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
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 skeptical 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
## Regulatory Framework for MFIs

<table>
<thead>
<tr>
<th>Type</th>
<th>Major Regulatory Issue</th>
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<tbody>
<tr>
<td>Prudential</td>
<td>• Minimum Capital</td>
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<td></td>
<td>• Capital Adequacy</td>
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<td>• Loan Documentation</td>
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<tr>
<td>Non-Prudential</td>
<td>• Permission to Lend</td>
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<td></td>
<td>• Consumer Protection</td>
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<td></td>
<td>• Credit Reference Services</td>
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<td>• Interest Rate Limits</td>
</tr>
</tbody>
</table>
## Existing Regulatory Structure

### Legal forms of MFIs

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

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

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Date</th>
<th>Nature of Change</th>
<th>Reason for Change and Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>West Africa</td>
<td>1990s</td>
<td>27% Ceiling</td>
<td>MFIs immediately pulled out of rural areas, and increased average loan size. Eventually found ways to circumvent with fees.</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>2001</td>
<td>The Central Bank publishes interest rate every month</td>
<td>Growth decreased to 2% annually to 30% annually. Several MFIs pulled out of rural areas.</td>
</tr>
</tbody>
</table>
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
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
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
**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
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
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.)
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
## Appendix I: Malegam Recommendation Over-indebtedness

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>Drawbacks</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Total indebtedness limit of Rs. 25,000 per household</td>
<td>• Hard to enforce, information is supplied by client</td>
</tr>
<tr>
<td>• MFIs can only lend to members of a Joint Liability Group (JLG)</td>
<td>• Reduces availability of credit, may make clients turn to informal sources</td>
</tr>
<tr>
<td>• A borrower cannot be a member of more than one SHG/JLG</td>
<td>• Reduces competition</td>
</tr>
<tr>
<td>• Not more than two MFIs can lend to one borrower</td>
<td></td>
</tr>
</tbody>
</table>
### Appendix II: Malegam Recommendation Qualifying for Priority Sector Lending

<table>
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<tr>
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</tr>
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<tbody>
<tr>
<td>• Customer household annual income does not exceed Rs. 50,000</td>
<td>• Creation of “NBFC-MFI” sub-category unnecessary</td>
</tr>
<tr>
<td>• Loans do not have collateral backing</td>
<td>• Narrowly defines who needs microfinance services</td>
</tr>
<tr>
<td>• Maximum loan of Rs. 25,000 Rupees</td>
<td>• Restricts competition from institutions that do not meet all requirements</td>
</tr>
<tr>
<td>• Minimum 75% of NBFC-MFI loans must be for income generating purpose</td>
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## Appendix III: Malegam Recommendation

### Credit Pricing

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>• Only interest, processing fee, and insurance premium charges permitted</td>
<td>• Will result in less credit for poorer borrowers and customers in rural areas</td>
</tr>
<tr>
<td>• Margin interest rate cap of 10-12% over cost of capital, depending on the size of institution</td>
<td>• Restricts product innovation</td>
</tr>
<tr>
<td>• Maximum interest rate cap of 24%</td>
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</tbody>
</table>
### Appendix IV: Malegam Recommendation

**Product Restrictions**

<table>
<thead>
<tr>
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<th>Drawbacks</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Minimum period of moratorium between granting of the loan and commencement of repayment</td>
<td>• Results in fewer consumer options</td>
</tr>
<tr>
<td>• 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</td>
<td>• Reduces product innovation</td>
</tr>
<tr>
<td>• The loan is repayable by weekly, fortnightly, or monthly installments at the choice of borrowers</td>
<td></td>
</tr>
</tbody>
</table>
## Appendix V: Malegam Recommendation Documentation

<table>
<thead>
<tr>
<th>Recommendations</th>
<th>Drawbacks</th>
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</thead>
<tbody>
<tr>
<td>• 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</td>
<td>• Potentially burdens loan process</td>
</tr>
<tr>
<td>• Effective rate of interest must be displayed in all offices, all literature, and on website</td>
<td></td>
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<tr>
<td>• Standard loan agreement</td>
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