I. Intro to Microfinance institutions

1a) mechanisms through which micro credit loans available:

- **Banks** lend directly to customers.

- **National Bank for Agriculture and Rural Development (NABARD)** sponsors the **Self Help Group-Bank Lending Programme (SBLP):**

  self help groups (SHGs) need to save for six months and maintain records and accounts to become eligible to be linked to local banks.

- **commercial banks or apex institutions** lend to **micro finance organizations (MFOs)** for further lending to groups or individuals.

  70% of Indian MFIs are not-for-profit organizations that help form self-help groups (SHG) and link them with formal banks. Remaining MFIs employ the **Grameen (group lending) model** or offer individual loans.

1b) make diagram:

- societies/trusts: NGO-MFI’s
- cooperatives
- section 25 co. (not-for-profit co.)
- NBFC (non-bank financial co.)

1c) At first, **NABARD** provided subsidized refinancing to encourage banks to lend to SHGs, but then saw there was less of a need for that as banks began to discover that SHG lending is quite profitable. Banks would lend to SHGs at about 12% per annum and groups would on-lend to individual members at a rate they determine, typically 24% per annum

1d) reason individual MFIs not reached as many poor as the SHG Bank Linkage program: lack of resources and capital.

1e) The right to collect deposits from the general public is restricted to regulated institutions: only cooperatives and NBFCs are subject to prudential regulations.

This means that NGO-MFIs can collect deposits only from their members, but not the general public.

The financial statements of most non-NBFC MFIs do not provide the true financial picture. Though they’re not legally allowed to collect savings, but it is widely acknowledged that many MFIs do collect deposits on behalf of their clients.

- some collect savings/thrift from each member of the group on a weekly/monthly basis and rotate the savings/thrift among members.
-the money is sometimes deposited in group accounts for clients in a commercial bank; in other cases the money is collected into a trust which is invested in the MFI.

This a gray area within the law: which highlights the need for the poor to keep their money in a safe, convenient place; and the need for MFIs to lower their cost of capital.

1f) The current (Reserve Bank of India’s) RBI regulation does not encourage not-for-profit MFIs (NBFC’s) to collect savings from their clients.

Technically, NBFCs are allowed to collect savings: must receive a minimum investment grade rating from an approved rating agency and be in operation for at least two years. In reality, however, very difficult:

- limit on the interest rate paid on deposits (cannot be more than 11 percent) and their duration (b/t 12-60 months).
- a minimum capital requirement of Rs. 20 million (approx. US $440,000—considerably higher than found in many other developing countries) and a long application process
- even then the authorization to collect savings is only granted by special permission from RBI, most requests are denied and RBI is thought to purposefully drag its feet on the applications so as to limit the number of NBFCs it is required to oversee.
- Many point out a number of NBFC failed in recent years, which explains RBI’s reluctance to grant licenses. But they note that microfinance institutions were not among those that collapsed, and argue that with adequate supervision steps could be taken to protect the poor and their deposits.

1g) Greater supervision of both NBFC’s and NGO-MFIs (not regulated at all) has therefore been recommended in the interests of protecting small savers, ensuring proper terms of credit and financial discipline, and the institution of a proper reporting system.

Indian microfinance associations (notably Sa-Dhan): are working on drafting a microfinance act.
- if standardized financial disclosures: MFIs doing well could become more visible to potential investors or donors.

II. 2007 Microfinance Sector Bill

2a) the bill proposes to bring societies, trusts, and cooperatives, termed microfinance organisations (MFOs), under an overarching microfinance regulation. In other words, NBFCs and section 25 companies are excluded from the purview of the bill.
2b) serious omission because NBFCs and Section 25 companies, which take up approximately 80% of microfinance loans outstanding as well as of the client base in the sector, the bill is relevant only for the remaining 20%.

2c) Bill defines financial services MFO’s provide: which cannot exceed

(a) Rs 50,000 in aggregate per individual for small and tiny enterprise, agriculture, and allied activities or
(b) (b) Rs 1.5 lakh in aggregate per individual for housing purposes. All MFOs (including those not offering thrift services) need to file their returns with NABARD at intervals to be prescribed.

