Short note on Micro Finance Institutions (MFI) bill -2011

A. Amarender Reddy

Unregulated growth of microfinance institutions

Microfinance industry is growing at faster rate in recent years with about 62% per annum in terms of numbers of borrowers and 88% per annum in terms of credit over the past five years. India had the world's largest microfinance market by number of borrowers, at 2.56 crore, and ranked fourth in terms of loan portfolio (Rs.20,000 crores) as on March 2010. It exceeds the number of borrower accounts served by the Regional Rural Banks by as much as 50% and represents 40% of the total number of micro-borrower accounts (of value less than Rs 25,000) in the entire Indian financial system. This represents more than 10 % of the total number of 22 crore families in the country and about 15 % of the 60% of the population that is thought to be financially excluded (M CRIL, 2010). The microfinance penetration in India is merely 3.6 per cent, and 60 per cent of the portfolio is concentrated in the southern states of Andhra Pradesh, Tamil Nadu and Karnataka. The Indian micro finance industry (MFI) would cross 11 crore borrowers and Rs 135,000 crore in loan portfolio by 2014 and will require a huge capital inflow both in debt and equity, according to a latest report by Intellecap (2010). The proposed new Micro Finance Bill (2011) came in the right time, which suggested a single regulator as it gives more clarity and uniform rules to all MFIs functioning across states. MFIs provide financial services to poor women and low income households, who are excluded by formal financial institutions and at the mercy of the money lenders. They are playing important role in the financial inclusion plan of government of India. The growth of microfinance is much faster after the entry of private MFIs, whose role cannot be underplay.

In the past few years, the microfinance sector has witnessed fast unregulated growth. Initially not-for profit organisations were active in the sector, however after seeing the huge business and profits in the sector many for-profit organisations started business in this sector. Many of the not-for profit organizations (NGOs) were switched over to micro-finance business and taken loans/funds from different sources (including banks, international donors) to expand microfinance operations for the sole purpose of making money as business proposition. It is observed that, between 2008 and 2011, loan disbursals of SKS Microfinance , India's largest and only listed operator, jumped from Rs. 1680 crore to Rs. 7830 crore (increase of 366%in 3 years). With the entry of commercial MFIs into microfinance business, one can expect that there will be increased competition and reduction in margins and interest rates and the benefits of competition would reach to borrowers in terms of lower interest rates. But in the last few years, the benefits of this competition were not percolating to the borrower, interest rates were not decreased. Moreover, potential borrowers were encouraged to take multiple loans without considering their repaying capacity. During the recovering loans the MFIs used coercive practices which resulted in number of suicides in Andhra Pradesh. With the proliferation of MFIs, the common complaints against microfinance institutions are (i) high interest rates exceeding 30%, (ii) coercive recovery practices and the aggressive tactics of for-profit MFIs, (iii) over borrowing, multiple lending (iv) concentration in only few states like Andhra Pradesh and Maharashtra and complete neglect of other states like Uttar Pradesh, Bihar, Rajasthan and north eastern states etc where banking density is low and expected profits to MFIs are low.

The Andhra Pradesh MFIs (Regulation of Money Lending) Act, 2010

Many suicide cases were registered in Andhra Pradesh in response to high interest rates, multiple loans beyond repayment capacity and aggressive loan recovery practices of MFIs. In response to this, Andhra Pradesh government issued an ordinance on October 15, 2010 with the intention to regulate microfinance activities in the state. This Ordinance was ratified two months later on December 15, 2010 by the Andhra Pradesh assembly. The key features of the Bill are: (i) All MFIs should be registered with the district authority (ii) No person should be a member of more than one SHG (iii) All MFIs shall make public the rate of interest charged by them on the loans extended (iv) Penalty on the use of coercive action by the MFIs and (v) Violation of the bill shall be punishable with imprisonment for a period of 6 months or a fine up to the amount of Rs 10,000, or both.

The demand for a cap on the interest rates charged by the MFIs for the loans extended to the SHGs was rejected during the ratification. The ordinance has severely curtailed the activities of microfinance lenders in the state, which had been their largest single market in India. The passage of the bill hampered the operations of microfinance lenders in the state. Collection rates in Andhra Pradesh have fallen to 20% from 95% since the ordinance took effect. The stringent rules in AP act has turned the opinion of the public and, more importantly, funding bodies against MFIs. The uncertainty in regulatory and political environment towards microfinance institutions has caused bankers/donors to play safe and not increase their exposure in microfinance.

