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POLICY PAPER

The Microfinance Bill: Need for a Fresh Outlook

(DRAFT FOR COMMENTS)

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ASSIST

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1 CONTEXT

Considering the twin facts of guidelines on SHG-Bank Linkage Programme (SBLP) issued in 1992 and initiatives by the Non-Governmental Organisations (NGOs) in 1990s to replicate the Grameen model, 1990s can be validly accepted as the start of microfinance as a recognized channel of financial services. The journey of the last twenty five years has been anything but smooth, but the contribution of the sector to the public policy objective of financial inclusion is unmistakable with a combined outreach of ~80 million clients. This policy paper being focused on the legal and regulatory framework for microfinance in India excludes the SBLP as banks regulated by the RBI extend loans to SHGs and thus SBLP from its start is within regulatory ambit. It is the MFI model, which in last twenty-five years has undergone a sea change in its legal composition as well as regulation. The issue merits attention as even in 2014 when the universal financial inclusion discourse is dominated by Prime Minister's Jan Dhan Yojana (PMJDY), Small Finance Banks (SFB) and Banking Correspondents (BC), the MFI sector despite its immense contribution to financial inclusion is characterized by correlating legal form with regulation and lacks a comprehensive regulation which can unify the sector based on activity rather than legal form. Critical impediments like periodic interference of the state governments in the legitimate business activity of MFIs and embargo on access to deposits continue to persist. Sound policy formulation underpins according priority to bringing institutions/interventions, which have demonstrated impact under facilitating regulatory architecture before embarking on creating new structures. Despite several efforts to do so in the last twenty years, the MFI sector in India is still waiting for a comprehensive regulation covering all forms of MFI model.

This policy paper presents the past efforts of regulating the sector, analyses the merits and demerits of various attempts beginning from the report of the Task Force[1] in 1999 and presents a road map for future which can maximize contribution of the MFI sector to financial inclusion.

[1] Task Force on Supportive Policy and Regulatory Framework for microfinance

2 REGULATORY FRAMEWORK PROCESS; SRO TO SRO

2.1 Sector in its Infancy; Task Force and SRO

The impetus for the kick-start of microfinance interventions in India in the early 1990s can be attributed to multiple factors: the realization of the inability of the formal banking system to reach the poor sustainably, beginning of financial sector reforms in the early 1990s and successful microfinance interventions across the world especially in Asia and in India by NGOs. Parallel to the SHG model of microfinance, many donor funded NGOs started group based savings and credit activities. As the microfinance work was taken up by the existing NGOs working in a range of developmental areas, the microfinance component was an add-on to the existing work. These interventions were successful in financial intermediation on account of their close grassroots links with the people, field-based development orientation and commitment. Launch of microcredit scheme (MCS) by SIDBI in February 1994 for providing financial support as well as capacity building grants to well managed NGOs and establishment of Rashtriya Mahila Kosh (RMK) by the Government of India in 1993 gave the necessary fillip to the sector. Significantly, even in the early stages of microfinance a critical outcome of the high-level policy forum on "Building India's Leadership in Microfinance" organized by FWWB in 1998 was to constitute a task force by NABARD to arrive at a conceptual framework for sustained growth of microfinance. Besides other things, policy and regulation were the key terms of reference for the task force constituted by RBI in 1998. This marked the start of bringing MFIs under regulatory framework and its importance increased manifold as the sector in 1998 was dominated by NGO-MFIs (registered as Societies or Trusts) and had only a handful of NBFCs with the task force putting the numbers at 500 and 5 respectively. The vision of the task force to bring the sector under regulation stemmed from its views of protection of small depositors' interest, bringing in financial discipline and reporting on performance indicators.

The task force preferred Self-Regulation arguing that regulation could stifle growth and rob the sector of its informality and flexibility. Ironically, the task force's liberal approach towards regulation and recommending setting up of Self Regulatory Organizations(SRO) (with recognition of the SROs to be conferred by the central bank), acceptance of the fact that deposit mobilization is a key microfinance service, non-interference with interest rate structure and an omnibus law for microfinance are still grey areas after fifteen long years. Though, 2014 has seen progress on SRO but its utility in the changed context has become debatable.

It recommended that all MFIs (registered associeties or trusts) register themselves with the SRO. The registration with the SRO was to be provisional for the first three years, during which time the MFI would either attain the standards specified by the SRO, or have its registration cancelled. It recommended that societies and trusts would have to transform themselves into cooperatives or companies once the sum of their deposits and loans exceeded a certain level, tentatively proposed at Rs 25 lakhs. Besides stipulating prudential norms regarding reserve requirements, the task force also specified exposure norms etc. It was further envisaged that for a large country like India there could be different SROs recognizedby the central bank for different states, given the fact that there was as yet no single apex body of MFIs for the country as a whole. State level Recognized SROs (RSROs) were suggested to take advantage of local knowledge, and of proximity for purposes of on-site visits and inspections.

The task force soundly enunciated two aspects relating to deposit mobilization and an omnibus law for microfinance, which are still the pain points in the sector. It sagaciously observed,*"... the intention of these agencies is not to utilize the mobilized savings for financing activities of the poor outside the purview of their developmental schemes. It is therefore inclined to believe that there is no deliberate violation of Section 45 S of the RBI Act on the part of such NGOs and SHG's federations and therefore, the same may be treated, at best as a technical violation".* Based on this, it recommended that RBI may treat NGOs as incorporated bodies for the limited purpose of the Section 45 S of the RBI Act. On the aspect of an omnibus law, it suggested that such a law should serve as a comprehensive legislation for covering the entire financial operations of the MFIs, which are non-banking institutions.

The recommendations of the task force required a great deal of further consensus building and preparation,but unfortunately the RBI never took a view on the task force recommendations. As a result, the sector is still grappling with these vexatious issues.

2.2 Growth and Transformation: Era of Microfinance Bill

This phase had two features namely separation of microfinance as a separate vertical and reduced dependence on donor funds. As financial intermediation required a different set of competencies, systems and attitudes, most NGOs found it difficult to cope with the additional requirement, which resulted in separation of microfinance activities. The limited nature of donor funds and the desirability of moving the sector towards sustainable operations was realised early. As the profitability of microfinance was established, the incentive to accumulate equity capital with which to leverage the funds increasingly becoming available from the banking system grew stronger, this led to the transformation in the 1990s of several of the larger and medium MFIs into NBFCs enabling the MFI to attract shareholder equity.