2d) The bill stipulates that MFOs are authorized to collect deposits, termed “thrift,” in certain conditions.
- significance: sector experts: savings is as important, if not more, than credit for the poor.
- If passed, will also help MFO’s funding constraints because mobilising savings can be an inexpensive source of financing, especially important for small NGO-MFIs as their weak capital structure prevents them from accessing capital markets and they can’t receive equity investments.
- because they can mobilize savings, lending rates in Bangladesh are lower than in India since almost a third of their funds comes from the savings of their members.

2d2) Presently, the Reserve Bank of India (RBI) regulates the collection of public deposits by banks and NBFCs. all deposits with banks are insured up to Rs 1 lakh, ie if a bank is unable to honour its liabilities, deposits up to Rs 1 lakh would be paid by the Deposit Insurance and Credit Guarantee Corporation of India.

2e) terms in the bill before entity accept deposits:
-the minimum capital base of Rs. 5 lakhs; three years of operation; and approval from the Microfinance Development Council (MDC), an entity promoted by NABARD
-relative ease of establishment, compared to becoming an NBFC, remains a grave concern for many sector experts: leaves risk of savings related scams.

2f) protection clauses:

-Every MFO has to create a reserve fund by transferring a minimum of 15% of its net profit from thrift services and microfinance services. NABARD may direct that this fund be invested in specified securities. If the MFO defaults in repayment of deposits, its depositors shall have first charge over such securities.

But: if an MFO offering thrift services does not make any profit and therefore doesn’t form a reserve fund, there is no safety net for the depositors.

-NABARD can appoint an Ombudsman to settle disputes between clients and microfinance organizations.
-The central government establish **Micro Finance Development Council** to advise NABARD on policies related to the development of the micro finance sector.

-**An MFO may appeal to the central government or any authority prescribed by the central government** if its registration denied, or prohibited from accepting savings or made to wind up.

**III. Criticisms of the Bill (controversial: 2 years later, as of early Dec. approval still pending)**

3a) **NABARD as a regulator:**

- not overarching: even though the very idea of the bill is to provide an overarching legal framework for microfinance activities: NBFCs continue to be regulated by the RBI; NGO-MFIs and cooperatives regulated by NABARD and the same cooperatives by the Registrar of Cooperative Societies; and Section 25 companies remain unregulated.

- RBI would be better regulator b/c it’s the entity responsible for the financial system as a whole. reasons RBI’s hesitate: bad experience in regulating UCBs in the past. However, issues there specific to the cooperative sector and not applicable to the microfinance sector as a whole.

- conflict of interests since NABARD also provides equity capital and debt funds to MFOs. Since other deposit taking entities (banks and NBFCs) are regulated by RBI, potential conflict of interest there as well.

- NABARD overstretched: already a regulator for Regional Rural banks (RRBs) and cooperatives, both sectors with serious operational and governance challenges.

- NABARD lacks expertise to regulate and develop MFOs in the urban sector as its role has been limited to rural areas and to agriculture. (50 per cent of growth in the number of borrowers is likely to come from the urban areas. The urban regions are also more impacted by weakening in macroeconomic environment).

3b) **Suggestions for further regulating NBFC’s:**

- reduce the foreign equity requirement from $5 Lakh to $1 lakh

- decrease capital that has now been stipulated for NBFCs: 12 per cent of risk-weighted assets by April 2009 and 15 per cent by April 2010. Many in the sector feel that this is a very high level when compared to the limits set for the banking sector, and especially unfair when the risks for NBFCs are lower, as demonstrated by the very high level of recovery.

Fear: the increase in the cost of capital: would lead to increase in the interest rates for the clients.
-give them tax concessions of 40% of their profits if they work in excluded districts as identified by NABARD.

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3c) bill should leave room for regulating future microfinance product innovations: insurance and pensions. Insurance companies are regulated by the IRDA (Insurance Regulatory and Development Authority), and bill to regulate the pensions is waiting passage in the Parliament.

3d) limit volume of deposits accepted by the MFO based on its reserve fund or its capital.

3e) though banks are exempt from both Usurious Loans Act, 1918 and state laws which cap interest rates, the Bill does not give similar exemption to MFOs. uneven playing field between banks and MFOs.