As a first step toward resolving the jurisdictional breach caused by the AP government's purported regulation of NBFCs, the RBI set up the Malegam Committee to study the issue and make recommendations. In its draft report, the Malegam Committee legitimized MFIs and the private sector's involvement in microfinance and called for continued priority sector lending support to MFIs. Some recommendations include (i) Loan limits. A limit on loans of Rs 25,000 to borrowers with household income of less than Rs 50,000. (ii) A cap on interest rates and margins (iii) Provisioning norms: The report recommends much higher provisioning norms than are currently in place. The RBI accepted the committee recommendations with some modifications. In continuation of reforming MFI regulation, Government of India comes up with the MFI (Development and Regulation) bill, 2011 for discussion.

Microfinance Institutions (Development and Regulation) Bill 2011

The area of operations of many major MFI's has been extended to more than one state. In such cases, facing different MFI regulations in different states may hinder the MFI performance. Therefore, keeping the objective of financial inclusion, poverty reduction and reasonable competitive environment and uniform regulation and clarity, Microfinance Institutions (Development and Regulation) bill 2011 was put up by the Finance Ministry, which proposes to override all other laws, including legislations passed by states like Andhra Pradesh, with an aim to protect the consumers.

The Act empowers all the regulatory powers to Reserve Bank of India to take disciplinary action and act as on ombudsman for MFIs and overrule all existing state acts. The key feature of this Bill is that it will bring all microfinance services under one regulator – the Reserve Bank of India. All microfinance companies must first register with the RBI before they begin operation. The Bill also directs all MFIs to set up a reserve fund which cannot be used without RBI's permission. All MFIs will also be required to submit their balance sheets to an RBI approved auditor. The bill has proposed that any entity, other than banks, which provides microfinance services, would be treated as a micro finance institution (MFI) and come under the RBI's regulatory oversight. The RBI will have sweeping powers to determine upper limits for margins besides fixing prudential norms. The Bill also proposes setting up of centre and state level councils to advise the government on policies for the development of the sector. The central council will consist of officers from Finance and Rural Development Ministries, the RBI, SIDBI, NABARD and NHB besides six experts. Draft MFI Bill is materially positive for all microfinance institutions. The state advisory councils will have representatives from the state microfinance sector, the RBI and banks. They will advise on lending, recovery methods and grievance redressal mechanism. If activities of MFIs are found to be hurting the interest of clients, the regulator can issue 'cease and desist' order and can even cancel the registration. If the MFI is not satisfied with RBI's actions, then it can appeal to the central government, which will have the final say. Among other things, the regulator will have a say on how much loans can be disbursed by the MFIs, the number of borrowers who can avail these loans and also the areas where they can operate. The RBI can also delegate an inspecting authority to look into the books of MFIs to NABARD.

Key Issues in the bill

Main competitive advantage of MFI activities lies in their reach and spread among remote villages, which are unreachable by traditional bank staff. Keeping this in mind, it is doubtful whether RBI/NABARD will be successful in regulating them with their meagre presence in rural/remote areas. It is also doubtful, keeping the low cost structure followed by most small scale MFIs, whether they are able to maintain the accounts/records as prescribed in the bill. It is general convention that RBI is the regulator for all organised money lenders like banks and NBFCs. The Money Lenders Act which is covered by Constitution, which is part of state subject and applies to unorganised sector where money lending is being done. Even though MFIs are alternatives to banks in financial inclusion objective in rural areas, in terms of loan disbursal and recovery practices, interest rates and book keeping they are closure to money lenders with local presence, low cost structure, high penetration to remote areas although with high interest rates and coercive loan recovery practices.

Even if the RBI becomes the sole regulator of the sector, the fallout of coercive recovery practices and resulted suicides becomes a subject of state. Some state governments including the AP state government criticized the act in terms of (i) why the issue of interest rate has been left untouched. The bill talks about capping margin, when the problem is with the interest rate. There are MFIs charging about 40% interest but showing just 6% margin over cost. (ii) It is mentioned in the bill that the MFIs are 'extended arms of the banks', many times it may not be true. MFIs acts as independent for-profit organizations with their own objective of profit maximization with more emphasis on increasing profit margins with little or no interest in farmers welfare, financial inclusion, reduction of poverty etc. Consequently, the lending practices, interest rates, recovery practices of the MFIs are more coercive and different from banks and (iii) Further MFIs also take funds from different other sources, whose objectives may not be in line with banks objectives and welfare of the poor.

