly uncollateralised loans, lower minimum capital, higher capital adequacy, lower unsecured lending limits, more aggressive loan loss provision, simpler loan documentation, lower physical security and branching needs, lower frequency and content of reporting, lower reserve against deposits, ownership suitability and diversification requirements are suggested. Most of the countries use a combination of quantitative and qualitative indicators to assess soundness of MFIs. The regulatory rating indicator of ACCION CAMEL has been suitably adopted to MFIs. The rating agencies like planet rating, M-CRIL, Micro Finanza, Moody's, Standard and Poor, etc., have also developed suitable rating norms and could be useful tools for regulators/supervisors. There has been also attempts to evolve social performance rating standards by integrating economic and social rating, by the Social Performance Task Force (SPTF), CERISE, CGAP - Grameen Ford, FINCA's FACT Tools, Planet, M-CRIL, etc. Although, guiding principles on Regulation and Supervision of Microfinance issued in 2003 by Consultative Group to Assist the Poor (CGAP) indicates certain consensus, there has been divergence in trends and practices across the world.

4.3 The following are certain broad experiences and lessons internationally, in microfinance regulation.

- (i) Microfinance has been conceived with a wider spectrum and perspectives
- (ii) Microfinance has been driver to building inclusive sector.

- (iii) Regulatory framework is tailored to the national circumstances.
- (iv) Regulation is directed towards activities rather than institutions
- (v) Regulation should be proportionate to the expected benefits
- (vi) Elements for an enabling framework are to encourage microfinance activities and increase the level of access to finance.
- (vii) The regulation is to encourage linkage and partnership between banks, Microfinance Organisations (MFOs) and other retail outlets.
- (viii) Regulation is to ensure consumer protection - prohibition of deceptive and unfair practices in lending and collection, to ensure disclosure of full costs, fees and terms of products and services, supply clients with accurate, full, accessible, comparable and transparent information.
- (ix) Microfinance regulatory framework should find ways to pressure the social objectives of microfinance transactions.
- (x) Regulation is to set performance standards portfolio management, MIS, internal control system and governance.
- (xi) Regulation ensures registration, reserves, compliance with prudential norms, directions in reporting needs.
- (xii) We need not regulate those which we cannot supervise.

The international experience of microfinance regulation clearly indicates that in several countries in Asia and Africa that microfinance could be central to achieving overall social objectives and that a conducive environment including a relevant legal framework needs to be provided for the sector to grow in orderly and systematic manner.

5. Proposed statutory framework for Micro Finances Services- Position and Perspectives

5.1 Draft Microfinance (Development and Regulation) Bill 2007

The issue of evolving/implementing a suitable statutory and policy framework for regulation and supervision of the growing microfinance sector had drawn the attention of the Policy Makers amidst the debates of over the issue in the country. A Task Force was constituted in 1999 (under the Chairmanship of the then Managing Director of NABARD). to look into the related issues, which had recommended certain short term and long term measures for the purpose. The GOI took the pro-active initiative of drafting Micro Financial Sector (Development and Regulation) Bill, 2007 in consultation with RBI, NABARD, Indian Banking Association (IBA) and microfinance sector, with a view to bringing about appropriate statutory framework, institutional mechanism and policy environment. The objectives were as under:

- (1) To bring about orderly, holistic and integrated development of microfinance sector;
- (2) To enlarge and facilitate financial inclusion to the poor and disadvantaged;
- (3) To protect the interests of small depositors/thrifts;
- (4) To eliminate the scope of exploitation to the vulnerable clientele of the sector and
- (5) To facilitate universal and easy access to credit, thrift and other financial facilities to women and disadvantaged.

The intentions of the GoI in this regard were spelt out in the consecutive Union budget announcements - 2006 and 2007.

The draft bill was approved by the Union Cabinet and then introduced in the Parliament on 20 March 2007. Then the bill was referred to the Standing Committee of Parliament. All stakeholders had presented their views/suggestions to the then Committee. The period of Lok Sabha expired and new Govt., at the Centre took over after the general election. The GoI is contemplating to re-introduce the bill in the Parliament. In the meanwhile, the Committee on Financial Inclusion (Dr. Rangarajan Committee) recommended that regulation of the entire MFI Sector including NBFCs may be kept under the Bill.