3f) Some members of the Standing Committee of the Parliament examining the Microfinance Bill have suggested that a cap on interest rates on microfinance loans be introduced. However, it’s a politically-sensitive issue. Some in the industry support a rate cap for consumer protection, but most prefer to allow MFIs the ability to set rates as they see fit, and allow competition to drive them down.

The Finance Ministry has sensibly opposed the cap for number of reasons:

-ways to repackage loan contracts to get around it (by varying definition of balance or timing of payment) so that effective interest rates remain same, while increasing transaction costs

-interest rates should be based on risk, cost of funds and transaction costs. A cap will lead to excluding customers whose risk profiles call for higher interest rates.

-a uniform interest rate would give MFIs incentive to move away from difficult and new geographies where transaction costs are higher, and it wouldn’t address different needs of the MFOs in rural and in urban areas.

-cap discourage private and foreign financial institutions to enter the sector, which is estimated to require funding of Rs.500 billion annually.

-If the caps are applied on Government of India or State Government mandated funds, incentives to borrow from lower cost funds to pay-back loans with higher rates. If as a result, default rates of government mandated funds increases, the taxpayers my end up bearing the burden.

IV. Recommendations for MFI’s (following model of banks):

4a) insurance schemes that cover deposits and credit: mitigate risks at both the clients’ and at the institutional levels. The NBFCs are not eligible to be admitted to the Deposit
Insurance Corporation Scheme, which currently covers deposits in banks. This scheme could be extended to cover NBFCs and other MFIs.

4b) The refinance facility: available to banks from the (RBI) should also be available to MFIs. The MFIs’ needs are smaller, but are dire. could be set up in the public sector, and made merit based without discretionary allocations. This would go a long way in ensuring funds flow to the sector, even during periods of recession and financial meltdown.

4c) Currently State governments also run their own independent microfinance programs. Should partner with MFO’s to increase the impact of their resources.

Andhra Pradesh’s (AP) Mutually Aided Cooperative Societies Act, which is being replicated in other parts of the country, helps in formation and supervision of groups that can access microfinance services on behalf of their members. But it sometimes undermine credit: decision that farmers don’t need to repay the principle on a loan for the first six months, unless they are borrowing from a bank.

4d) MFI’s should be eligible for subsidies given to borrowers of banks to level playing field

4e) financial incentives to banks and MSI’s for inclusion in the hinterland

V. General recommendations for MFI’s

5a) disproportionate reliance on group lending. The MFIs need to shift from group to individual-based lending, which will require development of appraisal skills and more modern management information systems.

5b) technology (smart cards) and mobile transactions to lower transaction costs (but have their own issues in terms of regulation: security/fraud).

5c) In response to certain undesirable practices with regard to interest rates and collection of some MFIs, Sa-dhan, the industry association of MFIs developed a voluntary code of conduct for the sector.

5d) Institutions like Adhikar based in Orissa have set up remittance facility; enabling the migrant clients to use the NGO’s bank account for remitting their funds to the families, back home. Money is paid into the NGO’s bank account by the migrant near his work place. The NGO transfers the money to its account at the paying centre; cash is withdrawn by the NGO’s staff and delivered by hand at the residence of the recipient. However, regulatory implications of such movement of funds are unclear

5e) The introduction of business correspondent (BC) model by RBI is to address the needs of small savers, with adequate safety for deposits, which a bank can provide. There are several states in which financial exclusion has resulted on account of the distances
involved and sparse population spread over a very large area of the state: need distance restrictions.

5e2) disclosure: for smaller MFIs even the reduced cost can be a significant barrier to having a credit rating conducted.

- little or no incentive for small MFIs to increase public disclosure because their operations are so small that they do not seek large amounts of foreign or domestic capital.
- But increasing involvement of large commercial banks in the sector is likely to encourage disclosure as MFIs compete to offer their client portfolios to the banks.

5f) RBI: financial literacy and credit counseling

5g) Interview with N. Srinivasan, former NABARD Chief General Manager:

-impact: time/size of loan: Studies show that SHG model where it has been in existence for five years or more has an impact on poverty: evidence that savings income, expenditure on education and health have all increased.

