Regulation of Microfinance Institutions in India

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Study Outline

- Microfinance sector - overview
- Analysis of the existing regulatory regime
- Global experience regulating Microfinance Institutions (MFIs)
- Assessment of pending regulatory recommendations
  - Malegam Committee Report
  - Microfinance Financial Sector Bill 2010
- Regulatory recommendations

Microfinance Sector

- The microfinance sector aims to provide financial services to poor clients
- Two models: Self Help Group (SHG) model and Microfinance Institution (MFI) model
- Microfinance Institutions (MFIs) serve 27 million clients and have Rs. 18,343 crores of loans outstanding in India
- Outreach has been geographically disproportionate
  - Services have expanded greatly in the Southern region, though services are limited in the Northern and Western regions
  - Poorest districts still generally do not have services
- Lack of product diversity is one of the limiting factors

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Andhra Pradesh Crisis, 2010

- Clients and politicians accuse microfinance institutions of coercive collection practices, usurious interest rates, and use of selling practices that result in over-indebtedness
- Microfinance clients stopped repaying loans in late 2010 in Andhra Pradesh (AP)
- AP state government issued an ordinance that severely limits the operations of MFIs
- Banks become skeptic about the future of the sector in other states , leading to a halt in Bank lending to MFIs and as a result, MFIs all over India faced great trouble in accessing adequate financing
- RBI enlisted the Malegam Committee to generate regulatory recommendations to address issues of the sector

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Regulatory Framework for MFIs

Type	Major Regulatory Issue
Prudential	•Minimum Capital •Capital Adequacy •Loan Documentation
Non-Prudential	•Permission to Lend •Consumer Protection •Credit Reference Services •Interest Rate Limits

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Existing Regulatory Structure
Legal forms of MFIs

Category	Type of MFI (Approximate Number)	Registration
Not for Profit	**NGO MFIs** (Societies &Trusts) **(500)**	Registered under Societies Registration Act, 1860 and / or Indian Trust Act 1882
	Section 25 Companies (10)	Section 25 of Companies Act, 1956
Mutual Benefit	**Cooperatives** **(100)**	Registered under State Cooperative Societies Act or Mutually Aided Cooperative Societies Act (MACS) or Multi- State Coop. Societies Act, 2002
For- Profit	**NBFC (50)**	Companies Act, 1956 & registered with RBI

For-profit MFIs account for approximately 90% of total outstanding loan portfolio of all the MFIs

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Existing Regulation

- NBFCs (for-profit)
  - Regulation primarily prudential, not specific to microfinance
  - Can collect deposits if achieve investment grade rating (no MFI has accomplished this)
- Other MFIs
  - No regulation beyond registration, which is often done at state level
- Central vs. State regulation
  - There is little clarity regarding central vs. state jurisdiction
  - Some MFIs are subject to various state laws such as Moneylending Act
  - A few states have passed ordinances restricting some microfinance practices

Existing Regulation

- Priority Sector Lending
  - Microfinance institutions qualify for priority sector funds
- Funding Restrictions
  - NBFCs cannot access External Commercial Borrowing
  - Minimum foreign equity investment is US $500,000 which can only account for 51% of company

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Existing Regulation
Limitations

- Lack of clarity on state and central jurisdiction
- No consumer protection regulation
- No regulation for credit reference services and information sharing
- Unduly restrictive standards for deposit collection
- Restrictions in accessing funding from various sources
- Overall lack of monitoring and supervision

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Global Best Practice

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Minimum Capital Requirements

- Used to control number of qualifying institutions
- Can change over time, and within country
  - Bolivia increases requirement as penetration develops and existing institutions mature
  - Pakistan minimum capital requirement changes depending on district and province of operation
- Wide range of variability exists in minimum capital requirements

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Interest Rate Caps

- Some countries impose interest rate caps aiming to protect the poor from usurious charges
- Interest rate caps often reduce financial services for lower-income and rural clients, increase MFI solvency risk, and encourage less transparency

Jurisdiction	Date	Nature of Change	Reason for Change and Implication
West Africa	1990s	27% Ceiling	MFIs immediately pulled out of rural areas, and increased average loan size. Eventually found ways to circumvent with fees.
Nicaragua	2001	The Central Bank publishes interest rate every month	Growth decreased to 2% annually to 30% annually. Several MFIs pulled out of rural areas.