The bill defined 'Micro finance services" as one or more of the following services involving small amounts to individuals or groups: (i) providing micro credit, (ii) collection of thrift, (iii) remittance of funds, (iv) providing pension or insurance services and (v) any other services as may be specified. The new draft Bill says microfinance is not money lending and therefore not under the state governments' jurisdiction. However, the facts indicates that big microfinance institutions get a larger share of income from interest income from micro-lending, and more likely share of interest income is increasing for even small microfinance institutions (M-CRIL, 2010). It may be kept in view that the crisis in AP precisely arose out of the coercive lending and recovery practices of MFIs, calling for regulation of their money lending activities. This justifies that the MFIs should be treated as money lenders.

Finally, the draft proposes to allow MFIs to collect the thrift from the poor. Thrift is the money of the members of the self-help groups, used for internal rotation to meet the emergency credit needs. It is a good proposition and inculcates and encourages habit of thrift among rural people at their door step. As until now only banks are allowed to collect deposits from the ordinary people.

Conclusions and Suggestions

At present the micro finance institution is in a transient phase. With too much proliferation of profit oriented MFI in the rural market charging high interest rates and exerting coercive forces for recovery. This has created an uncertainty regarding the functioning of micro finance institution in the rural credit market. Many MFIs complained that the existing AP MFI Act (2010) is over empowered local administration, which jeopardized their microfinance operations. The recovery rate of MFI's has come down drastically which is even effecting the functioning of not-for-profit MFI's which are really making a change in the lives of people by encouraging them to take up livelihood projects. For Example: It is observed in a case study of National Institute of Rural Development (NIRD/Hyderabad) that BASIX has been providing small loans through Joint Liability Groups to the farmers in Parbhani district of Maharashtra to purchase dairy animals. Besides this, it is also providing veterinary services and marketing services to the farmers by helping them to organize into dairy cooperative societies. The livelihood of the people in the area has been improved. While it is very much necessary to curtail the fraudulent and exploitative functions of MFI's, it is equally important to nurture and support the activities of those institutions that are serving the people. The following are some of the suggestions which may be worth exploring.

1. The birth of developing institutional networks like MFIs is rooted in helping rural population to get timely and hassle free loans at reasonable rates of interest with minimum processing/procedures and minimum documentation without collateral security. Under these situations, recovery of loans is a complex task. The lending and recovery of most of the MFI's is through Joint Liability Groups which empowers local women/poor households and act as vehicles for many developmental activities. The Joint Liability Groups/ Self-Help Groups should also be responsible for not taking multiple loans from different sources and also oversee the recovery practices and interest rates of MFIs.

2. Sufficient flexibility to MFIs to design their products in terms of loan amount and tenure, while retaining measures that protect borrowers.

3. As most of the previous problems with MFI's came from coercive and unlawful practices in recovery of loans, major role should be given to state advisory committees to frame rules and manage grievance redressal mechanism.

4. Accountability and time frame needs to be put in place for any grievance redresses mechanism.

5. Even though the last word regarding the MFIs may be rest with RBI, there is a need for delegation of many powers to local administration such as district collector, state level banking committee and even district level banking committee to be formed to oversee unlawful MFI operations.

6. The failure of grass root level functioning institutions, in implementation and enforcement of law, is a pointer towards failure of governance which demands some degree of urgency. Panchayat Raj institutions should have a role with checks and balances in the implementation of the bill.

7. We cannot expect MFIs could cater to the financial needs of ultra-poor, as they don't have necessary income sources to repay their loans. Invariably there is a need for public sector banks and regional rural banks to cater them with subsidized schemes.

8. Part of what got Indian microcredit firms into trouble was borrowers who took out multiple loans from different sources, with a large chunk of funds used for luxurious consumption, like buying TV sets or paying for private parties and weddings and unable to repay at the end. There is a mention of complementarities between the livelihood projects taken up through microfinance and increase in income of the people in many studies. Livelihood projects help borrowers to start and maintain an income-generating activity, such as rickshaw-pulling, street-selling or making jewellery, which greatly enhances repaying capability of borrowers of microfinance. Limiting the extent of finance to consumption loans and taking a livelihood approach in the provision of loans may lead to a win –win situation for both for MFIs as well as that of beneficiary.

References

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