5.2 Provision and features of the Draft Bill

The basic features of the draft bill are as under:

- i. In recognition of NABARD's track record in the relevant field, the bill envisages to entrust to the National Bank the regulatory, supervisory, promotional and developmental role for microfinance services through Microfinance Organisations (MFOs)
- ii. As NBFCs and Section 25 Companies are already regulated by RBI, it only seeks to regulate and develop the Micro Finance Organisations (e.g. Societies registered under Society Registration Act, 1860, Trusts created under the Indian Trust Act, 1982, Public Trust under State enactment, Cooperative Societies under Multi-Purpose Cooperative Societies Act, 2002, Cooperative Society/Mutual Benefit Society) undertaking thrift and/or other micro finance services for the poor and disadvantaged section.
- iii. A Microfinance Development Council (MFDC) comprising of senior executives from RBI, NABARD, SIDBI, NHB (National Housing Bank), GOI and eminent experts to advise Regulator and give policy directions.

- iv. Envisages policies and procedures for MFOs for registration and cancellation of registration.
- v. Defines the powers and functions of Regulator in various aspects in implementing the provisions of the Act and obligations of the supervised MFOs.
- vi. Envisages the functions and the jurisdiction of Auditors, Ombudsman (for redressal of public grievances) and the GOI.
- vii. The provision of penalties on account of violations of the Act
- viii. Institution of Micro Finance Development and Equity Fund (MFDEF) for promotion and development of microfinance services.
- ix. The areas under which regulations to be made by the Regulator and the rules to be framed by GOI.

5.3 Role Expectations from the Regulator

The following are the functions envisaged for the Regulator in the draft bill:

- i. To promote and ensure orderly growth of MF services;
- ii. Policy formulation for greater transparency, effective management, better governance and efficient MF services;
- iii. To evolve Sector-related benchmarks and performance standards – methods of operations, governance, codes of conduct;
- iv. Developing rating norms for mFOs – accessing bank credit, Business Correspondent/ Facilitator;
- v. Specifying Accounting/ audit standards, books of accounts;
- vi. Developing information/ database for mFI sector;
- vii. Promoting institutional development customers' education, training and capacity building;
- viii. Supporting research, documentation and dissemination of information;
- ix. Undertaking Registration – procedures, issuance, cancellation;
- x. Conducting On-site inspection, off-site surveillance, issuance of directions;
- xi. Exercising penal powers in case of violation/false information;
- xii. Coordination with other agencies; and
- xiii. Managing/ administering Ombudsman scheme, mFDEF, mFDC.

5.4 Broad Philosophy of the proposed Bill – Beyond conventional Banking Regulation

- i. Regulation of microfinance services – Directed to activities rather than institutions;
- ii. Regulation to ensure protection of the consumers (Micro-clients) – Public Grievance Redressal;

- iii. Regulation to concurrently trigger development processes considering the very nascent and delicacy of microfinance services/MFOs;
- iv. Regulation to cover thrift or any other financial services;
- v. Rigours of registration/regulations for MFOs doing thrift services compared to other financial services; and
- vi. Regulation to strike a balance between development of none/less regulated entities and tough financial discipline.

5.5 Expected Outcome for the proposed Bill

- i. Development of order and discipline and sound system, fair practices, Governance in MFOs;
- ii. Encouraging disclosures and transparency on the functioning;
- iii. Generating data-base and financial and information on MFOs – Common Reporting;
- iv. Development of Social Performance Management;
- v. Providing protection to thrifts of the members;
- vi. Ensuring Grievance Redressal of the customers;
- vii. Triggering Developmental and corrective action, based on on-site inspection and OSS;
- viii. Facilitating Sound Accounting Practices, Audit, etc.;
- ix. Ensuring Compliance to inspection and audit leading to improvement in performance.