SIDBI set up a dedicated department in 1999 called "SIDBI Foundation for Microcredit" to fund MFIs and also encouraged ratings to provide a credible third party assessment of performance which would help gain the confidence of bankers. Though reliable figures for bank lending to MFIs till 2005 are not available, SIDBI's cumulative lending to the sector reached Rs137 crore by 2005. Commercial banks, especially private sector banks led by ICICI bank joined the bandwagon.The private sector banks were motivated initially by priority sector obligations but increasingly saw lending to MFIs as a profitable activity given the almost perfect repayment rates. Data from 11 commercial banks shows that their exposure to MFIs had reached Rs 1,991 crore by March 2006 with ICICI Bank accounting for almost 60% of the total share. In the 2005 Budget speech, P. Chidambaram, the then Finance Minister asserted the government's focus on microfinance activities, doubling of the Indian Microfinance Equity Fund corpus to Rs 200 crors and also indicated the creation of a microfinance Bill in the following year.

The growth of the MFI sector funded by bank lending was starting to show as if there were only two constraints to growth; MFIs ability to expand and recruit field staff. The growth was also regionally skewed with southern region dominated by erstwhile Andhra Pradesh accounting for 50% share. With the heating of the sector, it was obvious to sector experts that something is going wrong especially in Andhra Pradesh, where state also had an expansive microfinance programme called "Velugu". In March 2006, action by Andhra Pradesh (AP) government in temporarily closing down nearly all the branches of MFIs functioning in Krishna district came on grounds of violating several laws including criminal laws came as a shock.

While a detailed account of the reasons for the state government's action is beyond the scope of this paper, its importance for regulation lies in the fact that it brought the issue to the forefront. Concerns on over lending, interest rates, jurisdiction boundaries between state laws and federal laws and appropriate collection practices came to the fore. While the Task Force had talked about self-regulation in 1999, nothing happened till the Krishna crisis and as a response to the crisis, Sa-Dhan hurriedly brought out a voluntary code of conduct in March 2006. This was replaced by statement of "core values and a voluntary code of mutual conduct" in January 2007 (Box 1). RBI also sprung into action from its state of benign negligence terming state government's action as having the potential to vitiate the repayment culture and also issued guidelines for NBFCs to abide by a Fair Practices Code (FPC).

Box-1: Essential features of Sa-Dhan's Voluntary Mutual Code of Conduct

In January 2007, Sa-Dhan released a statement of "core values and a voluntary mutual code of conduct", whereby all stakeholders would collaborate to improve the operating standards and foster sustainable, client-centric practices in the sector with the aim of bringing all low income households under the ambit of formal financial systems and providing them with a comprehensive suite of financial services.

The Code of Conduct (CoC) espoused the virtues of integrity and transparency and promised that all member organizations would be honest, ethical, and non-discriminatory, promote fair competition and offer affordable services to clients. It also asserted that adherence to the principles would be ensured by prominently displaying the CoC in all operating locations and by training staff and other representatives on appropriate decorum and the CoC.

Additionally, participating MFIs were also obligated to be transparent in their practices and divulge all terms and conditions to clients. These included disclosing the source of funds and borrowing cost of the MFIs, detailed calculation of the interest levied on credit products, interest rate offered on thrift services as well as the breakup of the insurance premium and pension charges along with regularly sharing its performance details with clients.

Both Sa-Dhan and RBI's actions were limited in their application. While Sa-Dhan's code was voluntary, RBI's FPC applied only to NBFCs. The limitations of multiplicity of regulating authorities and laws were evident and provided impetus to the draft microfinance bill promised by the Finance Minister in his budget speech of February 2005. The bill was introduced in the Lok sabha on 20 March, 2007 as "Micro Financial Sector (Development & Regulation) Bill, 2007" and was referred to the Standing Committee of Finance. The bill was a vastly changed version from what Sa-Dhan had initially given as a draft. The important provisions of the bill are presented in Box 2.

Box - 2: Key features of The Micro Financial Sector (Development and Regulation) Act,2007

Scope	Only NGO-MFIs registered as societies, trust and cooperatives (i.e. excluding NBFCs and S 25 companies)
Structure for the sector	One tier, MFOs only, (apart from NBFCs and S 25 companies, but no provisions applicable to them)
Savings authorization	Only "thrift" for MFOs
Regulator	NABARD
Role of Regulator	Establishing benchmarks, credit rating norms, specifying accounting standards, information dissemination, institutional development and consumer education
Role of Micro Finance Development Council (MFDC)	Advisory, with majority consisting of officials representing specified agencies ex officio
Ombudsman	MFDC "may" set up ombudsman
Definition of Micro credit	Loans less than Rs50,000 and Rs1,50,000 for housing

However, the bill proved to be raising more issues than it aimed to resolve. It covered only three categories of not-for-profit MFIs: societies, trusts and cooperatives, referred to in the bill as Micro Finance Organizations (MFOs). It excluded NBFCs and Section 25 companies and thus failed to achieve the expected outcome of covering all forms of microfinance institutions and the omission looked glaring as by 2007, the sector was dominated by NBFCs. By excluding NBFCs, it excluded 60 percent of the sector in terms of portfolio outstanding as on March 2007. The bill continued the chasm leaving NBFCs with RBI, Section 25 companies with Registrar of Companies and others with NABARD. However significantly, it contained provisions for MFOs to offer "thrift" services, defined as savings collected through groups after obtaining a certificate of registration from the new regulator. However, by bringing cooperatives under the bill, it adversely affected the ability of cooperatives to collect a variety of individual savings as well as fixed deposits from their members as per extant cooperative laws.It was paradoxical that 60% of the sector regulated by RBI i.e. NBFCs by virtue of not being part of the bill continued to be barred from accepting even member deposits. Importantly, it provided no protection against state acts like what is available to banks[2] but rather justified it by having S 36 in its provisions stating that "shall be in addition to, and not in derogation of, the provisions of any other law for the time being in force". The other contentious issue in the bill was related to NABARD being the regulator. The events in Krishna district of Andhra Pradesh had brought out the issue of conflict of MFIs with the state as the latter was championing its own microfinance programme. Questions were raised on similar grounds with NABARD as the promoter of the SHG-bank linkage model and also on the grounds of NABARD being an investor and lender to MFIs through the MFDEF. Taking into account the fact that the legal forms of societies and trusts are not the ideal form for financial intermediation, it was expected that the bill would provide an intermediate structure for transforming NGOs, as

[2] Section 21A of the Banking Regulation Act expressly exempts the rate of interest charged by banks from state moneylender acts, as well as from any other law related to indebtedness in force in any state

the minimum capital requirement for NBFCs (Rs 2 crore) appeared too steep. But no such provision was made in the bill.

