A STRATEGY REACTS TO THE INDIAN MICRO-FINANCE CALAMITY

T. R. Gurumoorthy*, **A. R. Annadurai****

kirthigurum@yahoo.co.in

ABSTRACT

Latest proceedings in India have brought a fresh focus upon the problem of regulation in the field of micro-finance. This paper delineates the three different aspects where government needs to play a role. The first is to protect the rights of the micro-borrower, the consumer of micro-financial services. The second is that of prudential oversight of risk-taking by firms operating in micro-finance, since this could have systemic implications. The third is a developmental role, emphasizing scale-up of the micro-finance industry where the key issues are diversification of access to funds, innovations in distribution and product structure, and the use of new technologies such as credit bureaus and the UID. Each of these roles needs to be placed in an existing or a new regulatory agency. There is a case for creating a new regulatory agency which unifies the consumer protection function across all financial products.

INTRODUCTION

In recent period, the inclusive micro-finance industry has faced a calamity because of the heads-on clash between their original goal of poverty alleviation and the profit-maximization goals of formal financial firms that have brought about a scale-up of the micro-finance business. In India, this calamity is compounded because these firms appear to maximize profits while simultaneously borrowing funds at Priority Sector Lending rates which have been set very low in order to benefit the poor micro-borrower. However, this is just one factor that caused the recent liquidity calamity in Indian micro-finance. In the state of Andhra Pradesh, micro-finance institutions have been accused of lending practices that adversely affected the lives of the poor borrower, to the extent that they have been driven to suicide. This has led to government intervention with an ordinance that effectively stopped collection of micro-debt and prohibited any new micro-loans in the state. The more systemic outcome from this was the lending-freeze by the banks to the micro-finance sector, not just in the state but all across India. The current stalemate puts into the forefront the importance and urgency of getting policy for the micro-finance sector right. It is important to ensure that the policy is not so much on the specifics of the business of micro- credit, but rather on the principles that will ensure sustained growth of the industry to achieve full financial inclusion in India. This requires focus on the overarching mandate for micro-finance regulation. An examination of the current complaints against micro-finance industry practices identifies three problems: a) mis-selling of micro-credit products, b) usurious interest rates, and c) coercive debt collection practices. From the perspective of financial regulation, these issues pertain to the distribution of credit services by the MFI to the borrower. This is very different from the issue of prudential regulation of micro-finance that has been proposed as the solutions for the Indian micro-finance calamity.

Besides, if the strategy contest is to focus on achieving financial inclusion through the growth of the micro-finance industry, it must address the issue of facilitating a stable flow of funds for micro-credit transactions. For instance, it is important to ensure that a calamity in one state, does not lead to a national liquidity crisis for micro-finance activities all across the country. Thus, policy must focus on improving the linkages of the firms with their customers by strengthening the rights of the micro-finance customer, and simultaneously, of strengthening the linkages of the firms with various funding agencies. Collective experience from financial regulation suggests the following broad focus:

1. Protect the rights of the micro-finance consumer with a primary focus on ensuring quality of financial services distribution.

*Professor, **Doctoral Research Scholar, Deptt. of Intl. Business & Commerce, Alagappa University, Karaikudi (TamilNadu)

2. Monitor and supervise the level of disclosure by micro-finance firms to ensure transparency about the risks in the micro-credit portfolios. This would assist funding agencies make informed decisions.
3. Promote the development of the sector by innovations in (a) Linkages between customer and MFI, creating an enabling framework where all types of financial services can reach those who are not financially included. (b) Linkages between funding agency and MFI, creating an enabling framework for all types of formal financial firms to fund micro- finance activities, not just banks. In this paper, we examine how policy can address each of the above, in the short term to resolve the multiple crises in the micro-finance sector, and in the longer term, to address the more fundamental issue of facilitating growth that does not run afoul of the political economy of doing business with the poor.

MICRO-FINANCE IN INDIA

There are two models in India that link the formal financial sector with lending to low-income households that cannot afford collateral. The first is the bank-led SHG model, promoted by the State through commercial banks, which lends to groups of 10 to 20 women called the Self-Help Groups (SHGs). The other model is that of micro-finance institutions (MFIs) which private sector entities are lending to small groups similar to the SHGs. Both are based on the joint-liability-group (JLG) method.

STRATEGY INFLUENCES IN INDIAN MICRO-FINANCE DEVELOPMENT

There have been two significant factors driving the development of the micro-finance industry in India. The first has been the implementation of the government goals of financial inclusion by setting priority sector lending targets for banks. The second has been the role played by the state government of Andhra Pradesh, a state that has been centre-stage in promoting micro-credit in India.

PRIORITY SECTOR LENDING

Financial inclusion has always been a priority for India polity, particularly given the socialist disposition of the state. With the bank nationalization of the seventies, public sector banks and other subsidies became the chosen implementers of this policy, primarily through mandated rules on priority sector lending. This requires banks to lend between 32-40% of net bank credit to specific areas (defined as priority sectors) at a rate lower than the prime lending rate of the bank. This rate is called the priority sector lending, or PSL, rate. Traditionally, most PSL was targeted towards the poor engaged in agricultural or allied activities. These were monitored by the National Bank for Agriculture and Rural Development (NABARD), a department of the RBI. The definition of what PSL activities entail have been steadily modified, and today include consumption loans for weaker sections, as well as micro-loans to SHGs, either directly or through any intermediary including NGOs.