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Consumer Protection

- Consumer protection requirements vary greatly across the globe, coming most often in the form of legislation or institution self-regulation
- Documentation requirements
  - Plain-language, documentation in the local language, describe recourse rights and processes, annual interest rate using a standard formula, all applicable fees, computation methods, required insurance
- Facilitate customer complaint procedures (Example: Peru)
  - Financial regulatory authority mandated procedure for receiving, responding, and resolving customer complaints
  - 99% of 400,000 customer complaints were handled by financial regulatory authority
  - Implement financial literacy education programs
  - On-site and off-site monitoring
  - As a result, customer complaints are down 32% since 2004

Pending Regulation

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Malegam Committee Recommendations **Overview**

- The recommendations address many of the major issues of the sector, broadly addressing:
  - Identifying microfinance institutions and qualification for priority sector lending
  - Consumer over-indebtedness
  - Credit Pricing
  - Product Restrictions
  - Documentation
- More research needs to be done as to how best to approach these issues

Micro Financial Sector Bill 2010
Overview

- Designates NABARD as regulator for societies, trusts, and cooperatives
- Permits institutions to collect and mobilize deposits
- Concerns:
  - Bill does not address regulation for NBFCs and Section 25 companies
  - Bill permits institutions to take deposits, but does not outline adequate prudential requirements

Regulatory Recommendations

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Recommendations

MFI Registration

- Registration for NBFCs should continue under the current structure.
- All other MFIs should register with RBI

Credit Reference Service

- Regulation should require submission of borrower information from all registered microfinance institutions
- Once credit bureau is functioning, regulation should require lenders to check borrower's credit history

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Recommendations

- More regulation and supervision is needed for the microfinance sector
  - Apply uniform standards and conducts to all types of microfinance institutions
  - Better monitor MFI lending practices and treatment of customers
- Regulation should encourage responsible growth, so that MFIs continue to expand to provide services to unserved customers

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Recommendations

Consumer Protection

- Develop clear definitions for coercive collection practices, adequate product transparency, and abusive selling practice
- Short term:
  - Delegate enforcement to Industry Associations (ex. Sa-dhan, MFIN)
  - Monitor code of conduct, employee training, random field checks
- Long term:
  - Implement consumer redressal procedure
  - Expand and improve framework established by Consumer Protection Act

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Recommendations

State vs. Central Regulation

- Regulator should explicitly determine central and state regulatory jurisdiction

Interest Rate Cap

- Sophisticated knowledge is required to implement a fair and effective interest rate cap. When this knowledge is absent, we recommend not imposing a cap.
- If an interest rate cap is put in place, it should consider factors that affect operational costs (MFI characteristics, region, loan size, etc.)

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Recommendations

Priority Sector Lending

- Qualification for priority sector funds should be based on region and borrower characteristics to incent MFIs to extend services to underserved regions

Diversification of Funding

- Lower minimum foreign equity investment restriction
- Permit NBFCs to access External Commercial Borrowing (ECB)

Thank You

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Appendix I: Malegam Recommendation
Over-indebtedness

Recommendations	Drawbacks
• Total indebtedness limit of Rs. 25,000 per household • MFIs can only lend to members of a Joint Liability Group (JLG) • A borrower cannot be a member of more than one SHG/JLG • Not more than two MFIs can lend to one borrower	• Hard to enforce, information is supplied by client • Reduces availability of credit, may make clients turn to informal sources • Reduces competition

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Appendix II: Malegam Recommendation
Qualifying for Priority Sector Lending

Recommendations	Drawbacks
• Customer household annual income does not exceed Rs. 50,000 • Loans do not have collateral backing • Maximum loan of Rs. 25,000 Rupees • Minimum 75% of NBFC-MFI loans must be for income generating purpose	• Creation of "NBFC-MFI" sub-category unnecessary • Narrowly defines who needs microfinance services • Restricts competition from institutions that do not meet all requirements

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Appendix III: Malegam Recommendation
Credit Pricing

Recommendations	Drawbacks
• Only interest, processing fee, and insurance premium charges permitted • Margin interest rate cap of 10-12% over cost of capital, depending on the size of institution • Maximum interest rate cap of 24%	• Will result in less credit for poorer borrowers and customers in rural areas • Restricts product innovation

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Appendix IV: Malegam Recommendation
Product Restrictions

Recommendations	Drawbacks
• Minimum period of moratorium between granting of the loan and commencement of repayment • The tenor of the loan is not less than 12 months where the loan amount does not exceed Rs. 15,000 and 24 months in other cases • The loan is repayable by weekly, fortnightly, or monthly installments at the choice of borrowers	• Results in fewer consumer options • Reduces product innovation

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Appendix V: Malegam Recommendation
Documentation

Recommendations	Drawbacks
• MFIs must provide borrower a loan card which shows the effective rate of interest, other terms and conditions to the loan, information which adequately identifies the borrower, and acknowledgements of payments received • Effective rate of interest must be displayed in all offices, all literature, and on website • Standard loan agreement	• Potentially burdens loan process

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