Considering the above deficiencies, the bill was hotly contested by the sector as the sole purpose served by it was providing a modicum of legitimacy to NGO-MFIs. Eventually, the proposed Billcould not be introduced in the parliament and lapsed after the dissolution of the 14thLokSabha in 2009.

2.3 Crisis in Kolar & Andhra Pradesh: Regulation Back on Anvil

As the status quo on regulation prevailed in the sector, the industry hurtled at break neck speed aided by private equity and debt funding from banks. Having the appropriate legal form under its belt, NBFCs were set to attract private capital for equity and leverage that for accessing bank loans. Success factors of the model were paraded in the form of high recovery rates and massive jump in outreach, peppered with an occasional anecdotal story of smiling clients and the demand for ever higher funds was predicated on the huge exclusion gaps to be filled in India. Equity investors were mesmerised by the prospect of attractive returns with negligible risk and started chasing MFIs for equity investments. With equity in place, bank funding to MFIs also touched a high of ~Rs17,000 crore by March 2010 excluding portfolio sales and securitisations.As a consequence, MFI outreach touched 26.7 million clients by March 2010.

Growth was achieved by cutting corners on the client acquisition process, improving efficiency and thereby profitability, rolling out a plain vanilla product (50/52 week loan) which obviated the necessity of investing in staff training and changes in operational systems, ignoring investments in control systems and MIS and competing in similar areas. It was evident that the crisis was round the corner. Early warning signals came from Kolar in Karnataka in 2009. Kolar witnessed a delinquency crisis with borrowers from a certain community defaulting on loans. A study of the Kolar crisis conducted by EDA Rural Systems documented aggressive growth, multiple lending, coercion in recovery and inability to restructure loans for clients in genuine difficulty as reasons for the crisis (EDA 2010).

As voices of sanity and caution were ignored and these happenings were rationalised as one off incidents in pursuit of the massive inclusion required in India, it was clear that a bigger crisis was round the corner. Unfortunately, the heavy handed ordinance of Andhra Pradesh government in October 2010 proved to be the straw that broke the back of microfinance. Linking it to the issue of SKS IPO or government's genuine concern for microfinance borrowers is not fair, as there were a host of factors leading to the government ordinance. Industry observers and borrowers have pointed to a variety of reasons like overlap with SHG programme, multiple borrowings, rising default rates under the SHG programme and also intense media scrutiny of SKS IPO and possible envy/concern owing to the profitability of MFIs (WMGF 2011), of which not all could be attributed to MFIs. However, the reasons offered by the Andhra Pradesh government focussed on coercive recovery practices, indiscriminate lending and usurious interest rates did not cut much ice with industry observers. The pattern seemed to be version two of Krishna. The consequences were disastrous with ~95% of MFI loans in Andhra Pradesh overnight turning into non-performing assets. Government scrutiny of the sector and news of defaults in Andhra Pradesh with implications on their own balance sheets caused the banking sector to retreat into a shell, choking flow of funds to the sector.

The legality of the Ordinance (later passed as bill) was challenged before the high court of Andhra Pradesh on the grounds of violating the fundamental freedoms given to citizens to carry out any lawful business and the legitimacy of the state government to take action against institutions which are regulated by the RBI (being the regulator for non-banking financial companies).

But it woke up the sleeping giant of policy and regulation. MFIN and Sa-Dhan jointly introduced an industry level Unified Code of Conduct (UCoC) in December 2011, which postulated the acceptable practices related to 'integrity and ethical behavior, transparency, client protection, avoiding over-indebtedness, appropriate interaction and collection practices, privacy of client information, governance, recruitment, client education, data sharing and feedback and grievance redressal'[3] that all member organizations would need to comply with.

Not to be left behind, the RBI appointed a committee[4] to examine the regulatory issues arising from the Andhra Pradesh government's law to take control over lending activities of institutions that were under its jurisdiction. The RBI reviewed the Malegam Committee recommendations and came up with a set of guidelines (including the creation of a new set of NBFC-MFIs), which were largely based on the Committees' report. The regulatory guidelines overnight went from a state of benign negligence to micro-management of MFIs by way of prescribing rules for customer acquisition, design of loan products, repayment tenure, household income, over indebtedness, interest rate cap, appraisal, disbursement and recovery processes. Also, the onus of monitoring adherence with the regulations was passed on to the lending banks, which implied that the loans given to errant institutions would not come under the purview of the Priority Sector Lending Guidelines, mandated for commercial banks. These regulations, modified from time to time based on submissions by the industry bodies like MFIN and Sa-Dhan, continue to be the guiding pole for NBFC-MFIs. The common consensus on these guidelines is that interest rate caps force MFIs to trim 'unnecessary' expenses, focus on the easy clients, avoid serving the poorest of the poor, steer clear of remote geographies and not focus on product innovations that would help satisfy the unique needs of each customer segment. Similarly, the guidelines on household income level have been criticized as not reflective of ground realities[5]. Still, the committee's report and RBI regulations strongly signaled that the microfinance institutions deserved to exist despite some aberrations in practice, which needed to be corrected.

Table 1 summarises the main features of the regulatory regime put in place by the RBI. Interestingly, though these regulations are applicable to NBFC-MFIs, lending banks have insisted compliance on operational norms like margin etc. by the NGO-MFIs also.