Since the MFI business falls under a PSL category, they can raise loans from banks at PSL rates. In addition, MFIs can deploy these funds with more flexibility than can be done under any of the bank-led efforts since they do not face the public sector constraints of the typical Indian bank. It is a combination of this operational flexibility together with their ability to raise funds at PSL rates that has enabled the MFIs to help displace the strong hold of traditional money-lenders on indebted households. The MFI growth has been so significant that the importance of deepening the outreach of micro-finance through both the bank-led SHG program and the MFI.

ETHICS OF FINANCIAL SECTOR REGULATION

The first call for problem resolution in financial markets has traditionally been the forces of competition. Economists advocate that when the market opens up to higher levels of competition, competitive forces will ensure that customer needs will be served the best. This assumes that all customers are alike and rational, and that they all have access to all information about the services and the service providers with no costs of acquiring that information.

A key role that regulation plays is to bolster trust in the sector. This is particularly relevant for the MFI in India, which has suffered a loss of confidence in the public view. It is evident from the crisis in the Indian micro-finance sector that the lack of transparency had crippled the ability of the MFI to deny accusations of bad debt practices. A useful example of the tremendous benefits of increasing

transparency in finance is the case of the Indian equity markets. From the early nineties, when policy changes were targeted to improve the processes and the transparency of the equity markets, these markets grew several times over, in terms of outreach to all stakeholders. These changes were also accompanied by the creation of a statutory regulator which got an explicit legal mandate to improve use and access of equity markets in India.

GUIDELINES FOR REGULATING MICROFINANCE

The common prototype in regulation for micro-credit is banking sector regulation, which has a focus on protecting the rights of the depositor. As a result, micro-finance regulation tends to differentiate between deposit and non-deposit taking MFIs, with a lot of the banking sector regulation applied to the deposit-taking MFIs. This does not quite apply in the case of the Indian micro-credit sector, where MFIs offer credit while deposit-taking has remained a distinctly uncertain future possibility.

To add to the complexity, banking regulation cannot readily translate into a framework to accommodate the heterogeneity of legal structures that the typical micro-finance sector is based on. If regulation has to be created for the micro-finance industry, it would need to be uniform across these different forms so that the industry does not get fragmented across regulatory lines.

REGULATORY MANDATE

Set this condition, if we were to create a principles-based mandate to effect improvements in the MFI sector, then the mandate should focus on:

1. Protecting the rights of the micro-finance consumer, with a primary focus on ensuring quality of financial services distribution.
2. Prudential monitoring and supervision at the level of disclosure by the MFIs to ensure transparency about the risks in the micro-credit portfolios. This would assist the funding agencies to make informed decisions.
3. Promoting the development of the sector by innovations in

Linkages between customer and MFI, wherein there should be an enabling framework so that all kinds of financial services can reach those who are not financially included.

Linkages between funding agency and MFI, wherein there should be an enabling framework for funding across all formal financial savings firms beyond the banking sector.

The current debate on MFI regulation focuses on credit as the financial service. However, once the distribution channels are in place, the micro-finance industry will be ripe to address a larger financial services domain.

IMPLEMENTING POLICY

The available legal structure that could be used to implement the policy issues in the regulation mandate listed above, in as short a time as possible. There is a sense of urgency here because a solution that can be rapidly implemented could help to resolve the conflicts that the micro-finance sector has been facing, since the 2010 AP intervention.

CUSTOMER LINKAGES: PROTECTING THE RIGHTS OF THE MICRO-BORROWER

Defining consumer protection for the micro-consumer of financial services with a caveat: the mandate of consumer protection extends to entities outside of the current MFI sector as well. It is therefore critical to explicitly acknowledge that any discussion on such regulation should be applicable to the domain of any financial service, and by any kind of a distributor.

A RECITAL SUPPORT

The above discussion suggests actions that policy can take so as to resolve some of the issues driving the liquidity calamity in the micro-finance industry. These strategy actions will also have repercussions on how growth in this sector can be fostered over the longer horizon while ensuring that the same problems that caused the recent political and funding has a lower likelihood of recurrence.

Split the strategy actions into three different time-frames: what needs to be done in the short-term, in the medium-term and in the long-term.