6. The Central Issues

Notwithstanding the merits of the Bill, there has been debates as to the rationale of regulation, the institutional mechanism and the precise reason for combining regulation and development aspects envisaged under the bill. These three issues are analysed in depth hereunder:

6.1 Rationale of Regulation

6.1.1 Increasing level of Access to Finance

During the past decade and a half, the role of Micro Finance as a component of poverty reduction strategies has come to be well recognised. As a result, increasing numbers of NGOs, as well as government, bilateral and multilateral funded development activities are including microfinance components in their programmes. As NGOs-MFOs have been expanding their businesses, the limitations of grants and donor funds are being experienced and the MFOs are looking more and more for funds from the banking system, capital from private and public sources and are seeking to raise deposits from their clients. It is estimated that the outreach of the MFOs is close to 5 million clients on a cumulative basis. The smaller of the NGO MFOs are providing financial services to the poor and this cannot be ignored anymore as the banking system may not be in a position to replace these MFOs overnight. Surveys show, however, that informal-sector lenders remain a strong presence in rural

India and are still able to deliver services that are not yet provided as well by the formal and semi-formal sectors.

6.1.2 Transformation of MFOs

‘The NGO MFOs’ are transitory organisations and they reach out to the very poor who are not at present being served by the banks. These clients could graduate to become direct clients of the banks, as they require higher level of funds to finance their enterprises. In rural financial system in India, these NGO MFOs serve an important role and they have to slowly graduate into full-fledged formal financial institutions either in the cooperative form or as companies or NBFCs. In order to help the NGO MFOs evolve into formal regulated financial institutions, they need to follow standards and practices befitting the entry into formal financial institutions. The MFO Development and Regulation aims to provide this transition and help them graduate into mainstream financial institutions.

6.1.3 Registrar’s limitations

The NGO MFOs are normally registered as Societies under the Societies Registration Act or as Trusts under the Indian Trusts Act or their variants in many States of the country. These legal forms are not designed to regulate financial intermediation. These MFOs operate sometimes conceptually in a vacuum as far as their responsibility in financial intermediation is concerned. The people who sometimes suffer on account of the omissions and commissions of these MFOs are the poor clients who have no protection whatsoever. These legal Acts under which the MFOs presently operate, although the Registrar is perceived as a regulator, is not a regulator of MFOs under these legal Acts in the strict sense of the term. The Regulator’s boundaries are strictly in the administrative sphere and the financial soundness of the MFOs is not his jurisdiction nor of his interest. For example, the Registrar of the Societies in each State enforces the provisions of the principal Act or the corresponding Acts enacted by the other states. The principal Act does not define the term ‘Registrar’.

It is clear from the list of powers and duties of the Registrar, he does not have overbearing powers in terms of handling of the affairs of a society. With respect to the functioning of the Micro Finance operations of a society, the Registrar has no responsibility for any form of prudential regulation or determination of its financial performance or solvency. The Registrar can intervene only if a major dispute arises in the management of the society or there is apprehension of an intention to defraud the creditors of the society or to engage in other unlawful or unauthorized acts.

The provision of financial services means not only the handling of funds that belong to public organizations but also the management of savings that belong to poor people. The availability of

resources combined with a liberal policy environment could result in NGOs or others undertaking microfinance without having a full understanding of the complexities and discipline of financial management. It is possible that the entry of under-prepared or ill-motivated organizations may assume financial intermediation as already happened to some extent. If the growth of this important sector is to be managed without significant disaster stories, it is important that not only the standards are introduced in the immediate future but also that some form of regulation be considered.

6.1.4 Market-Based System

The regulation and supervision of MFIs has the larger aim of developing a niche market-based financial system for all products — credit, savings, insurance, transfer facilities and other services for the clients. A market-based financial system assumes the existence of sufficient competition and incentives to provide the lowest-cost services possible to clients, where cost includes all costs — interest rates, transaction, and monitoring. The ultimate aim of MFIs and NGO facilitators involved in financial services for the poor ought to be to ‘mainstream’ their client base, to avoid the marginalization of the clients vis-à-vis financial services. The corollary aim is raising the standard of practice, making it sustainable and enabling it to contribute to the development of the financial system.