-MFIs should have a similar effect where they have provided loans to same clients over a period of time. But given the present small size of loans in both the models, it is difficult to see a rapid decline in poverty. In fact the loan sizes need to be about ten times the present average to provide a base for poverty alleviating income for a family.

-The “touch and move” models of for-profit MFI co: result in high transaction costs, low revenues per client, and low ability to manage risks. It makes it difficult to supervise operations and imposes higher costs on the customer. Small loans leave the customer open to poaching by other lenders. While widening is necessary for inclusion, deepening of services would lead to greater customer loyalty, higher revenues per client and lower transaction and risk costs. Consolidating their business in each location before moving to new ones would better serve the interests of MFIs.

-challenges of supporting smaller, more localized MFI’s:

the notion that an MFI needs to be very large to be effective has to be dispelled. The paradigm relevant in banks that have multi-location, multi-business clients is not relevant to MFIs, where clients are small and ticket sizes are also small.

-Most pan-Indian MFIs increase their costs of management and control because of extended spans and large staffs. The standardization that takes place to make the business manageable leaves little scope for innovation and no flexibility to respond to client specific requirements. small MFIs should be supported to find the right size.

Equity as the dominant funding option requires large MFIs so that the investor gets a viable exit strategy; hence there is a mutuality of interests among those wanting to grow huge and those wanting to invest in equity with a ‘return’ consideration.
Finding the right size is the challenge – one of the issues is sustainability, another risk management across clients and activities in the loan portfolio, a third is the absolute cost of regulatory/supervisory compliance which is the same regardless of size. But a critical consideration should be at what size the MFI could still be sensitive to the client’s needs. The short answer is that we should prioritise small localized MFIs.

Long-term: Sustaining fast pace of growth, and retaining clients after three or four cycles of lending with the same loan product.

long-term scalability issues w/SHG model. rural banks may be lending to SHGs at a loss because the cost of creating and sustaining new and high-quality SHGs. SHGs are too reliant on the whims of bank managers. Unlike MFIs, which specialize in the provision of microfinance, SHGs tend to build relationships with specific bank staff that do not normally have a development role.

VI. International perspective on Microfinance regulation:

Oct. 2008: Kenya

The Kenyan government passed an Act allowing microfinance institutions (MFIs) to take deposits for the first time, but MFIs have been slow to register under the Act to provide this service. Act as a platform that will allow MFIs to retain clients instead of acting as a “conveyor belt” for customers on their way to larger commercial banks. there does not appear any element of the Act that is glaringly prohibitive, although there may be more obvious operational challenges on the ground, such as the minimum capital requirement of KSH 60 million (USD 793 thousand) which must be maintained by deposit-taking MFIs at all times.

Oct. 2008: Cambodia

Regulators in Cambodia are planning the creation of the nation’s first credit bureau to link the country into a national financial database; desired date for the launch is April 2010. The credit bureau would act as a registry for the details of all loans which would be submitted by microfinance institutions (MFIs) in Cambodia: increasingly having problems with clients who don’t tell them when they have a loan at other institutions.” However doubted the logistic capabilities for regulating such large numbers of people who often lack identification or spell their names in different ways.

Uganda:

new regulatory body was a move to protect the Ugandan public from conmen and also to stop embezzlement of savers’ money collected by SACCOs. Elaborating on the need for the new monitoring body, Ms. Nankabirwa brought to focus the fact that several Ugandan MFIs tend to operate for a few months in a particular region and then relocate to another region thereby causing many Ugandans to lose money.

Bangladesh:
Nearly 700 plus microcredit organizations in Bangladesh are operating without any authorization or approval.

Kenya:

The Central Bank of Kenya (CBK) is also pushing for further policy guidelines that will enhance the regulatory framework of branchless banking and increase access to internet banking and mobile money transfer services.

Pakistan:

State Bank of Pakistan (SBP) [1] has amended the Prudential Regulations applicable to Microfinance Banks (MFBs) to increase the maximum loan size permitted. The purpose of this change is to encourage and allow microfinance clients to ‘graduate’ to bigger microcredit facilities.

When a microfinance client approaches a MFB, the MFB shall obtain a written declaration from the borrower regarding other loan or credit facilities that have been obtained from other MFBs or MFIs or banks.