SHORT TERM: THREE-SIX MONTHS

The immediate target of policy ought to be to free the micro-finance industry from the grips of the liquidity crunch that it is currently in. Since the latest crisis has been triggered by a lack of trust in the MFI sector, one action the industry can take immediately

is to increase transparency. In the next three to six months, the following ought to be implemented:
1. Institute an oversight body, for a limited period of two years that will be entrusted with the responsibility of carrying through the policy actions below. Since the current issues of micro-finance deal mostly with micro-credit, this oversight body could be placed within the RBI. However, the body must have the participation of other financial sector regulators, including pensions, insurance and securities markets, and other critical political stakeholders such as state governments that have a large micro-credit industry. This body should also be responsible for communicating the proposed and achieved reforms on a regular basis to state governments such as AP to revive the trust in the micro-finance industry.
2. Run a process to select one or two CIBs to collect MFI credit information data.
3. The CIB can be used to collate and disseminate credit information pertaining to any set of borrowers.
4. Incentives MFIs to submit information about the borrower and the loan to the credit bureau, such that 50 percent of the portfolios should be in the CIB in six months.
5. This push for transparency can continue to be a measure of good performance on the part of the MFI. In the first phase, the measure can be the rate at which the credit information database is populated.
6. Use securitization to broaden the possible sources of funds to MFIs. This will enable alternative participating financial institutions such as pension, insurance, and mutual funds to invest in the sector.
7. The process of registration and licensing of MFIs should proceed as it stands today. RBI should continue to be in-charge of developing prudential norms, and corporate governance guidelines for the NBFCs. The RBI should also co-ordinate with state governments to determine if the Money-lenders Acts in various states apply to the NBFCs, and resolve the issue of competing legislations.

MEDIUM TERM: IN 12 MONTHS

Within the next six months to a year, the above recommendations should proceed to the next level of development:
1. A framework should be put into place that combines provisions under the various relevant acts and operationalizes the process of consumers being able to seek redressal against malpractices committed by MFIs should be put in place.
2. There should be enough clarity about the nature of the contracts and appropriate definitions of what constitutes mis-selling, and coercive collection practices.
3. Bankruptcy procedures in the case of micro-lending should also be well-defined and incorporated in the legislation.
4. A concern about using the existing CPA machinery is the perceived inability of the small borrower to bear the legal expenses to take the MFI to court. Another concern involves the power dynamics in the lender-small borrower relationship.
5. The credit-bureau should have covered at least 90% of the industry. Individual MFIs should be asked to report the standard information set designed in the short-term to this oversight body. The body should have the legal power to demand compliance from delinquent MFIs.
6. There should be at least two securitized products that have found market acceptances with the mutual fund industry and the insurance companies.

LONG TERM: 2-3 YEARS

The long term goal of policy should be two-fold: protection of consumers from malpractices in the distribution of financial products and services, and an explicit recognition of credit products as one amongst a portfolio of financial products which include equity, insurance, pensions and savings.

Today, the financial sector in India has regulators for all products except credit. There is a case to be made for bringing all credit products under a single regulator for credit. This will require resolution of Center vs. State legislation as money-lending is a state subject in India. It will also require focus on protecting creditor rights, as unlike other financial products, in the case of credit, the customer i.e. the borrower also has an obligation to the lender. India does not have strong bankruptcy laws, and strengthening regulation on this front will be the key task ahead of the credit regulator.

Product regulation is typically focused on appropriate product design and prudential regulation of the product provider. The focus on distribution is missing. This lacuna should be addressed by establishing a regulator who would be

focused solely on distribution regulation. The regulator would oversee how products are distributed and information is communicated. The financial services regulator would derive powers from a new Financial Services Distribution Act to deal with the various products being sold in the financial market.

CONCLUSION

Financial inclusion is an important element through which the welfare of the poor can be improved. In addition, some poor people use borrowing in order to embark on entrepreneurship, and thus extricate themselves from poverty. The traditional strategy in India of improving financial inclusion – of emphasizing government interventions in banking – has not delivered results despite over 50 years of sustained effort. In contrast, in a short time, the micro-finance industry has delivered remarkable results. There are, hence, some important innovations that these new firms have to offer in improving financial inclusion.

Regulation also has an important role to play in facilitating funds flow to the MFI lending business. Policy needs to facilitate information sharing both between FIs and MFIs, and between MFIs themselves, about borrower quality, so that decisions are made on a base of trust that is not vulnerable to the vagaries of public opinion or of political economy. Policy measures should be implemented on a time-line to facilitate robust and stable growth of the industry that promises to deliver a scalable financial solution to poverty alleviation.

REFERENCES

- Arunachalam, Ramesh S. (2010): "The 2010 Andhra Pradesh Micro-Finance Crisis Revisited...," Blog: "Candid Unheard Voice of Indian Micro-finance", andhra-pradesh-micro-finance.
- Bass, Priya, and Pradeep Srivastava (2005): "Exploring possibilities: Microfinance and rural credit access," Economic and Political Weekly, 40(17), 23–29.
- BIS (2010a): "Considerations for trade repositories in OTC derivatives markets," Discussion paper, Committee report, Committee on Payments and Settlement Systems, Technical Committee of the International Organization of Securities Commissions.
- CFSR (2008): "Report of the Committee on Financial Sector Reforms: A hundred small steps," Discussion paper, Planning Commission.
- Chakrabarti, Rajesh (2005): "The Indian microfinance experience –Accomplishments and Challenges," Discussion paper.
- Christen, Robert Peck, Timothy R.Lyman, and Richard Rosenberg (2003):"Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision Of microfinance" Discussion paper, Consultative Group to Assist the Poor.