
Regulation of Microfinance Institutions

Pradeep S. Mehta has established an enviable reputation as an institution builder, as a clear-headed thinker and a very effective communicator. A large number of people recognise these qualities in him, but above all they admire him as a warm hearted, dependable friend, and a sensitive human being. His abiding interest in ensuring fair competition and constructive regulation in different sectors of the economy has prompted me to write a note on the issue of Regulation of Microfinance Institutions (MFIs), an issue on which still there is no unanimity among the scholars and practitioners. The following note attempts to suggest a type of regulatory mechanism which will not curb initiatives, at the same time, will ensure fair business practices in this sector.

Despite a large number of banking outlets a section of population is not able to take advantages of the formal financial system. These are basically small and marginal cultivators, tenant farmers, landless labourers, rural artisans, petty traders and urban poor in the unorganised sector. The banks are reluctant to lend to them because of high transaction costs, perception of high risk and urban bias of the bank personnel. The excluded sections are also not very keen to deal with the banks because of lengthy and unfamiliar procedures, insistence on collaterals and uncooperative attitude of the banks. There is a niche in the credit market, which MFIs can and do occupy.

Till very recently community based, not-for-profit MFIs were dominating the scene. These have now become secondary players; for-profit MFIs are surging ahead. Not only is their number large and coverage extensive, they have also become attractive vehicles

for investors, both domestic and foreign. They show large profits, pay high dividends, and sumptuous rewards to their Directors and senior officials. By themselves none of these are objectionable. However, there are serious complaints about their functioning, which have led to a growing demand to bring them under the orbit of some regulator.

There are basically three types of complaints, which are voiced more frequently at different forums. These are: (a) charging usurious rates of interest, (b) indulging in malpractices, and (c) using coercive methods for recovery. Usually interest charged by MFIs is between 24 to 30 per cent, though instances of charging interest as high as 40 per cent are not infrequent.

The justifications offered by MFIs are mainly the following: they maintain that their cost of capital is high compared to the commercial banks as the latter can collect deposits at low rate of interest; that they have to incur high costs to provide services to the really excluded sections in remote areas and that they also provide services other than lending. The main argument of the MFIs in defence of high rate of interest is that access to credit is more important than the cost of credit to the poor who are denied such access by the banking sector.

To take the last argument first, there has never been any serious problem of access to credit to the poor. All over the country, moneylenders were not only ubiquitous but also prepared to lend for any purpose and at any time. The problem was their usurious rate of interest and draconian methods of recovery. MFIs have to prove themselves superior on both the counts.

As regards the cost, their capital cost is high in most of the cases. But if they can get capital at 12 to 13 per cent, and many MFIs who have access to foreign funds at much lower costs, they do not have justification to charge 30 per cent or more. It only means that either they are grossly inefficient or they are making huge profits at the cost of the poor whom they claim to serve. If additional services inflate their costs, these should be shown separately and the borrowers should have option to avail of those services from MFIs or from any other source or refuse to have those services.

The other common complaint is that MFIs are more interested in lending money than in the productivity of the loan. The employees of most of these institutions are paid by the advances they make and recoveries they enforce. As a result, the employees go on giving loans indiscriminately. The practice of 'greening' loans, that is, advancing higher loans to square off the earlier loans (only by book entries) is quite rampant. This lands the borrower in a vicious circle, and when the bubble bursts, which would in the end, prove fatal for the borrowers as well as the lending institutions. This indiscriminate lending creates problems of recovery, and the institutions resort to coercive practices.

There is a justification for the existence and functioning of MFIs, as they do reach out to some of the sections that cannot be, or are not, served by other formal banking institutions. We have to see that they do not degenerate into sophisticated version of moneylenders. If the access to funds is the only justification for MFIs, it is a weak justification. While recognising their place in the credit structure of the country, there is a need to ensure that they do not exploit or otherwise harm the poor who are defenseless.

To ensure that MFIs are not allowed to play havoc at the cost of poor borrowers, some regulation of their activities is necessary. They being, essentially financial institutions (FIs) the agency suggested to oversee their functioning is Reserve Bank of India (RBI), which has a rich, long and successful experience of regulating FIs. However, the sheer quantum of regulatory work already being carried out by RBI, e.g., regulating the functioning of commercial banks, cooperative central banks, urban cooperative banks and NBFCs, would make it difficult to saddle them with this extra work. MFIs are different than other FIs as they deal with a poorer and less sophisticated clientele.

NABARD (National Bank for Agriculture and Rural Development) is another agency, which can be considered for the regulatory role. It has extensive presence all over the country and deals with other poverty alleviating agencies, namely cooperatives. However, NABARD has a more important developmental role in promoting MFIs. They should concentrate on this function and should not be

asked to do the tight rope walking between their role of developer and that of a regulator.

The number of MFIs has become so large and their spread is so wide that a centralised regulator might not be efficient. Besides, these institutions are expected to cater to the needs of the poor, who are dispersed. The conditions differ from region to region. Therefore, a decentralised, state-wise system will be more appropriate. It is also necessary to have a regulatory regime that would not throttle the initiative of these institutions. What is needed is a set of norms, which will ensure fair play and prevent exploitation of the customers, most of whom are weak and deprived. Either the RBI or SEBI should take initiative in defining such norms. The norms should cover the maximum interest rates, periodicity of repayment, limit to the amount to be repaid, and the business practices to be followed. It is equally important that these norms should be followed in letter and spirit. The Banking Ombudsman has performed well and such an institution may be of help in dealing with MFIs.

It is proposed that a two-tier MFI Ombudsman scheme may be introduced in every state. At the first tier, at the district level, a senior designated officer of the Lead Bank of the district should act as an ombudsman. At the second tier there could be an ombudsman at the state level, which could also act as an appellate authority. For the state level ombudsman, it is proposed that two active stakeholders in this area, namely, State Government and NABARD should nominate one person each on the MFI Ombudsman; the third person may be represented by a creditable civil society functionary. This will not be a unique set up as the RTI Commissions in several states have two or three commissioners. It is proposed that the MFI Ombudsman may take up *suo motu* action as well.

In sum, the effort should be to define the business norms and provide arrangements, at the district and state levels, to ensure compliance.