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[3] Source: http://www.microfinancefocus.com/sa-dhan-and-mfin-release-joint-code-of-conduct-for-mfis-in-india/
[4] The Committee was chaired by Mr Malegam, a member of the Central Board of RBI.
[5] http://www.m-cril.com/BackEnd/ModulesFiles/Publication/M-CRIL's-Supplementary-on-the-Malegam-Committee-Report.pdf

Table-1 : RBI Regulatory Framework for NBFC-MFIs: Major Elements

Qualifying asset under microfinance	• Collateral free; borrowers in rural households with annual income less than Rs60,000 and in urban and semi-urban households less than Rs120,000 • Loans less than Rs35,000 in the first cycle and Rs50,000 in subsequent cycles • Total indebtedness of borrower not to exceed Rs50,000 • 12 month tenure for loans <15,000 and 24 months for >Rs15,000
Deployment of microfinance	• At least 70% loans should be for income generation
Entry norms-existing NBFCs	• Net owned funds (NOF) Rs2 crore till 31st March 2014 and Rs5 crore with effect from 1st April 20 14 • For the north-eastern region, Rs1 crore till 31st March 2014 and Rs5 crore with effect from 1st April 2014
Capital adequacy	• Not less than 15% of the aggregate risk weighted assets
Pricing	• From 1st April 2014, margin cap of 10% for NBFC-MFIs with portfolio>Rs100 crore and 12% for all others • Interest rate capped to minimum of a) cost of funds plus margin, b) average base rate of five largest commercial banks by assets multiplied by 2.75 • Processing charge capped to 1% of loan amount (not part of margin/ interest cap) • Actual cost of recovery for insurance
Fair Lending Practices	
Transparency in interest rates	• Pricing of loan has only three components-interest charge, processing charge and insurance premium • No penalty charged on delayed payment
Multiple lending, over-borrowing and ghost borrowers	• One borrower, one SHG/ JLG • One borrower cannot borrow from more than two NBFC-MFIs • Membership of NBFC-MFI in at least one Credit Information Company (CIC)
Non-coercive methods of recovery	• Recovery at a central designated place; recovery at the place of residence or work only for those who are unable to come to the designated place of recovery on two or more consecutive occasions

The Government of India cognizant of the plummeting repayment rates, investor apathy and vitiating reputation constituted a drafting committee for another microfinance bill. The draft bill was placed in public domain for comments in 2011 and in May 2012, the Microfinance Institutions (Development and Regulations) Bill, 2012 was presented in the Lok Sabha and thereafter referred to the Standing Committee on Finance on 25th May, 2012.

Three features of the bill made it noteworthy. First, all organizations, which offered microfinance services (barring Cooperative banks, Regional Rural Banks, Primary Agricultural Cooperative Societies) were covered, secondly, RBI was designated as the regulator and lastly it categorically stated that MFIs that are registered under the Act with RBI will not attract the provisions of the money lending laws from state governments (section 42). It explicitly asserted that MFIs could not be compared with moneylending services, thereby shielding all players from the vicissitudes of state machinery and also provided for the collection of thrift. Other important features of the bill related to its provision for all systemically important organizations of varying legal forms (having net asset size > Rs100 crore) were required to transform into NBFC-MFIs/Section 25 companies and giving authority to RBI to set margin caps, create a reserve fund, conduct inspections, financially prosecute MFIs not conforming to the guidelines and even cancel their registration. Good corporate governance practices like compulsory disclosures and information reporting were also stressed upon. The Drafting Committee maintained that the focus of the Bill was to 'do no harm' and create an enabling environment for MFIs to function.

Though certain lacunae were pointed out by experts like low capital requirement of Rs0.5 million to collect thrift, the exclusion of cooperatives and federations from its ambit and severity of penal provisions which included even jail term, overall it was quite an improvement over the 2007 bill and covered most aspirations of the sector(Table2).It is significant that by bringing diverse entities engaged in microfinance under its scope, it sought to overcome the long standing confusion between form of incorporation and nature of business.

Table-2

Aspects	Microfinancial Institutions (Development and Regulation) Bill, 2007	Microfinance Institutions (Development and Regulation) Bill, 2012
Scope and application	Only NGO-MFIs registered as societies, trust and cooperatives (excluding NBFCs and Section 25 companies)	MFIs in all forms
Structure of the sector	One tier, MFOs only (apart from NBFCs and Section 25 companies, but no provisions applicable to them)	Two tiers—MFIs and Systemically Important MFIs
Savings mobilization	Only 'thrift' for MFO from members	Thrift mobilization possible
Supervisor	NABARD	RBI, with powers to delegate to NABARD
Advisory council	Advisory, with majority consisting of officials representing specified agencies ex-officio	Advisory with no role in regulation Both at National and State levels
Grievances handling and appellate authority	MFDC 'may' set up an Ombudsman	Ombudsman provided for
Capital norms	Net Owned Funds (NOF) of at least Rs5 lakh and a capital adequacy ratio of 15%	Rs5 lakh as minimum entry capital— RBI to stipulate prudential norms
Instruments	Registration for thrift taking MFOs and information reporting for all	Registration for all, information reporting and interest rate caps
Customer protection	Through Ombudsman	Norms for customer selection, size of loans, interest disclosure, process controls and interest/ margin ceilings
Powers of regulator	Minimal	Power to cancel registration, order for winding up, merger and acquisition, imposition of penalties, delegation of powers, issuance of directions

2.4 2014: Year of Paradigm Changes in the Financial Sector

2014 has been a year of 'blow hot and cold' for the MFI sector. The year started with the release of the report of Committee on Comprehensive Financial Services for Small Businesses and Low Income Households set up by the RBI under the Chairmanship of Dr. Nachiket Mor. The report sought to address key demand side challenges and pave the roadmap for universal electronic bank accounts, ubiquitous access to sufficient and affordable credit, payment services and deposit products, investment, insurance and risk management products as well as clients' 'right to suitability' as a part of its endeavor to promote financial inclusion and financial deepening in the sector. The key part of the report, which enthused the sector, was its commitment to maintaining channel neutrality as a pillar of regulatory stance. This was rightly seen as acceptance of MFIs as a vital cog in financial inclusion rather than relying on a bank-led approach. Other recommendations such as allowing NBFC-MFIs to become business correspondents of banks (which has since been implemented) and tax concessions on securitization added to the belief that MFIs are now being considered by public policy as important players.