6.1.5 Motivation for Regulation

The motivation for regulatory intervention is based on the assumption that an asymmetry of information exists between the lender and the borrower. The borrower *knows* more about what he is going to do with his funds and his ability to repay than the lender. In deposit-taking, the financial institution knows more about how the deposits are going to be used or its own solvency than the depositor. This asymmetry of information results in problems of ‘adverse selection’ and ‘moral hazard’ in the transaction. (Staschen 1999) Regulation to match the actions of the institution (agent) and the client (principal) exists and is accomplished in three ways — control the actions of the agent, restrict the decision-making power of the agent and set appropriate incentives for the agent such that the interests of the agent and principal are harmonized. The last option, while least costly in terms of monitoring, is the hardest to design. The first two options involve a supervising agency with statutory authority to control the agent and lead to inefficiencies in the market. In economic theory (but not in development finance), the manager’s role is to maximize his information advantage not only over his competition but also over the clients which are curbed by regulation. In practice, all three methods are employed to regulate financial institutions.

In short, the reasons for regulation are (a) It is difficult for small depositors to closely monitor the performance of the MFOs and (b) Even if the MFOs do not take deposits, they largely handle public

money in the form of debt raised from the banks and they are liable to behave opportunistically and pursue personal gains at the expense of the client and the tax payers funds.

Some regulatory framework is necessary if the ultimate aim is to expand, scale and mainstream this segment of the financial system. Thus, regulation attempts to accomplish limiting the danger of opportunistic behavior on the part of the institution (consumer protection) and preventing unwarranted runs on the system, thereby ensuring stability. If public deposits are not mobilized, then the regulation will be kept at a minimum.

6.2 Why to combine Development and Regulation

It is accepted that protection of depositor is the basic objective of a conventional regulation. However, under microfinance, it is supervision and regulation +. That is why the Bill is titled as MF (Development and Regulation) Bill envisaging promotion, supervision and regulation and prescribing multi-pronged developmental and promotional role of the regulator, besides registration, inspection, issue of directions and imposing penalty in case of non-compliance to its directions and regulations.

Internationally, Microfinance by definition includes micro savings, microcredit, micro insurance, micro pensions and micro money transfers. Sometimes, these are intertwined into each other and for example, micro insurance and micro savings are so intertwined that there would be a thin line between them. Anyway, the Bill is not about regulating these add on activities per se than about regulating micro financial services. In the case of micro insurance and micro pensions, regulation would be only in the area of client protection.

Moreover, the bill focuses on microfinance services rather than MFOs. In the recent legislations in India e.g., Insurance Regulatory Development Authority (IRDA), Provident Fund Regulation, etc., both developmental and regulatory aspects have been incorporated.

6.3 Why NABARD should be the Regulator

The GOI's choice in proposing NABARD as promoter, supervisor and regulator for MFOs has received acceptance at various levels, probably due to certain practical considerations as under:

(i) NABARD was conceived by the Committee to Review Arrangements for Institutional credit for Agriculture and Rural Development (CRAFICARD). Their thinking and vision was that in the context of complexities and diversities of rural India, an organisation like NABARD could take a holistic view of rural development and assume triple role of financing, development and supervision of Rural Finance Institutions for integrated rural development.

(ii) Various Committees (e.g. Expert Committee, Narasimahan Committee, Vyas Committee, etc.) had assessed the supervisory role of NABARD and appreciated its professional approach and balancing role.

(iii) Internationally, regulatory and supervisory organisational structures in banking and MFI Sector have displayed several varying models being effective in different countries. IMF Survey in April 2007 covering 139 Financial Sector Regulatory/Supervisory Agencies revealed existence of different organisational structures in regulation and supervision e.g., stand-alone supervisory agency, authority based in a Central Bank, Ministry of Finance or combined with other agencies.

(iv) NABARD's supervisory services in the context of difficult and complex organisational entities viz., RRBs and Cooperative Banks has been recognized during the last 27 years. It has put in place several supervisory best practices developed over the years. The professional Board of Supervision comprising the experts and stakeholders, separate Department of Supervision with expert and experienced staff ensure professional and independent approach. The officials who have exposures to the field in various capacities take holistic view of rural credit, RFIs and MFIs.

