CENTRE FOR MICRO FINANCE

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ON THE MICROFINANCE BILL 2007

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BACKGROUND

On 20th March 2007, the Union Government introduced the Micro Financial Sector Development and Regulation Bill 2007 in the Lok Sabha – the lower house in the parliament of India. If passed, this bill may change the way in which microfinance is practiced in this country – and possibly in a way that will not be beneficial to the microfinance sector. This note is an attempt to provide an overview of the bill and point out potential perplexities that would arise as a result of it. The following section highlights some of the important proposed changes. This paper will then turn to the implications of these changes and potential problems associated with them.

PROPOSED CHANGES

Three aspects of the bill, among others, have the largest implications for the industry and thus are the focus of the discussion here.

1) Selection of micro finance organisations

Indian microfinance is characterised by a wide range of legal entities that engage in microfinance activities. Some important entities include, but not limited to, the following: society, trust, cooperative including urban cooperative bank (UCB) and mutually aided cooperative society (MACS), section 25 company (not-for-profit entity registered as a company) and non-bank financial company (NBFC). Not-for-profit MFIs including societies and trusts – often bundled together as NGO-MFIs – and section 25 companies are in reality not bound by any regulations as far as their microfinance activities are concerned[1], while cooperatives and NBFCs are governed by their respective regulations. As microfinance becomes a crucial avenue for financial intermediation for the poor, policy makers started to realise the need for supervising microfinance activities, especially those provided by unregulated entities. Accordingly, the bill proposes to bring societies, trusts, and cooperatives, termed micro finance organisations (MFOs), under an overarching microfinance regulation. In other words, NBFCs and section 25 companies are excluded from the purview of the bill.

2) Mobilisation of savings

The current RBI regulation prohibits not-for-profit MFIs to mobilize savings from their clients. Technically, NBFCs are authorised to collect savings, provided they receive a minimum investment grade rating from an approved rating agency, after being in operation for at least two years. In reality, however, no NBFC to date has been achieved this status since the credit rating agencies tend to view lending to the poor and lending in rural areas to be quite risky (M-CRIL, 2005).

The bill stipulates that MFOs are authorized to collect deposits, termed "thrift," from their members provided they satisfy certain conditions. This change is one of the major positive developments in the bill. It is often suggested that Indian microfinance is standing on one leg (Ghate et al., 2007) because most microfinance providers are, whether because of regulation or practical difficulties, unable to provide one of the two essential financial products, namely

1 For section 25 companies, some conditions apply. First, they do not provide credit exceeding Rs.50,000 for a business enterprise and Rs.125,000 for housing. Second, they do not accept public deposits (RBI, 2000).

savings. It is widely acknowledged by sector experts that savings is as important, if not more, than credit for the poor.[2] If passed, not only will the bill enable MFOs to offer their clients a much needed product, but it will also ease their funding constraint because mobilising savings can be an inexpensive source of financing. This is often especially important for small NGO-MFIs as their weak capital structure prevents them from accessing capital markets and they are prohibited from receiving equity investments. As a result of the ability to mobilise savings, lending rates in Bangladesh are lower than in India since almost a third of their funds comes from the savings of their members (Ghate et al., 2007).

3) New regulator

Last, but not least, an important proposal in the bill discussed in this note is the appointment of a new regulator. The National Bank for Agriculture and Rural Development (NABARD) has been proposed as the new regulator for the microfinance sector. In this role, NABARD will also be the facilitator for systematic growth in the sector by setting sector-wide standards for customer education, accounting, performance benchmarks and codes of conduct. The bill also provides for the creation of an Ombudsman, who settles any client complaints against MFOs.

These changes presented above may appear favourable to the sector at the first glance. However, a close look gives rise to various problems – so large that it makes us wonder whether the sector will be better off after all.

ISSUES

The first and foremost question that policy makers must ask themselves is the efficacy of this bill. As it was pointed out in section one of Proposed Changes, the bill leaves out from its purview NBFCs and Section 25 companies, which take up approximately 80% of microfinance loans outstanding as well as of the client base in the sector. This essentially means that the bill is relevant only for the remaining 20%.