Even before the sense of relief and expectation could seep in, the report of the Standing Committee on Finance considering the "Microfinance Institutions (Development and Regulation) Bill, 2012" came out. The sector had high hopes on it as it was an overall good piece of legislation, covering all forms of microfinance service providers and considerable time was spent on discussions with the government. However, the hopes were dashed as the committee in its report said that

"*Committee find that the Bill is rather sketchy with inadequate groundwork and lacking in consensus, requiring wider consultations with stakeholders and deeper study on vital issues. The Committee are, therefore, constrained to convey their unacceptability of the Micro Finance Institutions (Development and Regulation) Bill, 2012 in its present form. The Committee would, thus, urge the Government to have wider consultations with the State Governments and stakeholders and arrive at a consensus; and reconsider / review the proposals contained in the Bill in all its ramifications and bring forth a fresh legislation before Parliament duly addressing the concerns expressed by the Committee.*"

This brought the sector back to a zone of uncertainty. A careful analysis of the detailed comments made by the standing committee is merited, as this will be precedence for future legislative endeavors.

Table – 3 Analysis of Standing Committee's Observations

Standing Committee Observations	Analysis
Contradiction between the Statement of Objects and Reasons and Long-title of the Bill	The committee's observation relates to the title having "development and regulation" as key words, while the object of the bill also had "promotion" and "orderly growth" as objectives. It can be argued that regulation leads to orderly growth and there is no material difference between development and promotion.
Insistence upon security or guarantee as per Clause 2(1)(h) of the Bill defeats the very objective of the Bill	Clause 2(1)(h) of the bill does not insist on security but says "....credit extended in cash or kind with or without security or guarantee". Further, once the MFIs come under RBI regulation as envisaged in the bill, the guideline of not having security for loans up to Rs1 lakh would apply to MFIs also.
The terms "financial inclusion"; "micro finance"; "poor households" are not defined in the Bill indicating lack of focus on facilitating financial inclusion	"Micro finance" has been defined in detail in Clause 2 (j) of the bill. Financial inclusion is a generic term and poor households for microfinance has already been defined by RBI based on household income limits. The bill has to be seen with existing instructions of the RBI for NBFC-MFIs.
Ministry of Finance, the nodal Ministry for achieving financial inclusion, is implementing the financial inclusion agenda without a National Policy on Financial Inclusion.	It is not clear as to how formulation of National Policy on Financial Inclusion is related to the bill. The bill had a limited objective of regulating one channel of inclusion.
Bill exempts Cooperative Banks, Regional Rural Banks and PACs from the definition of "Micro Finance Institutions".	Cooperative Banks and Regional Rural Banks perform full scale banking functions like deposit, credit and remittances and are regulated under different acts. The scope of the bill was limited to MFIs providing small-scale loans and collecting thrift from members.
No in-depth study / evaluation has been done by the Ministry on important matters like impact on banks, SHGs; expenditure on Micro Finance Councils at National and State levels and District Micro Finance Committees and requirement of regulator; sector-related benchmarks; performance standards pertaining to methods of operation; source and cost of funding to MFIs (both from Banks and Equity Market); risk factors in pursuing financial inclusion as highlighted by the RBI such as money laundering; threat to financial stability; and regulatory and supervisory structure to oversee the implementation of the provisions of the Bill.	It is ironical that while the committee wants a national policy on financial inclusion which can be achieved by harnessing the strengths of each channel, the committee seems to be more concerned about protecting banks and SHGs rather than the poor. Benchmarks/performance standards of MFIs as well as source and cost of funding are in public domain through data published by MFIN/Sa-Dhan, MIX market, rating reports of MFIs and sector reports. These could have been easily made available to the committee.

Bill lacks specific provisions which would provide and facilitate financial inclusion at an affordable cost to poor and weaker sections. Whereas, as per the RBI's extant guidelines, the rate of interest of MFIs may exceed 26 per cent.	The observation on cost seems to have been made without giving adequate attention to the cost structure of MFIs as brought out in submissions by Ministry of Finance, Industry bodies like Sa-Dhan and M-CRIL. RBI regulation started with an absolute margin cap in 2011 and later realizing that bank lending rates change and impact the rate of interest charged by MFIs has moved to a cost of funds plus margin cap stipulation. Fixing an arbitrary cap on interest rate without taking into account cost of funds and operating expenses is not in sync with sound policy. RBI in its submission stated that"rate of interest may look high but the rate that similar borrowers will have to pay the money-lender would have been far higher."
Only three State Governments namely, Andhra Pradesh, Bihar and Tamil Nadu participated at the stage of formulation of the draft Bill.	The process of consulting all states would lead to a never-ending process and moreover the states of Andhra Pradesh and Tamil Nadu together account for nearly 50% market share of microfinance.
Thrift: Lack of congruence between Ministry's view and RBI's view. RBI equated "thrift" with "deposits" and was not in favour of allowing thrift, Ministry of Finance was of the view that provision of thrift is only an enabling provision and that only those MFIs would get to collect thrift which fulfill the regulations of RBI.	This has been debated for long and has been argued that having ceilings in deposit mobilization so that clients remain net borrowers and not net savers can protect small depositors' interest. Savings are a much needed service by the poor and has been neglected by policy. Allowing thrift collection would also lead to reduction in lending rates, which is a desired policy objective.
In the absence of concurrence of the proposed regulator namely, RBI and the reluctance of NABARD which is proposed to be the delegate, it is apparent that the Ministry have not done adequate groundwork	While it is true that NABARD and SIDBI in their submissions considered their role as promoter and facilitator of the sector rather than a regulator, RBI in its submission observedthat it needs to be consulted further. Further consultations seems to have to been mixed with lack of concurrence and in any case the bill had provision for RBI to delegate regulation to agencies deemed fit by it.
Clause 2 (j) (A) provides for micro credit facilities involving such amount, not exceeding Rs.5 lakh for each individual and for such special purpose as may be specified by RBI. As the credit ceiling proposed is rather high considering the livelihood needs of the poor, there is a case for lowering the ceiling limit.	The Rs5 lakh limit was simply an enabling provision, which means that the RBI can respond to inflation by increasing the credit limit for microfinance without (each time) going through the time-consuming process of obtaining the approval of Parliament. The RBI is free to set any limit up to Rs5 lakh and the current limit of Rs 50,000 for borrowing by individual stands.

The above analysis clearly brings out that the reasons put forth by the committee are not material and reflect the need to educate the lawmakers on key aspects of MFIs' functioning like cost of funds, operation model and contribution to financial inclusion. The committee in its report refers to its thinking by saying "It is, therefore, felt that the Government should persist with pursuing the bank-led model as prime vehicle for achieving financial inclusion."