(v) Its pioneering role in financing, promotion and development of MF, particularly, its leadership role in SHG-Bank Linkage Programme and managing Microfinance Development and Equity Fund (MFDEF) have been recognised widely.

(vi) The inspection findings in respect of RRBs and Cooperative Banks are internalised and corrective remedial steps undertaken by the developmental and financial services departments of NABARD. This way, supervisory and regulatory inputs are expected to trigger developmental action by NABARD with respect to MFOs.

(vii) The All India presence of NABARD through its Regional Offices in all States and District Development Managers (DDMs) in districts would facilitate providing market intelligence which are having bearing on supervisory and regulatory functions.

7. Preparations Prelude to Passage of the Bill

The fate of the Bill will be dependent on the will of the GOI and Parliament. Irrespective of what would be the shape, structure and nature of supervisory and regulatory architecture, NABARD has taken a series of steps to better understand the system and practices of the MFOs through conduct of system studies in select MFOs, organising training/exposure programmes on promotion, supervision and regulation of MFOs for its officers and the officials of MFOs, evolving rating norms, development

of MIS, etc. Under the purview of Technical Collaboration - NABARD-GTZ Rural Finance Programme, the component of promotion, supervision and promotion of MFOs has been included envisaging various interventions as above. The GOI have been provided with various critical inputs on the related aspects from time to time.

8. International Cooperation and Exchange

There has been global efforts in micro credit/microfinance development. The Micro Credit Summit, Declaration of Millenium Development Goals (MDG) and role of international donor agencies have been instrumental in furthering microfinance sector over the years. Similar efforts in regulation and supervision by the majority of Central Banks, Regulatory and Supervisory Authorities could facilitate exchange of mutual experience and learnings. Developing a new regulatory regime for microfinance takes a great deal of analysis, consultation and negotiation. If cost of regulation and supervision is to be shared by the supervisory regulated entities, considerable study, analysis and insight in the working of MFIs may be required before opening a regulatory window. There could be mutual understanding and cooperation for development of regulatory, supervisory and development architecture, tools and methods, rating norms, disclosure standards, risk management system, Off-site Surveillance System (OSS), Computerisation and MIS, etc. Designing training modules for the supervisors and supervised on various aspects of systems and standards in the MFIs through collective efforts would be rewarding. The Inspection Manuals and Guidelines can be prepared by pooling together common experience.

Recent works (viz., Hirschland, Harper, Chao-Beroff - 2008) by a group of microfinance experts on member-owned institutions (MOI) points in a similar direction and recommends for international Task Force of experts, promoters and practitioners to build consensus on good practices for MOIs operating in rural areas and to identify norms, standards and related risks as a step towards appropriate regulation and supervision. Others (Wevas and Fisher 2006) have proposed a Basle Accord like process to develop international guidelines for MFIs' regulation.

9. Perspectives

The regulatory and supervisory framework envisaged will eliminate restrictions on orderly growth of the sector and lead to evolution of market-oriented financial and credit policies. The technology adoption, voluntary codes of internal discipline, risk management architecture, introduction of innovative MF products and models will lead to organisational transformation and growth. The improved performance will enhance the creditability and open up opportunities for garnering funds from banks. The public will get their grievances addressed through Ombudsmen like mechanism. Care needs to be taken to avoid over regulation and attempts to be made to facilitate development of

innovative MF products and models. In due course, the MFI will be integrated with mainstream financial system.

It may be difficult to envision sustained financial efforts without mainstreaming such institutions and equipping them with suitable business strategies. The MFIs will require huge capacity building efforts before they can be subjected to effective regulation and supervision.

The institutions already empowered with regulatory and supervisory powers in microfinance sector could be the torch bearers for the rest of the countries where regulatory and supervisory framework is yet to be set-up. They could guide, motivate, support and enlighten all others in this direction, in the years ahead for creating a better regulatory and supervisory environment in the MFI world. The Regulator and supervision should ultimately benefit the people at the bottom of pyramid.

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