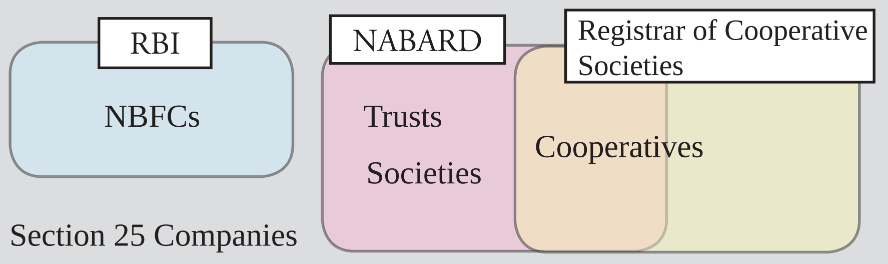
While the scope of the bill is extremely narrow, potential negative consequences can affect the entire sector, due to the provisions in the bill for savings. In the bill, NGO-MFIs are proposed to be eligible for mobilising public deposits. Although offering savings products to the poor is a large step towards financial inclusion, there needs to be a good balance of consumer protection and meeting clients' demands.

According to the bill, the criteria to become a deposit taking entity are the following: the minimum capital base of Rs. 5 lakhs; a minimum of three years of operation completed; and approval from the Microfinance Development Council (MDC), an entity promoted by NABARD, as a thrift-taking organisation. The relative ease of establishment, compared to becoming an NBFC, remains a grave concern for many sector experts. This is particularly worthy of consideration considering the clients are poor and are saving out of their meagre incomes. On top of basic concerns, India has a history of suffering from savings related scams. Even if all NGO-MFIs are operating in good intentions, many of them are likely to lack the experience and capacity to handle the banking business. One failure can dilute the reputation of the entire industry.

The rationale for the classification of affected entities is completely unclear. One may argue that the reason for the exclusion of NBFCs from the bill is that they are already regulated by the RBI. However, this does not explain why Section 25 companies have been left out and why cooperatives, which are currently regulated, have been included. As a result, the legal bird's-eye view under the new bill would be strangely distorted 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 (see figure in the next page).

2 A recent study conducted by CMF also confirms that SHG members also value the savings component of SHG membership as much as they do the credit component (Gadenne & Vasudevan, 2007).

Figure - Legal framework for microfinance activities under the new bill



There are concerns around the appointment of NABARD as the regulator of MFOs in the sector for two reasons. First, there appears to be no practical reason why microfinance must be regulated by NABARD, rather than by the RBI, which is the entity responsible for the financial system as a whole. One of the reasons posited for RBI's hesitation in regulating the microfinance space may be the unfortunate result of RBI's poor experience in regulating UCBs in the past. However, these fears may be misplaced since the issues pertaining to the cooperative sector are specific to its unique characteristics, rather than being applicable to the microfinance sector as a whole. Second, NABARD is also responsible for the administration of the Microfinance Development and Equity Fund, a fund created to provide equity capital, debt funds, or grants to MFOs. This clearly becomes the source of a conflict of interests with its multiple roles as a promoter and a regulator. NABARD is also envisioned as playing an 'enabling' role in the sector by (1) facilitating the development of credit rating norms and performance benchmarks, (2) specifying the accounting form and the auditing standards, (3) promoting financial literacy of MFO clients and sector-related research, and (4) disseminating information relating to best practices, amongst other things. While this is a worthy list of objectives and comes at a particularly pertinent time for the microfinance sector in India, there is no clear sense as to exactly how these goals are to be achieved.

CONCLUSION

In last few years in India, there have been a large number of policy measures introduced to facilitate access to finance for low income sections of society who continue to remain excluded from the ambit of formal finance. Microfinance has long been acknowledged as an important way to promote financial inclusion. Its social benefits have also been widely publicized by policymakers, practitioners and researchers. A bill that creates an enabling environment for microfinance institutions would be a welcome relief for practitioners. The proposed bill, however, seems to have failed to provide this environment. The new classification of regulated entities may well augment rather than ameliorate the complications the sector faces today. The appointment of NABARD as a regulator seems like a recipe for a political, factional discord. Admittedly, the fact that the bill authorises MFOs to mobilise savings is progress in the right direction, but more stringent standards are required if there is to be adequate consumer protection. If microfinance is to have considerable impact on the poor in providing them a foothold for financial inclusion, substantial revisions in the scope of the bill is called for.

References

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