The net result of this has been that years of painstaking work on building consensus, educating policy makers and drafting of the bill to unify the sector have been lost. Its impact is particularly serious on NGO-MFIs which remain at the mercy of state authorities and poor regulatory oversight.

April 2014 marked a watershed moment in the history of Indian microfinance when the central bank granted **'in-principle' banking licenses** to two applicants, one of whom being Bandhan Financial Services, the largest NBFC-MFI in India having over 5 million client accounts. Continuing its thrust on moving towards a differentiated banking system, RBI released the draft guidelines for licensing of Small Banks in July 2014.The draft guidelines indicate two key features of such banks, i) limited operational area in contiguous districts and ii) 50 per cent of [the small bank's] loan portfolio should constitute loans and advances of size up to Rs25 lakh. It was followed up by draft guidelines on licensing of Payment Banks and the draft guidelines envisage that these banks will not offer credit and to begin with deposits will be restricted to holding a maximum balance of Rs 1,00,000 per customer.

While the year was characterized by lot of action on the banking front and public policy driven inclusion in the form of PMJDY, the MFI sector after the report of the standing committee is back to a situation quite similar to 1999 – at the time of first Task Force on regulation in microfinance. NBFCs-MFIs are regulated by RBI albeit in a much tighter manner than in 1999, while NGO-MFIs registered as societies and trusts continue to be regulated by respective state laws notwithstanding the unsuitability of such laws to financial intermediation activities. The similarity with 1999 looks more obvious as the Task Force recommendation of a SRO mechanism for the sector got picked up after fifteen years with the RBI conferring MFIN with the status of **Self-Regulatory Organization (SRO)** for the sector whereby it has been accorded the uphill task of surveillance, dispute and grievance resolution and increasing the capabilities of institutions through training and dissemination of knowledge.

3 MAXIMIZING CONTRIBUTION OF MFIS; ENABLING FRAMEWORK

3.1 Role of Microfinance (MFIs) in the Changed Scenario

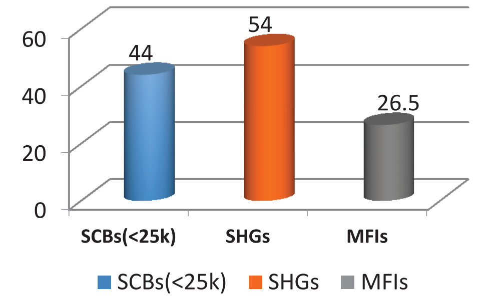
2014 started with the promise of having a policy framework that seeks to harness the strength of each channel be it banks, mobile operators or MFIs. However, by year-end it seems the policy discourse has shifted back to a bank-led approach in financial inclusion. Grant of in-principle banking license to the largest MFI (Bandhan), release of draft guidelines on small banks and payment banks and launch of PMJDY which aims to achieve universal inclusion through banks point to this direction. The question worth asking is where does it leave MFIs? Do they have a space in financial inclusion or gradual transformation, or are banks the only way out?

Two things need to be considered by those advocating that current policy is nudging MFIs towards transformation as banks. First and foremost, while full scale banking license is beyond the ambit of almost all MFIs barring one or two large ones and small bank guidelines in its present form do not suit most NBFC-MFIs and NGO-MFIs will not be able to meet the capital requirement alone. The draft guidelines for small banks though lists NBFCs and MFIs as eligible contenders, also specifies that the operational area has to be contiguous districts in a homogenous cluster of states/UTs and 50% of the loan portfolio ought to be constituted by loans and advances of size up to Rs25 lakh. The area limitation does not suit NBFC-MFIs as majority of them are spread across states varying from three to sixteen. Based on the representations received on the draft bill, even if RBI relaxes the operational area criterion, the moot point is that MFIs do not operate in a market where loan sizes are of Rs25 lakh. By relaxing operational area guidelines and making a few NBFC-MFIs fit into it still leaves the problem of inclusion unaddressed. It will only accentuate the problem of exclusion as MFIs which have an average loan size of ~Rs15,000 will drift towards the higher permissible ceiling of Rs25 lakhs for small banks. Past experience of financial sector proves that maximum permissible limits of exposure tend to become minimum. The point of contention is that on one hand licenses to a few NBFC-MFIs will leave most MFIs where they are and on the other, the market served by MFIs is entirely different from what is envisaged for small banks.

As per press reports, the final set of guidelines on small banks is with the government. If and when the guidelines come, the new set of banks will cater to the MSME market. It is pertinent that different committees have viewed the concept of small banks differently in the past. The Raghuram Rajan Committee (2009) in its report proposed the creation of deposit taking small finance banks that are private and voluntary institutions similar to LABs and listed 'Localness' and 'smallness' as their characteristics. However, Mor Committee (2014, p70) examining regional banks observed that "*However, a significant challenge that they face is in regard to deployment of their resources since* *their local nature also makes them more prone to "capture". This has led to persistent governance problems and owing to the higher exposure that they have to local systematic risk (weather, crop prices, and regional economic performance), they are likely to have to pay a higher rate to their depositors which in turn, might create the need to make riskier loans resulting in a vicious cycle of rising non-performing assets and eventual losses to their depositors.*"While the nature of the final guidelines remain to be seen, it will be interesting to see as to how this ambivalence towards concept of limited geographical area of operation and viability is resolved.

Before coming to the role of MFIs in financial inclusion, it is desirable to examine the impact of payment banks and PMJDY. The concept of payment banks was mooted by the Mor Committee (2014) based on the existing laws in Brazil and South Africa. These payments banks are supposed to transform the existing Pre Paid Instrument (PPI) issuers and fill the gap in small savings and payments, but their success will depend on how successful they are in leveraging the network of BCs, white label ATMs and progress in seeding of accounts to Aadhar. Viability remains an important concern as payment banks will offer interest on deposits but on the asset side will have to invest in government securities. To remain viable within these regulations would imply operating on a low cost model and many experts feel it will be a tough ask. PMJDY seeks to achieve universal inclusion by providing every citizen with a bank account and as per reports seven crore accounts have been opened in three months. The question to be asked is about the usage of these accounts as a study[6] on usage pattern of No Frills accounts (earlier avatar of PMJDY) found 64% of such accounts lying dormant for more than 1 year. The capacity of banking structure to

Figure-1 Share of micro loan A/Cs in Millions



handle the load is another contestable point as the float in these accounts will not be sufficient to generate profitability and are likely to be used to receive money under Direct Benefit Transfer (DBT). Both payments banks and PMJDY are focused on liability side of inclusion leaving the asset (credit) side inclusion to banks and MFIs.

The role of MFIs in financial inclusion especially credit inclusion is significant, if the data on micro loan accounts[7] is examined (Figure 1). Despite nearly 45 years of bank nationalization, scheduled commercial banks (which includes RRBs) had 44 million micro loan accounts as on 31 March 2013 and MFIs accounted for nearly half of it with 26.5 million loan accounts as on 31 March 2014. This impressive share of MFIs in extending small loans to poor clients also needs to be seen in perspective. The branch network of MFIs is mere 1/10th (10,074) as against 98,330 branches of scheduled commercial banks. Additionally, this extensive outreach has come in an environment of policy flux and sole dependence of wholesale debt funding from banks. Empirical studies have also proved that poverty outreach of MFIs is higher than that of SHG-Bank linkage programme as well as banks. NCAER (2011)[8] in its comprehensive study found that the average monthly income of clients of MFIs, SHGs and Banks were Rs1,411, Rs2,365 and Rs5,389 respectively clearly pointing the higher poverty outreach of the MFI model. The MFIs cater to a segment

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[6] Exploring reasons for dormancy in No Frills savings account in Tamil Nadu, Jose et al (2011)
[7] Loan accounts below Rs 25,000
[8] Assessing the Effectiveness of Small Borrowing in India, NCAER (2011)

which needs small loans, cannot be profitably served by formal sector banks and does not possess physical collateral and this definitely does not seem to be the intended market for proposed small banks.

These facts should make the policymakers ponder whether is it not more prudent to first facilitate and develop a model/set of institutions which have demonstrated their efficacy in reaching the poor before channelizing their energies in creating a new set of institutions.

3.2 Core Issues of MFIs; Deposits, Interest Rate and Innovation

Since inception, the MFI sector has been periodically questioned on the charges of levying higher interest rates, safety of poor clients' deposits (which has been stopped) and their focus on profitability over innovation and client focus. Crisis flashpoints starting from Krishna in 2006 and culminating in Andhra Pradesh exacerbated these charges. If the report of the Standing Committee on Finance (2014) is taken as the last version of policy stance, its concerns about MFIs also revolve around these three issues. The perception on interest rates has been legitimized through a cap on interest rates linked to cost of funds and concerns over safety of deposits has been operationalized through embargo on deposit mobilization. Both these measures have indirectly affected innovation and client focus. It is therefore critical to examine these aspects before suggesting a future regulatory roadmap for MFIs.

Protection of Small Depositors

On the deposit side, the concern is about depositor interests and systemic risk. The policy concerns in the wake of mushrooming of NBFCs and the crisis in late 1990s have led to tighter directives and regulation induced shift towards limiting deposit mobilisation to banks. It is nobody's case to risk either depositor interest or systemic stability, but argue as to how both depositor interest and systemic risk can be taken care of in case MFIs are allowed to accept deposits.

To begin with MFIs can be allowed to mobilise deposits from members (not public) in 1:2 ratio of CAR: Deposits. Going forward, the maximum permissible level of deposits can be linked to the rating grade. As another layer of prudential regulation, the deposits with MFIs can be covered under deposit insurance scheme and it be stipulated that overall borrowers remain net borrowers. While the above measures can adequately take care of apprehensions of putting poor people at risk, these will also end the present uni-dimensional relationship between the MFI-client by creating a two way interaction where the MFI is also partly dependent on its relationship with clients to generate funds for intermediation. Diversification of liabilities in the form of deposits will also reduce liquidity risk for MFIs. The Microcredit Regulatory Authority (MRA) in Bangladesh which supervises the operations of NGO-MFIs allows for compulsory, voluntary and term deposits subject to the various conditions like deposits should not exceed 80% of loans outstanding. Deposits now account for 35% of liabilities of NGO-MFIs in Bangladesh. Similarly, deposits account for ~47% of liabilities of Microfinance Development Banks in Nepal.

It is not that the poor who do not save with banks in India do not save; they continue to save with the local grocery store or a local chit or relatives or under their mattresses. Is it acceptable just because they are outside the purview of the central bank? It is high time this issue is seen from the prism of financial inclusion and development rather than purely as a systemic issue.

The Bogey of High Cost of Lending

The perception of microfinance institutions charging higher interest rates needs examination. The lending rate can be analysed with respect to two critical aspects a) comparison with the MFI lending rates in other parts of the world and b) unravelling the cost structure of Indian MFIs. On the touchstone of global comparison, it is clear that lending rates of Indian MFIs are well below global standards (Table 4). This is despite the fact that globally most MFIs have access to low cost deposits, while Indian MFIs depend solely on bank funding that comes at a higher cost.

Table-4: Interest rate of MFIs

Countries	**ROI**
India	**26.0%**
Cambodia	17.9 – 39.9%
Pakistan	29.31-36.05%
Philippines	>60%
Azerbaijan	39.4%
Source-Microfinance Transparency	

On the second aspect, the lending costs are a function of funding cost, operational cost and risk cost. For Indian MFIs, the funding cost is decided by banks and operational cost is based on expenses incurred in retailing small loans at the doorstep. Everybody realises that doorstep delivery of small scale financial services has a higher cost compared to the branch based higher loan size business model followed by banks. The measure of operating cost is Operational Expense ratio (OER) and as per M-CRIL estimates, the average OER of NBFC-MFIs has been on a steady decline and currently stands at ~8%. This has happened on account of the need to comply with the norm of 10/12% margin prescribed by the RBI and still remain profitable. It is a classic case of micro-regulation reducing the client centricity of microfinance as in order to comply with this, any prudent institution will aim to spread outreach in a densely populated area, change the repayment pattern with a view to boost staff productivity and reduce interaction time with clients. It is a dangerous path to follow as close interaction with clients and offering of products in line with clients' demands are the key characteristics of microfinance. The cap also does not account for the fact that institutions in different stages of growth have different costs; operating cost is seen to gradually fall with growth as economies of scale are achieved.

Under the present regulations, MFIs depend on equity (~20%) and wholesale loans from banks (~80%) for their funding, which at present is priced at around 14%. As such, while operating cost is already at a minimum, further reduction in interest rates can come either from allowing MFIs to raise deposits or lowering the bank lending rate to MFIs. Under the liberalised regime, lowering cost of bank lending may not be a market based solution but allowing deposits can lower lending rates and also be market driven solution. If MFIs are allowed to take deposits even in the ratio of 1:2 of CAR: Deposits, it can lower the lending cost by 3.6 % (Table 5)

Table-5: Existing cost structure compared with deposit based structure

Existing Cost structure		**Cost structure with deposits**	
Cost of equity (20%)	0	Cost of equity (20%)	0
Cost of Bank loans (80%)	11.2	Cost of Bank loans (40%)	5.6
Cost of Operations	11	Cost of deposits (40%)	2
Risk cost	1	Cost of Operations	11
Total Cost	23.2	Risk Cost	1
	Total Cost	19.6	

NB: 1. Equity taken as zero cost. 2. Bank loans costed at 14%. 3. All costs as % of portfolio

Thus, allowing well-functioning MFIs to accept deposits (with certain limits) can create a win-win position by lowering the costs, allowing for a holistic relationship between MFIs and clients as well as lowering the liquidity risk of MFIs by not being solely dependent on bank funding. On inclusion side, this can immediately add 20 million clients impacting 100 million (including their household members).

Even after ignoring the fact that doorstep delivery of financial services by MFIs entails higher cost than bank lending as well as SHG-Bank lending model, the empirical studies show that actual costs do not differ much across channels. NCAER (2011) in its study found that costs are highest for formal sources, followed by SHGs, MFIs and informal sources. The cost computation includes loss of wages due to time spent in getting the loan approved, cost of travel, money spent on food and payment of bribes (Table 6).

Table-6: Cost Of Borrowing From Different Sources For A Single Loan
(Weighted, Rs)

	KOLKATA	CHENNAI	LUCKNOW	HYDERABAD	JAIPUR
Formal	1,286	1,355	3,481	1,937	2,516
SHG	104	228	638	558	750
MFI	54	132	222	278	196
Informal	23	71	81	65	81
Source: NCAER (2011)					

3.3 Suggestions for Future

The above discussion brings out the useful role played by MFIs in financial inclusion and also indicates how key policy changes can maximise their contribution. Facilitating regulation is the most important part of required changes. It is time that regulations focus on nature of business rather than the form of incorporation and bring together all forms of MFIs under an omnibus policy. In practice, it is already happening as not for-profit MFIs are also being subjected to regulations applicable to NBFC-MFIs by the lending banks. It is appropriate to accept and legitimise this through a regulation which covers the entire spectrum of MFIs (Trusts, Societies, Section 25 companies and NBFC-MFIs). Concern is voiced in certain quarters that such a law will lead to double jurisdiction as trusts and societies are already regulated under state laws. It is felt that such a practise is already in vogue with respect to cooperative banks which are governed by the Banking Regulation Act in respect of banking activities, while they are also required to conform to the cooperative law in other respects.

The proposed bill should ideally have the following features:

	Proposed Regulations	**Remarks**
Objective	The regulations should be aimed at regulating and developing the delivery of microfinance services to a defined set of clients and should be neutral to the registration status of the institution delivering it. The objective should be development of the microfinance sector by allowing a number of regulated entities in providing credit and thrift services.	
Scope	Should cover all institutions that are involved in microfinance barring cooperatives (charitable trusts, societies, Section 25 companies and NBFC-MFIs) ambit, irrespective of the statute.	Cooperatives to be excluded as certain regulations on deposits might curtail their existing operations.
Definition of Microfinance	Loans below Rs 1 Lakh (capped with extant RBI regulations on collateral free loans); to be revised periodically in line with inflation. Deposits (both compulsory and voluntary) not exceeding Rs 50,000 per member.	Suggested limit of Rs50,000 based on the maximum loan size. Further restrictions based on linking it to capital adequacy can be imposed.
Regulatory jurisdiction	The regulations should explicitly state that the entities registered with it will be considered as microfinance institutions and will not fall in the ambit of state laws like money lending regulations.	
Regulator	Reserve Bank of India. A Micro Finance Supervisory Board (MFSB) could be thought of as a sub committee of the proposed FSDC.	It should draw experts from the sector.
Deposits	Regulations should allow collection of deposits by all institutions (only from members) meeting the prudential requirements for the collection of deposits.	
Regulatory architecture	Three tiered Tier I – MFIs with asset size of more than 200 crore Tier II-MFIs with asset size between 50-200 crore Tier III-MFIs with asset size less than 50 crore	
Prudential norms	Prudential norms relating to CAR, reserve requirements, liquidity/ALM and reporting to be based on three tier classification – ranging from stringent to less stringent. For Tier II and III MFIs, which will be mostly NGO-MFIs, CRAR requirements may be suitably tweaked to substitute Tier 2 capital with Tier 1 capital, taking into consideration the regulatory limitations in mobilizing equity by not for profit entities.	
Margincap	No absolute cap. Based on size and model, ranges can be prescribed.	Empirical studies can be commissioned to come up with relations between size/model and operating cost
Client Protection	Key provisions of the Unified Code of Conduct pertaining to client protection, prevention of over-indebtedness and sharing of data with credit bureau should be included	

This is not an exhaustive list but intends to serve as the basic building blocks of any future regulation. Aspects listed above ensure that both policy objectives and interests of the MFI are taken care. Limited and regulated deposit mobilization by MFIs will deepen their relationship with the clients and also lower the lending rates. By bringing all forms of MFIs under the law with provision for tiered regulations, the law can give the much-needed fillip to the sector and bridge the divide between for-profit and non-profit entities. The question of requisite regulatory bandwidth is a real one; but public policy needs to ponder whether regulation and regulatory capacity should evolve in line with field realities or vice versa. In the proposed regime, MFI branches can act as customer touch points for payment banks and those willing to graduate to small banks will have the freedom to do so. Such a regulatory arrangement will ensure that channel bias is removed from policy and the freedom to choose rests with the customers.

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